
The Baltics – 10 Years of Independence

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INTRODUCTION

Estonia, Latvia and Lithuania declared their independence from the Soviet Union on respectively 20 August 1991, 21 August 1991 and 11 March 1990. Denmark re-established diplomatic relations with the three Baltic states on 24 August 1991¹. Closely linked to the wish for political independence was the desire for a rapid transition from a planned to a market economy. Independence and the commencement of the transition process were an economically painful process, but the tide was turned, and many good results have been achieved. However, the standard of living is still far below that of the western market economies.

This article outlines the central aspects of the economic development in the Baltics during the past 10 years, as well as the challenges in the medium term.

THE TRANSITION IN BRIEF

The transition process refers to the change from a planned to a market economy. The transition requires changes in practically every area of society and has proved to be a lengthier process than many people may have expected on the collapse of the Soviet Union. The centralised detailed management and considerable trade barriers characteristic of the planned economies meant that the economic adjustment and incentive mechanisms applying in free market economies had been put out of action, and the Baltic states' standard of living was far behind western levels. The detailed management also meant that there was much less need for actual macroeconomic stabilisation policies.

Broadly speaking, the transition process involves the following main elements: liberalisation, macroeconomic stabilisation, privatisation and

¹ Estonia, Latvia and Lithuania declared their independence on respectively 24 February 1918, 18 November 1918 and 16 February 1918. Denmark acknowledged Estonia, Latvia and Lithuania as independent nations in 1921. Their annexation by the Soviet Union in 1940 was not acknowledged by Denmark. The Danish acknowledgement of the three nations was still valid in 1991, so that Denmark did not have to re-acknowledge the Baltic states in that year.

restructuring, as well as legal and institutional reforms (Gros and Steinherr (1995)).

An important prerequisite of a well-functioning market economy is that market forces can influence price formation and thereby resource allocation. In the planned economy, prices and production plans were determined centrally, and the system did not succeed in matching supply and demand. Consequently, liberalisation of prices and trade was the first major step in the transition process, a step which was fairly easy to take.

Macroeconomic stabilisation is necessary to ensure a predictable environment and balanced development. With free price formation, the first challenge to macroeconomic stabilisation was to control the major inflationary wave which followed in the wake of the liberalisation of prices.

Liberalisation and macroeconomic stabilisation were achieved relatively quickly in the Baltics and were key prerequisites for the ongoing process, but did not in themselves raise standards of living. Central elements in this respect are privatisation, restructuring and the establishment of new companies. This part of the process e.g. relates to the need to improve incentive structures by transferring ownership to private individuals, to restructure businesses to enable them to compete in a free market, and to establish a financial sector.

Finally, legal and institutional reforms refer to a wide range of measures which are necessary in order to support a market economy, including securing rights of ownership, setting up competition authorities and financial supervisory authorities, etc. Whereas liberalisation, macroeconomic stabilisation and some elements of the restructuring were generally initiated relatively quickly, the legal and institutional reforms are a somewhat more complicated and protracted process.

THE FIRST FEW YEARS

The first few years of the transition were turbulent in every way. Like other former planned economies, the Baltics experienced significantly rising inflation in connection with the extensive and rapid liberalisation of prices. Before the reform process, high wage disbursements and widespread shortages of goods in the shops led to continued cash stockpiling and subdued demand, which was not adjusted for, as many prices were fixed at an artificially low level. The combination of extensive cash holdings among private citizens (also called monetary overhang) and sudden liberalisation of prices then resulted in extensive adjustment of the previous disequilibrium in the form of significant price increases. The well-known queues thus also vanished.

INFLATION		Table 1		
Per cent	Estonia	Latvia	Lithuania	
1989	6.1	4.7	2.1	
1990	23.1	10.5	8.4	
1991	211	172	225	
1992	1,076	951	1,021	
1993	89.8	109	410	
1994	47.7	35.9	72.1	
1995	29.0	25.0	39.6	
1996	23.1	17.6	24.6	
1997	11.2	8.4	8.9	
1998	8.2	4.7	5.1	
1999	3.3	2.4	0.8	
2000	4.0	2.8	1.0	
2001	6.2	3.3	2.0	

Note: The figures for 2001 are estimates.

Source: EBRD Transition Report 2000 & EBRD Transition Report Update April 2001.

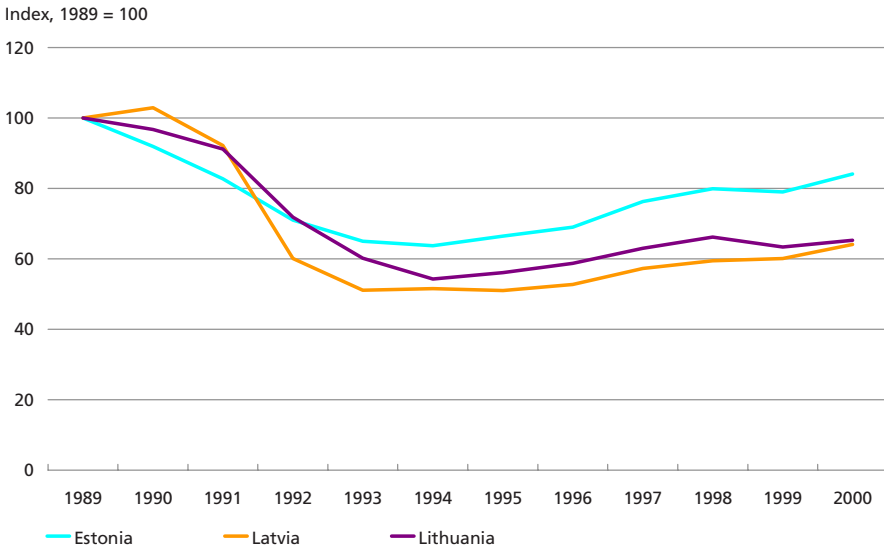
The Baltic states were also affected by a major external shock at the beginning of 1992 when Russia raised its energy and commodity prices to the world-market level. This led to significant deterioration in terms of trade and steeply rising inflation, cf. Table 1.

While inflation soared, the first transition years also brought a marked decrease in GDP, cf. Chart 1. The domestic products were almost halved in the Baltics, equivalent to a return to the levels in the late 1960s or early 1970s (De Broeck and Koen 2000).¹ Naturally the strong price increases had a negative impact on private demand via the drastic decline in the households' real financial assets (typically consisting entirely of either cash or bank deposits), and also in real incomes, which declined by around 50 per cent. Many people thus saw their savings wiped out and their wages becoming practically worthless, although, as described above, part of the savings and wages were of no real value in the planned economy, as the extensive shortage of goods meant that savings were to a large extent involuntary and virtually worthless. However, there can be little doubt that purchasing power and the living standards declined sharply, particularly for the weakest groups. A number of standard-

¹ It should be emphasised, however, that the statements of domestic products may exaggerate the drop in living standards. Part of the decline in the domestic products may be attributable to measurement problems and statistical uncertainty. The transition thus meant a shift from incentives to report (over)fulfilment of certain targets in the planned economy, to incentives to underreport for tax reasons. In addition, factors such as incomplete statistical coverage of new sectors in the economy, including the "black" economy, and lack of adjustments for quality improvements, should be taken into account. Caution should be exercised in uncritically viewing the decline in domestic product as an expression of the shift in living standards. Part of the decline in output might reflect direct welfare improvements, e.g. part-closure or closure of energy-intensive and polluting industries. Finally, the abolition of rationing, and the familiar shopping queues, and increased choice in the form of a larger selection of goods, are also welfare improvements which are not necessarily reflected in the domestic product.

DEVELOPMENT IN GDP/NMP 1989-2000

Chart 1



Note: 1989 can be seen as the last "normal" year in which the Baltics were part of the Soviet Union. In the following years, the political confrontation started and the initial steps towards reforms were taken, which influenced the Baltic economies.

Data for 1989 relate to the net material product (NMP), whereas 1990-2000 relate to the gross domestic product (GDP). The net material product in the Soviet national accounts system deviates from the gross domestic product by e.g. not including services and administration, for which reason direct comparison is difficult. Here the two series have been linked via calculations of both the net material product and the gross domestic product for 1990.

Source: UN/ECE, Economic Survey of Europe, 2001, No. 1.

of-living indicators confirm this. For instance, the food component of the households' total expenditure rose from 34 per cent in 1990 to 62 per cent in 1993 in Lithuania, indicating a significant loss of purchasing power. The same trend was seen in Estonia and Latvia, albeit to a lesser degree. In all three states life expectancy also declined considerably up to 1994, and infant mortality rose up to 1995.

Although falling demand has been a contributing factor, the decline in domestic product is presumably primarily a result of the major systemic shock resulting from the collapse of the planned economy. The final collapse of the Soviet planned economy in 1990-91 caused considerable disruption to trading and finance, resulting in e.g. shortage of goods, loss of traditional export markets, lack of credit facilities and the collapse of payment structures. Moreover, changes in the allocation of resources in the wake of price liberalisations and the resulting shifts in relative prices are normally always time-consuming. Therefore, in the short term the decline in production of unrequired goods will tend to more than offset the increase in production of goods in higher demand (Havrylyshyn, Wolf et al. (1999)), leading to a fall in overall output. Considerable uncertainty and confusion as to e.g. relative prices, property

ownership, legislation in general and the macroeconomic situation moreover also led to general restraint in connection with investments, etc.

MACROECONOMIC STABILISATION

In around mid-1992 the Baltic states adopted major stabilisation and reform programmes. As regards stabilisation, the key elements were the introduction of monetary-policy independence as protection against inflationary impulses from Russia¹, and a tight fiscal-policy stance in order to introduce stability and maintain its credibility.

Estonia, Latvia and Lithuania all left the rouble zone shortly after regaining independence and introduced their own currencies and independent monetary policies. It was important to establish the credibility of the new currencies in order to e.g. drive out other currencies in circulation, curb the inflationary expectations and ensure a favourable competitive position which could stimulate trading integration with Western Europe. The credibility gains from fixed exchange rates were considered vis-à-vis the flexibility required in changing times. Initially, the three states chose to pursue different paths.

Credibility was a major concern in Estonia, and in June 1992 the new Estonian currency, the kroon, was pegged to the D-Mark within the framework of a currency board². The chosen rate meant that an average Estonian monthly wage could be exchanged for approximately 30 dollars, equivalent to around a seventh of the average wage in Poland (Banerjee, Koen et al. (1995)). This was of benefit to competitiveness, and it is worth noting that it has not subsequently been necessary to change the rate, despite periods of high inflation. Both Latvia and Lithuania initially opted for floating exchange rates. Credibility was also a high priority in Latvia, so the Latvian central bank was made independent in as early as 1992, and a tight policy had broad-based political support. Since February 1994 the central bank has pegged the Latvian lat to SDR. The Latvian money supply has a high coverage ratio in international currency reserves, and the fixed-exchange-rate policy therefore resembles a currency board. Stabilisation via monetary policy was not achieved with the same resolve in Lithuania as in Estonia and Latvia. Major stabilisation did not take place until May 1993, and in April 1994 Lithuania also introduced a currency board, the Lithuanian litas being pegged to the US dollar. The background was that the

¹ Between 1 July 1992 and 14 August 2001 the Russian rouble depreciated by 23,315 per cent vis-à-vis the US dollar.

² For a more detailed description and discussion of currency boards, cf. Bie and Hahnemann, 2000.

authorities found a more binding exchange-rate peg necessary in order to prevent monetary financing of fiscal-policy deficits (Korhonen (2000)).

Since then, the fixed-exchange-rate regimes of the Baltic states have been the anchors of their economic policies. Lithuania has decided to replace the dollar anchor in its currency board by a euro anchor as from 2 February 2002. This is a consequence of Lithuania's wish to join the EU and its trading integration with the EU. In the slightly longer term the Baltics may be able to adopt the euro. Prior to that, the states are expected to participate in the ERM II exchange-rate mechanism for at least two years in order to qualify for euro participation. It is now possible for countries with euro-based currency boards to participate in ERM II while maintaining their currency boards.¹

A tight fiscal policy has also been a key element of the three countries' economic programmes and considered an important signal from the authorities. Contrary to experience from many other transition economies, where large deficits were an impediment to stabilisation, the Baltics succeeded in entering the transition process with relatively good fiscal balances. This was partly due to a favourable starting position. Firstly, the Baltics did not inherit any of the Soviet Union's debt, domestic or foreign, at their independence. Secondly, all three states, in particular Latvia and Lithuania, had been major net contributors to the Soviet budget. Therefore the transition to independence significantly improved their budget balances.

In many of the former planned economies the development in inflation was closely linked to the development in public finances. Large deficits were a widespread phenomenon, and since the financial markets were underdeveloped, a large proportion of the deficits had to be financed directly by the central banks, which contributed to sustaining inflation. This was not the case in the Baltic states, which is a major reason that the Baltics have generally fared much better than the CIS countries² in terms of achieving price stability. The Baltic monetary and fiscal policies have generally supported each other, which has been a key contributor to macroeconomic stabilisation.

STRUCTURAL DEVELOPMENTS

Liberalisation of prices and trade and a stability-oriented macroeconomic policy were central preconditions for the three countries to start

¹ For a more detailed description of the exchange-rate schemes of the candidate countries in relation to their potential EU membership, cf. Kjærgaard and Roed Sørensen, 2001.

² Full or associate members of the Commonwealth of Independent States (CIS) are all former Soviet republics, with the exception of the Baltic states.

the catch-up process with real economic progress. Restructuring and privatisation of the often outdated businesses of the planned economies were key elements in this respect. However, the emergence of new, competitive sectors and the discontinuation of obsolete industries involve radical changes which have had considerable social costs. The reforms have also brought significant variations in regional development. Progress has to a large extent been centred around the capitals and larger towns. Rural districts, in particular regions dominated by few, large industrial businesses founded in the days of planned economy with a view to supplying the entire Soviet market, have thus experienced massive social problems and very high unemployment.

The development in the three countries' sectoral structure gives a good impression of the major upheavals which have taken place. The planned economy was generally characterised by a large, non-competitive industrial sector, but the importance of this sector to economic activity has diminished considerably, cf. Table 2. This development was particularly rapid in Estonia and Latvia, where the industry component of GDP was over 40 per cent in 1990 (IMF (2000)). The relative importance of agriculture has diminished even more than that of industry, and in Estonia and Latvia this component of GDP is now only slightly larger than in Denmark. The proportion of the labour force employed in industry and agriculture has not diminished at the same rate, however. On the other hand, the restructuring and modernisation process has caused the service sectors to flourish. These sectors were generally highly underdeveloped in the planned economy. In 1998 the service-sector component of GDP was 67 per cent in Estonia, 66 per cent in Latvia and 57 per cent in Lithuania, in contrast to 69 per cent in the EU (IMF (2000)). As regards the relative importance of the various sectors to the economies, the Baltic states now resemble the EU countries to a great extent. Baltic business enterprises are also strongly oriented towards new markets, including the EU. This is especially true of Estonia, where trade with other transition countries accounted for only 24 per cent in 1999.

STRUCTURAL DEVELOPMENT

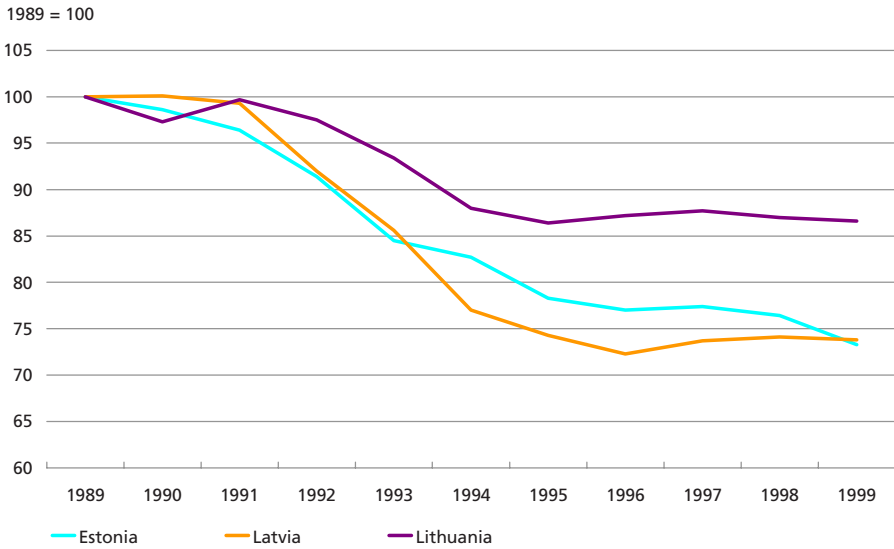
Table 2

	Agriculture (in per cent of GDP)		Industry (in per cent of GDP)		Private sector in per cent of GDP	Percentage of trade with non-transition countries
	1992	1999	1992	1999	1999	1999
Estonia	13	4	28	15	75	76
Latvia	17	4	28	18	65	67
Lithuania	25	8	47	20	70	51

Source: EBRD Transition Report 1999 and 2000.

EMPLOYMENT, 1989-99

Chart 2



Source: UN/ECE, Economic Survey of Europe, 2001, No. 1.

The marked fall in production output in the first years of transition and the ongoing restructuring of the Baltic business community have led to a significant drop in the rate of employment, cf. Chart 2, particularly in industry.

Unemployment, which in 2000 was 13.7 per cent in Estonia, 14.3 per cent in Latvia and 15.4 per cent in Lithuania¹, has been rising despite a declining workforce². Particular challenges include high youth unemployment at 1½-2 times the average, and the large number of long-term unemployed, particularly in Latvia and Lithuania. However, there are several indications that the Baltic labour markets are relatively flexible, especially in a European perspective.

In the second half of the 1990s more attention has been paid to alleviating the social consequences of the reforms, including better integration of the large Russian minorities. The deterioration in the standard-of-living indicators seen in the first years of independence has in fact to some extent been reversed since the mid-1990s. Life expectancy and infant mortality are back at the pre-transition levels. If the fact that food accounts for more than 50 per cent of total household expenditure is to be seen as an *absolute* measure of poverty, around half of all Lithuanian

¹ According to labour-force surveys, cf. OECD Main Economic Indicators, June 2001.

² The populations of Estonia and Latvia have declined by more than 8 per cent since 1990, especially as a result of the emigration of ethnic Russians, but also due to a negative growth rate among the Baltic populations (OECD (2000)). In Lithuania the population figure has also stagnated.

and Latvian households are still poor, however, while the corresponding figure for Estonia is just under 20 per cent. In terms of *relative* poverty – measured as household income below 50 per cent of the average – less than 20 per cent of Baltic households could in recent years be classified as poor (OECD (2000)). The income inequalities have increased in the past 10 years, but are comparable to those of countries such as France and the UK, where the standard of living is considerably higher, however (UNDP (2001)).

Status of the structural reforms

The European Bank for Reconstruction and Development, EBRD, has set up a number of qualitative indicators for all the transition countries with a view to gauging the development in a number of sub-elements of the transition compared to the standard in an industrialised market economy, cf. Table 3. The Table presents the status of the reform process for each of the Baltic states in 2000 as well as the average for the CIS countries and the Visegrad Four, i.e. Poland, Hungary, the Czech Republic and Slovakia.

It is apparent that the Baltics have generally come far in the reform process and in several important areas have reached a standard which does not differ much from that of an industrialised market economy. Estonia has progressed a little further than Latvia and Lithuania, but all three countries are approaching the level of the Visegrad Four, which

STRUCTURAL INDICATORS, 2000					Table 3
EBRD index	Estonia	Latvia	Lithuania	CIS	Visegrad Four
<i>Companies</i>					
Privatisation of large companies.....	4	3	3	3-	4-
Privatisation of small companies.....	4+	4+	4+	3+	4+
Governance and business restructuring	3	3-	3-	2-	3/3+
<i>Markets and trade</i>					
Price liberalisation	3	3	3	3-	3/3+
Trade and currency systems	4+	4+	4	3	4+
Competition policy	3-	2+	3-	2	3
<i>Financial institutions</i>					
Bank reforms and liberalisation of					
interest rates.....	4-	3	3	2-	3+
Securities markets and other fin. inst.	3	2+	3	2-	3+

Note: Indicators are rated on a scale from 1 to 4+, where 1 indicates no or very limited change from a planned economy, and 4+ represents a standard which does not differ from that of industrialised market economies.

The Visegrad Four are Poland, Hungary, the Czech Republic and Slovakia. See www.visegrad.org for a more detailed description of the Visegrad cooperation. Full or associate members of the CIS are all former Soviet republics, with the exception of the Baltic states.

Source: EBRD Transition Report 2000 and own calculations.

have made very strong progress, partly due to a favourable starting point. Especially Lithuania moved ahead in 2000. The CIS countries are lagging behind, but the figures conceal considerable variations among the countries.

In general, most progress has been made in the privatisation of small businesses and in trade liberalisation (Estonia, Latvia and Lithuania are members of the World Trade Organization, WTO). Price liberalisation was another element of the transition which in most cases was initiated at an early stage, but further progress on the EBRD scale requires among other things that prices for electricity, water, heating and gas are to a greater extent determined on the basis of the economic costs of using an appropriate technology. While much progress has been made in terms of securing a basis for free competition, only little progress has been made as regards policies to ensure that the rules of free competition are observed. It is a general trait of the transition countries that the development of institutions to support the markets has lagged behind liberalisation and privatisation.

The financial markets of the Baltics have also developed rapidly. The greatest progress has been within traditional banking, where a number of banking crises have led to significant foreign ownership, especially in Estonia. This has brought an influx of expertise and strengthened the sector. In Lithuania the banking sector has, however, not yet been fully privatised. In comparison with the standards in the industrialised market economies all three countries still have far to go, e.g. in expanding their stock and capital markets, establishing insurance markets, private pension funds and the related regulatory framework.

THE GROWTH PERIOD

After a period of stabilisation and reforms, the economic development in the Baltics really took off in the mid-1990s. In Latvia and Lithuania growth was accompanied by major banking crises from the summer of 1995. Estonia had already experienced a similar banking crisis in 1992-1994. The positive growth was a result of a strong export trend and significant growth in private consumption and private investments. In 1997 the growth rates soared, and growth in the Baltic states was among the highest levels in the transition economies in 1997 and the first half of 1998. The background was considerable money and credit growth resulting from extensive capital inflows. The monetary-policy authorities took measures to dampen this development, and these combined with a higher level of interest rates following the Asian crisis led to a dampening in the spring of 1998. This

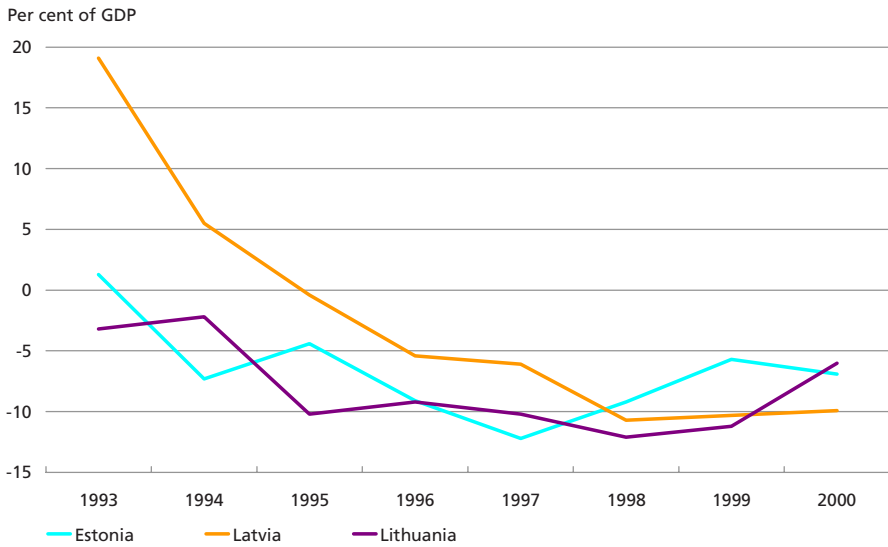
was succeeded by a strong, but short-lived, recession in all three countries in the autumn of 1998 and the spring of 1999, in the wake of the Russian crisis in August 1998. In spite of significant reorientation of trade away from the CIS countries and towards western markets, the crisis revealed continued strong dependence on the old markets. Exports and industrial output fell immediately, particularly in Lithuania, where trade with the CIS countries was still considerable. In Latvia and Lithuania competitiveness was also under pressure as a result of the pegging of their currencies to the dollar, which appreciated vis-à-vis the euro. A new upswing in exports in step with stronger growth among the European trading partners, as well as rising investments, contributed to re-establishing high growth rates in Estonia and Latvia in 2000, whereas growth in Lithuania was still more moderate. In the 1st quarter of 2001 the growth rates compared to the 1st quarter of 2000 were 5.8 per cent in Estonia, 8.2 per cent in Latvia and 4.4 per cent in Lithuania, which must be considered to be encouraging.

The Baltic hyperinflation in 1992 was halted relatively quickly and was followed by a number of years of rapidly declining, albeit still high, rates of inflation, cf. Table 1. The development has presumably been characterised by a degree of sluggishness in inflation expectations, while the ongoing elimination of low, administratively fixed prices and the transition to indirect taxation have also played a role. Another contributing factor may be quality improvements. There are also clear indications that the new Baltic currencies were initially grossly undervalued (Richards and Tersman (1995)), which meant that price levels vis-à-vis other countries, i.e. real exchange rates, were unnaturally low. Normalisation of the relative price levels has then led to higher inflation due to the fixed-exchange-rate targets. For instance, the low wage levels have probably attracted strong capital investments, which in themselves have exercised pressure on prices. Although the initial underestimation of price levels has been adjusted for, sustained higher inflation may still be expected as a natural element of the catch-up process towards higher income levels, cf. the section on real exchange rates.

Since 1998, when the recession had an obvious dampening effect on prices, all three countries have brought inflation down to single-digit rates. The improved growth in 2000 pushed inflation up a little. For Estonia, this development was primarily attributable to rising oil prices and the depreciation of the euro. The appreciation of the Latvian lat and the Lithuanian litas vis-à-vis the euro contributed to a more subdued development.

CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS, 1993-2000

Chart 3



Note: Figures for 2000 are estimates.
Source: EBRD, Transition Report 2000.

Since growth resumed in 1994-95, all three countries have had large trade-balance and current-account deficits, cf. Chart 3.

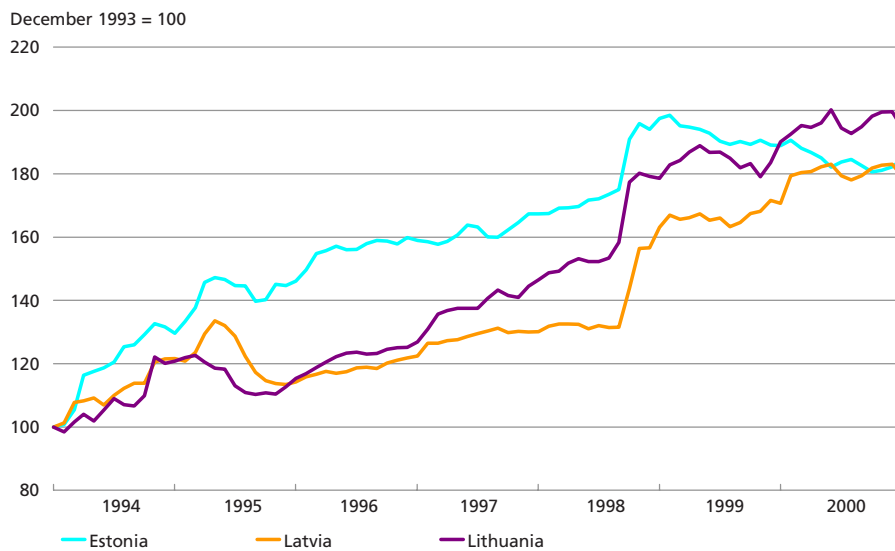
In Estonia, the current-account deficit reached a low in 1997 of 12 per cent of GDP, but has then fallen to around half that level in the last two years. In Lithuania, the Russian crisis also led to a deficit of around 12 per cent, which was also reduced by half in 2000. In Latvia, the deficit was still close to 10 per cent of GDP in 2000.

As in the other transition economies, the deficits are partly a natural consequence of the major structural changes resulting from upgrading and restructuring the existing capital apparatus and establishing a new one. This has required a high degree of external financing. The sustainability of the deficits depends to a high degree on whether the modernisation of the economies improves the Baltics' export potential. Much progress has already been made in this respect. Estonia's export volume for goods and services more than doubled in 1995-2000, while those of Latvia and Lithuania almost doubled.

The persistent large current-account deficits make the three countries dependent on the goodwill of foreign investors. It must be expected that the debt-to-GDP ratio sooner or later has to stabilise at a level deemed reasonable by international investors. However, the risk of a sudden reversal of capital flows has been reduced by a high proportion of stable financing sources. In all three countries foreign direct invest-

REAL EFFECTIVE EXCHANGE RATES

Chart 4



Source: National central banks.

ment has increased considerably since the early 1990s, but as the privatisation process draws to an end a hitherto large source of financing will be reduced. On the other hand, the prospects of EU membership may keep the level of foreign investment high.

Real exchange rates

During the 1990s the real effective exchange rates of all the Baltic states showed clear appreciation trends¹, cf. Chart 4. The significant increases in the autumn of 1998 were attributable to the deterioration in the value of the rouble as a result of the Russian crisis. The subsequent depreciation in Estonia was driven by the ongoing depreciation of the euro.

The significant appreciation in the Baltic states reflects that their price levels have risen against those of their trading partners. It is therefore relevant to ask whether the development has caused their currencies to be overvalued. There are several good reasons to believe that this is not the case.

Adjustment for the initial *undervaluation* is probably part of the explanation. As described above, price levels in the Baltic states were considerably lower than even in comparable countries at the start of the transition, leading to a number of years with higher inflation.

¹ The real effective exchange rate is a measure of the domestic price level in relation to the price levels of trading partners, calculated in the same currency. Appreciation of the real effective exchange rate means that inflation is higher than abroad and/or that the nominal exchange rate is appreciating.

In addition, trend-related appreciation of real exchange rates is a characteristic and natural part of the adjustment process in countries with relatively high productivity growth¹. At the start of the transition process, productivity was very low in these countries compared to the Western European economies, but as the reform process gains momentum and more sophisticated production technologies are introduced, the gap is narrowing. There are also clear signs that price increases for goods that are not traded internationally have contributed more to the real appreciation than price increases for traded goods. However, the unit labour costs in D-mark rose by 227 per cent in Estonia, 130 per cent in Latvia and 316 per cent in Lithuania between 1994 and 1999, and the current-account deficits have been considerable, as stated above. However, all three countries have seen strong export growth, including to the Western European market, in spite of the significant appreciation.

CHALLENGES

The key overall economic challenge is to maintain sustained, robust growth and to narrow the gap in living standards to the mature market economies. This has by no means been achieved yet. The standard of living, measured as GDP per capita adjusted for purchasing power, is only approx. 1/3 of the EU level, cf. Table 4.

Even if the average growth rates seen in the Baltic economies for the past 5 years were to continue, it would still take more than a generation to reach the welfare level of the EU member states. Portugal is proof that it is possible to narrow the welfare gap. Purchasing-power adjusted GDP in Portugal was approximately half the EU average when Portugal joined the Community in 1986. In 2000, it had risen to approximately 75 per cent.

In view of the achieved macroeconomic stability, the main focus must be on continuing the structural and institutional reforms. Greater focus on the social field, including a solution to the labour-market imbalance, is also urgent. Compared with the first reforms, which brought considerable efficiency gains owing to the widespread inefficiency inherited from the planned economy, future reforms are likely to have more gradual effects. Productivity enhancements and reducing unemployment will be decisive to the continued improvement in living standards. In that sense the challenges faced by the Baltics are to a larger degree

¹ Real appreciation in catch-up countries is theoretically founded on the Balassa-Samuelson hypothesis. The argument is that the real exchange rates of the transition countries will appreciate if large productivity increases in the traded-goods sectors lead to higher wages in general, exerting upward pressure on prices for non-traded goods, and thus the general price level.

GDP PER CAPITA (PURCHASING-POWER ADJUSTED), 1999		Table 4
	Dollars	Index, EU-15 = 100
Estonia	8,223	37
Latvia	6,074	27
Lithuania.....	6,833	31
Czech Republic	13,389	60
Hungary.....	11,256	50
Poland.....	8,845	40
EU-15.....	22,303	100

Source: IMF, World Economic Outlook, October 2000.

identical to those which the western market economies have faced, or are facing.

At the centre of the reforms in the years to come will be the goal of EU membership. This also helps to keep up the momentum of reform. The first new members will be able to join the Union in 2004, but who they will be is yet to be determined. EU membership will be a key milestone of the economic development of these countries and could be said to mark the conclusion of the transition process itself and the start of the maturation of the young market economies. The overall economic preconditions for EU membership are functioning market economies which can handle the free competition within the EU. While the Baltics meet the requirement to be functioning market economies, the opinion in November 2000 of the European Commission was that they are still not quite able to compete freely within the EU. The Commission e.g. calls for better management of the unemployment problems, better opportunities to obtain market-based financing for SMEs, and the implementation of the outstanding elements of privatisation. However, the three countries' increased trade integration with the EU is a good indication that they are moving in the right direction.

The process towards EU membership in itself entails considerable costs, e.g. to establish the required legal and institutional framework and to ensure compliance with EU standards, notably in the environment field. The EU provides subsidies, but undoubtedly further reforms of public spending are required to ensure sufficient fiscal-policy scope, inter alia to provide for an ageing population and due to the key role of fiscal policy in stabilising the cyclical development. The prospects of a strong, but also varying, inflow of capital up to and after EU membership also require a flexible fiscal policy.

In recent years the Baltic banking sector has been characterised by strong consolidation and by foreign takeovers, which should lead to more effective and financially well-consolidated institutions. The an-

nouncement in 2001 of a merger between the two Swedish banks, Foreningssparbanken (Swedbank) and SEB, both of which are majority shareholders in a number of the leading Baltic banks, has, however, on competition grounds led to demands on the part of the monetary-policy authorities for a reform of the ownership structure of several Baltic banks.

The financial markets are not yet an effective alternative to bank financing. Market capitalisation and liquidity are still moderate, and a major priority of the Baltic states must be to change this. The plans for financed pension schemes and the establishment of mortgage-credit systems must be expected to lead to considerable expansion of the financial sector. Better enforcement of existing regulation, more stringent publication requirements and increased transparency in the financial markets may also serve to promote the financial markets as an alternative to bank financing (IMF (2000)).

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