

# **The Baltics**

## **Competitiveness on the Eve of EU Accession**

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## Preface

This Special Issues Paper assesses the competitive position of the Baltic countries—Estonia, Latvia, and Lithuania—as they stand on the threshold of membership of the European Union. It focuses in particular on the viability of their strategy of maintaining their fixed exchange rates upon joining the European Union, participating in its exchange rate mechanism, and then adopting the euro at the earliest possible date. The paper is based on a staff background paper for the 2003 Article IV consultations between the International Monetary Fund and the Republic of Estonia, the Republic of Latvia, and the Republic of Lithuania.

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## Overview

Large current account deficits in Estonia and Latvia, and the continued real appreciation of the exchange rate in Lithuania, have prompted concerns about the competitiveness of the Baltic economies and called into question the sustainability of their current fixed exchange rate arrangements. Recent external performance, however, appears to be explained more by temporary or cyclical developments than by a deterioration in the underlying competitive position of the Baltic economies.

Real effective exchange rates (REERs) have in fact been quite stable over the last four years compared with the strong real appreciations experienced in the earlier stages of the transition process, appreciating by an average of 2 percent a year since 1999. Estonia's effective exchange rate has been particularly stable, reflecting the kroon's peg to the euro in combination with a high proportion of trade with euro area countries. Latvia's REER is also close to its level of early 1999, although in the intervening period it has been sensitive to swings in the dollar-euro exchange through the peg to the SDR. In Lithuania, the exchange rate was pegged to an appreciating dollar until February 2002, and has been pegged to an appreciating euro since then. Very low inflation, however, has helped to limit the extent of real effective appreciation, which is only a little above the average of other central and eastern European countries acceding to the European Union (EU). Indicators based on measures of relative prices or costs that are more representative of the traded goods sector, such as producer prices or manufacturing unit labor costs, have been even more stable. A more direct assessment of competitiveness based on export performance is complicated by the importance of electronics subcontracting in Estonia and oil processing in Lithuania, which are significant in terms of trade flows but much less so in terms of value added. In general, however, exports have performed well despite the global slowdown, and the Baltics have been successful in maintaining and, in some cases, increasing their share of EU markets.

Several factors appear to have driven movements in equilibrium real exchange rates in the Baltics since the start of the transition process. In the earlier years of transition, price liberalization, increased demand for services and other nontradables, and shifts in domestic production and exports toward higher valued-added products contributed to real appreciation through higher measured inflation. The strength of the real appreciation during these years appears to also reflect the correction of an initial undervaluation of exchange rates. While these factors have to varying degrees dissipated, strong productivity growth, together with increased capital inflows in response to improved growth prospects, has continued to contribute to real appreciation. There is inevitably much uncertainty over estimates of equilibrium exchange rates. But an assessment based on a broad range of indicators and analysis of the factors behind exchange rate

movements suggests no clear evidence of exchange rate misalignment that would call into question the underlying competitiveness of the Baltic economies or the sustainability of their exchange rate regimes.

The extent of any further appreciation of real exchange rates in the Baltics has important implications for their goal of participating in exchange rate mechanism (ERM) II and adopting the euro at an early stage. Productivity growth in the Baltics has been impressive in recent years and will likely continue to outstrip that in the euro area over the coming years. As a result, equilibrium real exchange rates will tend to appreciate against the euro in the period leading up to and beyond EU accession. If, as they intend, the Baltics maintain or adopt fixed exchange rate arrangements with a peg to the euro, this will be reflected in inflation rates that are higher than in the euro area. The heavy weight of the tradable sector in the Baltics relative to the euro area, however, will limit significantly the extent to which productivity convergence translates into higher consumer price inflation. As such, productivity convergence alone is unlikely to preclude the ability of the Baltics to meet the Maastricht inflation criterion.

On balance, the strategy of maintaining fixed exchange rates within ERM II and then adopting the euro at the earliest possible date appears to be viable. But the strategy is not without risks. The continued consistency and credibility of macroeconomic and structural policies will be essential to ensure the maintenance of competitiveness and a smooth entry into the European Economic and Monetary Union (EMU). Fiscal policy has a key role to play in this regard by ensuring that domestic demand does not add to inflationary pressures and lead to a deterioration in external balances. Public sector pay restraint, for example, will be particularly important in moderating wage demands. Moreover, fiscal policy will also be the first line of defense in the event that there are temporary surges in capital inflows in anticipation of entry into ERM II or adoption of the euro. In such circumstances, a more contractionary fiscal position may be necessary to counteract the inflationary impact of such inflows.