CHAPTER

5 Conclusions and Policy Implications

Since 1999, real effective exchange rates in the Baltics have been quite stable compared to the strong real appreciations experienced earlier in the transition process. REER indicators based on measures of relative prices or costs that are more representative of the traded goods sector have been even more stable. A more direct assessment of competitiveness based on export performance is complicated by the importance of electronics subcontracting in Estonia and oil processing in Lithuania, which are important in terms of trade flows but much less so in terms of value added. Aside from this, exports have generally performed quite well despite the global slowdown.

Strong productivity growth, together with increased capital inflows in response to improved growth prospects, have continued to contribute to the real appreciation of equilibrium exchange rates. Other factors that contributed to the strong real appreciations in the early years of the transition process have, to varying degrees, dissipated. While there is inevitably much uncertainty over estimates of equilibrium exchange rates, an assessment based on a broad range of indicators and analysis of the factors behind exchange rate movements suggests no clear evidence of exchange rate misalignment that would call into question the underlying competitiveness of the Baltic economies or the sustainability of their exchange rate regimes.

The extent of any further appreciation of real exchange rates, however, has important implications for the Baltics' goal of participating in ERM II and adopting the euro at an early stage. Productivity growth in the Baltics has been impressive in recent years and will likely continue to outstrip that in the euro area over the coming years. As a result, equilibrium real exchange rates will tend to continue to appreciate against the euro in the period leading up to and beyond EU accession. Estonia and Lithuania intend to maintain their euro-based currency board arrangements within ERM II, while Latvia intends to adopt a conventional fixed exchange rate peg to the euro within the ERM II fluctuation bands. In all three cases, therefore, real appreciation will tend to result in inflation rates that are higher than in the euro area. The heavy weight of the tradable sector in the Baltics relative to the euro area, however, will limit significantly the extent to which productivity convergence translates into higher consumer price inflation. As such, productivity convergence alone is unlikely to preclude the ability of the Baltics to meet the Maastricht inflation criterion.

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