CHAPTER

1 Introduction

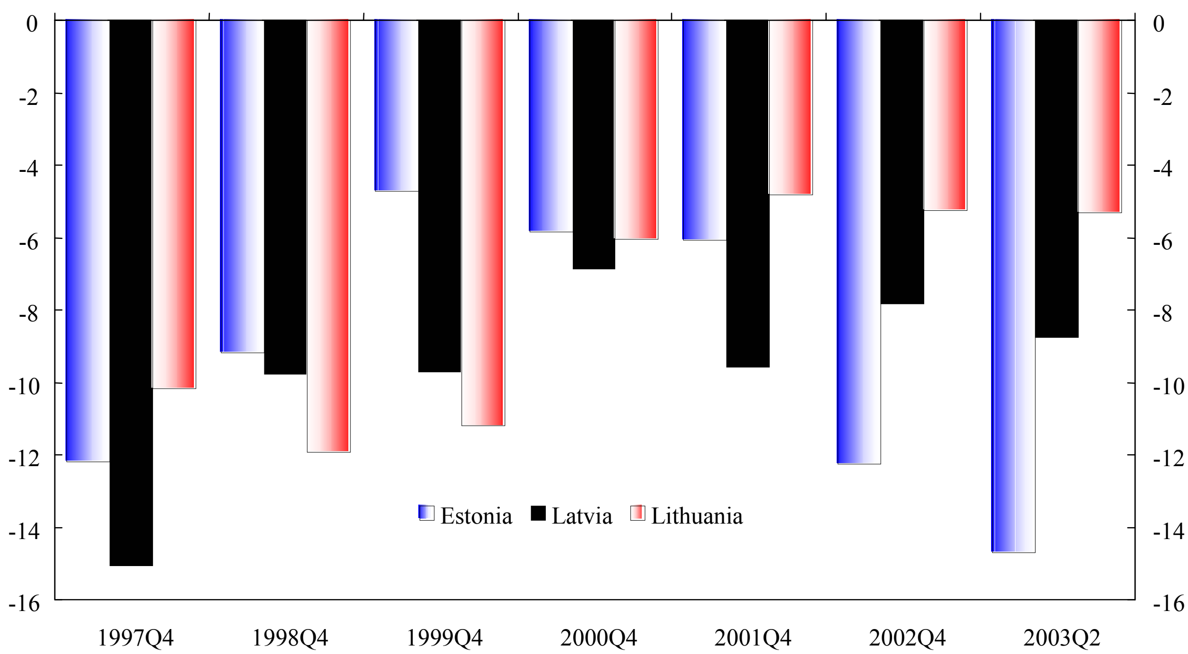
Concerns about the competitiveness of the Baltic economies have reemerged, as current account deficits have widened in Estonia and Latvia, and the real exchange rate has continued to appreciate in Lithuania. Annual current account deficits in Estonia and Latvia are currently running at about 14¾ and 8¾ percent of GDP, respectively (Figure 1).[1] Current account deficits of this magnitude are clearly unsustainable over the medium to longer term. While foreign direct investment (FDI) inflows remain substantial, net external indebtedness has increased.[2] In Estonia, this has been accompanied by persistently strong growth in wages over the last couple of years, in excess of productivity growth. Other indicators, however, including strong enterprise profitability, tend to mitigate concerns about competitiveness. In Lithuania, the current account deficit is 5¼ percent of GDP, and net external debt has fallen. But the litas has continued to appreciate following its repegging from the U.S. dollar to the euro in February 2002, raising concerns about the future competitiveness of Lithuania's exports to

[1]The recent deterioration in Estonia's current account position is largely the result of a decline in the balance of trade in goods and nonfactor services rather than an increase in factor income outflows. The latter are substantial and reflect the profits of foreign companies operating in Estonia, which are recorded as income outflows on the current account. The reinvested share of these profits has typically been high and is recorded as FDI inflows on the capital account.

[2]Mueller and others (2002) estimate that current account deficits in the Baltics of about 6–7 percent of GDP would be consistent with broadly stable levels of external debt. External indebtedness in the Baltics is, however, relatively low by international standards. Moderate increases in external debt ratios over the medium term need not necessarily precipitate a sudden and damaging reversal of capital flows, especially if foreign borrowing is used to finance productive investment that enhances the countries' long-term growth prospects. Similar results are derived from applying a broad range of models to determine sustainable current account positions in the Baltics from a medium- to long-term perspective; see IMF (2003).

Figure 1. External Balances: Current Account Balances

(Last four quarters as percent of GDP)



Source: IMF staff estimates.

countries outside the euro area.[3] Inflation, however, has been low, which has helped to offset (but not fully eliminate) the appreciation in the nominal effective exchange rate.[4] Wages also remain subdued, with real wages declining in 2001 and growing only moderately since then.

The correct policy response, if any, to these developments depends on their causes, specifically whether they reflect short-run cyclical or other temporary factors that can be expected to reverse over the medium term, or a more fundamental underlying deterioration in the competitiveness of the Baltic economies that would call into question the sustainability of their current fixed exchange rate arrangements. At least part of the recent deterioration in the

[3]The euro has appreciated by about 35 percent against the dollar since the repegging.

[4]Consumer price inflation in Lithuania was negative for much of 2002 and 2003.

external position in Estonia and Latvia, for example, reflects a divergence in their cyclical position relative to the EU. This has been exacerbated by low interest rates in the euro area, which have contributed to the relatively easy monetary conditions currently prevailing in the Baltics. Imports into Latvia and Estonia have also been boosted by a number of one-off large investment projects associated, for example, with recent railway privatization and long-term restructuring of the energy sector. The relative cyclical position has not, as yet, had the same impact in Lithuania, where the current account has widened only modestly since 2001 because of the exceptional performance of exports. This report, however, focuses on the second set of issues and attempts to assess the underlying competitive position of the Baltic economies.

These issues are also of particular relevance given the proximity of EU accession. The Baltic states are among the 10 countries that have been invited to join the European Union in May 2004 (currently referred to as "acceding countries").[5] EU accession and the accompanying commitment to work toward eventual adoption of the euro will have a number of implications for the exchange rate arrangements of the Baltic countries (see Box 1). Upon accession, although not necessarily immediately, they will be expected to participate in ERM II.

The concept of international competitiveness, as applied to national economies, is popular but hard to define. An appropriate level of competitiveness in the short run is typically associated with the value of the real exchange rate, which, in conjunction with other domestic policies, ensures both internal and external balance. The terms "competitiveness problem" and "inappropriate real exchange rate" are thus often used interchangeably. Over the long run, however, when real exchange rates are expected to have converged on their equilibrium value, competitiveness is more generally defined in terms of an economy's ability to support increases in living standards.[6] This in turn is largely a function of, and

[5]The other countries are the Czech Republic, Hungary, Poland, the Slovak Republic, Slovenia, Cyprus, and Malta. The accession treaty was signed in April 2003 and ratified following popular referenda in Lithuania in May 2003, and Estonia and Latvia in September 2003. References to acceding countries in the remainder of this report refer to the transition countries of central and eastern Europe (i.e., excluding Cyprus and Malta).

[6]Competitiveness in this sense has been variously defined as "the degree to which a country can, under free trade and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long term" (Organization for Economic Cooperation and Development); "the ability of an economy to provide its people with high and rising standards of living and high rates of employment on a sustainable basis" (European Commission); and "a country's ability to maintain high rates of growth and employment in the medium term" (World Economic Forum).

Box 1. Exchange Rate Aspects of EU Enlargement

The EU has identified three distinct stages for the full monetary integration of candidate countries: the pre-accession stage; the accession stage, covering the period from accession to the EU until the adoption of the euro; and finally the adoption of the euro. Each stage has different implications for the choice of exchange rate policy.

- Prior to accession, there are no formal restrictions on the choice of exchange rate regime, although exchange rate policies, like other economic policies, are expected to contribute to macroeconomic stability and promote real and nominal convergence.
- Upon accession, new member states will be expected to treat their exchange rate policy as a matter of common interest, to participate in the coordination of economic policies, and to work toward fulfilling the Maastricht convergence criteria as a prelude to adoption of the euro. In the interim, they will be expected to join ERM II, although not necessarily immediately.
- Finally, participation in the euro area will be decided as soon as a new member state complies with the conditions for the adoption of the single currency (i.e., the fulfillment of the Maastricht convergence criteria, including participation in ERM II for a minimum of two years), and subject to agreement on the rate of conversion.

ERM II involves stable but adjustable central rates to the euro for participating currencies, with fluctuation bands of plus or minus 15 percent around the central rate. All three Baltic states have indicated their intention to join ERM II as soon as possible after entry into the EU. The EU has indicated that the currency board arrangements of Estonia and Lithuania, with their pegs to the euro, could be compatible with participation in ERM II.[1] The situation for Latvia, with its conventional fixed exchange regime with a peg against the SDR, is different, however, because the EU has determined that pegs against anchors other than the euro are incompatible with ERM II. Latvia will therefore be required to either repeg to the euro or adopt a managed float within ERM II bands around a mutually agreed central rate. In all three cases, any decision regarding participation in ERM II would also be subject to a satisfactory assessment of the appropriateness and sustainability of the arrangements, and mutual agreement on a central parity.

The Maastricht criteria also state that average inflation should be no higher than 1.5 percentage points above the average of the three EMU member states with the lowest inflation rates (which would currently set an inflation limit of about 2.9 percent); the general government fiscal deficit should be no more than 3 percent of GDP; gross general government debt should be no more than 60 percent of GDP; and long-term nominal interest rates on public debt should be no higher than 2 percentage points above the average of the three EMU member states with the lowest inflation rates (which would currently set an interest rate limit of about 6 percent).

[1]The EU has declared that "although currency board arrangements cannot be regarded as an acceptable substitute for participation in ERM II, they may in some circumstances constitute an appropriate unilateral commitment within ERM II. Such a commitment would not impose any additional obligation on the European Central Bank, beyond those deriving from the ERM II resolution and the Central Bank Agreement." See report by the Council to the European Council in Nice (ECOFIN): http://europa.eu.int/comm/economy_finance/publications/european_economy/2001/c2001_01_en.pdf.

Box 2. Survey-Based Indicators of Competitiveness

Survey-based indicators of absolute competitiveness take into account a broad range of factors thought to be related to national economic performance, including value-added produced, the cost of living, the degree of economic openness, the cost of capital, intellectual property, labor costs, labor force characteristics, and human capital measures. The competitiveness of countries and that of firms are regarded as interdependent concepts, with countries ranked according to how their environments sustain firms' competitiveness. Although there have been few formal studies of the relevance of such composite survey-based indicators, they have a high profile among national policymakers, politicians, and business analysts. The two most widely quoted studies were prepared by the World Economic Forum (WEF) and the Lausanne-based Institute for Management Development. Estonia is the only Baltic country that appears in both lists, and has a rank that compares very favorably with the central and eastern European acceding countries, as well as some existing EU member states. Latvia and Lithuania are ranked thirty-sixth and forty-fourth, respectively, according to the WEF report.

Global Competitiveness Lists
(2002 rankings)

	WEF	IMD
Finland	2nd	2nd
Germany	14th	15th
Portugal	23rd	33rd
Ireland	24th	10th
Estonia	**26th**	**21st**
Slovenia	28th	38th
Hungary	29th	28th
Lithuania	**36th**	**...**
Greece	38th	36th
Czech Republic	40th	29th
Latvia	**44th**	**...**
Slovak Republic	49th	37th
Poland	51st	45th

Sources: World Economic Forum (WEF) and Institute for Management Development (IMD).

synonymous with, trend productivity growth. The focus on international competition is thought by some to be irrelevant or misleading since what matters most for achieving higher incomes are the domestic forces that propel productivity growth. Krugman (1994), for example, highlights the dangers of blaming international competitiveness for economic difficulties that are primarily domestic in origin. International comparisons of competitive benchmarks or indicators, however, can yield useful information about national economic performance without necessarily implying competition between nations in the popular ("win-lose") sense of the word. And there is no shortage of available indicators of competitiveness—ranging from the relative price or cost indicators regularly published by the IMF, OECD, and national statistical agencies to absolute measures of competitiveness prepared by the World Economic Forum and Lausanne Institute for Management Development (see Box 2).

This report is organized as follows. Chapter 2 reviews a typical range of competitiveness indicators, in some cases comparing performance against other acceding countries in central and eastern Europe. Chapter 3 briefly assesses recent productivity performance and the extent of convergence with the EU. Chapter 4 analyzes the factors that have affected equilibrium exchange rates in the Baltics, focusing on the role of productivity, and presents some quantitative estimates of underlying exchange rates. The policy implications of these issues are considered in Chapter 5, with particular emphasis on the Baltic countries' goal of EMU membership.