Policy insights from a decade of Baltic transition

From Soviet Republics to integration with Europe

Following their renewed independence in the early 1990s, the Baltic countries have achieved impressive progress over a decade of transition. They have liberalised and opened their economies to the international market, and have implemented a significant number of difficult and complex market-oriented structural reforms. The tremendous output fall of the early nineties reflected the extent of the economic distortions existing before transition and the degree of restructuring required. By 1994-95 positive growth had resurfaced, and by 1997 growth in the Baltics was amongst the fastest in transition economies. The Russian crisis of mid-1998 brought a halt to fast growth, but did not reverse the trend. The Baltic countries are on the track to sustainable growth, although the deterioration of macroeconomic indicators has raised concerns and suggests that the transformation process, even if relatively advanced, is not yet over.

The Baltic countries had similar starting points, but adopted a different management of the transition. This created some divergence in the economic situations up to the mid-1990s. But the prospects of EU enlargement stimulated convergence, and even emulation, across the three countries by creating a common policy framework and goals. Facilitated by the cyclical upswing there was convergence in macroeconomic policies and in some important areas of structural reform. However, the impact of the Russian crisis on these economies brought back into focus the differing pace of structural adjustment that the apparent convergence had obscured. In this regard, the way each Baltic economy reacted to the Russian crisis has been revealing.

This Study is a regional economic assessment, focusing on the process of transformation in the Baltic area as a whole, rather than a sequence of country-by-country developments. Within this context, the different approaches to reform adopted in the first decade of transition in Estonia, Latvia and Lithuania have provided a real policy experiment. Some relevant insights can be drawn on the basis of this comparison of policies, and their outcomes.

Transition is a package of interdependent reforms

Like other transition countries, the Baltics were offered roughly the same "policy package" in the early 1990s: a liberal approach towards economic policy under a rigorous macroeconomic framework. Drawing the lessons from a decade of transition, the initial recommendations of this package need to be fine-tuned in several areas. Not only does each country face specific conditions that need to be taken into account, but also the process of transition itself has been quite unique. The OECD's policy recommendations towards transition countries have aimed precisely at designing coherent macroeconomic stabilisation and structural reform packages tailored to each country's needs. In retrospect, the critical advantage of a liberal policy package is its strong internal coherence. Indeed, most policy prescriptions are targeted towards the same aim: the use of market mechanisms to obtain the best possible allocation of resources, which in turn creates the conditions for sustainable growth and an improvement of living standards. This truly makes the management of the transition a package of interdependent reforms. The experience of the Baltic countries confirms this insight: in practice, the difficulty of managing a transition process is about the need to set up a coherent policy framework for mutually supportive macroeconomic policies and structural reforms, encompassing a vision of the dynamics.

Many examples of these policy links can be found. The observation of a decade of transition in the Baltics and in other transition countries reported in several OECD Surveys provides solid evidence that macroeconomic stabilisation is not an end in itself. It is a necessary condition to start the reform process. But stabilisation can only be sustained and lead to economic recovery if significant and steady progress is achieved in the area of structural reform. In turn, all structural reforms have to be adequately co-ordinated. For example, even the best-laid plans for large enterprise restructuring cannot bear their full fruits if the banking sector is not behaving according to appropriate market incentives ensuring financial discipline. Likewise, if banks have been restructured but bankruptcy proceedings are not effective, banks cannot both provide credits and impose financial discipline. Fiscal discipline cannot be sustained if the sector of the large state-owned enterprises remains unrestructured. It is hard to attract foreign capital when privatisation lacks momentum or insiders are privileged.

In the Baltic countries, differences in the management of transition have been concentrated in the approach to structural reform, both in terms of scope and timing. In most cases, transition countries need not only to solve the problems of *stocks* related to legacies of the previous regime, such as bad debts and unrestructured firms, but also to ensure that policies get the *flows* right, namely exit and entry of firms, new financing and investment. When the flow problems have not been solved, the stock problems tend to re-emerge, sometimes making their solution even more costly. The direction of causality is often difficult to disentangle. Given that all the variables are interdependent there is in principle no optimal sequencing of policies; reforms have to take place in parallel. Where it is not possible, for whatever reason, actually to implement a well-focused and comprehensive liberal reform package, a second-best approach is to identify and prioritise the bottlenecks in the adjustment process. But policy-makers need to tread carefully. If the policy links are not in place, there is an increased risk that isolated policy initiatives may inadvertently lead to crisis situations, with all the social and political consequences they may entail.

Insufficient emphasis has been put on the time needed for institution building

Successfully making use of market mechanisms requires Baltic countries to develop new institutions, without which transitional reforms will be delayed or frustrated. They are needed for macroeconomic management and structural policy, but go wider than economic management to include an effective and transparent system of civil justice and achieving a clear set of working relationships between central government and local authorities. In many cases commentators have underestimated the time and effort needed to develop the human capital to operate new institutions, and the bureaucratic complexities in getting them established. Good policy choices minimise the time taken to build institutions needed for a market economy, but there is a limit below which this time cannot be compressed.

Institutions that can be created quite quickly include establishing a two-tier banking system and setting out new tax structures. This is not enough on its own. Authorities are needed to ensure adequate banking supervision and collect taxes that are due. Bureaucrats and entrepreneurs need to be trained. Even with good banking supervision, medium-term health in the industrial sector depends on developing transparent and accountable governance from within, and imposing effective competition policy from without. This includes developing corporate governance structures. Many of these institutions derive their authority from government legislation, and their actions must be based in law. To be effective they must operate in an environment where there is open and speedy civil justice. But it takes time to train judges, and for them to build up experience of dealing with complex civil cases.

A given exchange rate regime is unlikely to be a permanent policy choice

Exchange rate pegs in the Baltics have provided currency stability and significant progress with disinflation. Overall, governments have embraced the constraints that this choice imposed, leading to convergence of fiscal policies. But existing exchange rate regimes should not be considered permanent policy choices. Choosing between a fixed or a flexible regime depends on the economic environment at a particular time and the nature of expected economic developments. A credible fixed rate clearly increases confidence in the quality of the domestic currency. This effect produced good results in the case of the Baltic currencies and fitted well with the need to establish institutions and improve their credibility.

However, where the exchange rate is fixed, the burden of adjustment in response to external shocks, or shifts in relative competitiveness, falls elsewhere in the economy. To the extent that prices or wages are not flexible enough, the real economy has to adjust. In a world where both fixed and flexible exchange rates co-exist, a fixed rate regime can actually induce large variation in relative prices among trading partners. So far, the Baltics, as other transition countries, have benefited from comparatively lower unit labour costs and average wages. Owing to incomplete price liberalisation, they still benefit from lower utility costs. It is likely, nevertheless, that further wage and price adjustment will start eroding these initial advantages over the medium-term. To compensate for this, the supply-side will need to become more diversified and less price-sensitive. Some time will be needed for these conditions to emerge, as it requires development of private entrepreneurship with much higher rates of firm creation and survival. Therefore, balancing the risks and advantages of a fixed versus a flexible exchange rate regime will ultimately need to be a fine policy judgement. So far, the Baltic governments are committed to maintain their exchange rate arrangements. Some flexibility in the exchange rate could be a way to absorb external shocks or pressures, such as a tendency to high import growth, but excessive flexibility could jeopardise stabilisation and the restructuring effort by artificially sustaining unrestructured industries or complicating long-term investment plans.

Better control of public expenditure requires prioritisation

The Baltic countries all adopted a tight fiscal stance to support their fixed exchange rate regimes. This led to a substantial reduction in their budget deficits, though the heart of this lay in maintaining, and indeed increasing, revenue collection. Fiscal prudence was severely tested in the wake of the Russian economic crisis that began in August 1998. Growth slowed in all the Baltic countries, fiscal positions deteriorated and the process of further fiscal reform has had to contend with a less favourable environment. The Russian crisis revealed the different degree of progress made in the three countries. In two cases, public expenditure increased significantly in relation to GDP, calling into question the sustainability of the macroeconomic framework.

Governments have had to work hard to restore fiscal credibility. All Baltic countries are implementing improved expenditure monitoring and budget management. The most important element in setting credible fiscal plans is for the budget process to make transparent choices about expenditure priorities, and then to monitor that expenditure is distributed as has been agreed, and has achieved the intended objectives. Progress in meeting these aims is made difficult by the presence of significant off-budget funds and an unclear financial relationship between central government and local authorities or state-owned enterprises. It is also complicated by the presence of significant one-off revenues from privatisation. The need to make important and sustainable policy choices will only increase as the Baltic countries seek to reform currently unaffordable public pensions systems. Public trust depends on difficult decisions being made transparently.

Banking supervision is central to releasing entrepreneurial energy

The banking sector is central to transition. Access to finance is an important constraint on many entrepreneurs, and the nature of the links between banks and industry are a powerful determinant of speed and outcome of industrial restructuring. Privatising the banking sector is a first step, but more is needed to provide a durable solution. Experience in the Baltic banking sector underlines the importance of co-ordinating reform policies. Rapid capital account liberalisation and relaxation of the rules on establishing new banks culminated, in the absence of adequate banking supervision, in a financial crisis in all three Baltic countries. This followed an explosion, in the early 1990s, in the number of undercapitalised and weakly managed banks that lacked even basic credit controls or systems for managing financial risk. In the event this had a cleansing effect. National authorities tightened supervision and there was a wave of consolidation in the sector. But it has taken some time to rebuild public confidence, and the impact of any future crisis would be much greater as there has been considerable financial deepening in the intervening period.

The response to banking crises in the Baltics has been to encourage prudent behaviour by tightening capital standards and preventing a recurrence of unsustainable growth in the number of banks. The constraint of currency board arrangements has further underpinned governments' insistence that they would not intervene to rescue troubled banks. Prudent lending policy has to be tempered by the need to compete for capital and customers if it is not to discourage dynamic entrepreneurs from capitalising on restructuring by making it difficult for them to gain access to loans. There is also a danger that too much concentration, especially if accompanied by a bar on foreign ownership, damages competition. It is vital that the banking system collects and allocates credit efficiently. Good supervision ensures that the right incentives are in place. But it goes wider than just eliminating moral hazard by enforcing tough bankruptcy rules on banks and financial institutions; supervision has to mature to cope adequately with systemic risks and to support other reforms in the transition process.

Dispersed ownership does not favour industrial restructuring

The three Baltic countries initially adopted very different approaches to managing the transition of their state-owned industrial sectors. Finally, however, they all adopted the "Treuhand" model of privatisation, by which enterprises are generally sold by international tender to a strategic investor. Interestingly, where firms started with wide employee ownership this is now giving way to more concentrated manager-ownership. Indeed, the most important change in the dynamics of ownership in the Baltics has been the taking over by managers of employee-owned firms, especially in small and medium sized enterprises. Consequently, a strong element of insider ownership will prevail in the foreseeable future.

Diffuse ownership resulting from voucher-based investment funds was also unhelpful in promoting necessary restructuring. However, a useful insight that emerges from the comparison of Baltic experience with privatisation is that the disadvantages of voucher privatisation can be circumvented if the voucher market is open for outsiders, notably foreign investors. Concentrating ownership through the accumulation of vouchers in investment funds has turned out to be a less favourable option, as these funds often do not have the means to exercise efficient control over their investments, further weakening corporate governance.

Foreign ownership can be a way to circumvent weak corporate governance structures

Comparison of relative enterprise performance in the Baltic countries suggests that foreign companies tend to implement active restructuring, whereas insider owned enterprises tend to restructure in a more defensive manner. Thus, the challenge is not only to develop further co-operation with foreign investors, but also to improve the conditions for the domestically owned enterprises to match the advantages and standards provided by foreign ownership, such as access to capital, management training or building networks for exports. Certainly, the development of domestic businesses would be stimulated by the development of financial markets, which in turn, benefit from the openness of the economy. Also the development of institutions for management training and consulting, and international networking for SMEs could be an important elements in restructuring the Baltic economies. Employee-owned enterprises also have the chance to develop in certain cases, if firmly profit-oriented. A competitive environment enhances motivation and aligns the interests of owners and employees.

In order to improve domestic corporate governance structures, the Baltic countries have achieved substantial progress in enacting essential economic legislation during a relatively short time-span. But important work remains to be done. There are several areas in which further efforts are likely to be required. Notably, the institutional capacity of the regulatory and judicial authorities to implement legislation and enforce property rights needs to be enhanced. Encouraging the emergence of a set of intermediary market institutions, such as brokerages and custodians would also help keep shareholders informed and assist them in exercising their rights of control. Finally, by improving the capacity of the accounting, audit, and legal professions through appropriate education and training.

Labour markets have adjusted flexibly, but social policies need better targeting to support economic restructuring

Increasing wage dispersion is evidence of labour market adjustment, as are the job loss figures by industry sector, and the growth of the service sector. Labour has not been a constraint on restructuring or growth potential, though until now transitional adjustment has led to only a partial recovery in living standards. The prospects for further improvement are good in the medium term, as restructuring permits the largely well educated labour forces to become more profitably employed. However, for the time being large parts of the three countries' populations still suffer some degree of deprivation. Pensions and other public income transfers are often too low to bring the recipients above conventional poverty limits. For many low-income households actual living standards depend significantly on home-produced food and various informal economic activities. While such alternatives may have helped many to endure the transition period they seem to be associated with low mobility among the unemployed, weakening their chances of finding more productive work in the formal economy.

In this situation, any large increase in social spending financed by taxes or compulsory contributions would be potentially counter-productive, as it would further reduce the financial incentive for individuals to work in the formal compared with the informal economy. Some increase in unemployment benefits may nevertheless be warranted, where they are currently very low, as a means to facilitate public acceptance of economic adjustments in enterprises that lead to job cuts. This could also be useful as an incentive for jobless individuals to keep contact with the public employment service, which can help make their job search more effective. Job search in the Baltic countries has to become nation-wide to overcome the constraints of relatively small local labour markets.

In the long run, minimum pensions and means-tested social-assistance benefits should be gradually increased up to the level of an objectively defined poverty line. But this can only be done in line with economic progress so as not to prejudice growth potential. Transition countries in particular depend on rapid modernisation and growth in the whole economy to reduce poverty. While extreme hardship has generally been overcome, many inhabitants in these countries still suffer moderate degrees of poverty, because much of the economic restructuring has yet to be accomplished.

Fifty years of central planning have not altered Baltic comparative advantage

Adopting free trade policies has led to dramatic geographical and sectoral shifts in the pattern of Baltic trade. While some pre-transition trade links have remained, in 1998 the EU countries accounted for between 38 and 57 per cent of the exports of the Baltic countries and between 50 and 60 per cent of their imports. Trade liberalisation has interacted strongly with inter-sectoral adjustment and economic restructuring. Employment and revealed comparative advantages have decreased in most heavy or capital-intensive industries, such as machinery, textile fabrics or electronics, whereas the light industry and sectors in line with Baltic resource endowments, such as wood and wood manufactures and clothing have re-surfaced. In other words, trade structures have partly reverted to the pattern observed at the time of Baltic independence before World War II. It will take time to create new dynamic comparative advantages on the basis of new investments, creation of new enterprises and diversification of output. It is worth noting that new industries that have been emerging in terms of trade specialisation, such as telecommunication equipment or furniture, are largely connected with foreign direct investments. Notwithstanding the impact of these new influences, the Baltic experience is a powerful practical expression of the law of comparative advantage, and demonstrates how resilient its effects have been to fifty years of central planning.

Regional integration has helped Baltic transition

The Baltic economies have traditionally played the role of East-West gateway. However, hopes in the region that the Russian economy will recover quickly and provide a boost to production, trade and services may have to be reconsidered given the uncertainty of political and economic developments in the Russian Federation. Neither should the Baltic role as an intermediary for eastern commercial flows be taken for granted. The prospect of accession to the EU and possible benefits from access to a larger market should not overshadow the challenges posed to comparatively weaker production structures. These include, on the one hand, aggressive and competitive businesses in Western Europe, and, on the other hand, the costs of the EU regulatory framework.

The Baltic Sea Rim can provide an intermediate level of integration where many economic synergies can be exploited. In this regard, the Baltic cities enjoy advantageous locations and have benefited from significant inflows of foreign direct investments, notably from their Nordic neighbours. FDI has brought in its wake new management and technical skills releasing the potential of a well educated labour force, and has opened up wider markets for products made in the Baltics. These conditions favour network externalities in production, and vertical specialisation that can be an important source of both static and dynamic efficiency gains. Together with a continuous regional intergovernmental co-operation, this relationship has proved a useful way to support the Baltics in their progression to European integration.