

BALTIC ACCESSION TO THE EUROPEAN UNION

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During the 1990s, the Baltic states have made extraordinary progress in reforming their economies. A decade ago, few dreamed that the Baltic countries would be negotiating membership in the European Union in the year 2000. Yet, here we are. Their success testifies to their commitment to reform economic structures and to pursue consistent economic policies. This tough policy line has largely compensated for their disadvantageous starting conditions.

Even so, significant differences persist among the Baltic states. These differences illustrate the importance of holding to coherent economic policies in building a market economy. Estonia followed radical, but consistent, reform policies; while Lithuania's commitment to reforms has lapsed at times and been indecisive. Latvia, which once fell squarely between the two Baltic extremes, rapidly closed the gap with Estonia over the past two years. Estonia's efforts were rewarded in 1997 with an invitation from the European Union to start membership negotiations. Latvia and Lithuania were invited to negotiations in 1999. If compared with Central and Eastern European transition economies generally, Estonia and Latvia have fared well with their reforms.

The EU accession process has provided the applicant countries, including the Baltic states, with clear targets for market-oriented reforms. It has motivated reform despite difficult circumstances.

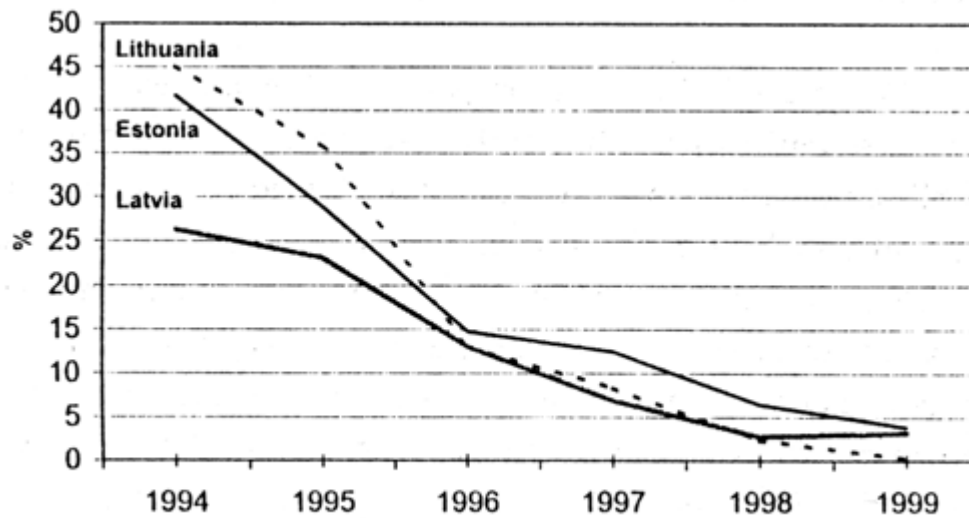
I. Economic Policies

When the Baltic states regained independence in 1991, their economies were, due to their earlier status as Soviet republics, in a much more disadvantageous position than most Central and Eastern European countries. But by the end of the 1990s, the Baltic economies had caught up with those of most Central and Eastern European countries and even surpassed them in many areas. In terms of per capita income, the Baltic states are still at the low end of EU applicant countries. In 1998, their GDP per capita (at Purchasing Power Parity) varied from 27 percent of the EU average in Latvia to 36 percent in Estonia. For the richest Central and Eastern European countries, Slovenia and the Czech Republic, the shares were 68 percent and 60 percent, respectively.

Macroeconomic development has been generally sound in the Baltic states since they regained independence, providing a stable ground for structural and institutional reforms. The clear commitments of Estonia and Latvia to achieving and maintaining economic stability are particularly notable. Throughout the Baltic republics, political consensus strongly favors development of a market economy. Despite changes of government, no major readjustments of economic policies have taken place.

Inflation was brought down rapidly in all the Baltic economies from the extremely high annual levels of 900 percent to 1000 percent in 1992, following price liberalization (Figure 1). Latvia and Lithuania achieved single-digit annual inflation in 1997, Estonia in 1998. The Baltic states posted some of the lowest inflation figures in Central and Eastern Europe in 1998 and 1999. Deceleration of inflation has stabilized the operating environment of enterprises and been instrumental in attracting foreign investment.

Figure 1: End-Year Inflation



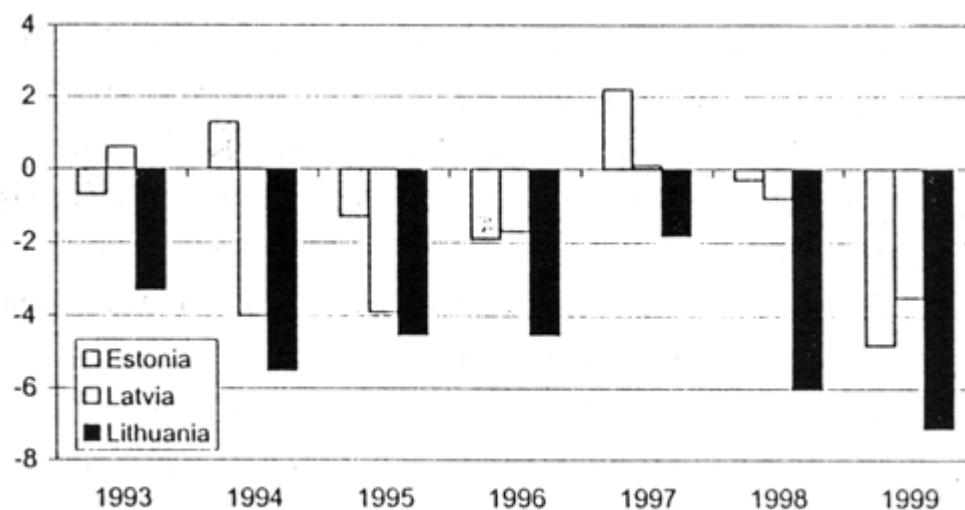
Source: National statistical authorities

The fixed exchange rate regimes of the Baltic countries have been a cornerstone of their economic policies. Estonia moved to a fixed exchange rate in 1992, Latvia and Lithuania followed in 1994. The currency board arrangements of Estonia and Lithuania impose strict institutional limits on economic policymaking. A currency board removes the monetary policy function from the central bank, and by limiting the financing tools of the central bank, it also promotes disciplined fiscal policies. Today, currency boards are widely discussed as a policy option for transition economies, but in 1992, Estonia's reintroduction of a currency board in Europe caused considerable discussion among foreign advisors and specialists about the feasibility of such a system.

Lithuania introduced a currency board in 1994, and the same year, Latvia fixed its exchange rate to the International Monetary Fund's currency basket, SDR. Latvia's stringent monetary policy has been guaranteed by the highly independent position of its central bank. Latvia pursues a traditional monetary policy in principle, but in some respects it follows the stricter currency board principles.

Fiscal policy has been tight in Estonia and Latvia, while Lithuania has followed somewhat less ambitious policies (Figure 2). During the past six years, the general government budget in Estonia recorded a deficit exceeding 2 percent of GDP only once, in 1999. In two other years of that period, Estonia ran surpluses.

Figure 2: Fiscal Balance
per cent of GDP



Sources: EBRD, national authorities

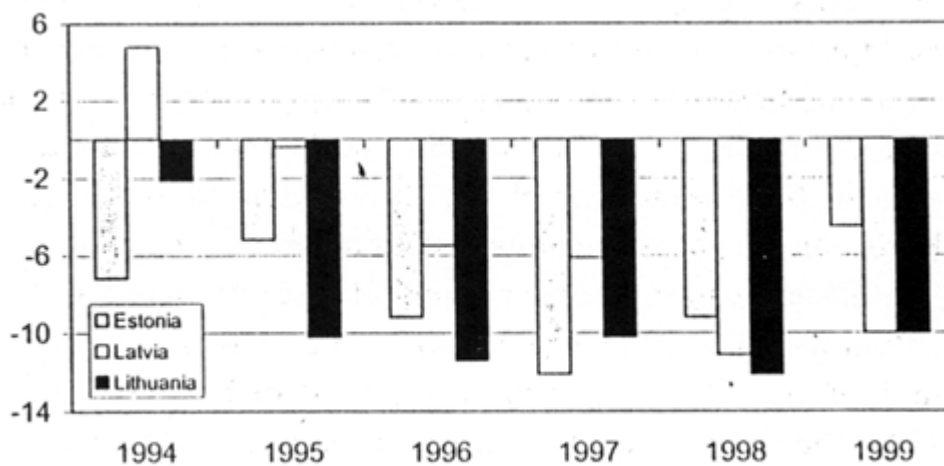
This is a significant achievement for a country that is building state and economic administrations from scratch and simultaneously responding to compelling needs in the social sector, education, etc. Throughout the 1990s, Estonia's fiscal policies have been the tightest among Central and Eastern European countries, as witnessed by budget deficit data.

Despite more frequent budget deficits than Estonia, Latvia has also managed its fiscal policy rather well. In the mid-1990s, Latvia experienced a period of high deficits. In 1994, the deficit was caused by an easing of fiscal policy, while in 1995, the source was a serious banking crisis that caused GDP to decline. Thereafter, deficits fell due to expenditure cuts and enhanced revenue collection.

Lithuania has allowed for higher general government budget deficits than its Baltic neighbors. Since 1993, the budget has recorded a deficit each year. Starting from 1994, deficits have, with the exception of 1997, exceeded 4 percent of GDP. Structural changes in the Lithuanian economy have been slower than in the other two Baltic countries, with the state playing a more active role, for example, in enterprise and agricultural financing.

A more disquieting picture is offered by the Baltic economies' external balance sheet. Lithuania and Estonia have suffered from high deficits for several years now (Figure 3). In Lithuania, the current account deficit has hovered around or above 10 percent of GDP every year since 1995. Estonia considerably reduced its deficit in 1998 and 1999. Latvia has outperformed its neighbors in this area: it has had a current account deficit exceeding 10 percent of GDP only once, in 1998. In 1999, the decline of deficits in all three countries was due to the dampening effect of economic depression on domestic demand.

Figure 3: Current Account Balance
Per cent of GDP



Source: National authorities

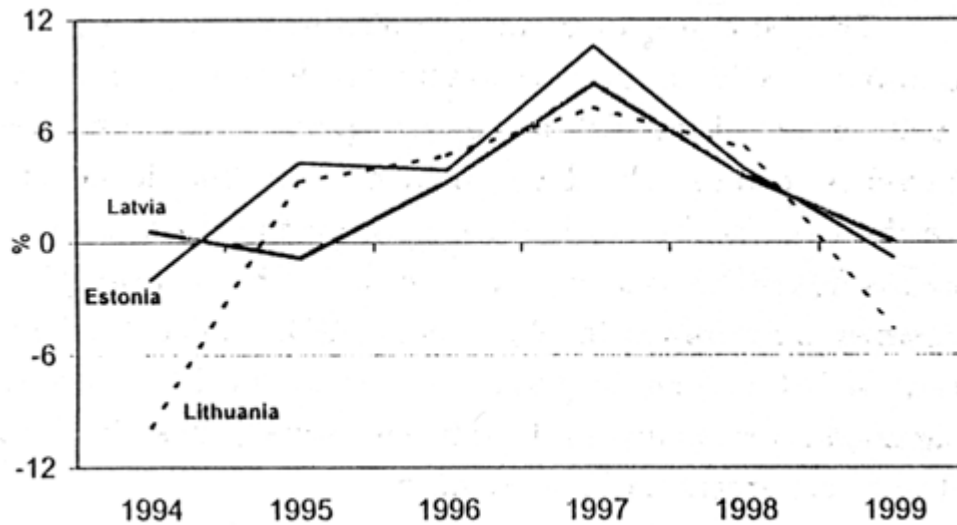
The existence of external imbalances in fast-growing economies with huge investment needs is not negative as such, provided that future imports generate enough foreign currency to repay the debts incurred. This should generally be the case in the Baltic states, where the share of investments in GDP is reasonably high. In 1998, for example, investments amounted to 29 percent of GDP in Estonia, 23 percent in Latvia, and 28 percent in Lithuania. Furthermore, a significant proportion of deficits has been financed by foreign direct investment, not borrowing.

II. The Russian Crisis

After a dramatic collapse of production at the beginning of the 1990s, the Baltic economies started to grow in the middle of the decade. The growth was, however, halted by the Russian economic crisis of August 1998 (Figure 4). According to preliminary information, Estonia's real GDP declined by 0.8 percent in 1999, while in Latvia, GDP grew slightly. In Lithuania, the GDP decline amounted to about 4 to 5 percent. In the latter part of 1999, Estonia's and Latvia's economies turned to growth.

The Russian crisis was reflected in the fiscal development of all the Baltic states. In 1999, Estonia and Lithuania recorded their highest fiscal deficits ever. Their general government deficits reached 4.8 and 7.1 percent of GDP, respectively. In Latvia, the deficit amounted to 3.5 percent. For their 2000 budgets, the Baltic countries have prepared austerity packages that should significantly reduce deficits.

Figure 4: GDP Growth*



Source: National authorities

The Russian crisis revealed economic weaknesses that remained hidden as long as exports to Russia grew rapidly. One weakness was the still considerable dependence of the Baltic economies on Russia and some other former Soviet Union republics. A lack of competitiveness of Baltic products in Western markets was not considered problematic as long as exports to the former Soviet Union were successful. In the long run, however, the Russian crisis should prove beneficial to the Baltics to the extent that it compels them to increase their efforts to penetrate Western markets.

In Lithuania, the government's response to the Russian crisis was to increase enterprise support. This further expanded the country's large internal and external imbalances. The crisis exposed the unsustainability of the Lithuanian government's policy of extending support to several sectors of the economy.

The direct effects of the Russian crisis on financial sectors were most notable in Latvia, where several smaller banks had invested a large share of their assets in Russian financial markets. Indirect effects through payment difficulties of enterprises whose exports suffered were observed in all three countries, but these impacts never threatened the banking system.

III. Structural Policies

During the 1990s, the Baltic countries significantly improved their relative positions among transition economies in regard to the presence of market economy features. This can be readily seen from the transition indicators regularly compiled by the European Bank for Reconstruction and Development. In 1999, the EBRD placed Estonia in fourth place after Hungary, Poland; and the Czech Republic, while Latvia and Lithuania shared seventh place after Slovakia and Slovenia on a list evaluating achievements of transition in each country. With Croatia, these countries form a group that has pulled ahead of other transition economies. At the start of transition, however, the Baltic states' weak initial conditions placed them far behind Central and Eastern European countries.

In several areas, Baltic economic policies-Estonia's and Latvia's in particular- are strikingly more liberal than those pursued in the West. In this respect, the Baltic states also stand out among other transition economies. First and foremost, this concerns external economic policies. In Estonia, a liberal foreign trade system, with practically no import or export tariffs, was introduced in the early 1990s. In Latvia, border protection is limited mainly to agricultural products, while Lithuania's trade policies are more similar to those of Western countries. The Baltic states started to approach Western countries and international institutions immediately after regaining independence. Free trade agreements with European trade partners topped the list, along with the liberalization of capital movements. These policies opened the Baltic markets, and Estonia in particular, to the forces of international competition at an early stage.

In less than a decade, the Baltic states achieved significant trade integration with the EU. At the beginning of the 1990s, only a few percent of Baltic exports went to Western Europe. In 1998, however, Estonian exports to the EU amounted to 55 percent of total exports; in Latvia and Lithuania, the shares were 57 percent and 38 percent, respectively. In 1999, EU's share in Baltic exports increased further, due to a large extent to declining trade with Russia and other former Soviet republics. For Estonia, the Nordic countries-and Finland and Sweden/in particular-are significant trading partners. Russia was Lithuania's most important trading partner until 1999.

When the Baltic states started to build their fiscal systems, they established simple tax schemes, featuring flat tax rates. This made the systems transparent and easy to administer. Tax rates are low by international comparison: 25 percent in Latvia and 26 percent in Estonia for both physical and legal persons. In Lithuania, the tax rate is 33 percent for physical

persons and 24 percent for legal persons. The share of tax income in GDP has remained rather stable during the past few years—well above 30 percent in Estonia and Latvia and around 30 percent in Lithuania—reflecting the systems' satisfactory performance. As in all transition economies, there are problems with tax evasion, but its extent is difficult to quantify. In any case, there is still room for improvement in tax collection.

All the Baltic states have strong institutional requirements for fiscal prudence. The Currency board arrangements and other legislation prohibit central banks from financing public sector deficits. In Estonia, an extrabudgetary stabilization reserve fund was created in 1997 to accommodate budget surpluses and privatization revenues. The reserve fund is kept in Germany. According to a law governing the principles of accrual and use of the fund's resources, the resources are to be used only in exceptional cases for financing, for example, large reform programs, such as the pension reform currently under preparation, or alleviating social crises.

All the Baltic states went through a banking crisis in the 1990s. Estonia was the first to experience it in 1992-1993, and Latvia and Lithuania followed a few years later. In the beginning of the 1990s, numerous small banks emerged in the Baltics while banking sector regulation was still underdeveloped. Several new, inexperienced banks got into trouble quickly and were compelled to close down. These developments made the Baltic states appreciate the importance of well-functioning and credible banking supervision. All the countries follow the internationally agreed Basel principles and EU directives in the design of their financial regulation and supervision systems. The systems are not yet complete, but are, nevertheless, rather comprehensive. The Latvian banking supervision system is one of the best among transitional economies. This is a considerable achievement. At the start of transition, Latvia pursued extremely liberal policies in the financial sphere, letting markets largely control themselves.

Estonia is one of the leaders in privatization among transitional economies both in speed and scope. By the end of the 1990s, Estonia had privatized nearly all of its state-owned enterprises. Infrastructure enterprises, including railways and utilities producers, are now slated for privatization. In Latvia, much of the privatization has been completed, thanks to good progress in 1997-98. Developments in 1999 were disappointing, however. The sell-off of the three largest remaining strategic enterprises (a shipping company, an energy producer, and a telecom operator) was retarded due to economic and political difficulties.

The main methods of large-scale privatization in Estonia and Latvia have been open tenders and direct sales to core investors. Those methods, as a rule, instill better corporate governance and stronger financial position in enterprises than mass privatization or insider deals. Further, foreign participation in privatization in Estonia has never been restricted. Lithuania had taken a more reserved attitude toward foreign participation and favored insiders during the first stages of privatization. Cash privatization was introduced on a large scale only in 1997. Since then, privatization has proceeded rapidly, but Lithuania still lags behind its Baltic neighbors.

Private sectors currently make up 65 to 70 percent of total production in the Baltic states. This corresponds to the average in Central and Eastern European countries. The creation of new private enterprises is important in building a functioning market economy. The institutional setting in Estonia is considered most favorable for entrepreneurial activity. In Lithuania, on the other hand, frequently changing regulations on enterprise activity have been identified as major hindrances. Functioning bankruptcy legislation is essential to imposing financial discipline on the enterprise sector. Again, Estonia is at the forefront among transition economies. In Lithuania, more efficient bankruptcy legislation is currently under preparation.

IV. Accession to the EU

Like other Central and Eastern European countries, the Baltic states began approaching Western international organizations as soon as they regained independence in order to gain access to Western markets and receive support for transition. The Baltic republics established an official relationship with the European Union in 1992, when treaties on trade and commercial and economic cooperation were concluded between the EU and each country. Free trade agreements were signed in 1994. In 1995, the Baltic states applied for membership in the European Union and concluded Association Agreements with the EU. These "Europe Agreements" enhance integration between the EU and applicant countries and prepare applicants for EU membership. With these agreements, a gradually expanding cooperative framework was established. The agreements and related technical and financial assistance from the EU have tied the Baltic reforms to the EU model of a market economy.

In 1993, the heads of member states of the European Union approved the expansion of the EU to former socialist countries. For the accession, three types of membership criteria were established to cover political and economic, as well as legal and institutional spheres.

The political membership criterion calls for the presence of an established democracy with stable institutions, guaranteeing the rule of law, human rights, and protection of minorities. The economic criterion presupposes the existence of a functioning market economy and the ability of the applicant country's economy to sustain competitive pressure of the common market. This criterion contains various elements, including, among others, balanced macroeconomic development, law and contract enforcement, adequate human and physical capital, trade integration with the EU, and an effective state economic policy. The third criterion deals with the legal and institutional ability to take on obligations of

membership, which in practice calls for adoption and implementation of the vast legislation of the European Union (the *acquis communautaire*) in applicant countries.

In 1997, after assessing the political and economic situation of countries 'that had applied for membership, the European Union decided to start negotiations with six. The 'first-wave' comprised Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia. The EU's decision took the view that, in addition to establishing sustainable democracies, these countries had made sufficient progress in economic reforms.

During 1999, general opinion in the European Union increasingly favored enlargement on a wider front. In October 1999, the European Commission recommended extending membership negotiations to all applicant countries fulfilling the political criterion, regardless of their economic readiness. Hence, six 'second wave' countries (Bulgaria, Latvia, Lithuania, Malta, Romania, and Slovakia) were invited into membership talks at the European Council meeting in Helsinki in December. The notable exception was Turkey.

Estonia, the only Baltic country to receive an invitation to membership negotiations in the first wave, was credited for its advanced economic reforms. In 1997, complaints could be heard from Latvia and even more so from Lithuania concerning the EU's decision. Speculation arose, among other things, on the effect that the differentiation would have on Baltic cooperation. In hindsight, however, no negative effects were observed, rather the contrary. By the second half of 1999, when the decision on the 'second wave' countries was taken, Latvia and Lithuania had shown great progress in their reforms. This time, Latvia certainly deserved its invitation to negotiations based on its economic progress.

For the accession process, the European Commission regularly monitors political and economic developments in applicant countries, as well as how closely their legal and institutional systems approximate EU rules and practices. The results are published in annual progress reports, the first of which came out in 1998. The most recent progress reports of the Commission from October 1999 present, with some reservations, a rather positive picture of the Baltic states.

As regards macroeconomic development and the functioning of markets, Estonia continues to rank with Hungary, Poland, and Slovenia as the best-performing applicant countries (the Czech Republic also makes it into this good-performer category). The Commission's report also promoted Latvia to this group of good performers. Latvia is the only 'second wave' country to gain such distinction, due to its considerable progress during the past couple of years. All countries in this group can be considered functioning market economies. The reports also state that Estonia and Latvia should be able to "withstand competitive pressure and market forces within the Union" in the medium term, like all first-wave countries.

The Commission notes that Lithuania failed to proceed as rapidly as had been expected during the past year, in part due to the fact that it was hit harder by the Russian crisis than its two Baltic neighbors. Lithuania should be able to enter the group of functioning market economies during the year 2000, provided its latest round of reforms are implemented as planned. The same concerns Lithuania's ability to face competition in EU markets.

As to legal reforms and institution building, the Commission's latest report again singled out Latvia for its progress. The vigorous reforms in Latvia have to some extent been driven by deep disappointment within the country after the Commission's decisions in 1997 and 1998, despite Latvia's rapid reforms, not to recommend starting membership negotiations. Estonian and Lithuanian achievements in legal and institutional reforms during the past year were somewhat mixed, with good performance in some fields and slow-going in others. Estonia continues, however, to be the Baltic leader in the area of institutional reforms.

Although the two first membership criteria, i. e., the political and economic criteria, are demanding, since they involve deep changes in the structures of the society and economy, the third criterion, institutions, also poses serious challenges to applicant countries. The EU's huge body of rules and legislation has to be approved in applicant countries, organizations must be created to implement laws and regulations, and civil servants need to be hired and trained. For membership negotiations, EU legislation has been divided into 31 chapters covering a wide range of topics from taxation to environment and social policy to agriculture. In membership negotiations, each chapter is dealt with separately. In each case, the applicant country has to adopt and implement all the related legislation or specifically request a transition period to complete the required reforms.

On the one hand, the Baltic states are in a good position, because economic reforms launched at the beginning of the 1990s used Western European legislation as a model. On the other hand, due to limited administrative capacity, the small Baltic nations face difficulties when drawing up detailed EU legislation and recruiting and training civil servants to implement new regulations. Estonia, for instance, was compelled to create a complete customs duty system for which it had no earlier need, given its liberal foreign trade regime.

The Economic and Monetary Union, EMU, which serves to unite monetary policy at the EU level and coordinate member countries economic policies, is one of the basic elements of the EU. New members join the EMU upon accession, but with a derogation from adopting the common currency, the euro. The EU's legal and institutional accession requirements related to EMU oblige applicant countries to liberalize the movement of goods, services, capital, and persons, and to prohibit public deficit financing by the central bank. Further, the central bank must be independent from the government. The Baltic states adopted most of these regulations years ago, and their monetary policy arrangements and tight fiscal

stances largely comply with EU principles. Unlike some of the other applicants, the Baltic economies have already been through a period of adaptation and adjustment.

Upon accession to the EU, new members do not join the third phase of the EMU, which features adoption of the common currency. That takes place at a later stage, when the newcomers fulfill the so-called Maastricht convergence criteria. The criteria establish limits for inflation, public sector deficit and indebtedness, long-term interest rates, and exchange rate movements. These criteria are not monitored during the accession phase, but certain applicants, including the Baltic states, fulfill several of them already.

Maintenance of fiscal prudence, however, may become more difficult in the Baltic countries in coming years because EU-related reforms-such as infrastructure building, social sector reforms, and environmental projects-require significant public financing.

Environmental questions are among the thorniest for all applicant countries. The EU sets strict environmental standards, and transition economies carry a serious legacy of problems inherited from the socialist period. Huge investments, are needed to build new or upgrade existing systems for environmental protection, such as waste water treatment and emissions control. Although the EU is committed to providing financial aid for these ends, domestic financing is also required. Lithuania has a special problem in the area of nuclear safety: the Ignalina nuclear power plant, which is the only nuclear power plant in the Baltic countries. The EU has demanded speedy closure of this Chernobyl-type plant, due to the possible risks involved. Lithuania, for its part, has been reluctant to give up its main source of domestic power generation. In October 1999, the Lithuanian government finally agreed to decommission the first of the Ignalina nuclear power station's two reactors by 2005, thus removing another obstacle to membership negotiations with the EU.

V. The Challenges and Virtues of Accession

Estonia seeks to become an EU member in 2003, along with most first-wave applicants. Also Latvia and Lithuania would like to enter the EU among the first new members. Such goals are optimistic, however, given the huge tasks of economic convergence and legal approximation ahead. In addition, the EU also needs to complete its own internal reforms before it admits any new members. Under the Helsinki Summit decisions of December 1999, the basic reforms of EU institutions should be in force in 2002. Given all the preparatory work, it seems probable that the earliest new members will be admitted into the EU in 2004 or 2005.

The EU membership criteria are extremely demanding for countries whose economies some ten years ago still functioned according to socialist principles. Applicant countries will have to fight hard to meet the criteria. Copious amounts of work are still ahead in the areas of legal and institutional reform. Although the legislative task is in itself huge, the real challenge lies in the implementation of laws and regulations. Applicant countries' administrative systems-including the Baltic states-suffer from the socialist legacy. Public administrations are often weak and lack trained specialists. Further, they are often plagued with bureaucracy and inefficiency, and corruption is not unknown, due partly to relatively low salaries. While public administration upgrading and building of training systems for civil servants continues in all the Baltic states as a part of accession-related reforms, inertia is often deeply rooted in administrative structures. It will take time for new ideas and new ways of thinking to gain acceptance.

This basic reality complicates the EU's assessment of progress in legal and institutional reform. The necessary institutions may well have been set up in an applicant country, but these are likely newly created organizations, whose personnel still lack the qualifications and experience prevalent within the EU. Hence, the actual effectiveness of new systems can only be verified over time. Moreover, the economic criteria of membership, such as the ability to withstand competitive pressures and market forces within the Union, are difficult to define concretely. And they lend themselves to differing interpretations. The European Commission, therefore, carries a daunting responsibility in evaluating the progress of applicant countries.

Accession to the EU has proven important for applicants in their transition to a market economy. It offers countries a clear economic and political target for transition and motivates them to continue with their reforms. EU legislation also provides a tested framework for the creation of coherent legal systems in transition economies, where Western-type economic legislation has been largely absent. Consider transition economies outside the accession process briefly, and the importance of these factors becomes apparent. Most former republics of the Soviet Union still have considerable difficulty creating and implementing consistent market-oriented policies, which partly, at least, may be attributed to the lack of clear targets.

The Baltic states serve as excellent examples of the positive effects of EU accession. When Latvia and Lithuania were left outside the 'first wave' group of accession countries in 1997, they redoubled their reform efforts. Further, the EU's tough line showed it was serious in expecting applicants to execute reforms.

By contrast, the EU's December 1999 decision on starting membership negotiations with all countries fulfilling the political criteria may send a dangerous signal to applicants that some aspects of their reform efforts can be relaxed. As political considerations are given greater weight in membership decisions, the monitoring of economic reforms in applicant countries becomes all the more important. Thus, a clear distinction needs to be made between the political goals of

enlargement and the economic criteria of membership. As some of the economic criteria are difficult to determine anyway, it is crucial that they do not receive a politically colored interpretation.

* The general government budget includes the state budget, local budgets, and extrabudgetary funds. As recommended by the IMF, income from privatization is treated as a financing item rather than budget revenue. These definitions apply to all three countries.