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# The viability of the Baltic exchange rate strategies toward convergence and the EMU

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**Abstract:** This study analyses the way the three Baltic states (Estonia, Latvia and Lithuania) have chosen to respond to the requirement of converging both in nominal and real terms to the European economy. I begin by describing the successful convergence process and the conflicts and problems that policymakers necessarily come across while looking for the optimal policy framework. The main findings include the explanation of the viability of the fixed exchange regime and the sustainability of large current account deficits. The paper also makes an attempt at pointing to some of the long-run shortcomings of the system the Baltic countries have opted for.

**Key words:** convergence, capital flows, current account sustainability, currency regimes, Baltic states.

Pre-accession countries are particular in the sense that they are faced with the simultaneous challenge of catching up to the development level of advanced EU countries and joining the common currency area. This requires from them active nominal and real convergence.

Several authors point to potential conflicts between nominal and real convergence of pre-accession economies and analyse the different cases for exchange rate regimes from the point of view of managing of these conflicts. Studies such as Gáspár (2001) come to the conclusion that a relatively flexible alternative fosters convergence and helps most in managing the trade-offs between nominal and real convergence.

Having accepted this, however, we are confronted with the counter-example of the Baltic States: Estonia, Lithuania and Latvia. These countries adopted hard pegs early on in the last decade and still seem to be faring well as far as convergence is concerned. The problem dealt with in this paper is how these countries could have been successful in avoiding the risks usually associated with achieving convergence while maintaining a fixed exchange rate regime.

In the first section of the paper I shall outline the most important conflicting points between real and nominal convergence with special regard to pre-accession economies. In the second part it will be necessary to point out some key factors that make fast liberalisation of the capital account together with hard pegs a rather risky choice for pre-accession countries in general, not least because of its potential negative effect on the pursuit of real and nominal convergence at the same time. In the next section, I shall try to give empirical evidence (using economic indicators from ICEG) to support the statement that these countries have been converging to EU levels both in nominal and in real terms in past years, while running major foreign deficits every year. In the remaining part of the paper I shall point to some specifics of the Baltic states that might explain the viability of the large CA deficit and the different path in general followed by these states, toward convergence and the EMU.

### ***Conflicts between nominal and real convergence***

According to Gáspár (2001) real convergence may accelerate after nominal criteria are met, but the two objectives may also be in conflict. In the following paragraphs I shall highlight potential conflicts and trade-offs associated with the particular economic situation of pre-accession economies, with special reference to those most relevant for Baltic states.

There are several channels through which nominal convergence can support real convergence and vice versa. To give some examples, we must mention that price stability and fiscal soundness are generally reflected in lower interest rates, exchange rate stability on the other hand creates better conditions for exports, which are all preconditions for higher growth. At the same time, growth allows for more non-inflationary wage increases and for a better fiscal consolidation, which help meet the nominal criteria.

Contrary to such synergetic effects, nominal criteria may be in conflict among themselves or work against real convergence. Exchange rate based stabilisation was widely used in Central and Eastern Europe as part of the disinflation efforts, because of the relatively high degree of exchange rate passthrough. First, the output costs of disinflation increase the lower the rate of inflation, thus economic growth may be suppressed in order to meet the inflation criterion.

Second, the Balassa-Samuelson effect described by Halpern and Wyplosz (1998) makes the fulfilment of the inflation criterion particularly difficult for pre-accession countries. Dividing the economy into tradable and non-tradable sectors<sup>1</sup>, we see that there is a marked trend of productivity increases in the former one which is not the case for the latter, and yet the wage level is equalised on a national basis. This contributes to a large-scale appreciation of the real exchange rate, and ultimately results in either the strengthening of the currency in nominal terms (in case of a flexible exchange rate regime), or creates inflationary pressures independent of policy decisions (in a fixed regime). In both cases, one of the nominal criteria – either the reduction of exchange rate volatility or low inflation – is impossible to meet, which is why inflation targeting systems introduced by several of the central banks of pre-accession countries do not support exchange rate stabilising policies.

Real exchange rate appreciation driven by real convergence is the source of another type of risk as well. In a small economy open to massive capital flows as Central and Eastern European countries, an overvalued exchange rate can lead to a current account sustainability problems, especially with domestic savings being low as they are and given vulnerable financial systems. Reduced exchange rate volatility improving conditions for foreign trade can also shoot back on real convergence if the exchange rate is fixed and misalignment problems occur. In this situation, the misalignment problem can only be remedied through loss in credibility, whose costs would exceed those of the original problem. This argument points to the relevance of the analysis of current account sustainability, given the high risk of

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<sup>1</sup> The group of industries that compete with foreign products are taken as tradables, the rest as non-tradables.

currency and banking crises, which, needless to say, would significantly delay both real and nominal convergence in these countries.

Fourth, a slower convergence of interest rates is a general phenomenon among the countries in question. On the one hand, this is explained by the so-called “convergence play”. This argument points to the fact that although expected price convergence and the EU-accession in perspective suppress long-term interest rates in Central and Eastern Europe, due to short term risks and potential sources of instability, the region is still perceived as emerging markets by investors, which keeps risk premia relatively high. Real exchange rates thus remain high and drive up real exchange rates, and as a consequence the risk of crises referred to above are not negligible. On the other hand, in countries where sterilised intervention is a major policy tool in managing capital inflows, interest rate differentials are unlikely to disappear.

Fifth, the pressure to maintain a reasonable (flow and stock) fiscal position can have negative effects on real convergence, for that would require strategic capital investment by the government. Most of the countries did not use upturns in economic performance to improve the budget balance, so problems are to occur at the “bust” part of the cycle. The risk is increasingly high when public debt is large, imposing a burden on the budget and lowering fiscal authorities’ capacity to absorb shocks. Institutional reforms in the social security systems yet to come in these countries will only worsen that.

### ***Liberalisation and the choice of exchange rate regimes***

Small open economies in general are exposed to various instabilities, among them speculative short-term capital flows. Empirical results from Edwards (2001) support the view that emerging economies are different in the way they are affected by capital market liberalisation. Therefore, pre-accession countries were advised to pay attention to the sequencing of the liberalisation process.

As regards exchange rate regimes, in the early 1990’s pegs were popular among Central and Eastern states, and were used as an external anchor of inflation. With stabilisation becoming less of a need, these regimes shifted toward more flexible arrangements. By the end of the decade, according to the hollowing-out hypothesis given by Fischer (2001), the general trend in the choice of exchange rate regimes is a shift toward corner solutions, that is maintaining either a “hard peg” or a flexible regime, in-between solutions being considered more crisis-prone.

Pre-accession countries were advised to follow more flexible exchange rate policies (pegging their currencies to the Euro within a broad band), which is supposed to increase their capacity to handle conflicts between nominal and real convergence. The main benefit of this approach advocated by the European Commission is that it supports the fulfilment of nominal convergence criteria, while fostering real convergence, especially because it allows for substantial exchange rate appreciation.

The Baltic states have followed a different path from the rest of the pre-accession countries in several respects. They are extremely small and open, still opted for fixed exchange rate regimes and liberalised their capital accounts relatively early and fast, well before having a strong financial system. Adopting a very hard peg can also help in managing some of the conflicts pointed to in the previous paragraphs. It allows efficient nominal convergence through the decreasing of country and exchange rate risk, lowering inflation and interest rates (while the exchange rate criterion no longer makes any sense). Growth is supported by lower nominal and real interest rates and by exchange rate stability.

Nevertheless, there are considerable risks involved. For Baltic states with fixed exchange rate regimes, the most relevant problems out of the ones outlined in the previous section are potential exchange rate misalignment, that is real exchange rate appreciation and the resulting current account sustainability problems. This, coupled with the losing of investor confidence have resulted in the case of many countries in financial crises, which had a long-term impact on growth and general welfare. A banking crisis can be especially damaging with the central bank deprived of its function as lender of last resort. The recent example of Argentina has shown that while economies with hard pegs are more resistant to sudden speculative attacks coming from capital markets, the real costs of adjustment are higher.

### ***Real and nominal convergence in Baltic states***

The narrowing of the gap between the income, wage and price levels of pre-accession economies and that of the European Union is described with the concept of real convergence. On the other hand, nominal convergence is the term for the process in which countries meet the inflation, interest rate and fiscal criteria of the Maastricht-treaty.

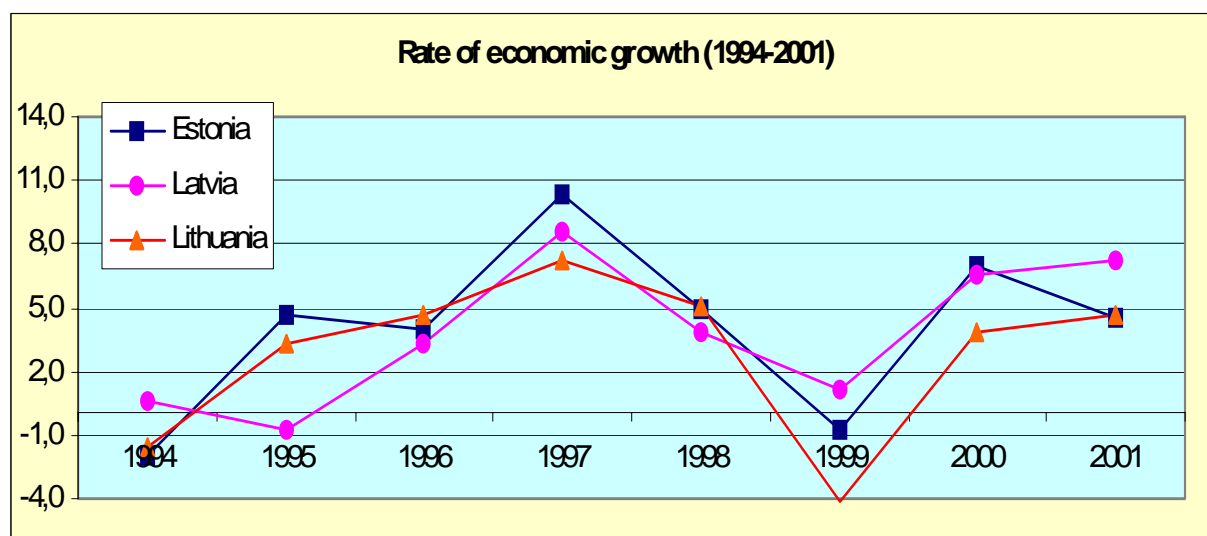
The Baltic states have in common their size and level of development, as well as their real and financial openness. The data available underline the fact these countries have performed reasonably well in both nominal and real terms.

Before 1991 around 95% of Estonia's outside trade was with the USSR (Sutela, 2002). The same is true for Latvia and Lithuania. The dependence on Russian market delivered a huge blow when the Soviet bloc collapsed in 1991. GDP declined by 40% in the Baltic region as a whole and was accompanied by hyperinflation in 1991-92. The data below indicate that a favourable trend is leading the Baltic states out of their initial disadvantageous conditions.

The stabilisation program and the introduction of credible fixed exchange rate regimes in the early '90-s was successful in bringing down the inflation rate close to EU-levels.

<i>Inflation rates</i>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Estonia	41.7	28.9	14.8	12.5	6.5	3.9	5.0	4.2
Latvia	26.3	23.1	13.1	7.0	2.8	3.2	1.8	2.6
Lithuania	45.1	35.7	13.1	8.4	2.4	0.3	1.4	2.1

Estonia established its DEM-based currency board in 1992, Lithuania a dollar-based one in 1994<sup>2</sup> and Latvia has maintained a very hard peg to the SDR since 1994. Responsible fiscal policy has also supported disinflationary efforts and the convergence of interest rates. Another important point in explaining the fair inflation performance is that factors increasing labour market inflexibility do not result in inflationary pressures through higher wages, but are reflected in alarmingly high levels of unemployment (16.6% in Lithuania according to ILO methodology) .



<sup>2</sup> Lithuania has tried to exit its currency board earlier on, but has kept it for credibility reasons. With the consent of the IMF, they have re-pegged the Litas to the Euro in February.

The figure above shows that the major setback in growth suffered in 1999 as a consequence of the Russian crisis could only temporarily break the favourable decade long trend in the Baltics.

One of the most important reasons behind high growth performance of Baltic states was the successful reorientation of foreign trade. The pick-up in exports beside the gradual recovery in domestic demand have balanced the unfavourable world economic conditions since the second half of 2001. Both Latvia and Estonia scored the highest on the IMF's trade openness index; trade to GDP ratios are over 100% in the region.

All three countries have been running major trade deficits, which is reflected in the current account balance below. The trade deficits, however, are almost always covered by net capital inflows, especially non-debt creating FDI. The current account deficit is decreased by the positive services balance, in Latvia especially through transportation incomes between Russia and the Baltic sea. It follows that the CA deficit is more than covered by FDI, which leads to growing official reserves and the practice that neither the government, nor the monetary authorities borrow from abroad.

<i>CA deficit (in % of GDP)</i>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Estonia	-7.2	-4.4	-9.2	-12.1	-9.2	-4.7	-6.4	-6.5
Latvia	-0.2	-3.6	-4.2	-6.1	-10.6	-9.6	-6.9	-6.3
Lithuania	-2.1	-10.2	-9.1	-10.2	-12.1	-11.2	-6.0	-6.7

Although there is substantial FDI inflow into these countries, unemployment is relatively high (and persistent) compared to other countries in the peer group of pre-accession economies. The main reason behind the high rate of unemployment is that new investments following privatisation are labour-substituting ones (ICEG, 2001). Moreover, FDI is mostly used to enhance existing features and does not take up new labour force. Another short-term negative impact of growing FDI is the rising import demand from the side of foreign investors, which further increases the gap between trade incomes and expenses.

The combination of a large current account deficit, hard pegs and financial openness is usually regarded as a source of high external vulnerability. In spite of the large foreign deficit, there has been no significant external financial shock or currency crisis in the Baltic region. The indicators for external vulnerability (especially those of Estonia) are favourable, growth and current account deficit look sustainable. In the previous sections I have pointed to some

of the most important factors slowing convergence in the typical case of small, open economies and the risks associated with the real and financial openness and the fixed exchange rate regimes.

How can these countries sustain such trade deficits? Partly following the line of thought in Sutela (2002), we list provides six reasons to explain this phenomenon: (1) the virtual absence of public debt and (2) fiscal discipline (3) few and thin asset or debt markets, that is, only formal financial openness (4) low degree of monetisation (5) steady inflow of FDI bridges trade gap, or actually accounts for the high import demand (6) reinvestment of profits increases current account deficit without increasing the financial vulnerability of the economy.

### ***Specifics of the Baltic economies***

The fixed exchange rate regimes maintained in the Baltic already have their own particularities. The correlation between the change in foreign reserves and the reserve money is 0.89, 0.39 and 0.40 respectively, so if the first two regimes are declared currency board arrangements, Latvia can also be considered a quasi currency board<sup>3</sup>. The arrangements in place are now judged consistent with the ERM-II requirements, so Baltic states are to enter the Euro directly from their currency boards.

The small size and non-diversified production base of the Baltic countries are consistent with the fixed regimes, but their inflation-proneness and openness to capital flows is a source of risk. The Balassa-Samuelson effect detailed earlier in this paper suggests that pre-accession economies face the problem of real exchange rate (RER) appreciation, which in the case of fixed exchange rate regimes puts pressure on inflation. Despite this factor pushing inflation upward, the relatively favourable inflationary trends outlined in the first section are the result of monetary and fiscal discipline and that labour market inflexibility is reflected in the rate of unemployment .

The appreciation of the RER also heightens the risks of speculative attacks. Having a very hard peg does not follow directly that speculative attacks and an exchange crisis are made impossible. Official reserves usually cover a much narrower monetary aggregate than,

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<sup>3</sup> The low values also point to the fact that the Baltic arrangements are somewhat different from classical currency boards, where correlation is expected to be 1.00. This can be partly explained by nominal changes in the reserves caused by fluctuations in the anchor exchange rate, and partly by the specifics of these states mentioned below. An important argument made by Sutela (2002) is that from the low correlation value it does not follow that the authorities pursued sterilisation policies – the Baltics had different means in avoiding or if any occurred, overcoming the crises.



for instance M2. Given the low degree of monetisation, reflected in the low levels of domestic savings and the total credit/GDP ratio (about half of the market economy benchmark), this type of risk is less relevant. It remains a question to what extent this low degree of monetisation affects growth rates. Another important factor is that Baltic central banks have accumulated reserves backing the money base at well over 100%, which increased the capacity of Baltic states to survive speculative attacks.

The Estonian currency board has managed to avoid the other often cited problem of the currency board arrangement: the absence of the central bank's lender of last resort function. Estonia established with its high reserves a Stabilisation Fund, though minor in size, that allows the monetary authority to intervene in case of a liquidity contract. Excess reserves up to 6% of base money were used to provide liquidity support to problem banks during the 1994-5 banking crisis, which was a consequence of the very fast growth of the banking sector not accompanied by a similar development in the banking system supervision. During the Russian crisis in 1998 the central bank of Latvia provided similar financial assistance. In the 1995 banking crisis however, the Bank of Lithuania could not provide sufficient funding for large problem banks and the crisis was resolved through government loan guarantees. The experience further encouraged the central bank, which had initially opposed the currency board to opt for a more flexible regime that allows for higher monetary autonomy, i.e. LOLR-function, sterilisation, etc. Nevertheless, Lithuania was not able to exit the currency board because of a serious threat to its credibility and pegged its currency to the Euro.

Another important variable of external vulnerability is public and especially foreign debt. As Baltic states emerged from the Soviet Union in 1991, Russia adopted all foreign assets and liabilities of the USSR, so the Baltics started out without any foreign debt. On the other hand, they were able to regain reserves (gold) that was initially used to back up the currency. The original zero level debt has played a major role in facilitating the running of large foreign deficits without overly loss of credibility, especially given the responsible fiscal stance of Estonia and Latvia shown in the table below.

<i>Budget deficit (% of GDP)</i>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Estonia	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.7	0.0
Latvia	-4.0	-3.9	-1.7	0.1	-0.8	-4.0	-2.8	-1.8
Lithuania	-5.5	-4.5	-4.5	-1.8	-5.8	-8.2	-3.3	-1.4

Fiscal prudence in Estonia is more or less guaranteed by the legal constraint that the government cannot propose a budget with deficit. Latvia has also maintained fiscal equilibrium. As a result, both countries external debt is in single digits (that of Lithuania is no more than 17%), which means that one of the key vehicles of currency crises is absent.

The low levels of debt is not merely the result of the Baltic fiscal stance. Sutela (2002) argues that a key factor in the lack of indebtedness is that local debt and equity markets are still quite underdeveloped. The small size of these economies contribute to the smallness of domestic financial markets in the first place. With equity market capitalisation as low as 35% in Estonia, 10% in Latvia and just 5% of GDP in Lithuania, there is very little scope for potentially destabilising short-term inflows. Even more importantly, with the exception of Lithuania running chronic budget deficits, government bonds are virtually non-existent, so there simply aren't any assets available.

Stock exchanges went through a boom in late 1996, followed by the extraordinary growth rate of 10.4%, the highest in Europe that year. In the end the cycle came to a bust in late 1997. Interest rates increased so banks started calling back credits and the stock exchange index dropped by 19.4%. At this point, one of the major drawbacks of the CB system manifested itself: the central bank was deprived of its capacity to provide liquidity to ease the liquidity crunch. Given the sound fundamentals, the authorities argued that the unfavourable events were the direct consequences of the fast credit expansion and the large current account deficit and an adequate correction in the macroeconomic variables. In November a stand-by-agreement was signed with the IMF and eventually market confidence was regained and speculative pressures faded. Trading value at the stock exchange declined in 1998 and as a consequence, the index froze and has stagnated since then.

The low levels of public debt, the responsible fiscal stance and the virtually non-existent markets for assets has reduced the risk of speculative attacks and the subsequent capital account crises. The low degree of monetisation on the other hand facilitates the maintaining of a hard peg and acting as a lender of last resort by the central bank. For the time being, these factors reduce the external vulnerability of the Baltics and allow for running large current account deficits necessary for sustainable growth accompanied by financial stability as seen in the previous section.

Nevertheless, we cannot conclude that the Baltic policy arrangements have successfully reconciled conflicting aspects of convergence. While the disinflation process is steady,

unemployment is extremely high, and the increase in real wages has remained below the general rise in productivity. This underlines the fact that positive returns of stability and high investor confidence are yet to be felt in terms of increasing living standards and the rise of general welfare.

In the long run, the absence of a sound financial system may become an obstacle to further development, and what now seems as a responsible fiscal stance may result in a lack of public investment in infrastructure and human capital.

Having understood the economic and financial viability of the Baltic convergence policies, we must ask if they are also viable politically. Since the convergence process is socially costly in spite of the overall prosperity in these countries, any delay in the accession may provoke dissatisfaction and social unrest, and this in turn may result in the undermining of economic performance in the Baltic States.

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