Economic Prosperity in the Baltic Region: Achievements and Challenges

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Introduction

I would like to begin by thanking the organizers of this conference—the European Committee under the Government of Lithuania—for the opportunity to speak about macroeconomic implications of the EU integration for the accession countries. I will use this opportunity to speak about what more needs to be done to promote macroeconomic stability and high quality growth in the Baltic region.

I. Achievements

The transformation that has taken place in Estonia, Latvia and Lithuania since the early 1990s has been remarkable, as the Baltic countries have transformed their societies into democratic states and market economies at a very fast pace. Now they stand on the threshold of reaching their strategic goals of joining the EU and NATO. The Baltic countries have quickly overcome the Russian crisis and have since then exhibited high rates of growth while the inflation has remained subdued. Significant fiscal consolidations have been undertaken, with budget deficits cut to low levels. Current account deficits have been reduced, and the countries have good track records of attracting foreign investment. The trade regimes have been liberalized, the privatization processes are well advanced and the conditions for new businesses have improved, with the private sector accounting for 70-80 percent of GDP.

In summary, Estonia, Latvia and Lithuania have been well served by their strategy of EU and NATO accession, use of favorable geography, broad political consensus, effective cooperation with the IMF and other international financial organizations, and flexible and effective economic policies. These efforts leave the Baltic countries well placed to reap the benefits of the EU and NATO membership.

II. Challenges

1 The authors are the former and the current IMF resident representative for Lithuania and Belarus, respectively. We thank Patricia Alonso-Gamo, Thomas Richardson and Dalia Treigiene for helpful comments.
Still, the challenges ahead are significant. The countries need to continue to protect macroeconomic stability, in particular by maintaining prudent fiscal policies as the main macroeconomic policy instrument under the fixed exchange rate regimes and open economies. Yet, fiscal policies themselves face numerous challenges, from weaknesses in revenue performance, combined with a desire to ease the tax burden to improve the business environment, to considerable expenditure needs for EU projects and capital investment. In order to achieve high and sustainable rates of growth, the Baltic states also face numerous structural challenges: business environment suffering from excessive regulations, high and persistent unemployment, weak fiscal situation of municipalities, a need to promote improved health and education, and aging populations demanding timely and effective pension reforms. Accordingly, I will discuss the following three topics:

- First, effective fiscal management to enhance macroeconomic stability and to promote high quality growth;
- Second, improvement of the business environment to encourage growth, competitiveness and job creation; and
- Third, addressing gaps to ensure that all groups of society share the benefits of EU and NATO membership.

**Macroeconomic policy management**

Let me begin with macroeconomic policy management. The main risk to the macroeconomic outlook in Baltics is that, if realized, unsustainable levels of domestic demand under fixed exchange rate regimes could lead to sharp widening of the current account deficits, and erosion of competitiveness. Also, since the financing of the current account deficits in these countries depends heavily on FDI inflows, any loss of confidence leading to reduction in these inflows would result in higher gross external financing requirements and eventually in a slowdown in growth. In these circumstances, maintaining appropriately prudent fiscal policies and monitoring the credit expansion are crucial.

While the recent fiscal adjustments in Baltics were necessary to maintain stability, they were achieved through heavy expenditure cuts, as revenues declined. In response, the three Baltic states have initiated tax reforms with a view to simplify the tax system and reverse the decline in revenues. To achieve the revenue increases is even more important, given pressures on rising expenditures associated with spending needs for EU and NATO accessions. Transfers from the EU will help, but significant contributions from national budgets will be needed.

One might ask, “why not simply raise the deficit?” Despite the expected expenditure increases in 2003 and 2004 associated with costs of EU and NATO accessions, the Baltic countries need to continue fiscal consolidation and move towards structurally balanced
budget. Maintaining fiscal discipline will be also crucial for the participation of these countries in ERM2.
In addition, an appropriately prudent fiscal stance will help maintain low interest rates, key to further growth and avoid increased external imbalance. Moreover, over the medium term, high rates of economic growth are crucially dependant on vigorous export growth and cautious domestic demand management, as well as on conducive business environment.

**Business Environment**

Estonia, Latvia and Lithuania have significantly improved their business environments over the past several years, as evidenced by high share of the private sector in GDP and employment and high rates of FDI inflows. The next steps will be centered on enhancing the quality of public administration and targeting investment in infrastructure and education, and further streamlining regulations, including licensing procedures. Specifically, efforts will continue to simplify procedures and reducing costs in the areas of:

- Taxation and customs
- Labor markets;
- SME development;
- Export promotion;
- Restructuring and bankruptcy;
- Management of state property; including energy sector restructuring; and
- Financial market development.

Let me talk briefly about labor markets. With fixed exchange rate regimes, labor market flexibility is essential to ensure adjustment to exogenous shocks on world markets. The past three years have shown that Baltic labor markets are indeed relatively flexible. There are few constraints on hiring and firing, minimum wages are fairly low and unemployment insurance is modest. Still, unemployment is high, and tends to be geographically concentrated, as labor mobility is limited. The share of long-term unemployed is growing, and there are mismatches between the skills of the unemployed and the needs of new enterprises. In segmented labor markets, there is simultaneously high unemployment and labor shortages. The Baltic governments are keenly aware of the “skills gap” and aim to better tailor education to labor market needs. Other measures to address the unemployment include regional and sectoral variation of minimum wages and reducing taxes on labor income.

Turning to financial sector reforms, all three Baltic countries have participated in the joint IMF-World Bank Financial Sector Assessment Program. The FSAP reports found that Baltic countries financial sectors are generally well regulated. Non-bank financial segments remain less developed, while there is a need to strengthen oversight and regulation in securities and insurance. As the recovery of the Baltic economies has accelerated, credit growth has reached high levels. So far, ratios of non-performing loans have remained modest, but the rapid credit expansions warrant monitoring.
“Gaps”

Turning to “Gaps” we can observe the need for efficient and targeted social spending, for further progress in implementing pension reforms, for effective public administration, and again, most of all, for high economic growth. Regional income disparities are significant, as incomes in the Baltic capitals are far above national averages, while some regions have income levels of just 60 percent of the national average. These disparities will require constant attention so that discontent of the vulnerable groups of population does not lead to slow growth, characterized by continued revenue weaknesses and further expenditure cuts; increased fiscal deficits crowding out private sector; and increased current account deficits.

III. Concluding Remarks

What are the economic prospects for the three Baltic countries? The answer is that given the policy track record of past few years and the recent invitation to join EU and NATO, they are very good. The prospect accession have stimulated investment; macroeconomic stability and improved business environment, which have created a sound basis for continued high long-run growth. Prospects are very good, but challenges remain. The risks outlined above are well known and well understood among the Baltic governments. With continued efforts, the “slow growth scenario” will not materialize and Estonia, Latvia and Lithuania will move to even greater prosperity and security.

References


