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1 Introduction

The Baltic countries only reappeared on many maps less than three years ago. Since that, they have become to be widely regarded as the appropriate models for the other former Soviet republics[2]. The Baltic countries, in particular Estonia and Latvia, have succeeded in recreating many of the preconditions of independence. In particular, the Baltic currency reforms[3] have been a veritable success contributing to some of the lowest inflation rates among post-communist countries. This would not have been possible without responsible monetary and fiscal policies supported by most of the electorate. Indeed, together with the Czech Republic the Baltic countries are the prime example of how popular in the electoral sense stabilisation policies may be. The reorientation of foreign trade, economic liberalization in general as well as the growth of the private sector are among other generally acknowledged Baltic successes. The difference of Estonia and Latvia – in particular – from their neighbours in the East is visibly evident to any visitor.

Still, the Baltic countries share many of the well-known post-communist problems. The decline in statistically recorded production has been particularly drastic, one of the steepest in the region. As it has not been accompanied by large-scale open unemployment, recorded productivity has collapsed. Budget balance is maintained, but on a lower level of revenue than would be needed to maintain many traditional budgetary expenses. The inevitable and often simply necessary cuts in expenditure have seldom been accompanied by much-needed structural overhaul of the public sector. Policy making is not always as cool-headed and professional as one might wish. Political consensus may be fragile, especially in those countries with large minorities. Many Russians in Russia still – and ominously perhaps even increasingly – see the Baltic countries as a history-given part of their sphere of influence.

One should always remember that the Baltic countries are far from being the homogenous whole often perceived by distant viewers. They are divided by historical memories (Lithuania has a regional great power past, the others do not

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[1] The opinion expressed in this article are those of the author and do not present the views of the Bank of Finland. Comments by Seija Lainela and the assistance of Tiina Saajasto are gratefully acknowledged.

[2] There is a terminological problem additional to the usual ones. The Baltic countries rightly disapprove of any notion that might imply that they have been willing parts of the USSR. Still, the usual conventions of "former USSR" and "former Soviet republic" have to be followed as long as a proper substitute is found.

[3] See Lainela (1993) and Lainela - Sutela (1993).

have one), religion (Lithuania is Catholic, the others Lutheran), culture (Estonia and much of Latvia once belonged to Sweden), industrial traditions (strong in Estonia and especially in Latvia), foreign exposure (Northern Estonia, which always used to watch Finnish TV, is linked with Finland by half a score daily ferry connections) as well as by current political differences (Lithuania has a leftist government, others a right-of-centre one)[4].

These differences have a bearing on the way in which the Baltic countries perceive one another. Though this is not always appreciated and seldom admitted even in the countries involved, there is only little real interest in and historical basis for down-to-the-earth Baltic economic cooperation. Thus, there is a Baltic free trade agreement, but that has been primarily inspired by the logic of parallel negotiations with the European Union. But neither should one jump into exaggerated conclusions and forget the fact that these small countries still do share common recent history and current problems. Therefore, they do form a common subregion, and even though current domestic policies often seem to be taking the countries perhaps even further away from one another, they common position vis-a-vis cooperation in the Baltic Sea region and beyond that in Europe as a whole will continue to maintain a pressure for subregional cooperation.

The Baltic free trade agreement process[5] highlights the communalities and differences of the countries. Following the traditional imperial trade pattern – common to the Ottoman and Habsburg empires as well as both to the USSR and the CMEA – the Baltic countries used to have much trade with Moscow, very little with one another. While the FSU share in Baltic foreign trade was around 90 per cent, intraregional trade was for decades almost negligible, just a few per cent of total trade turnover. After independence, the relative importance of Western trade has risen very fast, while that of inter-Baltic trade has generally perhaps even declined, certainly not increased to the degree that might have been expected[6].

As already mentioned, the Baltic free trade agreement of September 1993 is largely due to outside European pressures. After it had been signed, an Estonian government official publicly commented on the divergent policies which the three countries were pursuing in their trade negotiations with the European Union[7]. Estonia's policy, he argued, was more liberal and open, and her government had given up protectionism[8]. "Latvia wants to protect its agricultural producers from

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[4] Lieven (1993) gives a vivid introduction to the mosaic called the Baltics.

[5] See Lainela (1994).

[6] Statistics are unreliable, but the decline seems to be true especially when re-exports are excluded. The nearest exception to this trend is energy trade, which has seen some important growth. Even here, cooperation is overshadowed by attempts at self-reliance. Thus, in the face of outside advice to the contrary, Lithuania is planning to build a coastal oil terminal to diversify the supply for its Mazeikiai oil refinery now dependent on deliveries from Russia. The underutilized Latvian oil harbour of Ventspils is just on the other side of border.

[7] Priit Kolbre, cited in The Baltic Independent November 19-25, 1993, p. B1.

[8] A World Bank report agrees: "Estonia is without question the most successful of the newly independent states in terms of establishing a highly liberal external trade regime with virtually no tariff or non-tariff barriers". Estonia: Trade (1993), p. III.

European competitors, while Lithuania strives at a gradual transition to a market economy and wants to preserve import restrictions and quotas".

As such, these comments are accurate enough. But in the Latvian and Lithuanian view, no doubt, these countries are simply following the well-established pattern of the asymmetry principle[9]. A Russian observer might furthermore point out that Latvia's approach of taxing agricultural but not industrial imports actually amounts to a consumption tax on town-dwellers. In an ethnically hung society, Latvian farmers are almost completely Latvian, while the Russians dominate many of the towns. They are also arguably underrepresented in the policy process[10].

These examples hopefully convey some of the political economy complexities beyond Baltic macroeconomic policies and underlying developments. The economics of transition is complicated enough. Seldom does it become as complex as in the Baltic mosaic. This complexity is not nearly sufficiently appreciated, often for the simple reason that it is not known. Furthermore, learning to appreciate Baltic complexities is not easy. Though Baltic statistics are probably better than those in the FSU in general, the small size and traditional provincialism of these countries is visible in the meagre amount of analytical economic and political economy studies available. The outside observer therefore has to limit oneself to hypotheses and conjectures to a larger extent than usually deemed appropriate.

[9] Latvian authorities have commented that their alleged protectionism actually consists of temporary measures taken in response to the unsettled situation and subsidiazition of goods in neighbouring countries – meaning Russia and the rest of FSU. The Estonian policy – naturally strongly opposed by the agricultural interests and their advisors coming largely from Finland, perhaps the country with the most protected agriculture in the world – naturally does raise interesting second best problems in a protectionist world.

[10] Another argument which has become somewhat of a favourite in Moscow asks why Estonian and Latvian stabilisations have succeeded while that in Russia has failed. The alleged answer is simple: in all three countries Russian workers carry the burden of stabilisation, but only in Russia are they eligible to vote. – Needless to say, this argument is seriously misleading both concerning its concept of the burden of stabilisation and its distribution among the population.

2 The Inherited Economic Potential

Joint work by Finnish and Estonian researchers has recently confirmed the widely-held interpretation that the immediate pre-war development levels of the two countries were roughly similar[11]. This conclusion follows whether one looks at industrial wages on a purchasing power parity basis, export performance, or the level and structure of consumption. Similarly detailed comparisons are not available concerning the other Baltic countries, but an educated guess might be that Latvia's development level was roughly similar to or probably higher than Estonia's, while predominantly agricultural Lithuania probably lagged in income and productivity.

Whether the Baltic countries had matched or surpassed Finland's growth in the absence of Soviet occupation remains an open question[12]. What is clear is that the decades of Soviet industrialization from the late fourties to the late eighties were in the case of Estonia and Latvia based on an inflow of labour – which was not needed in Lithuania as rural labour was still abundant –, much trade and production dependence on the USSR as well as hugely inflated statistics. A measure of economic dependence is that Estonia's import share of GNP in 1989 was at 38.3 per cent almost double that of Finland's[13]. As already mentioned, almost all of this trade was with the USSR. A measure of inflated statistics is that Estonia's official growth was recorded as having in 1939–1988 almost doubled Finland's. Still – and contrary to such statistics – in 1988 the real Estonian consumption level was actually a fraction – perhaps just over a tenth – of Finland's[14].

But within the USSR, the Baltic countries were the best pupils of an admittedly very bad class. Baltic living standards and productivity levels were by almost any measure the highest among the Soviet republics. According to provisional World Bank estimates, Estonia's per capita income in 1991 was USD 3700, Latvia's USD 3410 and Lithuania's USD 2700. These figures compare with a former Soviet Union average of USD 2600 for the same year[15]. Whatever one's opinion on the range of World Bank estimates, the rank ordering of the countries corresponds with anecdotal evidence and visual observation. So also does the small distance between Lithuania and the FSU average.

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[11] See Lugus – Vartia, eds. (1993).

[12] First, this test is exceptionally tough, as Finland was in 1900–1990 one of the fastest growing economies of the world. Second, though the evidence is sketchy, it may be that in 1900–1938 Finland already grew faster than Estonia and thus improved its relative position. Third, the relative specialization of Finland in forestry exports in the inter-war period may have predetermined better growth prospects than the specialization of Estonia and Lithuania in agriculture and Latvia also in heavy industries. These conjectures necessarily remain speculative.

[13] This is an approximate calculation based on input-output tables. See Lugus – Vartia, eds. (1993), p. 87. The share of the USSR in imports was about 85 per cent and in exports about 95 per cent.

[14] See the calculations by Robert Hagfors and Toivo Kuus in Lugus – Vartia, eds. (1993), pp. 301–332.

[15] Estonia (1993); Latvia (1993); Lithuania (1993).

The dependence of the Baltic industries on USSR labour, resources and markets was formidable. Essential plants were naturally under direct all-union (or Moscow) subordination. In the case of defence plants, domestic authorities did not necessarily even have access inside plant walls. The oil shale power stations of North-Eastern Estonia, parts of Latvian engineering and the Ignalina atomic energy plant in Lithuania are just some examples of true Soviet Russian appendices within the Baltic countries. A gas main from the North-Eastern Estonian oil shale works to Tallinn was introduced only several years after a similar one to Leningrad had become operative.

Data on transactions between FSU and the Baltic countries is naturally partial and fragmentary, and all the relevant items can probably never be added together. As calls for republic autonomy and sovereignty became vocal in the late 1980's, Russian economists soon came forward with calculations showing that due to relatively underpriced Russian energy and raw materials, on world market prices the Baltic countries would run huge trade deficits with the FSU. Later Senik-Leygonie and Hughes (1992) estimated that all the Baltic countries had a higher than the FSU average share of industries with negative value added. Indeed, in their calculations Latvia came out as the worst short-run case of all of FSU republics, while Lithuania and Estonia have the dubious honour of heading the list of worst long-run cases. Estimating the impact of inter-republican trade on national income in FSU republics, Senik-Leygonie and Hughes could find no solution for Latvia which yields positive national income and is consistent with the assumed decline in trade volumes. The Baltic countries, importers of energy and raw materials, exporters of manufactures and food to the FSU market, really looked like basket cases.

Most of old Soviet industries in the Baltic countries are probably of no economic value under the new set of circumstances. Two years into independence, almost the only examples of adaptation of old state-owned enterprises to changing environment seem to come from subcontracting, primarily in Estonian and other textile industry[16]. This is an example of exploiting the most conscipious relative advantage of the Baltic economies, that of cheap and relatively well educated labour force. This is naturally an advantage shared with other post-communist economies. The Balts – primarily Estonia and Latvia – have the added advantage of close geographical position to the Nordic countries. According to Estonian statistics, Finland has become the main trading partner of Estonia. A substantial share of this trade consists of subcontracting flows. There are also thousands of Estonians working in the grey labour market of Finland.

Another asset left by Soviet rule is the Baltic transportation infrastructure[17]. If future Russian developments were positive and if Russian-Baltic disputes could be regulated, the ports and East-West railroads and pipelines of the Baltic countries might prove to be a major asset to be exploited for transit. Naturally, these are no negligible ifs. Consequently, the popularity of thinking about the Baltic countries as future "Hollands of the Baltic Sea" – as it is sometimes put – has had

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[16] In December 1993, however, the Latvian RAF car manufacturer launched a newly-designed minibus model (The Baltic Independent January 7-13, 1994). The future of RAF, a car factory with great traditions, which only a few years ago dominated the Soviet minibus market, may well hinge on the success of this model.

[17] For a survey see Van Arkadie and Karlsson (1992).

its ups and downs among Baltic policy planners and decision makers. Currently, Estonian and possibly also Latvian thinking on Russian future is dominated by somewhat apocalyptic views of coming dissolution, collapse and chaos[18]. Therefore, any ideas of Baltic gateways as a feasible long-range strategic alternative have in these countries currently only little topicality.

This naturally does not prevent taking all available short-run advantage of trading Russian resources as long as that remains possible. Long-range thinking on these matters in Lithuania may be somewhat different from that in Estonia and Latvia, reflecting the generally greater willingness of the current Lithuanian administration to cooperate with Russia[19].

An awkward aspect of the Soviet heritage are the minorities so much boosted in Estonia and Latvia by immigration. Many of the issues involved are well-known and need no elaboration here. One might however add the probably less-understood detail that the propensity of minorities to involve themselves in entrepreneurship seemingly varies across countries. Thus, in Estonia most new businesses are probably ethnically Estonian. The same is not necessarily true in Latvia. An at least potentially important issue of ownership and control arises, as it may be that interlinking Baltic-Russian business interests may become of great importance. The prospect raises all kinds of queries in these countries. Though our knowledge of the extent of this phenomenon is scarce, one should never forget that in the Baltic case, foreign direct investment quite often means Russian investment. This is a further reason why the Balts are often less than enthusiastic about the ideas of East-West gateways. They in most cases do not want to become Russian bridgeheads in the West[20].

[18] Perhaps needless to say, these perceptions are often accompanied by a conviction that the Balts are the only ones really to understand Russian developments. "The Nordic and Western countries should be obedient when we speak of what is going on in Russia. The Baltic states know Russia much better than Washington, Paris or Bonn", said Estonian President Lennart Meri while commenting the Russian parliamentary elections of December 1993. See The Baltic Independent December 24, 1993 – January 6, 1994.

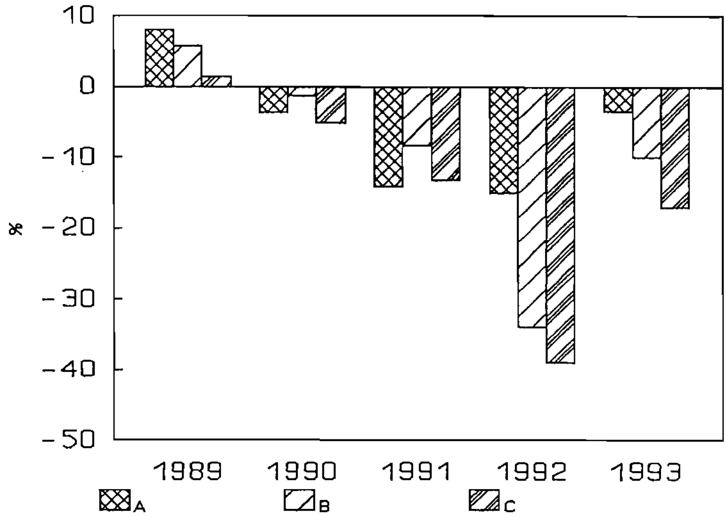
[19] Though one should beware of all easy generalisations on current Lithuanian government policies. It was, after all, the leftist Lithuanian government which was the first one among the Baltic states to officially apply for membership in NATO. In other respects as well Lithuania's Russian policies have had their seeming inconsistencies.

[20] Again, Lithuania may be something of an exception. One example of this is the Lithuanian–Russian agreement on joint use of the Mazeikiai oil refinery. Lukoil, the Russian oil giant will invest around USD 100 million in Lithuanian oil industry. They are also intent on building a network of service stations in all the Baltic countries. The future use of Mazeikiai remains controversial. As already noted, there are also Lithuanian plans to diversify its supplies away from complete dependence on Russia.

3 Production: Collapse and Recovery

As Chart 1 shows, Baltic production – as officially recorded – declined in three years from 1990 to 1992 by a rough average of one half. The decline is among the deepest recorded in FSU republics. In 1993, production levels continued to decline, though the decline clearly slowed down in all the three countries.

Chart 1. **Change in GDP in 1989–1993**
1993 estimated



A Estonia
B Latvia
C Lithuania

Naturally, all the usual caveats in post-communist national accounts apply. There is certainly no reason to think that Baltic statistics would give a true picture of welfare generated by production. Still, the fact of extremely fast production decline should be in no doubt. Neither should one jump into the conclusion that all disappearing production was unnecessary or detrimental.

The Institute of Economics of the Estonian Academy of Sciences estimates that gross domestic product (GDP) declined in 1993 by 5.1 per cent[21]. Recovery probably started in the second half of the year, and it is forecast by the Institute that GDP will grow in 1994 by 4.9 per cent and in 1995 by 3.3 per cent.

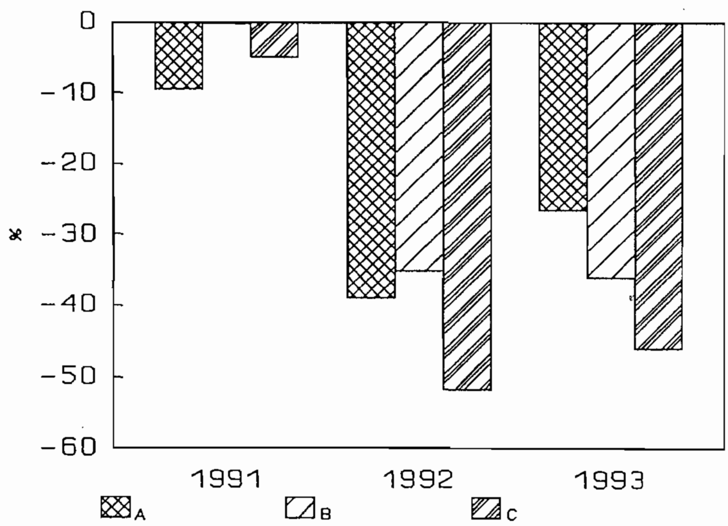
The current Estonian recovery is based on foreign trade, the service sector and new entrepreneurship. During 1993, Estonian exports grew from EEK 5.5. bn to EEK 10 bn, and the value of services surged from EEK 2.3 bn to EEK 4 bn (8 EEK = 1 DEM)[22]. As Chart 2 shows for all Baltic states, the picture in manu-

[21] Rajasalu (1993).

[22] As reported in Kaubaleht December 23, 1993 – January 3, 1994.

facturing is a different one. In Estonia, production has declined in all industrial branches.

Chart 2. **Change in industrial production in 1991–1993**



A Estonia
B Latvia
C Lithuania

Engineering has been particularly badly hit. Thus, during the first nine months of 1993, the output of electric motors was only about 15 per cent of the 1991 level. Large segments of traditional Estonian industrial production have been practically wiped out. This is true of most forestry production and large parts of chemical industry. Both branches have been characterised by outdated capacities and serious environmental problems. In 1993 previous decline became steeper in textile industries, which are severely constraint by the unavailability of FSU raw materials. The official forecast for 1994 is optimistical. Total Estonian industrial output is expected to grow by 6 per cent[23].

Given huge price shifts and the currency reform of Summer 1992, no reliable estimate on change in investment in 1992 is available. It is probably safe to guess, however, that the decline in investment in 1991–1992 must have been more than a half. Against this background the currently expected growth in Estonian investment – if it were to materialize – is a hugely positive sign. The real level of investment is on one count expected to double in 1993[24], and a similar growth is confidently forecast for 1994[25]. Even more remarkable is that almost three

[23] Äripäev December 24 1993.

[24] Comparisons with 1992 are however hugely complicated by the currency reform of summer 1992 and recent price changes. Thus, an Estonian Finance Ministry expert claims that during the nine first months of 1993 total invetsment was on the same level as in 1992. See Estoniya January 1994.

[25] Kala – Vitsur (1993).

fourths of these investments seem to be in newly established enterprises, primarily in equipment and machinery. Construction investment is of secondary importance. Services and transport invest more than manufacturing and energetics, and an overwhelming 74 per cent on investment is financed by enterprise resources.

These are basically positive characteristics. Necessary structural change seems to be well underway. Unfortunately, this is not the whole picture. The data also tell that bank credits are only little used for investment. They only finance 8 per cent of all investment[26]. The Estonian financial market still concentrates on short-term finance. And whatever the change of investment from previous year, neither should the absolute volume of current investment be exaggerated. The total amount forecast by Kala and Vitsur (1993) for 1994–1995 is about DEM 1 bill. To put the absolute amount in perspective, this is perhaps double the cost of a modern pulp and paper plant[27]. Finally, the optimistical forecasts quoted above received recently a cold shower when the Statistics Department released its figures for the third quarter of 1993[28]. True, the Estonian GDP seemed to be growing at a rate of 6.4 per cent, but the growth is led by foreign trade and consumption, not investment. Total investment actually declined by 1.7 per cent relative to second quarter. The Estonian recovery may therefore have a weaker base than one would hope.

The collapse of investment in Latvia and Lithuania in 1990–1992 was recorded to be steeper than in Estonia, around 60–70 per cent. In Latvia, GDP continued to decline in 1993 by an estimated 10 per cent[29]. There is no firm evidence of a upturn in investment, though the authorities are relatively hopeful on this. They are counting on using foreign credits for domestic investment. It may anyway be that the bottom of production has been reached in Latvia as well as in Estonia. The Latvian authorities confidently forecast that the economy is starting to grow, perhaps as fast as by 5 per cent annually in 1994[30].

The situation is probably gloomier in Lithuania. The decline in production has been even steeper than in Latvia, and according to preliminary information it continued in 1993 by 17.1 per cent[31]. In January–August statistically recorded industrial production was a whopping 47.3 per cent lower than in previous year. There was some probably seasonal growth in industry in early Autumn, but that

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[26] In Estonia the problem in 1993 was not in overly high ex post real interest rates, but – at least according to banks – the lack of bankable investment projects.

[27] The comparison is not totally arbitrary, as the collapse of earlier industry makes Estonia (or perhaps Latvia) a potential site for a modern forestry plant. The possibilities have been studied by the Nordic forestry corporations, with no results so far. One of the reasons for disappointing results must be the fact that as long as future owners of forests are not known, there is no way of forecasting their timber supply behaviour and thus the cost level of a potential plant.

[28] Baltic News Service December 28 1993.

[29] Latvian macroeconomic statistics remain controversial and possibly contradictory. The figures released by the statistical authorities tell of an even steeper decline. The estimate here cited is the one used by the international financial organisations and also by the goverment of Latvia. See 'Program' (1993), Annex 5.

[30] Baltic News Service December 29 1993.

[31] BBC Survey of World Broadcasts SUW 103/3 WA/4-6, December 24 1993.

seemed to level off fast and further decline seemed to follow. Domestic politicians are however upbeat concerning a gradual upsurge. Industrial production is expected to grow by 1.2 per cent in 1994[32]. The actual basis for optimism must however be judged to be weak. Existing investment seems to be mostly in residential construction, a form of asset protection under high and variable inflation. The share of industrial products in non-FSU exports declined further in 1993.

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[32] See previous note.

4 The Reasons for Output Decline

As in other countries in transition, part of recorded output decline in the Baltic countries is illusory, as resources are shifted to badly recorded small-scale production and services, in particular in the emerging private sector. The usual index number problems due to price liberalisation are also present[33]. But there are also other reasons for output decline, ones that are more interesting in the particular context of the Baltic countries. In this section, we look at four such explanations: credit contraction, institutional uncertainty, demand constraint and finally trade collapse with the FSU. The discussion is largely speculative, as there is little reliable data and almost no analytical research from the countries concerned.

It has been controversially argued that undue restriction in the availability of credit may have contributed notably to production decline in Poland in the first phase of the stabilisation programme[34]. The argument is that the withdrawal of subsidies coupled with massive devaluation and severe limits on credit expansion implied that the enterprises no longer commanded the credit needed to continue production at former level of output. Consequently, the enterprises resorted to increased levels of inter-enterprise credit – something the authorities also attempted to prevent.

Though any enterprises will almost always complain of what they see as being insufficient availability of credit, there is little evidence that this would have been recently – with the obvious exception of only short-term credit being available[35] – a major problem in Estonia or Lithuania. Under the Estonian modified currency board system interest rates in principle freely equilibrate the demand and supply of finance. Though forward looking real interest rates are always difficult to define under nominal price level uncertainty, the Estonian interest rates – though possibly positive in real terms – are probably not excessively high[36]. The situation may have been quite different in 1992, when the introduction of the currency board led to a temporarily severe credit squeeze which also contributed to the first Estonian banking crisis. It is generally interpreted that Estonia did have a liquidity crisis in 1992 and beginning of 1993.

In Lithuania the real volume of credit seems to have remained almost constant over a period of time when production declined[37]. This is also no evidence of a credit squeeze.

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[33] Osband (1992).

[34] Calvo – Coricelli (1993). For a taxonomy of alternative explanations of output decline in Eastern Europe see Williamson (1993).

[35] This should be seen primarily as a consequence of general uncertainty and therefore not as an independent causal factor, though it is true that institutional underdevelopment also contributes.

[36] With a nominal rate of interest about 30 per cent in late 1993, Estonian banks still preferred to invest either abroad or in government CD's with a 6 per cent interest rates. This given a measure of risk perceived in Estonian money markets. See Ross – Sutt (1993).

[37] Bulletin of the Bank of Lithuania 1993:1, pp. 38–47.

The situation is different in Latvia where stabilisation has been especially in 1993 accompanied by huge positive real interest rates, ranging – deflated by current inflation – up to about 100 per cent annually. This is in contrast with 1991–1992, when real interest rates were strongly negative due to high inflation[38]. Recent interest rates probably reflect the level of profitability available in short-term commercial activities, particularly in trading commodities originating from the FSU area. If this is so, real interest rates in Latvia may remain too high for long-term investment as long as many commodity prices remain subsidized in FSU states. This is an obvious impediment to investment-based Latvian growth, but one that the domestic authorities can do little to alleviate, though they are naturally aware of the possible consequences of current interest rates.

The role of institutional uncertainty in the Baltic countries is great. Some of the originally perceived uncertainty concerning the viability of the three countries as independent entities still remains. Currently of greater importance is the political uncertainty concerning both the future position of Russian-speaking industrial labour force – in Estonia and Latvia – as well as future economic policy lines in general. Much uncertainty concerning future relations with the FSU naturally remains. The level of political stability is somewhat paradoxically currently perhaps the greatest in Latvia. This is paradoxical, as the country is governed by a minority coalition government. The Estonian right-wing government is plagued by increasing political passivity among the population as well as by continuous internal erosion. The Lithuanian leftist government is strong in the parliamentary sense, but more generally the country is characterised by institutional uncertainty, winddrift policies and recurring scandals. Neither the liberal Estonians nor the more interventionist Latvians and Lithuanians have been able to outline any framework of future industrial policies. Given the importance of Russian-speaking industrial workers, an announcement of laissez faire would probably make disastrous ethnic politics in Estonia and Latvia.

Another source of uncertainty is the peculiarity of Baltic privatisation policies. Because of the nationality issue, restitution has been given an exceptionally prominent role in Baltic privatisation. At the same time it has tended to increase uncertainty on ownership claims, and as the example of forests given above (note 27) shows, the issue remains in certain branches a serious impediment to investment. In large-scale privatization, the three countries have chosen divergent paths. Estonia follows a German-type privatisation programme by sale. Investment plans are one argument used by prospective buyers in their offers. On the other hand privatization by sale is inevitably a slow path to restructuring. There is little interest in investment in those plants that remain state-owned. In many cases, the intention seems to be to let them die a slow death by attrition, as competent labour force emigrates to the emerging private sector[39].

Latvia originally opted for a decentralised privatization scheme where industrial ministries were supposed to divest state-owned plants. The approach failed to deliver almost any privatization, and the country is in the process of creating the institutions needed for a centralised privatisation programme.

[38] Shteinbuka (1993) argues that though there were no quantitative restrictions on credit in 1991, state enterprises used credit for boosting incomes and investories, not for investment. This is probably a measure of the degree of uncertainty at the time.

[39] For a somewhat different interpretation see Lainela (1994).

Ownership uncertainty thus remains. While most industries remain state-owned, the state is hardly capable of investment-based industrial policies. Budget-financed investment is negligible, around 1 per cent of GDP.

Lithuania has taken a voucher-based fast track to privatization. Most industrial enterprises should be privatised by the middle of next year. The authorities wish that this would give a steady basis for future economic growth. One may have doubts on that, however, as the practice of Lithuanian privatisation is characterised by insider worker privileges, closed auctions and an important role given to almost non-supervised investment funds. The corporate control mechanism to appear is therefore quite unclear. Observers also point out that the Lithuanian privatization programme, because of its complexity, leaves much room for corruption and directly criminal activities. The state in many cases clearly wants to maintain controlling shares.

The third explanation for output contraction to be discussed is demand constraint. In principle, as we know, a totally credible stabilisation programme might have no impact on output. In practice it has, in particular on that part of output which is best captured by post-communist statistics. The balancing of budgets cuts directly into public demand, while an eventual end to subsidisation will increase prices to realistical levels and will therefore depress both household and – assuming hardened budget constraints – enterprise demand. Any attempt to impose tax discipline will force part of production and exchange beyond the statistician's scope.

Interviews of Estonian enterprises indicate that they moved from a supply-constraint regime to a demand-constraint regime very fast in the summer of 1992[40]. In March 1992 90 per cent on enterprises cited the shortage of production inputs as an obstacle to the growth of production. By autumn 1992 the percentage declined to 40. At the same time the share of enterprises citing lack of demand as a problem rose from less than ten to 70 per cent. This partly reflects loss of foreign markets, but the impact of domestic stabilisation – probably aggravated, as seen above, by a liquidity crisis – is also evident.

Though detailed analytical studies are not available, it is taken for granted that stabilisation policies have also contributed to output decline in Latvia (Shteinbuka 1993). This might not be the case in Lithuania, were stabilisation efforts have been less successful, at least until 1993.

Finally we have to focus on the impact of trade on production. It is generally interpreted that collapse of Baltic trade with the FSU was the main short-run reason for output decline, especially in 1990–1992. This had both supply- and demand-size aspects. On the demand size, the deterioration of the Soviet economy hit Baltic exports badly. True enough, terms of trade first moved in the favour of Baltic exports, as the prices of manufactured goods were liberalised sooner than those of raw materials and energy. When the terms of trade shock finally came in 1992–1993, it was a heavy one[41]. At the same time, the independence and currency reforms of the Baltic states necessitated new institutional and payment arrangements in trade with the FSU. In the short run, this also contributed to trade

[40] See Sepp (1993). The results are also reported in Hansapanga toimetised 1992:IV, p. 14.

[41] The calculated size of the terms of trade shock may have reached 50 per cent of GDP. – It is still unclear – at least to the present author – whether the Baltic countries currently in fact pay world market prices for energy imported from the FSU.

decline. Finally, there was the issue of Baltic exchange rates vis-a-vis the rouble. Exporters in Latvia in particular complained that the rate originally chosen was overvalued and therefore tended to unduly depress export volumes.

Supply side effects were important as well. The unavailability of FSU energy and raw materials created various bottlenecks and possibly important secondary effects. Finally, the sudden liberalisation of Western trade certainly shifted demand from domestic to imported goods, especially in consumption. In spite of the undervalued currencies, it also created competitive pressure in many sectors[42]. Not surprisingly, agricultural imports have become – as already noted – a fiercely debated issue in all the three countries[43].

In the light of the discussion above, the priority of foreign trade disruption in explaining output decline in the Baltic countries seems self-evident. Countries just cannot undergo terms of trade losses amounting to several tens of per cent of GDP without a steep decline in production. Still, the factual evidence available is rather less than perfect. Our picture of Baltic dependence on the FSU is still imperfect, and inflation, relative price changes, rate of exchange fluctuations as well as incompletely recorded physical flows together with changes in statistical practice make any data-based attempts at decomposing the various existing impacts largely arbitrary. The foreign trade statistics of the Baltic countries are clearly the best in FSU, but even they can be useless or misleading. Trade flows with the FSU are most probably understated, but Western trade statistics also have their problems[44].

Clearly, much work still remains to be done before we can claim to have a comprehensive picture about the reasons for production decline in the Baltic states.

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[42] Even Finnish-made consumer goods are at the prevailing rate of exchange often clearly cheaper in Tallinn than in Helsinki, which has given rise to large-scale shopping tourism.

[43] Protective tariffs may indeed have a justification in a situation where grain, whose exports to Russia have been financed by Western governments, finds its way to Baltic markets at a price well below world market levels. – At the same time one should remember that the agricultural sector, employing almost a fifth of population, is currently too large in all the three countries.

[44] It for instance seems that there is a major discrepancy between Swedish imports of nonferrous metals from Estonia – as recorded in Swedish statistics – and similar Estonian exports to Sweden as recorded in Estonian statistics. Note that this is an addition to the well-known problem that Estonian statistics show much more metal exports than imports in spite of the country having no production of its own. Here, underreported imports, sales by withdrawing Soviet army as well as domestic thefts all play their role, as admitted by Estonian authorities. See Neumann (1993). Still, the problems of Estonian trade statistics are minor compared with Lithuania, where all transit and re-export seems to be excluded.

5 Maintaining employment

In spite of the output collapse, Baltic unemployment has not risen to Western European levels. In Lithuania recorded unemployment was in autumn 1993 only 1.5 per cent and seemingly stable. In the other countries unemployment has been somewhat higher and rising, but the available figures still imply a huge drop in productivity.

The Estonian labour market is considered relatively flexible. The trade union movement is weak, and a law on collective bargaining was only passed in 1993[45]. Pensions are state-funded and do not link people to their current jobs. Still, official unemployment figures varied in mid-1993 from 0.4 per cent in the Tallinn area to 6.7 per cent in Voru (Southern Estonia) and 5.9 per cent in Narva (russified North-Eastern Estonia). Lack of a proper housing market is clearly one of the reasons for such regional disparities.

Unemployment has risen steadily to 5.3 per cent in late 1993[46] – though so far more slowly than officially expected[47] – in Latvia and it is currently expected to reach 15 per cent in 1994. As in Estonia, regional variation in unemployment is great. Latvia is currently changing its welfare system to a means-tested direction, and that together with the planned cuts in unemployment benefits – as of late 1993 90 per cent of minimum wages – might be expected to increase labour market flexibility. There is no formal incomes policy outside the public sector and no collective bargaining.

Again, the situation may be different in Lithuania. Though privatized enterprises have in principle full autonomy in employment and wage decisions[48], the still paternalistic insticts of the Lithuanian administration, together with the remaining role of the state even in privatized enterprises, mean that traditional state paternalism still prevails. As noted, there is consequently almost no open unemployment.

Small numbers of open unemployment hide existing levels of underemployment, short working weeks, involuntary vacations and wage arrears. Estimates of such practices necessarily vary, but a "gross" unemployment figure of at least 10 per cent might give a truer picture than those officially recorded[49]. On the other hand, in numerous cases official employment is only nominal. Tax avoidance is the primary reason why people might want to have a nominal state

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[45] On earlier developments see Bolz – Lenzner (1993), pp. 52–57.

[46] Baltic News Service January 5 1994.

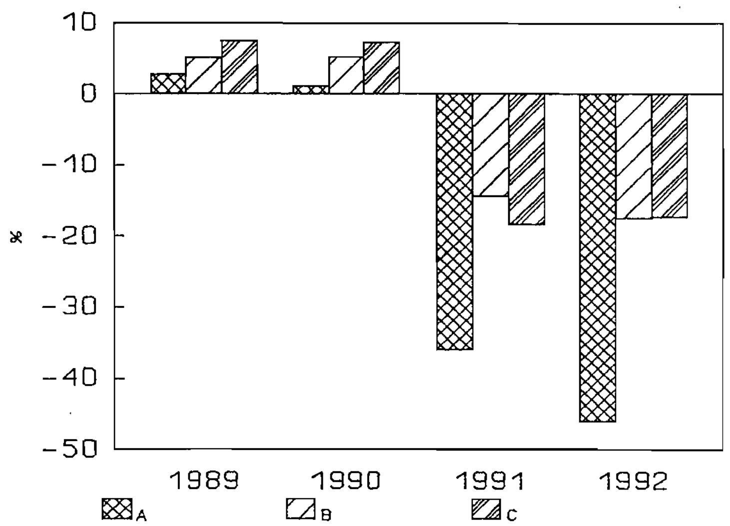
[47] Latvian labour officials expected 20 per cent unemployment in 1993. See Polkowski (1993), p. 48.

[48] Pissulla (1993), p. 36.

[49] For Estonia the EMOR research institute has estimated a gross unemployment figure of 7.9 per cent for the third quarter of 1993. Interestingly the estimated unemployment figure has declined from 9 per cent in early 1993. This reflects the development of Estonian entrepreneurship. See Kaubaleht December 23, 1993 – January 4, 1994.

sector job while actually earning in the private sector. This is another facet of the death of the state sector through attrition referred to above.

Chart 3. **Statistical real wages in 1989–1992**



A Estonia
B Latvia
C Lithuania

Companies finance excess employment primarily through a decline in statistical real wages (see Chart 3). This is particularly true in Lithuania, where state sector real wages declined from 1991 to mid-1993 quite steadily by 60 per cent[50]. In Latvia, on the other hand, state sector real wages dropped from 1990–1991 to 1992 by approximately only 20 per cent. Since that they have remained basically on the same level, with even a clear upward trend in 1993[51]. It is thus not surprising that Latvia is the Baltic country with the largest open unemployment. Estonian real wages collapsed by 40 per cen in early 1992. Since that they have remained stable with some growth in 1993.

Other adjustments to collapsing productivity have been probably of less importance, though wage arrears, tax avoidance, tax arrears and mutual non-payments have all appeared, though to different degree across countries and over

[50] In fact the drop in real wages was so severe that the IMF reportedly pushed the authorities towards more liberal incomes policies – a rare occurrence in itself! – so that Lithuanian real wages are expected to rise through 1994.

[51] State Committee for Statistics of the Republic of Latvia: Bulletin of Latvian Economic Statistics, January – September 1993, p. 70.

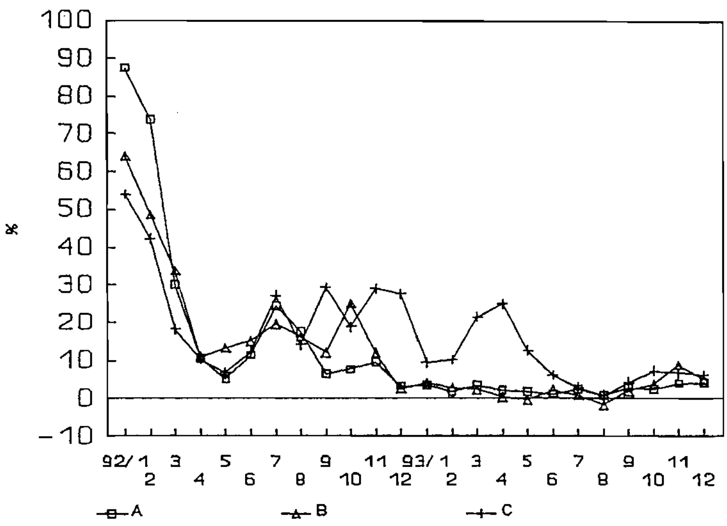
time[52]. Anecdotal evidence also tells of wage payment in unsold goods produced. State administrations in all the three countries are weak, and the impression is created that officials are not always overly anxious to impose financial discipline over enterprises in cases where employment is seriously threatened. The situation is further complicated by the relative importance of Russian-speaking labour force in Estonia and Latvia. On one hand they have very little policy input; on the other governments have to be careful not to antagonize them excessively.

[52] It is sometimes believed that payment arrears have been less a problem in Latvia than in most other economies in transition. This seems to be an exaggeration. Thus, Latvian authorities have had to confiscate enterprise bank accounts to compensate for tax arrears. Statistical authorities have only recently started to collect information on the actual amounts of interenterprise arrears and the government freely admits that it has not yet even formulated its policy in this respect. A secondary market in interenterprise debt will probably be part of the solution.

6 Inflation

The Baltic success in stabilization is well known. Estonia's modified currency board system and Latvia's dirty float have both been accompanied by strict fiscal and monetary policies so that by the end of 1993 monthly inflation in both countries was down to low single digits (Chart 4) and the values of domestic currencies stable[53]. These states have possibly the best post-communist stabilisation outcome in – with the exception of the war-torn countries – probably the worst circumstances. Lithuania, which had been earlier characterised by strict fiscal but slack monetary policies also succeeded in 1993 in getting inflation under a much better control by a notable tightening of monetary policies[54].

Chart 4. **Monthly inflation in 1992–1993**



A Estonia
B Latvia
C Lithuania

The Balts have had the somewhat peculiar habit of debating whether the Estonian currency board solution or the Latvian dirty float with slow appreciation of the currency is "the" right way of stabilisation. Actually, both paths have proved feasible and highly successful, when they have been accompanied by prudent economic policies. The main attraction of the Estonian solution is its high

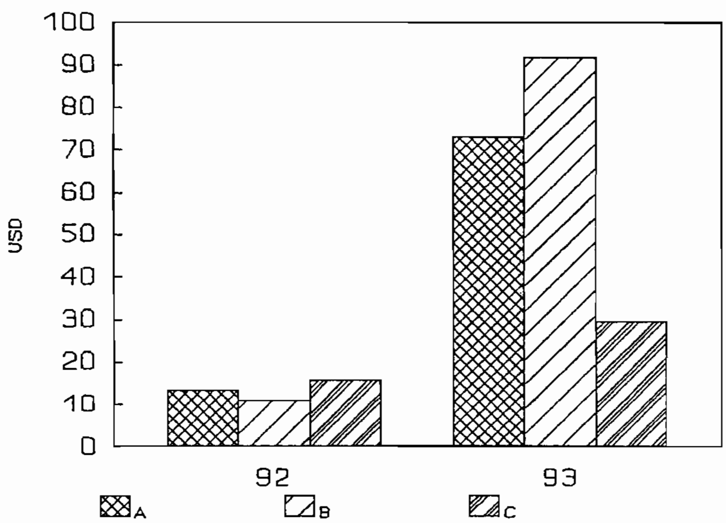
[53] Latvia even went through a short period of deflation, which led to an easing of policies and consequently to higher inflation in autumn 1993. As there were also important singular reasons for the upsurge of price level, this should probably not be seen as evidence of a fundamental policy shift.

[54] In the Lithuanian case the upsurge in inflation towards the end of 1993 may reflect more the influence of political decisions and infighting upon monetary policies than any slackening of central bank policies as such.

resistance to pressure to reflate. Therefore, Estonian achievements should be sustainable. Due to nominal rigidity and the continuing need for relative price shifts the country does not, however, plan for zero inflation[55]. The Latvian solution lacks similar institutional guarantees and is therefore much more dependent on the stamina of policy makers. The underdevelopment of financial markets in Latvia also means that policy makers have only one instrument – interventions in foreign exchange markets – for pursuing two goals, low inflation and exchange rate stability. The policy-makers must therefore increasingly pay attention to developing markets through which to transmit their policies[56].

The Estonian currency board may not be a suitable long-term arrangement. Currency boards elsewhere have developed toward classical central bank systems, and the probability that Estonian policy makers would like to forego the possibilities of monetary policy forever is not high. Estonia's great economic policy challenge is how to move towards a central banking system without endangering the credibility and stability reached. In terms of average dollar wages (Chart 5), the current Estonian rate of exchange (8 EEK = 1 DEM) should remain feasible for some time more.

Chart 5. **Average monthly wages in dollars 1992/1 and 1993/5**



A Estonia
B Latvia
C Lithuania

[55] Rajasalu (1993) forecasts 20–25 per cent inflation for 1994 and 15–20 per cent for 1995. In Latvia, the official inflation forecast for 1994 is 16 per cent.

[56] See 'Program' (1993), Annex 6.

Currently, the post-socialist Lithuanian government is intent on moving to a currency board solution. This may seem surprising, as in 1993 Lithuania seemed able to start to learn the nontrivial art of prudent monetary policies in a floating currency environment. Obviously, the longer-term success of an eventual Lithuanian currency board would depend on the ability to maintain reasonable economic policies. In spite of the improvement in policy record during 1993 recent Lithuanian policy performance is such that a repetition of the Estonian success story is far from being self-evident. The short-term preconditions for a currency board, a nearly balanced budget and sufficient currency reserves[57], are available.

[57] See Hansson (1993).

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