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IMF and the Baltics: A Decade of Cooperation

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Abstract

The paper is an economic history of the IMF's involvement in the Baltic states. It describes and analyzes the initial economic stabilization; the period of consolidation and recovery; the effects of the Russian crisis of 1998; and the current growth phases of Lithuania, Latvia, and Estonia. There is also an assessment of cooperation with the Fund based on interviews with a number of ex-officials. The major conclusion is that the Baltics have been so successful because of their early commitment to change the stabilization and reform policies needed for successful transition, and their ownership of their IMF-supported programs.

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I. Introduction

The Baltic countries—Estonia, Latvia, and Lithuania—regained their independence in August 1991 after over fifty years of Soviet rule. Since then, they have pursued an active, and successful, policy of transition from central planning to a market economy This transition needs to be seen against the background of strong national identity in each of the three Baltic countries as well as their prolonged struggle to escape from Soviet domination. Almost from the outset, the Fund supported the Baltics in their efforts to establish the laws, institutions, and policies necessary for market economies. By all standards, all three countries have been remarkably successful in their efforts to transform their economies; and there is doubtless much to be learned by a retrospective review of the relationship between the Fund and these countries. To this end, this paper attempts to assess the cooperation between the Fund and the Baltics over the past decade.

This cooperation took many forms. It began with the acquaintance and membership missions in late 1991 and early 1992, when staff explained to the authorities what the Fund was, how it worked, and how it could be of assistance to them. This was followed by two or three staff visits, each of which discussed the formulation and implementation of economic and financial policies that could be supported by the Fund with its financial resources. The next step was the establishment of resident representative offices in all three countries in mid–1992. The posting of a full-time staff member to live and work in the country was invaluable in facilitating a continuous dialogue between the Fund and the authorities. The personal contacts of the resident representatives with the authorities often proved crucial in the implementation of the economic policy programs. They were uniquely able to explain the logic of the Fund's policy advice and respond immediately to questions and concerns raised by the authorities. This was particularly true when programs had been difficult to negotiate and the authorities had yet to be fully convinced that the policies were the right ones to follow. Technical or analytical notes prepared by the staff also helped in formulating policy advice and in convincing the authorities of its appropriateness.

The policy advice and the associated financing were of undeniable importance, but the cooperation between the Fund and the Baltics extended beyond this. Another dimension of the cooperation was the technical assistance extended by the Fund. This took a variety of forms: short-term missions; long-term resident advisors; and a variety of special classes and courses, for example. In retrospect, it is clear that technical assistance was crucial for institution building, which, in turn, enabled the authorities to implement proper policies. Technical assistance was provided mainly in the fiscal, financial, statistical, and legal areas. Other institutions—such as the World Bank—tended to focus on other areas, such as structural reform. Finally, the training of officials and parliamentarians provided by the IMF Institute (INS) and the Joint Vienna Institute (JVI) was another important part of the assistance.

To date, the Baltics have gone through four distinct phases of transition:

- economic stabilization 1992–1993
- consolidation and economic recovery 1994–mid-1998
- recession—the effects of the Russia crisis mid-1998–1999
- recovery and preparation for EU accession 2000–present

Cooperation between the Baltic countries and the Fund has evolved over these phases (Box 1). There was very close cooperation in the first phase in the form of financing through traditional stand-by arrangements (SBAs) and use of the structural transformation facility (STF), a special facility developed for transitional countries in the wake of the breakup of the former Soviet Union. Importantly, there was also intensive technical assistance designed to rapidly build institutions. This was followed in the second phase mainly by precautionary stand-by arrangements in Estonia and Latvia and use of the extended financing facility (EFF) in Lithuania. The arrangements were accompanied by intensified technical assistance. Existing arrangements were allowed to lapse at the outset of the Russian crisis in the summer of 1998, but this was quickly followed by renewed close cooperation with precautionary stand-by arrangements. With accession to the EU nearing, cooperation has entered a new phase without Fund programs but with continued close cooperation in a surveillance mode.

II. Economic Stabilization

The initial conditions were much worse in the Baltics at the time of the collapse of the Soviet Union than when reform efforts started in Eastern and Central Europe. The systemic shock brought on by the collapse of Soviet central planning was very large, with wide spread disruptions in both trade and financial channels. There were shortages of goods and raw materials; losses of export markets, as trade concentration had been very large—although not efficient—in the former Soviet Union (FSU); and a disfunctioning of payments and monetary arrangements. In addition, the Baltic countries faced a severe terms of trade shock in the beginning of 1992, as Russia moved to world market prices for energy and raw material exports to the Baltics. The terms of trade deteriorated by over 20 percent of GDP, implying an enormous loss of real incomes for the Baltic countries. In fact, they faced a much more severe terms of trade shock than the three to five percent of GDP deterioration that the Eastern and Central European countries faced after the dissolution of the Council for Mutual Economic Assistance. Thus, in early 1992, the economic situation in the Baltics was characterized by sharply falling output, rapid price increases, and sharply falling real incomes.

Box 1. The Baltics and the IMF

The Baltic countries applied for membership in the IMF shortly after regaining independence in August 1991. The first formal contact with the IMF took place when the Deputy Managing Director of the IMF (Richard Erb) met in Tallinn with delegations from the three Baltic states on September 22–25, 1991. Acquaintance missions visited all three Baltic states in November 1991, followed by membership missions in January/February 1992. The Baltic countries formally joined the IMF in April/May 1992.

Staff missions to negotiate programs of financial cooperation took place in April/May, June/July, and August/September 1992. Resident Representatives were stationed in all three capitals mid-1992. The Managing Director (Michel Camdessus) visited all three Baltic countries in August 1992. The first stand-by arrangements (SBAs) with the IMF were approved by the Fund's Executive Board in September/October 1992. In stand-by arrangements, financial resources of the Fund are pledged in support of economic policy programs agreed between member countries and the Fund. Disbursement of the funds occurs in stages, if the agreed policies were adhered to. This is tested through performance criteria and through periodic reviews of the arrangements by the Fund's Executive Board. Performance criteria usually apply to financial indicators such as credit expansions, budget deficits, official reserves, etc. In some cases, performance criteria also relate to structural policies.

Early on, the Baltic states also made use of the temporary structural transformation facility (STF), which had been introduced in 1993 specifically to assist transition economies that had to undergo massive structural transformation.

Following the first phase of transition, Estonia and Latvia made use of precautionary stand-by arrangements. Precautionary SBAs are arrangements where the authorities declare ahead of time that they do not intend to borrow under the arrangement, but they would nevertheless be legally entitled to do so in case of need (assuming that the economic policy program was "on track"). The Fund considers economic policies to be on track if the agreed performance criteria are met (or they have been waived by the Executive Board) and program reviews have been concluded. In this second phase of transition, Lithuania made use of the extended financing facility (EFF). The EFF is a medium-term (usually three years) financing facility with a heavy emphasis on structural policies.

Another important part of cooperation was through technical assistance, concentrated in the fiscal, financial, statistical, and legal areas. Technical assistance was provided through staff visits from headquarters as well as advisors placed in the respective capitals. Technical assistance was coordinated with other providers, such as the World Bank and the European Union (EU), and bilateral assistance, in particular by the United States and EU countries. Invaluable assistance was also provided by the IMF Institute and the Joint Vienna Institute through training of numerous officials from the Baltic countries.

Finally, with EU accession approaching, cooperation between the Baltics and the IMF has now switched into a "surveillance mode". Surveillance of members' policies is carried out mainly through so called Article IV consultations. The name refers to Article IV of the Fund's Articles of Agreement, which prescribes that surveillance should be carried out through regular consultations with all members. For this purpose, IMF staff teams visit member countries, usually annually, to discuss the economic outlook and policies. Following these visits, the staff reports to the Fund's Executive Board, where the consultation is concluded in a discussion of the reports. The discussion offers the international community the opportunity to offer its views regarding a member's economic policies. A summary of the discussion is communicated to the member. It has now become common practice, followed by all three Baltic countries, to publish the staff reports as well as the summary of the Board discussion by placing them on the Fund's website. In the Baltics, these annual consultations are usually supported by additional staff visits to advise on specific economic policy issues.

Text Box Table 1. IMF Arrangements with the Baltics

Estonia

Type of Arrangement	Approval Date	Expiration or Cancellation Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	9/16/1992	9/15/1993	27.9	27.9
STF	10/27/1993	N/A	11.6	11.6
Stand-by	10/27/1993	3/26/1995	11.6	11.6
STF	1/9/1995	N/A	11.6	11.6
Stand-by	4/11/1995	7/10/1996	14.0	-
Stand-by	7/29/1996	8/28/1997	14.0	-
Stand-by	12/17/1997	3/16/1999	16.1	-
Stand-by	3/1/2000	8/31/2001	29.3	-

Latvia

Type of Arrangement	Approval Date	Expiration or Cancellation Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	9/14/1992	12/13/1993	54.9	54.9
STF	12/15/1993	3/14/1995	45.8	45.8
Stand-by	12/15/1993	3/14/1995	22.9	9.2
Stand-by	4/21/1995	5/20/1996	27.5	-
Stand-by	5/24/1996	8/23/1997	30.0	-
Stand-by	10/10/1997	4/9/1999	33.0	-
Stand-by	12/10/1999	4/9/2001	33.0	-
Stand-by	4/20/2001	12/10/2002	33.0	-

Lithuania

Type of Arrangement	Approval Date	Expiration or Cancellation Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	10/21/1992	9/20/1993	56.9	56.9
STF	10/27/1993	N/A	25.9	25.9
Stand-by	10/22/1993	10/24/1994	25.9	5.2
STF	4/8/1994	N/A	25.9	25.9
EFF	10/24/1994	10/23/1997	134.6	134.6
Stand-by	3/8/2000	6/7/2001	61.8	-
Stand-by	8/30/2001	3/29/2003	86.5	-

The first and perhaps most crucial period of close cooperation between the Fund and the Baltic authorities was in developing the proper policy response for this situation. The Baltic authorities actively sought this cooperation. Indeed, it was already at the end of October 1991, when the three prime ministers of the Baltic countries visited the Managing Director at IMF headquarters and requested the Fund's assistance in these difficult economic circumstances. Only days thereafter the first acquaintance missions left to visit the Baltics.[2]

Over the next few months, the staff assisted in formulating economic policy programs that were supported financially by the Fund in the form of stand-by arrangements and the use of the structural transformation facility. In the discussions of the proper policy response, there was no choice—or even debate—of gradual versus rapid adjustment. The systemic shock was already there: output and real incomes were collapsing, and inflation was soaring (Figures 1 and 2). The aim, therefore, was to achieve rapid economic stabilization, while simultaneously initiating the transition to a market economy. The main elements of policy were tight monetary and fiscal policies aimed at bringing down inflation, and structural measures aimed at institution building and the rationalization of economic incentive structures.

Tight, anti-inflationary monetary policies required first the introduction of own currencies to insulate the countries from inflationary impulses from the FSU which were still using the ruble. Their own currencies were also to provide an important signal of the re-gained political independence. Only own currencies would enable the Baltic countries to pursue sovereign monetary and exchange rate policies. Fund staff were, however, initially reluctant to support a rush toward the introduction of the new currencies, stressing that it was crucially important to have the supporting economic policies in place before currency reform.

Estonia was the first country to leave the ruble area, in June 1992, when the kroon was introduced under a currency board arrangement (CBA)[3]. In fact, the Estonian authorities went ahead with the introduction of the kroon in June 1992, although initially Fund staff advised Estonia to wait with the introduction until a stand-by arrangement with the Fund was in place in a few months time. However, when the Estonian authorities insisted on the early introduction of the kroon, they and Fund staff agreed to closely cooperate in the run-up to the currency reform. Indeed, a staff mission worked closely with the Estonian authorities on technical details of the monetary reform as well as on a stabilization program in support of

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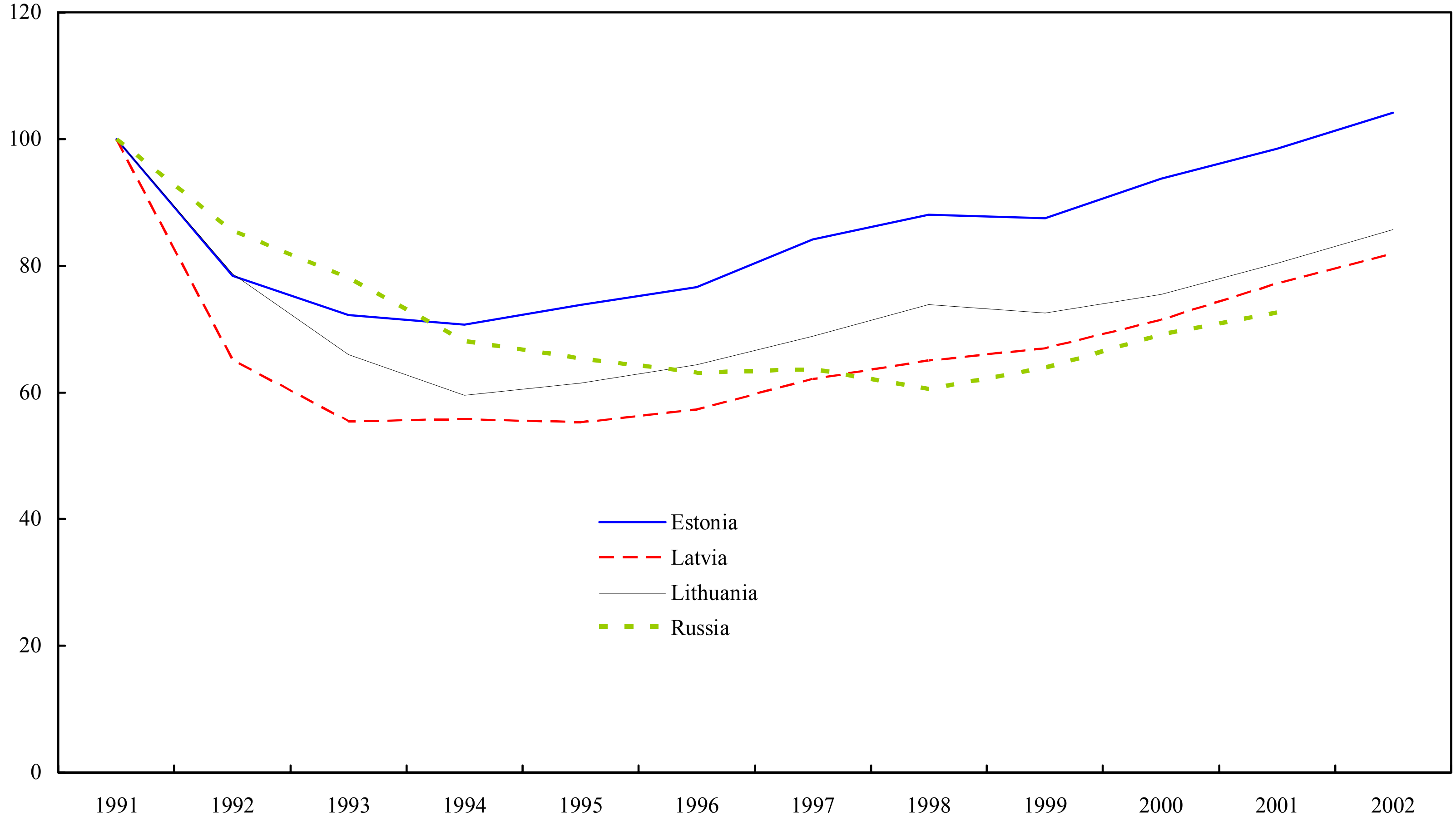
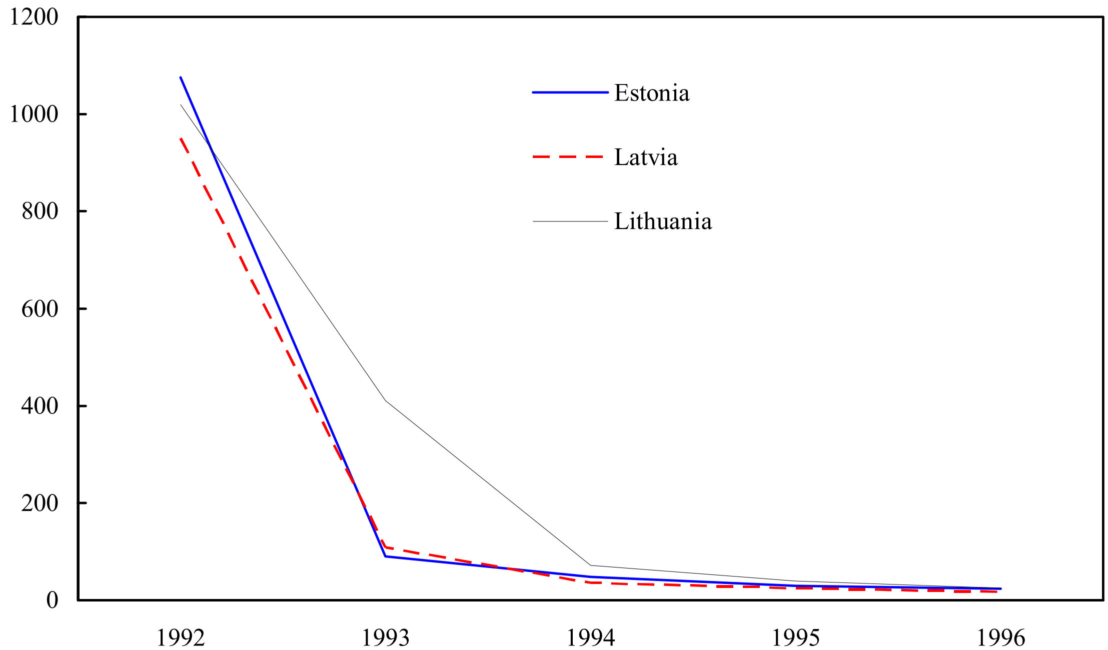
[2] In fact, the first formal contact with the IMF took place when the Deputy Managing Director, Richard Erb, met in Tallinn with delegations from the three Baltic countries on September 22–25, shortly after the three Baltic countries had regained their independence.
[3] Under a currency board arrangement, base or central bank money could be created only against convertible foreign currency. Thus, there would be no scope for discretionary monetary policy; no central bank credit to Government or enterprises; and lending to banks only under exceptional circumstances, when the soundness of the entire banking sector was at risk.

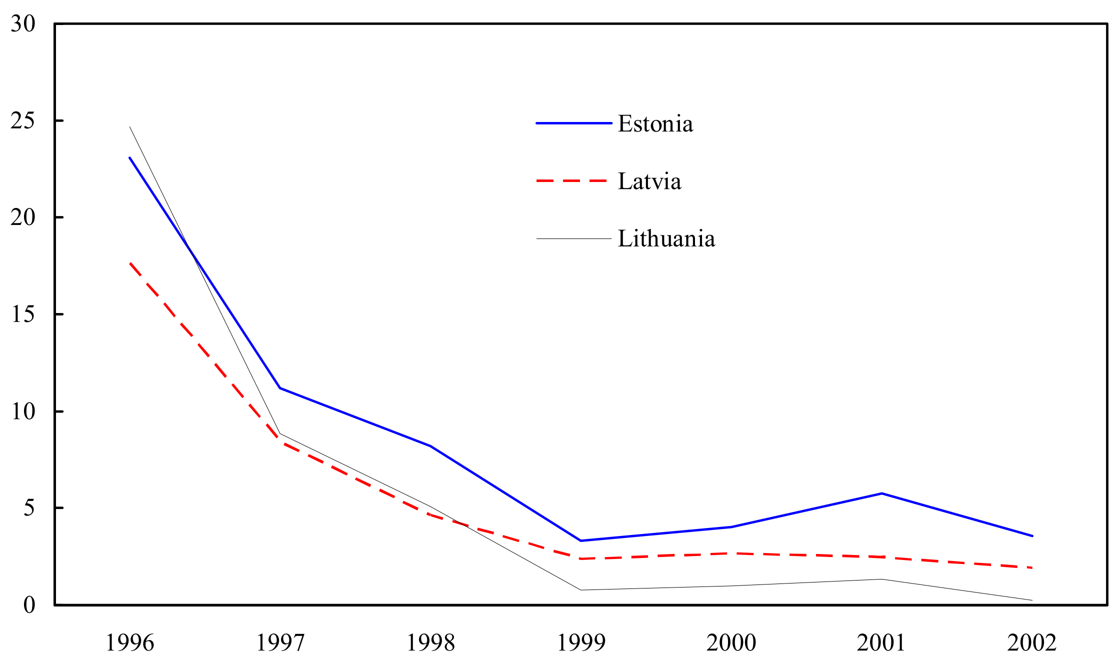
Figure 1. Real GDP
(1991=100)



Source: Country authorities.

Figure 2. Inflation Rate
(In percent)





Sources: Country authorities; and International Monetary Fund, *International Financial Statistics.*

the kroon[4]. Work on the technical details proceeded in working groups of staff of the Bank of Estonia and the Fund, while much of the stabilization program, most importantly a fiscal tightening in the order of 5–6 percent of GDP, was agreed to by the Minister of Finance, his staff, and the Fund mission in an informal setting on a visit to the island of Saaremaa one week before the currency reform. Although a stand-by arrangement was in place only in September 1992, the Fund expressed its support for the currency reform in a joint press release with the Estonian authorities issued at the time of the introduction of the kroon in June.

Latvia left the ruble area one month later, in July 1992, when the Latvian ruble, which was introduced to deal with a cash shortage in May 1992 and circulated initially alongside the ruble at a rate of 1:1, became the sole legal tender. Subsequently the Latvian lats gradually replaced the Latvian ruble, beginning in March 1993; the conversion was concluded in June 1993. Until the announcement by the Latvian authorities that the Latvian ruble would become the sole legal tender, Fund staff had also advised the Latvians not to rush in leaving the ruble area, emphasizing the added responsibility this would entail for the Bank of Latvia to follow appropriate monetary and exchange rate policies. The Latvian authorities stressed that the main reason for taking the decision so quickly was that Latvia had experienced a large inflow of rubles after the currency reform in Estonia. The lats was initially allowed to float, and in fact appreciated significantly, before being informally pegged to the SDR in February 1994.

Lithuania left the ruble area in October 1992, when the interim currency, the talonas, was declared the sole legal tender, as part of a stand-by arrangement that had been negotiated between the Lithuanian authorities and Fund staff over the summer. The timing of the currency reform was forced by Russia, as a new system of correspondence accounts was introduced by the Central Bank of Russia on October 1, 1992, and Lithuania could no longer settle accounts in rubles. Despite the stand-by arrangement, monetary discipline was initially weak, independence of the central bank was limited, and political pressure to extend credit was high. As a result, the talonas depreciated sharply and inflation remained high. This reflected an initial lack of commitment by the Lithuanian authorities to the policies agreed with the Fund. Although program discussions with the Lithuanian authorities were difficult, the President apparently had advised the Prime Minister and Governor of the Bank of Lithuania that under no circumstances could negotiations with the Fund be allowed to break down. Over time the Lithuanian authorities also became convinced that economic stabilization required a policy of monetary restraint. In close cooperation with Fund staff (the resident representative played a significant role here through his daily participation in meetings with the new Governor of the Bank of Lithuania), the authorities tightened monetary policy sharply from May 1993 onward, in anticipation of the introduction of the litas in June 1993. In response, the talonas and, later, the litas appreciated before stabilizing against the US dollar.

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[4] Details of the introduction of the kroon can be found in Knöbl, Sutt, and Zavoico (2002).

Besides the introduction of their own currencies, the economic policy programs worked out in cooperation between the authorities and Fund staff concentrated on fiscal adjustment in support of the new currencies, and the beginning of structural reform. Fiscal restraint was achieved mainly through a reduction in expenditure, frequently this involved cuts in subsidies. In contrast to many other transition economies, and with the exception of Lithuania, revenue was largely maintained in relation to GDP. Tax policy was crucial in mobilizing revenue by establishing simple sets of tax rates (largely flat rates), limiting or eliminating tax exemptions, and strengthening of tax administration. Structural policy was used to support financial stabilization, with early price and trade liberalization, and the establishment of a two tier banking system. Importantly, there was the beginning of privatization and enterprise reform, and the creation of a legal and institutional framework for commercial activity. Structural reform in the early stages of the transition was indeed far reaching, in particular in the areas of price and trade liberalization. In fact, the Baltics created one of the most open trade systems in the world. Estonia, for example, established a system without any trade restrictions, tariffs, or other barriers. Technical assistance provided by the Fund, the World Bank, and others played an important role in moving forward in these areas. Indeed, one of the functions of Fund staff was to coordinate technical assistance provided by other international financial institutions and bilateral providers of assistance, in particular, the United States and EU countries, so as to avoid overlap in the areas of the Fund's particular competence, namely on macro-economic issues.

The response of the economies to the stabilization policies was relatively swift. Inflation fell rapidly after monetary policy was tightened (Figure 2). On the other hand, the decline in output was very steep over 1991–1994 (Figure 1), much steeper than had been experienced in other Eastern and Central European transition economies. This can be explained by the much more severe systemic and terms of trade shocks. It is, however, worth noting that the steepest decline in output occurred before stabilization policies were put into place (Figure 1). In fact, output stabilized quickly as stabilization policies took hold. This suggests that the short term cost of rapid disinflation in terms of lost output was negligible, but recovery was initially slow[5]. Indeed, recovery was only possible after stabilization was achieved. Thus positive real economic growth was recorded in the Baltics from 1994/95, while Russia achieved this only from 1999, apart from a temporary and minor recovery in 1997.

The relative success of the stabilization policies pursued by the Baltic authorities with the advice and financial support of the Fund in the early years of transition laid a firm base for

[5] One general note of caution is in order. When interpreting official output statistics one should keep in mind that the initial decline in output may be overstated, as some of the previous recorded output was not marketable. On the other hand, in the recovery phase, actual output may be higher than recorded; the unrecorded sector (services and small industries) is typically rising rapidly in transition economies. See Anders Åslund, *Building Capitalism: The Transformation of the Former Soviet Bloc*, Cambridge University Press, 2002, on this point.

continued close cooperation between the Baltics and the Fund. But even this early experience of cooperation showed that it was crucially important that the authorities were convinced that the recommended policies were the right ones to follow. It took a little longer for the Lithuanian authorities to be convinced of the appropriateness of the policies, so it also took a little longer for stabilization to take hold there than in Estonia or Latvia.

III. Period of Consolidation and Recovery, 1994–Mid-1998

Against the background of the early success in lowering inflation and stabilizing output, the Baltic countries continued their strategy aimed at sustained economic recovery. The main elements were the continuation of financial stabilization through tight financial policies, and a determined push on further structural reform to lay the basis for economic growth. Thus a new phase of cooperation between the Baltics began, with the emphasis on further structural reform. This new phase was characterized by the use of the EFF in Lithuania and precautionary SBAs in Estonia and Latvia. The principle reason that Lithuania chose the use of the medium term EFF over the shorter term SBA was that Lithuania at the time had been lagging behind the other two Baltic countries on structural reform[6], and the Prime Minister hoped to speed up structural reform and overcome domestic opposition to it through negotiating a medium term economic program with the Fund, with heavy emphasis on structural policies. Key areas of structural policies were banking sector restructuring, a push on further privatization, enterprise reform, and creation of the appropriate legal infrastructure.

A large part of the cooperation consisted in developing policy programs together with the authorities that were then expressed in Memoranda of Economic Policies (MEPs) which were approved by the Fund's Executive Board. In the case of Estonia and Latvia, no further financing was involved as the SBAs were precautionary. Even so, the countries valued the cooperation for developing economic policies that helped them overcome domestic opposition and had international support. Since the emphasis was on structural reform, cooperation between Fund and World Bank staff was also intensified. This was done through consultations with World Bank staff on areas of their competence before negotiating missions went out; or by participation of World Bank staff in Fund missions, such as on the final negotiating mission of the EFF in Lithuania in 1996.

This close cooperation required continuation of frequent, usually quarterly, staff missions, first to negotiate the MEPs, and then, importantly, to follow through with their implementation. Besides these quarterly staff missions, contact was maintained on a continuous basis by the resident representatives, who played a crucial role in the implementation stage of the policy programs. They also had an important role in explaining

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[6] In Lithuania, structural reform was also made difficult by the large agricultural sector and several large companies, such as the Mazeikiu refinery, that had complicated links to Russian energy providers.

the rationale for various policy measures to the public via the media, and to other policy makers, such as coalition partners or politicians in the opposition. In addition to the formulation of MEPs, the writing of technical or analytical notes became an increasingly common vehicle for conveying the Fund's policy advice. On numerous occasions, the prime ministers, ministers of finance, and governors of the central banks approached staff missions and resident representatives with policy questions that were on their minds at the time, and Fund staff responded with short notes, highlighting the thinking behind their advice. Often these notes proved important in stopping various policy initiatives that would have been inconsistent with the MEPs; sometimes the content of the notes found their way into the MEPs.

Technical assistance was also intensified through missions from headquarters, but more important was the placement of long term experts in the central banks and ministries of finance (see Table 1). Technical assistance was concentrated on banking and financial sector reform through the strengthening of banking supervision and prudential regulation. This was important, as banking crises had occurred at various times in all three Baltic countries (see also below). In the fiscal area, technical assistance was concentrated on establishing treasuries, assisting on tax reform, and improving tax administration. In the mid–1990s, the Fund also placed a statistical resident representative in the Baltics, who assisted in developing reliable statistics. Finally, training courses at the Joint Vienna Institute (JVI) and at the IMF Institute in Washington were also increasingly used by country officials, and constituted an important part of assistance by building up a critical mass of technical proficient officials who had received training in the workings of market economies.

In addition to the regular staff missions discussed above, the authorities from time to time requested special visits to advise on particular policy issues. One such occasion was a request by the Lithuanian Prime Minister to assist the authorities in the setting up of a currency board arrangement (CBA). As was noted above, in Lithuania monetary policy often had been subject to political pressures, which, at times, had been very pronounced. As an illustration of this, by October 1993, the fourth governor had already been appointed in the short life of the re-established Bank of Lithuania (1990). In order to insulate monetary policy from political pressure, the Prime Minister wanted to introduce a currency board, initially against the wish of the central bank. In close cooperation between the Lithuanian authorities and Fund staff, a currency board arrangement was introduced on April 1, 1994, and has served Lithuania well since then.

During the consolidation phase, the transition process was not always a smooth one, with several serious "hiccups" along the way, the most serious ones relating to banking crises that had erupted in all three Baltic states. A banking sector crisis emerged first in Estonia in late 1992 and early 1993, then in Latvia in 1995, and finally in Lithuania in late 1995 and early 1996. In each case, the authorities called in Fund staff teams to assist them in developing strategies for dealing with the crisis. The early stages of each crisis

Table 1. Latvia: IMF Technical Assistance (TA) in the Baltics 1/

	Estonia		Latvia		Lithuania	
	TA Missions	Experts	TA Missions	Experts	TA Missions	Experts
1991	2	0	2	0	1	0
1992	10	7	14	3	15	2
1993	5	5	19	9	14	6
1994	12	7	14	3	6	4
1995	8	1	6	0	4	2
1996	6	6	6	3	4	3
1997	3	1	2	0	10	9
1998	4	3	2	1	4	4
1999	4	2	2	1	5	3
2000	2	2	3	2	4	3
2001	0	3	0	0	2	0
2002	0	0	1	0	2	0

Source: IMF.

1/ Number of missions, and short-term expert visits or long-term expert placements.

involved government intervention in support of troubled banks, a central bank moratorium on the operations of some of the banks, and subsequent closure or liquidation of several large banks. About one third of the broad money stock was destroyed during these banking crises. However, because of the low level of financial intermediation, even the failure of large banks had limited systemic effects and only a limited negative impact on output and incomes. The short term response to the banking crises was followed by efforts to strengthen the regulatory and supervisory systems, supported importantly by technical assistance from the Fund and others, such as the World Bank, European Bank for Reconstruction and Development, and EU Phare.

There was a period in the mid-1990s, when policy had started to slip in Latvia. The budget deficit had been allowed to rise, and there was pressure to reverse some of the trade liberalization carried out early on. This represented an important test of the cooperation between Latvia and the Fund. The Fund resisted the introduction of trade restrictions, and suggested a re-tightening of fiscal policy. Eventually, the policy slippage was reversed and close cooperation with the Fund continued. Resisting pressure for trade protection, in particular of the agricultural sector, proved also to be the most difficult part in the negotiations of the EFF program in Lithuania. Reversal of increased protection of agriculture became, in fact, a structural performance criterion in the EFF. This was accepted by the Lithuanian authorities only very reluctantly and proved difficult to achieve over the three year period of the EFF.

The key achievements of the period of consolidation and recovery were very good inflation and growth outcomes. With tight financial policies, inflation came down to single digits, and with structural reform moving ahead, GDP growth accelerated sharply, reaching double digits in Estonia in 1997, and close to double digits in Latvia and Lithuania. The counterpart to the recovery was, not unexpectedly, large current account deficits in all three countries, though to a large extent financed through foreign direct investment (FDI).

As noted, cooperation with the Fund moved from financing in the first phase of transition, to assistance on stabilization and structural reform through the development of policy programs that were formally supported by the Fund. Intensified technical assistance was also crucial for structural reform, more and more this was provided by technical experts stationed in the field. Resident representatives and long term technical experts played an increasing role in that period. However, experience also showed that the effectiveness of technical assistance depended very much on whether the authorities had really sought the assistance or whether they had been "persuaded" to seek the assistance. The personalities of the experts could also make a great difference to their effectiveness. A down to earth, hands-on approach was usually most successful.

IV. Recession—Effects of the Russia Crisis, Mid-1998–1999

By mid-1998, the Baltic economies were in strong economic recovery, with inflation down substantially, but with relatively large external current account deficits. In fact, the Estonian economy had shown clear signs of overheating in 1997 as a result of large capital inflows that had financed an excessive domestic credit expansion. Under Fund staff advice, the authorities had started to take action to slow down the economy in late 1997.

Then, in August 1998, the Russia crisis hit the Baltic economies. Although much progress had been made over the years since regaining independence in reorienting external trade toward the West, trade relations with Russia and the CIS were still significant. In 1997, export shares with Russia and the CIS ranged from over 15 and over 20 percent, respectively, for Estonia, to 20 and 30 percent for Latvia, and 25 and 45 percent for Lithuania. In addition to the direct trade links, there were also financial links, though these were of significance only in Latvia.

The crisis in Russia had a major economic impact on the Baltic economies. As exports fell, the economies moved into recession, with output declining significantly. In the weakening economies, the policy response was a general easing of fiscal policies, and budget deficits rose. The Estonian economy had already started to slow down in the first half of 1998, following a stock market crash in late 1997 and the tightening of financial policies. The weakening intensified after the Russia crisis, and the budget deficit was allowed to rise in response to the recession and a pre-election spending spree from close-to-balance in 1998 to almost 5 percent of GDP in 1999. Similarly, the Latvian economy moved into recession in the aftermath of the Russia crisis, though the recession was not as deep as in Estonia. The main difference was that in Estonia the effects of the Russia crisis came on top of the slowdown that was already in progress as a result of the stock market crash and the tightening of policies. In response, the Latvian authorities also eased fiscal policy, with the budget deficit allowed to rise from 1 percent of GDP in 1998 to 4 percent in 1999. In both countries heavy strains emerged on the banking sector, and a number of banks failed. The policy response in Lithuania was a general easing of fiscal policy, as in the other Baltic countries, but also selective support to industry and agriculture. In addition, privatization proceeds were used for restitution of savings that had been frozen and eroded by inflation in 1991[7]. Thus, the fiscal deficit rose from 3½ percent of GDP in 1998 to 8½ percent in 1999 in Lithuania. Monetary regimes were left unchanged, with currency board arrangements in Estonia and Lithuania, and the exchange rate peg of the lats to the SDR in Latvia.

Cooperation of the Baltics with the Fund underwent a further change in this period. The new Lithuanian government that came to power in late 1997 decided not to seek another arrangement with the IMF after the EFF expired in October 1997. The main reason cited by the then Prime Minister was that Lithuania was ready to pursue proper policies in the absence of a formal arrangement with the Fund. He also thought this would be seen as a sign of strength by the EU. Cooperation was, nevertheless, continued through the resident representative office and frequent staff missions. Technical assistance also continued as before, including the placement of a long term advisor in the Bank of Lithuania.

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[7] Deposits with the state savings bank had been blocked in 1991, and their real value had been eroded by inflation rampant at the time.

In the wake of the Russia crisis, Fund staff repeatedly warned the Lithuanian government that its policy response constituted a reversal of the previous successful policies and carried great risks. Fund staff also warned against the macro-economic consequences of the sale of the Mazeikiu refinery complex to an American investor, with the government carrying almost all the commercial risks. This was done in the form of aide-memoires addressed to the Lithuanian authorities by Fund missions, as well as public statements. After a number of disagreements with the President, the Prime Minister was forced out of office by him in April 1999. The new government again sought an arrangement with the Fund in the form of a precautionary SBA. However, just after negotiations had begun, the new Prime Minister and the Ministers of Finance and Economy resigned, having been outvoted in cabinet over the Mazeikiu deal. Negotiations continued with the new government, which also signed the sale of the Mazeikiu refinery complex. Negotiations were drawn out, as the budget deficit had risen to a level that made it difficult to adjust it down quickly. However, after agreeing on difficult adjustment measures, a precautionary arrangement was put in place in early 2000.

The situation in Estonia and Latvia was somewhat different at the time. Precautionary SBAs were in place in both countries when the Russia crisis hit, but were allowed to lapse as the fiscal deficits exceeded the agreed targets by a wide margin. Although the authorities sought to negotiate new arrangements in the spring of 1999, fiscal policy had weakened to an extent that the Fund could not support, and the authorities thought they could not adjust it sufficiently in the very short run. However, discussions on new programs resumed in late 1999, and precautionary arrangements were again in place in early 2000, with fiscal policies being tightened under the programs.

The lesson from this period was close cooperation between the Fund and the authorities was important, even in the absence of formal arrangements. Again, frequent staff visits and continuous contacts with the authorities through the resident representatives proved to be invaluable. Although the authorities found it difficult for a time to follow Fund policy advice, eventually, and in each case after a change in government, formal cooperation through precautionary arrangements was resumed. An important, and perhaps surprising, political lesson from this time was that the fiscal weakening did not seem to pay off in the elections. In all three countries, the governments that were responsible for easy fiscal policy lost in the elections that followed the fiscal easing. In Estonia and Lithuania, the governments were replaced outright, while in Latvia a new party became the largest political force in the elections.

V. Present Phase

The Baltic countries recovered briskly from the effects of the Russia crisis. Exports to the West rose strongly beginning in 1999, testifying to the strong competitive position of the Baltic countries.. The attention of the authorities was focused increasingly on preparing the countries for EU accession. Thus, negotiations with the EU on accession moved to the foreground. The prospect that all three Baltic countries would be able to join the EU in the foreseeable future gave a strong impetus to further structural reform, in particular in Latvia and Lithuania, which had initially been judged to be lagging behind. Technical and other assistance was increasingly provided by the EU. The EU delegations also started to play a bigger role in communications with the authorities. Indeed, EU accession became the new anchor for policymakers.

Thus, a new phase in the cooperation between the Baltic countries and the Fund started. Estonia was the first Baltic country that moved from a formal arrangement with the Fund to a surveillance mode. The precautionary arrangement that had been in place since the spring of 2000 expired in August 2001, and the Estonian authorities decided not to seek another arrangement. Instead, they decided to continue cooperation with the Fund through the annual Article IV consultations, buttressed by contacts with the resident representatives and additional staff visits for specific purposes, such as advice on the budget proposals at the planning stage, as well as assessment of general economic policies for the Pre-accession Economic Programs (PEPs) prepared annually for submission to the EU. The focus of the Article IV consultations also shifted over time toward analysis of specific topics of relevance to the countries, such as another look at the currency board arrangements and hard currency pegs for EU accession countries; medium term fiscal issues related to EU and NATO accession; an assessment of the competitiveness of the Baltic countries; and a study of financial markets in the Baltics. All of these were papers that could help the authorities in their discussions with the EU. In the absence of a formal arrangement, the authorities also have been keen in publicizing the final statements of the Article IV missions and the staff reports and selected issues papers after the conclusion of the consultations by the Fund's Executive Board.

The development of cooperation with Latvia was somewhat different. The precautionary SBA that had been negotiated in late 1999 went off track in mid-2000, after a new government felt it could not adhere to the budget targets agreed to at the start of the program. A follow-up program was negotiated in early 2001, but again Fund staff found it could not recommend conclusion of the first review of the program in late 2001, as the budget proposed for 2002 by the government—and then accepted in the Saeima—was inconsistent with program targets. However, agreement on indicative budget deficit targets for the first half of 2002 was reached by the government and the staff. These targets were adhered to, and performance criteria well below the approved budget for 2002 for the remainder of the program were agreed, so the first and second reviews of the program were concluded in mid-2002. The SBA expired in December 2002 and, as in Estonia earlier, the new government decided not to seek a further formal arrangement. As in Estonia, future cooperation with the Fund would concentrate on the annual Article IV consultations, supported by additional staff visits to advise on specific policy issues, likely to be focused on budget preparations.

Precautionary SBAs were in place in Lithuania from early 2000, in support of the significant fiscal adjustment after the excessive easing in 1999, and more generally of the "catching up" in the EU accession process. The arrangement also proved useful in support of the repegging of the litas from the US dollar to the euro in February 2002. The last precautionary SBA expired at the end of March 2003 and was not followed by another one.

Thus, since the end of March 2003, all three Baltic countries have moved from cooperation with the Fund in the form of formal arrangements to a surveillance mode concentrated on Article IV consultations, a development that testifies to the progress these countries have made over the past decade. It should also be considered as the normal form of cooperation for countries that are approaching accession to the EU. However, close cooperation with the Fund on appropriate economic polices will continue, as the Baltic authorities value the policy advice and assessment by the Fund. An important economic policy issue now is how to accommodate the public expenditures required for EU accession within the fiscal requirements for an early entry into the euro area.[8] Thus, policy advice on budgetary issues will remain important for some time to come, given also the large external current account deficits in all three Baltic countries (Figure 4). As noted above, such advice is increasingly contained in analytical papers on policy issues of particular relevance for the Baltic countries which now form an important part of the reports prepared in the context of Article IV consultations. In another sign of the maturing of Fund relations with the Baltics, it was decided not to replace the resident representative to Estonia and Latvia when his term expired in January 2003. The local offices will, however, be maintained at least until after EU accession. For the time being, there will still be a resident representative in Lithuania (shared with Belarus).

The role of technical assistance has also diminished in recent years (Table 1), though in specific cases, such as assessment of the tax systems or expenditure reviews, assistance has continued to be provided. However, issues of transparence have moved into the foreground as Reports on Standards and Codes (ROSCs) have been or are being prepared for the Baltic countries in the fiscal, financial, and statistical areas. The Baltics also have been very supportive of greater transparency through publishing staff reports on their countries, final statements of missions, memoranda of economic policies, and, to the extent possible, ROSCs. The authorities found that this helped them in explaining the policy choices to the public at large, as well as usually indicating the international support for their policies. Even in case of some disagreements on specific policies, the authorities did not hesitate to make the disagreements public, explaining their position to the public. This was the case, for example, recently in Latvia when Fund staff urged a more restrained fiscal policy than the authorities wished to pursue.

In sum, Fund cooperation with the Baltic countries has matured in the present phase of transition. The time of stand-by arrangements is over, though cooperation is continuing in other forms, focused on Article IV consultations. The Baltic authorities have also quickly learned that Fund staff can assist them in their discussions with the EU, not only with

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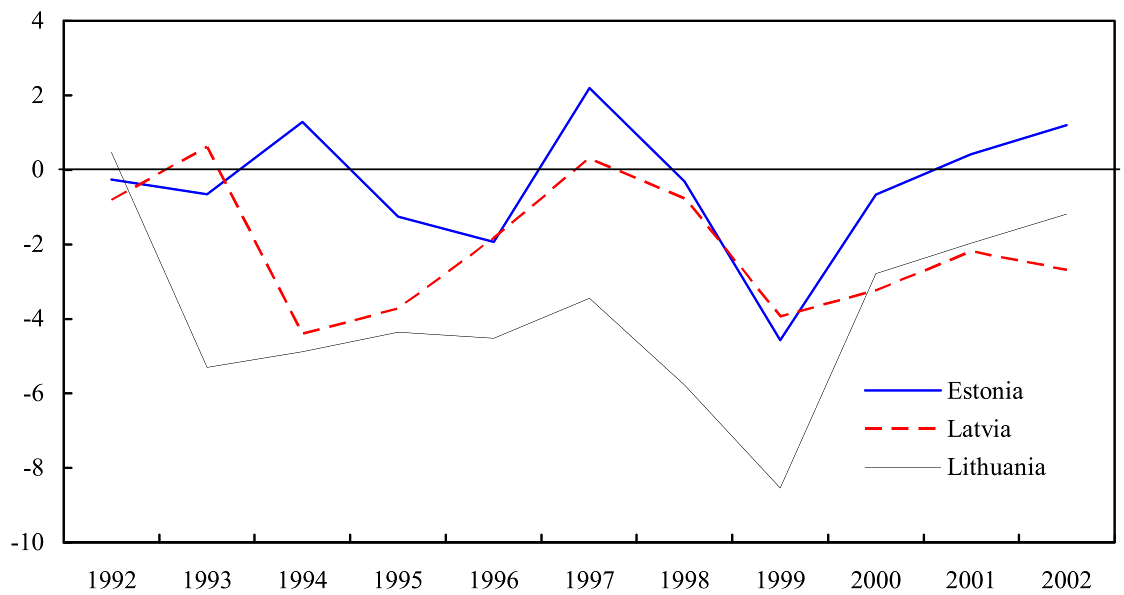
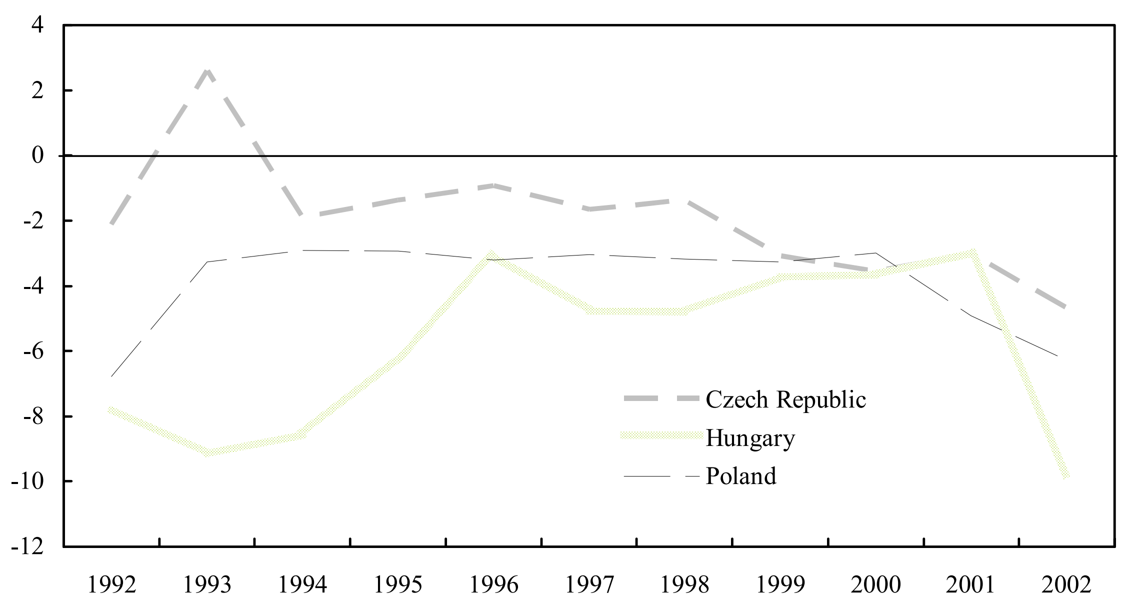
[8] It is interesting to note in this connection that the Baltic countries, with their low budget deficits, seem to be in a much better initial position for achieving this than the other accession countries (Figure 3).

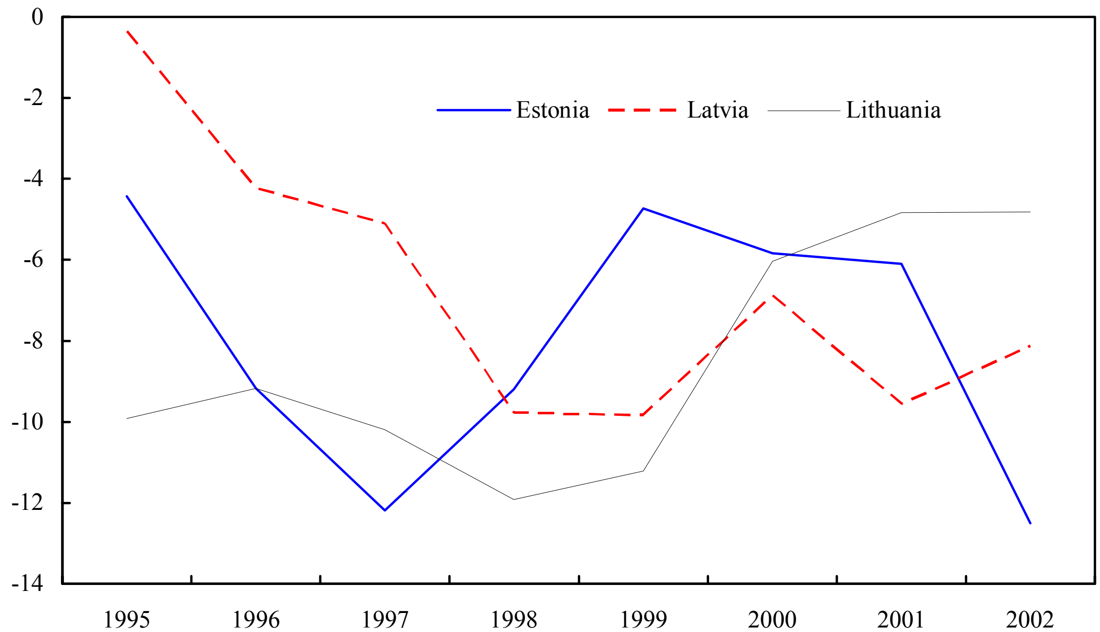
Figure 3. Fiscal Balance
(In percent of GDP)

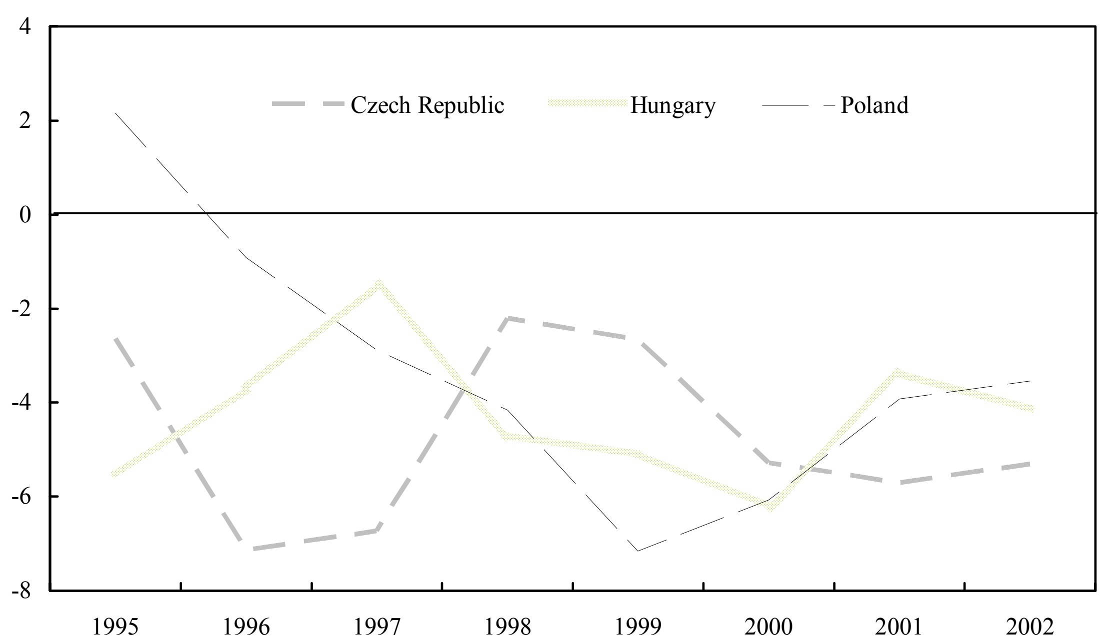




Sources: Country authorities; and International Monetary Fund, *International Financial Statistics.*

Figure 4. Current Account
(In percent of GDP)





Sources: Country authorities; and International Monetary Fund, *International Financial Statistics.*

analytical papers, but also through direct contacts of Fund staff with EU officials. For example, after participation by Fund staff in the debate, the EU Commission as well as the European Central Bank accepted that fixed exchange rates and currency board arrangements can be compatible with ERM II, a position that was strongly favored by Fund staff. Future Fund relations with the Baltic countries will depend largely on how useful the authorities think cooperation with the Fund will be to them. Experience over the past decade would suggest that close cooperation will continue.

VI. Assessment of Cooperation with the Fund by Baltic Policymakers

In order to get a balanced picture of the role of the Fund in the Baltics, over 20 current and former senior officials in the three countries were interviewed. Most had left public life, but all had been active during the critical, early years. Their views were sought on a number of topics. A surprisingly large amount of unanimity emerged.

All of the officials viewed Fund support in the early days as crucial. In part this was because it showed the world that the three countries were independent members of the community of nations in good standing. In part it was because a favorable opinion of the Fund was instrumental in getting a good credit rating that allowed them access to world credit markets. (In fact, in this regard, one former prime minister said, perhaps with some hyperbole, “The Fund gave us a license to live” referring to the catalytic nature of Fund resources.) And in part because the Fund offered financial assistance when it was not forthcoming from other sources and technical assistance of a type not readily available elsewhere.

In all cases the Fund was well received and trusted from the earliest days. In some cases it was because officials—often members of the returning diaspora—knew of the Fund and understood that it could be helpful. In other cases it was little more than blind trust in an unknown international institution. In these cases, achieving clear results—such as stopping inflation—quickly gave added credibility to the Fund and helped nurture trust and cooperation. The Fund was also able to, as one official put it, “Give good answers to our questions” and , “Explaining why the medicine it was proposing was not always sweet, but needed.” In the words of a former central bank governor and, subsequently, prime minister, “Our desire to get to capitalism was enormous, but the details of what this involved were lacking. We saw the Fund as the repository of market and financial knowledge that we needed.”

It also did not go without notice that the Fund did not “push” loans on the countries and this helped the local authorities perceive the Fund as an institution with good intentions. In fact, all three countries borrowed very little from the Fund by conventional standards, but, as was frequently pointed out, knowing that the money was there if needed was important. As was the “seal of approval” from the Fund in dealing with other creditors.

The Fund is frequently portrayed by its critics as unduly harsh and inflexible often using coercion to get its way. This was not a view shared by any of the officials. Indeed, when asked, several said that, in retrospect, things could have been achieved more quickly had the

Fund been more forceful or if the World Bank had tied its lending more closely to Fund programs. Nor did any of them think that coercion had been used although one must be careful here for there is a fine line between undue coercion and useful pressure. Their feeling was that the Fund had never used coercion in the sense that threats were never used. At worst the country would be in the same shape after negotiations broke down as it was before they began. There was surprising uniformity in this regard.

The views on Fund flexibility were similar. If any cooperative arrangement is to work, flexibility on both sides is necessary. The interviewed officials understood this and felt that both sides had shown flexibility. A case in point is the currency board in Estonia. As noted above, the Estonians went ahead and established the currency board despite Fund staff views that it was premature. But as soon as the decision had been made by the Estonians, they noted, the Fund staff was completely supportive. Indeed, ten years later, the former governor of the central bank thanked the Fund for its support and remarked that we were right to be cautious because it was clear to him now – but not then – that a currency board had many potential difficulties. More generally, the sense of the vast majority of officials was that the Fund was demanding, but sought out compromise whereever possible.

Clearly, to most observers, the transformation process was quicker and more successful in the Baltics than in the other states of the former Soviet Union. A number of reasons have been put forward for this: a collective memory of a market economy before WWII; a deep seated desire to put virtually anything soviet behind them and rejoin Europe as quickly as possible; a diaspora of émigrés to draw on for financial and technical assistance; relatively less corruption than elsewhere in the FSU; and a willingness early on to accept help from the IFIs, including Fund programs and assistance.

Doubtless all of these factors have more than a grain of truth to them. But the one clear message that came out in the interviews was that nothing would have happened if the countries had not believed in what they were doing; if they had not thought of their policies as their own. There is no substitute for commitment and ownership. The Baltics are a testament to this. In the words of one former prime minister, " The success of any program is a function of a country's understanding and will." And in the words of another, " Political will is absolutely indispensable."

This ownership was achieved in a number of ways. In the early days, it was clear to the local authorities that new policies were need to first stabilize, and then transform, their economies. But, by and large, they freely admitted that they had no idea which policies were needed initially. In particular, they said that they lacked an overall view of the economy and its macro linkages. In this regard the Fund was instrumental. Macroeconomics is the particular competence of the Fund and, importantly, Fund staff were able to teach macroeconomics very quickly to able and willing students.

The mission chiefs and resident representatives were the "face of the Fund" to the local authorities. Their work was particularly important – and noticed – in the early years. In most cases it was Fund staff that assembled the first balance sheet for the central bank, the first balance of payments for the country, and showed governments how to put together a budget. The local authorities frequently met with Fund staff—sometimes on a daily basis—and asked for and received short technical notes on a variety of topics. Some of these notes are still in use today. Several former officials mentioned that during the banking crisis, the Fund was the only institution that could—and did—help them with highly specialized technical assistance. In sum, in the words of a central banker, “The Fund put us on the learning curve.”

Numerous mission chiefs and resident representatives were singled out time and time again for their ability to explain macroeconomics and convince the authorities of the logic of the needed policy changes. The JVI and INS were also important here, as were a number of long term advisors. In this regard, the value of informal meetings and working arrangements cannot be over-estimated, nor can the value of the personal relationships that developed over time. Indeed, one thing that the authorities frequently mentioned was the desire that staff be assigned for longer periods of time so that the country specific knowledge could be better exploited. Obviously, over several years, each of the countries developed its own institutional capacity, as intended, and the need for the Fund as teacher was greatly diminished.

Also instrumental in developing ownership was the use of MEPs and Letters of Intenet (LOIs). While these documents were originally intended for the IMF Board, they were used extensively in all three countries to help in the transformation process. In some cases they were used by prime ministers to convince recalcitrant members of their own party of the need for radical change. In other cases they were used to convince – even push – members of parliament whose support was obviously critical. They were also useful in making sure that any new legislation was not contrary to the policy package agreed with the Fund. In the words of one ex-official, “The MEPs kept us from doing crazy things in the early years.” They were also used as detailed “action plans” in the various ministries. And, last but not least, from the very early days, all three countries have been very open and transparent. This has meant that virtually all MEPs and LOIs have been published, often within hours and on the web. The consensus view was that the information would have leaked out anyway and by publishing it the authorities could explain the policy decisions that were needed to the public. MEPs and LOIs are viewed with such importance that recently the National Museum of Lithuania has asked for original copies of these documents to put in their archives.

VII. Summary and Conclusion

Following the regaining of independence, the Baltic authorities were determined to move quickly on the economic transition from central planning to market economies. The determination reflected the long struggle for independence and the strong desire to re-integrate with Western Europe as quickly as possible. For this, they sought from the beginning Fund advice and support. The advice and support was promptly given, and close cooperation between the Fund and the Baltics continued throughout the transition.

The cooperation between the Fund and the Baltic countries evolved over the past decade. The foundation for the close cooperation was laid in the stabilization phase of the transition. Faced with an enormous systemic shock, the Baltic authorities and the Fund cooperated closely in designing the proper policy response, and the policy programs were the also supported with financial resources from the Fund. The early experience also showed that policies work best when the authorities are convinced of the necessity of certain measures. The success of the policy programs encouraged further Baltic cooperation with the Fund in the consolidation and recovery phase, although the support was then provided mainly in the form of precautionary arrangements, without further financial support. Baltic cooperation with the Fund was tested during the recession as a result of the Russia crisis. While, for a time, the Fund was unable to support the economic policies through formal arrangements, informal cooperation continued throughout the period and relatively quickly again led to support in the form of formal arrangements. In the present phase of preparing for early accession to the EU, Fund cooperation with the Baltics has matured to the extent of moving to a surveillance mode. Even so, cooperation with the Baltic countries is likely to continue to be close, mainly in the form of advice on and assessment of policies.

In the view of the authorities, the Fund was invaluable in transforming the Baltics. It gave the imprimatur of a well-known international financial institution which was important in its own right and because it facilitated the countries'access to international capital markets. The financial support of the Fund was important not because it was large – it wasn't – but because of its catalytic nature. But, in the view of the authorities, it was the policy advice and technical assistance the Fund provided that was particularly important. In contrast to many other transforming economies, the Baltics took the policy advice to heart and adopted it completely. In short, they took full ownership of the programs, and this made all the difference.

Are there any lessons to be learned from the experience over the past decade? One thing seems to be clear: cooperation with the Fund was, and still is, highly valued by the Baltic authorities. An important reason for this was the relative success of the policy programs that had been designed in cooperation with the authorities. This also seems to explain why the Fund has been able to maintain a positive image with the Baltic press and, more importantly, with the public at large. This is in sharp contrast to many other member countries. In conclusion, Fund involvement works best when the authorities as well as the public are convinced that Fund advice is in the best interest of their countries; this was the case in the Baltic countries for most of the past decade. The experience of Fund cooperation with the Baltics may, however, be rather unique in the sense that the Baltic authorities from the beginning sought close cooperation with the Fund, and this cooperation was rarely put in doubt, even at times of domestic difficulties. The degree of program ownership by the Baltic authorities was unprecedented and was a key factor in the success of the economic transition, that will soon be crowned by accession to the EU.

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