
Economic Developments in the Baltic States: Success and New Challenges

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INTRODUCTION AND SUMMARY

This article provides an overview of the economic developments in the Baltic States since 1991 when they regained their independence from the Soviet Union. The emphasis is on recent years and the economic-policy dilemmas.

Thanks to comprehensive economic reforms, the Baltic States are now open, dynamic market economies. After difficult years in the early 1990s, the countries have gradually regained their economic strength. They have shown the highest growth rates in Europe since the mid-1990s despite a slowdown in 1999 in the wake of the Russian crisis. Unemployment has declined to 4-6 per cent of the labour force, and in 2006 income per capita reached 50-60 per cent of the level in Western Europe.

The Baltic States are now facing new challenges as labour shortages, higher inflation and considerable current-account deficits seem to indicate overheating of the economies. The countries' entry into the European Monetary Union, EMU, has been postponed since inflation is too high to meet the inflation criterion of the Maastricht Treaty.

This article outlines two possible scenarios. One scenario foresees a gradual cooling of the economies, entailing lower inflation rates and smaller external deficits. The other scenario is a crisis scenario with capital flight, exchange-rate pressures and tight credit markets. The result could be a strong drop in demand from the private sector, with the risk of an economic downturn.

The probability of each scenario is difficult to assess. The countries have stable exchange-rate regimes which have proved to be resilient in the past. In addition, they have implemented a number of measures to cool down the economies, although policies are considerably restrained by a lack of economic instruments and the wish to rapidly bridge the income gap to Western Europe.

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BACKGROUND AND REFORM

In August 1991 the Baltic States broke loose from the Soviet Union and regained independence after almost 50 years of Soviet rule. As a result, the Nordic countries acquired three new neighbours on the eastern shore of the Baltic Sea. The Baltic States are relatively small in terms of both area and population. Estonia, the northernmost of the three, has a population of 1.4 million, of which almost half live in the capital, Tallinn. Latvia, whose capital is Riga, has a population of 2.3 million, while Lithuania, whose capital is Vilnius, has a population of 3.4 million, cf. Eurostat (2007a). The countries have considerable national minorities, primarily Russians in Estonia and Latvia, and Poles and Russians in Lithuania.

Until 1991, the Baltic States were an integral part of the Soviet Union, with centrally planned economies, fixed prices and state-owned means of production. However, at the end of the 1980s, the countries gained a certain degree of economic autonomy thanks to Mr. Gorbachev's perestroika reforms. Small private enterprises were allowed, the economies were decentralised to some extent, and the tax systems were restructured.

After having regained independence in August 1991, the countries had to make a number of difficult choices in the establishment of the new market economies that were to replace the planned economies. The cornerstones of the reforms were well-known from Latin America and Central Europe, namely (i) liberalisation of production, trade and prices, (ii) stabilisation of inflation, (iii) privatisation, and (iv) institutional reform, cf. Andersen and Stæhr (2006).

The implementation of the reforms was challenging since the countries had just regained independence, which meant that they had to build up most government institutions from scratch. In addition, the countries' output collapsed, inflation came close to hyperinflation, Russia imposed a trade restrictions, and trade relations with the other former Soviet republics were partly cut off.

Despite their unfavourable starting points, all three countries managed to implement extensive reforms over a period of very few years, resulting in a fundamental restructuring of their economies. By the mid-1990s, the countries had been transformed to market economies in which privately-owned business enterprises accounted for the major share of output. For the sake of brevity, only sample elements of the reforms are mentioned here.¹

¹ The economic reforms of the Baltic States are discussed in more detail in e.g. Berengaut et al. (1998), OECD (2000), Stæhr (2004) and the EBRD's *Transition Report* for the years 1992-2007.

It took the Baltic States only a few years to liberalise their economies. Being very small economies, they opted for a high degree of free trade. In 1992 Estonia completely abolished import duties and quotas and abstained from measures to protect agriculture and other business interests. Latvia and Lithuania maintained certain protective duties, but the tariffs were kept low.

From the outset the Baltic States encountered monetary instability with surging annual inflation that reached around 1,000 per cent in all three countries in 1992. The reason was a strong expansion of the money stock in the rouble zone. Each former Soviet republic thus issued money, expecting the inflation burden to be borne by all countries in the zone. It was therefore necessary to decouple the Baltic States from the rouble zone in order to stabilise inflation. In June 1992 Estonia was the first country to introduce its own currency, and the exchange rate was fixed against the D-mark via a currency board, i.e. the domestic money stock is fully covered by reserves in foreign currency. In 1994 Lithuania introduced a currency board too, but chose to peg its currency to the dollar. In 1994 Latvia introduced a more conventional fixed-exchange-rate regime vis-à-vis the SDR, i.e. the basket of currencies fixed by the International Monetary Fund, IMF, while maintaining a very high level of reserves to domestic money stock, cf. Berengaut (1998), Chapter III.

The three countries chose different approaches to privatisation. Estonia opted for the most radical solution, which was to sell as many business enterprises as possible to foreign investors. Latvia and Lithuania initially opted for complex coupon privatisation schemes for distribution of businesses to their citizens, but these countries subsequently chose to sell many state-owned enterprises to foreign investors. Most of the banking sector is foreign-owned in all three countries.

The Baltic States implemented a large number of structural and institutional reforms concerning banking and finance, property rights, business liquidation, regulation and public administration. The most notable reform may be the introduction of the "flat tax", whereby all private individuals pay the same percentage of their income above a certain basic allowance. Estonia was the first to introduce a flat tax rate in 1994, followed by Lithuania later in 1994 and Latvia in 1995. A number of other Eastern European countries have since adopted the same model, cf. Saavedra et al. (2007).

As a result of the reforms, the Baltic States soon became integrated into the international economy and the major European institutions. In particular, close relations have been established between the Nordic countries and the Baltic States. Estonia was invited to open negotiations on EU accession in 1997, while Latvia and Lithuania were invited

in 1999. All three countries joined the EU in May 2004, which was a stamp of approval to show that they had attained functioning and adaptable market economies – one of the Copenhagen criteria that candidate countries have to fulfil prior to joining the EU.

Overall, the Baltic States have shown great commitment to reforms despite their unfavourable points of departure. Quantification of the extent of reform and the degree of market orientation place the Baltic States far ahead of the other countries that emerged from the collapse of the Soviet Union. Such quantification also shows that the Baltic States have reached almost the same level as the former Communist countries in Central Europe, cf. Andersen and Stæhr (2006). In several areas the Baltic States have chosen unconventional or radical solutions, in most cases pioneered by Estonia, cf. Laar (2002).

GROWTH AND INCOME CONVERGENCE

Until the late 1990s economic policy aimed at establishing national autonomy, abolishing the planned economy and laying down the framework for a dynamic market economy. Subsequently, the principal aims of economic policy were compliance with the requirements for EU membership and further structural reform of e.g. pension systems, social legislation and education systems.

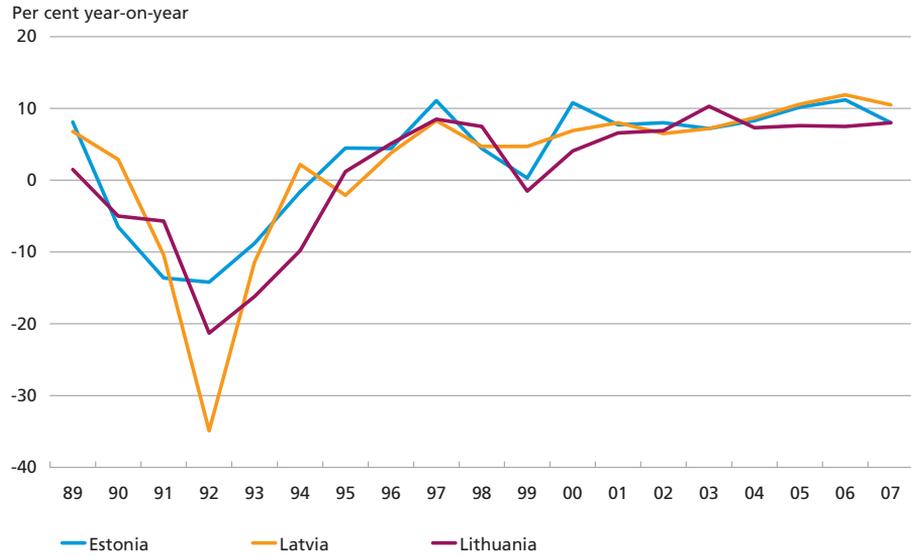
From the outset the cornerstone of economic policy in Estonia, Latvia and Lithuania was to generate economic growth with a view to enhancing the living standard, cf. Vilpisauskas (2005). Already at the time of independence in 1991 it was clear that the countries' income levels were considerably lower than those of their Nordic neighbours and the other Western European countries. The opening of borders and the ensuring travel activity made it clear to a large part of the populations how wide the income gap was. According to IMF statistics, in 1992 PPP-adjusted GDP per capita was approximately 25-35 per cent of the Danish level at the time, cf. IMF (2007a).¹

Chart 1 shows economic growth in each of the three countries since 1989. There are three notable features. Firstly, output plummeted before and after independence in 1991. It can be argued that the official output figures to some extent overestimate the actual drop, due to such factors as insufficient statistical coverage of production in the new emerging private sector, cf. Andersen and Stæhr (2006). Private consumption declined less than output as e.g. investments and military expenditure were reduced strongly in the period.

¹ In the inter-war years the three countries' income levels were 40-60 per cent of the Swedish level (and hence also the Danish level), cf. Central Statistical Bureau of Latvia (2002). The following 50 years of Soviet rule further widened the income gap to Western Europe.

ECONOMIC GROWTH IN THE BALTIC STATES

Chart 1



Note: IMF forecast for 2007. Data for the period before 1995 is subject to large uncertainty.
Source: IMF (2007b) and EBRD (2007) before 1994.

Secondly, the Chart shows an economic downturn after the Russian crisis in 1998-99. Exports to the eastern neighbour of the Baltic States collapsed when Russia defaulted on its government debt and had to devalue the rouble. Estonia and Lithuania were the most severely affected, but for all three countries the downturn was short-lived because they quickly managed to restructure their foreign trade and redirect exports to Western Europe.

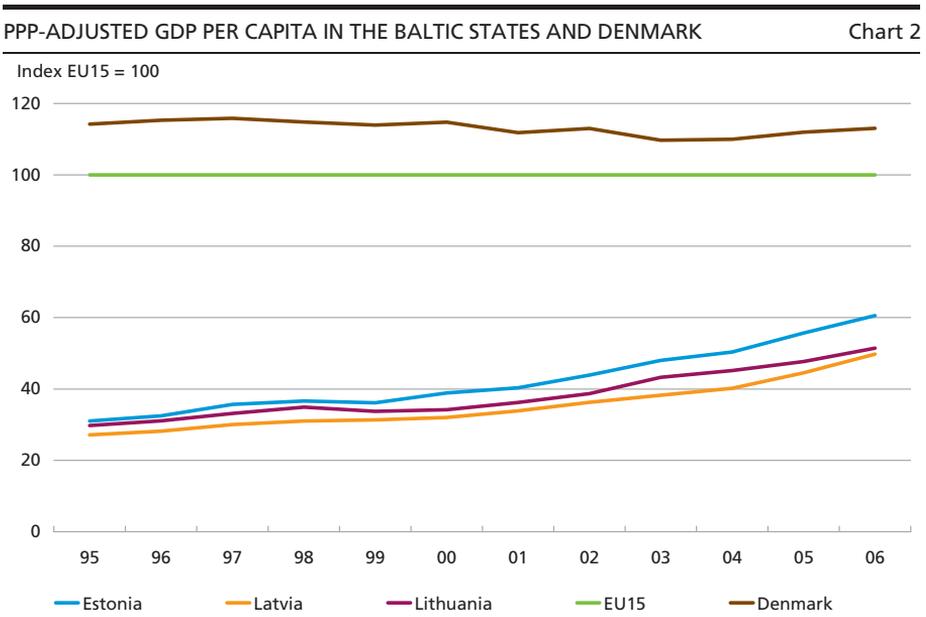
Thirdly, Chart 1 illustrates the very strong growth in the region since 2000, with annual growth rates of 6-12 per cent and a tendency for increasing growth after EU membership in 2004, at least in Estonia and Latvia. These growth rates and their relative stability have caused some observers to use the term "Baltic tigers" about these countries, borrowing the term frequently applied to the high-growth economies in Asia, cf. IHT (2003).

The natural or trend growth rates of the Baltic States are difficult to estimate, due to the very short time series for output, employment, capital stock, etc. Lithuania's growth rate of 7-8 per cent is probably at the level of the medium-term natural growth rate, while the growth rates of Estonia and Latvia have probably been somewhat higher in recent years than what is compatible with price stability in the longer term. The high growth brings about a gradual narrowing of the income gap to Western Europe.

All three Baltic States have considerably lower income levels than the Nordic countries and the rest of Western Europe. Chart 2 shows PPP-adjusted GDP per capita for the Baltic States compared with Denmark and the EU15 average.

The high growth rates since 1995 have entailed a considerable narrowing of the income gap to Western Europe. PPP-adjusted GDP per capita was around 30 per cent of the EU15 level in 1995, while it had reached 50-60 per cent in 2006. Estonia, which is the most affluent of the three countries, has seen somewhat higher growth than the other two, but the income gap to Western Europe is still significant. In all three countries a key objective for policy-makers is to continue the rapid convergence with the income level in Western Europe.

Considering the Baltic States' well-educated labour force, strong capital built-up and largely well-functioning institutions, there should still be potential for continued growth above the Western European level. Income convergence is important to the welfare of the population, as higher incomes pave the way for improved living standards and more favourable social conditions. The latter is particularly important because the income distribution is relatively unequal in these countries where the upper income quintile earns on average 6-7 times as much as the lower income quintile. The corresponding inequality measure for Denmark is 3.5, while it is 4.8 for EU15, cf. Eurostat (2007c).



Source: Eurostat (2007b).

One important effect of the high economic growth has been a considerable reduction of unemployment in all three countries. Chart 3 shows the EU harmonised unemployment rate since 1999. The decline in unemployment has been very strong since the turn of the century, especially in Lithuania.

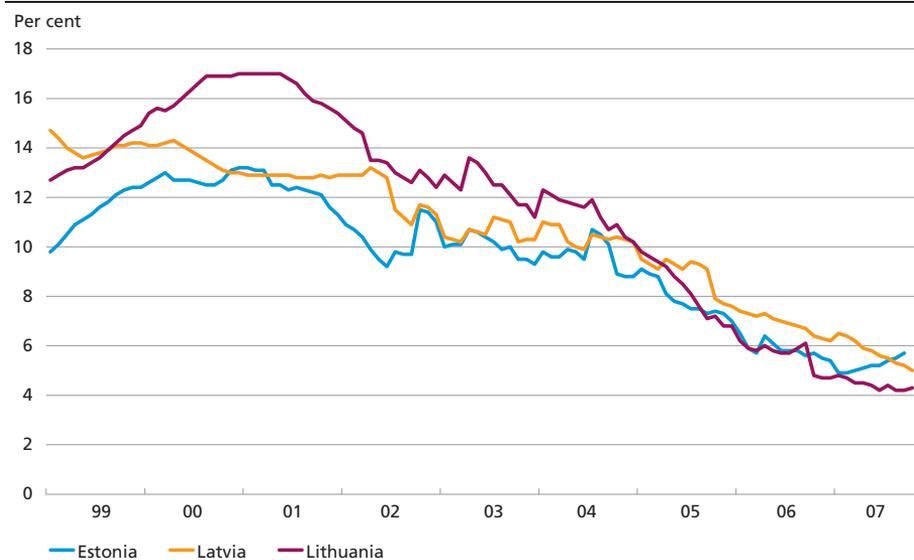
The Baltic States' policy objectives of rapid income convergence and low unemployment have an extra dimension, namely to restrain emigration. The latter is a priority area considering the countries' small populations and ongoing reconstruction processes after decades of occupation. As a result of the Baltic States' EU membership in 2004, the UK, Ireland and Sweden allowed Baltic citizens to freely take up residence and employment in these member states. It is relatively easy for the highly-educated to get a work permit in the other EU member states.

There are no reliable statistics for emigration since 1991, or for that matter since the Baltic States joined the EU in 2004. One reason is that it is difficult to determine when exactly a person has emigrated. It is also difficult to track an individual emigrant who may work in Sweden, but has retained his/her registration in the home country.

An interview-based analysis in 2005 showed that among the EU member states the percentage of the population that wanted to emigrate was highest in the Baltic States and Poland. Approximately 7 per cent of the population in Estonia and Latvia thus expected to move to another EU member state within five years, while the corresponding figure for

UNEMPLOYMENT IN THE BALTIC STATES, SEASONALLY ADJUSTED

Chart 3



Source: Eurostat (2007d).

Lithuania was around 9 per cent, cf. Vandenbrande et al. (2006). Data from Finland, the UK and Ireland shows considerable immigration from the Baltic States, leading to a shortage of certain types of labour, e.g. doctors, engineers, technical staff and craftsmen, in the Baltic States.

INFLATION AND EMU MEMBERSHIP

As mentioned previously, after regaining independence Estonia and Lithuania opted for currency boards and Latvia for a traditional fixed-exchange-rate regime in their efforts to stabilise inflation from almost hyperinflation. During the 1990s the three countries succeeded in reducing annual inflation to below 10 per cent, and they have retained their chosen exchange-rate regimes with only very few adjustments despite considerable financial shocks, e.g. in connection with the Russian crisis. Estonia switched anchor currency from D-mark to euro on the introduction of the euro in January 1999, Lithuania switched anchor currency from dollar to euro in 2002, and Latvia chose to target the euro as from 2005.

Chart 4 shows annual consumer price inflation on a monthly basis since 1999. Inflation was relatively low in all three countries until 2004, although it was generally higher in Estonia than in the other two countries. Lithuania's switch of anchor currency from dollar to euro entailed a considerable real appreciation of its currency, which led to negative inflation from mid-2002 to mid-2004.

CONSUMER PRICE INFLATION

Chart 4



Source: Eurostat (2007e).

Inflation rose in all three countries when they joined the EU in May 2004, caused by e.g. higher food prices. The price hike was particularly strong in Estonia due to the prior absence of protection of the agricultural sector or duties on most other imported goods. The inflation increase in 2004 turned out to be more persistent than expected. In 2004-06, annual inflation in Latvia was around 6-7 per cent, while it was a few percentage points lower in Estonia and Lithuania. However, inflation rose further in 2007, reaching more than 10 per cent in Latvia in August.

The higher inflation in recent years is driven by several factors. In general, trend inflation is high in countries with high economic growth and a fixed exchange rate, cf. the Balassa-Samuelson effect. High productivity growth in traded sectors leads to wage increases that influence wages in non-traded sectors, entailing strong price inflation in the non-traded sectors. Such structural inflation is an unwanted side effect of a basically favourable development, i.e. high economic growth, but is difficult to combat under a fixed-exchange-rate regime, cf. Dobrinsky (2006).¹ However, the higher inflation since 2004 is also driven by a number of specific shocks such as higher energy prices, administrative prices and indirect taxes. Furthermore, it probably also reflects increased pressures on the product and labour markets, against the background of high growth and declining unemployment.

In recent years inflation in Estonia, Latvia and Lithuania has reached a level where it interferes with economic decision-making and thus becomes a cause of concern. The high inflation rates also prevent the countries from joining EMU. The three countries' EU membership entails an obligation to apply for EMU membership as they – unlike Denmark – have no derogation. Entry into EMU as soon as possible is a priority goal for policy-makers in the Baltic States.

EMU membership assumes compliance with the Maastricht criteria, i.e. a stable exchange rate, small budget deficits, a relatively small government debt and converging interest rates and inflation. The Baltic States have long complied with the first four criteria, but have been unable to meet the inflation criterion. According to the inflation criterion, the inflation rate measured by the Harmonised Index of Consumer Prices, must not exceed a reference value, which is calculated as the average of the inflation rates of the three EU member states with the lowest inflation plus 1.5 percentage points.

¹ It is important to point out that domestic inflation as a result of the Balassa-Samuelson effect does not erode international competitiveness, which is solely determined by the price of traded goods.

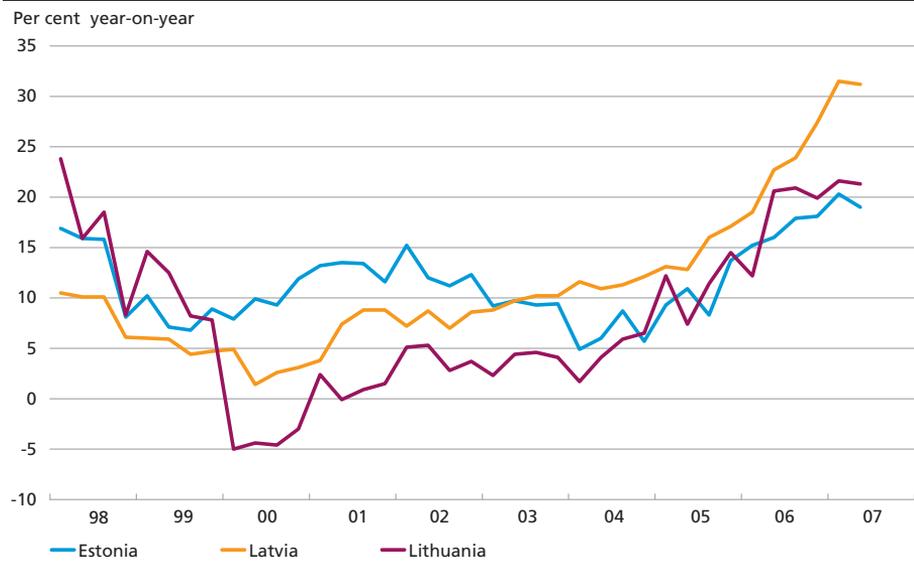
Lithuania is the only Baltic State to have applied for EMU membership, but according to the 2006 convergence reports of the European Central Bank and the European Commission, Lithuania did comply with the inflation criterion. Specifically, the inflation rate in Lithuania was 0.1 percentage point above the reference value and it was expected to increase in future, cf. ECB (2006). Lithuania's application was therefore rejected.

All three countries are still in ERM II, i.e. the waiting room for member states before EMU membership. It is uncertain when inflation will fall sufficiently for the countries to meet the inflation criterion. In this connection it is worth noting that the enlargement of the EU to 27 member states has brought about a lower reference value than before, which means that it is even more difficult to meet the inflation criterion, cf. Lewis and Staehr (2007).

The labour markets in the Baltic States are generally regarded as flexible and market-oriented. However, the question is how wage formation will be affected by the declining unemployment and the rising inflation – and whether a wage and price spiral will emerge.

Chart 5 shows growth in nominal wage costs in the Baltic States since 1998. There are clear signs of considerable wage pressures in recent years, particularly in Latvia. The very large wage increases should, however, be viewed against the background of the high real GDP growth and high inflation in these economies. At the same time, there may be a catching-up effect in relation to the functional distribution, as the wage share was previously very low.

NOMINAL WAGE COSTS Chart 5



Source: Eurostat (2007f).

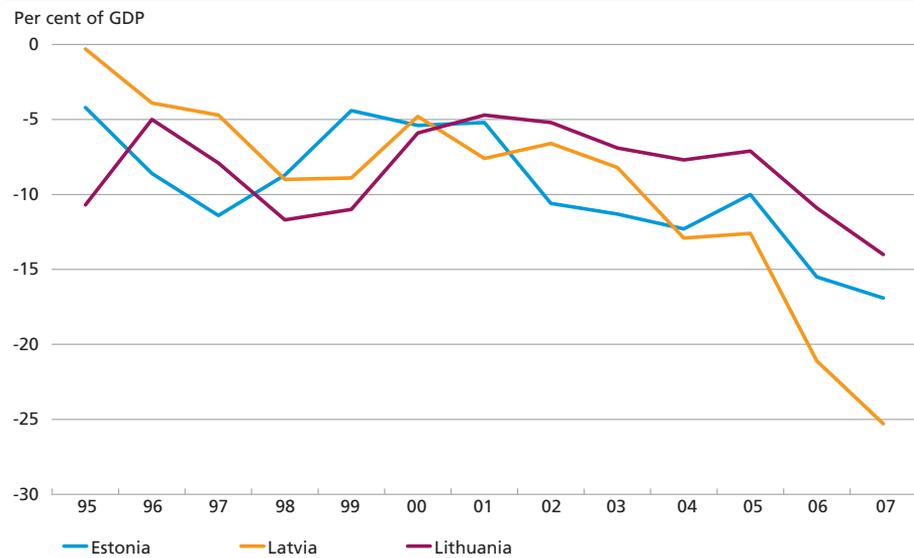
The Chart also illustrates the pronounced fluctuations in the rate of nominal wage increase observed over the years. The curve for Lithuania even shows a wage decrease from 1999 to 2000. Overall, this suggests considerable flexibility with wage growth adapting to the cyclical position. If this interpretation is correct, the countries are still facing the problem that recent years' economic upswing can lead to considerable nominal wage increases, which may in turn contribute to higher inflation.

IMBALANCES

Inflow of capital from abroad has been a key driver of the high growth in the Baltic economies. These countries are attractive investment targets since high returns are expected, while legislation and regulation of the financial markets are compliant with international rules. As regards the balance of payments, the capital inflow has generated large capital-account surpluses and substantial current-account deficits.

Chart 6 shows the current account of the balance of payments relative to GDP since 1995. There were considerable deficits in the period, although with some moderation in the years immediately after the Russian crisis, when the unrest in the global financial markets temporarily reduced the capital inflow. The current-account deficits have risen significantly in all three countries in recent years, with Latvia accounting for the strongest increase.

BALANCE OF PAYMENTS - CURRENT ACCOUNT Chart 6



Note: IMF forecast for 2007.
Source: IMF (2007c).

The composition of the capital inflow has changed considerably in recent years. From the 1990s until the Baltic States joined the EU, a very large share of the current-account deficits was financed by direct investments, which do not increase the external indebtedness of the recipient country. The direct investments could be attributed to privatisation of state-owned enterprises as well as establishment of new enterprises in the Baltic States. Recent years' capital inflow has primarily consisted of bank and bond loans either raised directly by businesses in the Baltic States or channelled to enterprises and households via the banking sector.

The substantial capital inflow in 2005-07 is mirrored in strong domestic credit expansion. In Estonia, the stock of loans to non-financial corporations and households thus increased from 48 per cent of GDP in 2004 to 95 per cent in 2006. In Latvia, the loan stock increased from 51 to 93 per cent of GDP, and in Lithuania from 29 to 54 per cent of GDP, cf. IMF (2007d, p. 38). In 2006 the loan stock in Estonia and Latvia, as a share of GDP, roughly corresponded to the average level in Western Europe. Another notable feature is that most of the loans to business enterprises and households are denominated in foreign currency, typically euro. In Estonia and Latvia more than 70 per cent of the loan stock is denominated in foreign currency, cf. IMF (2007d, p. 41). As a result, the borrowers are highly exposed to exchange-rate changes. One consequence of the improved access to loans for business enterprises and households has been surging real-estate prices, which in turn have made it easier to provide collateral for loans.

The high growth rates, rising inflation and considerable current-account deficits can be regarded as signs of overheating of the economies in the Baltic States, particularly in Estonia and Latvia. This raises the issue of whether a correction will take place in the near future and especially what form it may take. Two scenarios are indicated.

The first is a "soft landing" with gradual, controlled adjustment. In this scenario, various factors will bring economic growth down towards the trend growth, inflation will subside and capital imports will be reduced. First, one possibility is that the capital inflow to the Baltic States will be gradually reduced, e.g. as a result of the international financial turmoil that started in the US loan markets in the summer of 2007, cf. IMF (2007d). Second, the demand for loans in the Baltic States may decline in a situation where much of the population has already taken out substantial loans.¹ Third, the increasing real wages will re-

¹ In all three countries growth in new lending seems to have subsided somewhat during 2007, even though it is still considerable. For example, the stock of loans from Estonian banks to households and non-financial corporations rose by 61 per cent in the 12 months up to October 2005 and by 65 per cent in the 12 months up to October 2006, but "only" by 40 per cent in the 12 months up to October 2007, cf. Eesti Pank (2007). The pattern is similar in the two other Baltic countries.

duce competitiveness and help dampen economic growth. Fourth, various policy measures may contribute to a soft landing, as described below.

The second scenario is a "hard landing", i.e. a financial crisis scenario. In this scenario, a shift in expectations may lead to capital flight from the Baltic States, entailing pressure on the exchange rates and tight credit markets. This will significantly reduce domestic demand, leading to an economic downturn. A number of observers have emphasised that the crisis scenario can become reality, especially if nothing is done to cool down the economy. The concerns related initially to Latvia, but Estonia and sometimes Lithuania have later been described as vulnerable, cf. IMF (2007d) and IHT (2007b).

It is notoriously difficult to predict financial crises with any degree of precision.¹ Statistical analyses of financial crises have failed to identify individual factors or certain variables as reliable indicators of a future crisis, cf. Kaminsky et al. (1998). The current-account deficits of the Baltic States have received attention, but many of the countries that were affected by the financial crisis in Asia in 1997 had negligible current-account deficits or even surpluses.

Another argument against the crisis scenario is that it is not clear whether the currencies in question stand to be devalued or revalued. The high growth rates and the inflationary pressures may warrant revaluation, whereas the large current-account deficits point to devaluation. In other words, there is no indication of any unambiguous imbalance in the present fixed-exchange-rate regimes.

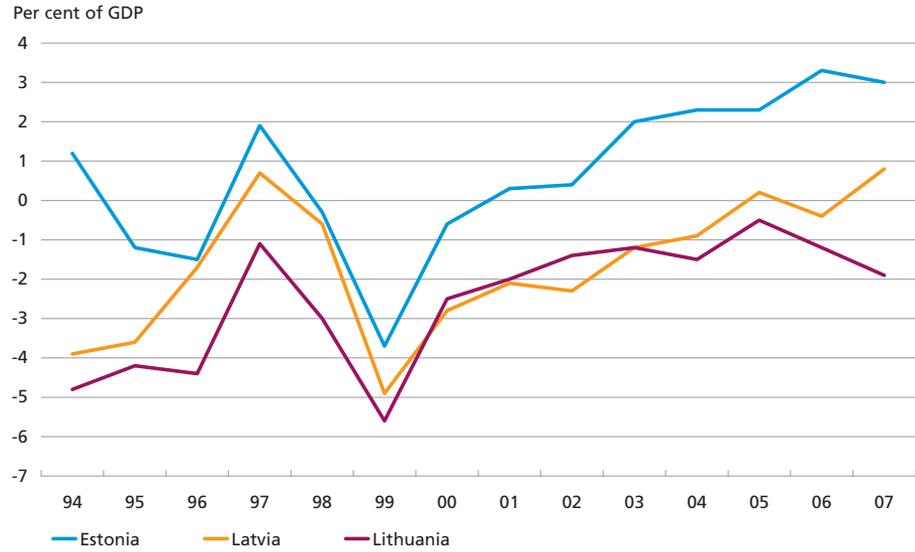
The high economic growth rates in the Baltic States will make it easier for them to service their external debt in the future, assuming, of course, that their industry structure is adaptable so that the traded sector can expand sufficiently in the future, cf. IMF (2007d). The resilience of the countries' exchange-rate regimes and financial systems in previous situations has also been emphasised. This applied both in the crisis years until 1995 and during the Russian crisis. Finally, the national authorities have implemented a number of measures to prevent overheating of the Baltic economies.

Chart 7 shows the development in the overall government budget balance in the three countries since 1995. Fiscal policies have been relatively restrictive in recent years, especially in comparison with the situation in the 1990s. Estonia has shown considerable government surpluses, Latvia's deficit has been reduced, and a surplus is expected

¹ The economist Yoram Bauman has said that "macroeconomists have predicted nine out of the last five downturns", with a slight twist of a Paul Samuelson dictum (<http://www.standupeconomist.com/>). The proportion of false alarms is probably even greater for analysts predicting financial crises.

CONSOLIDATED GOVERNMENT BUDGET BALANCE

Chart 7



Note: IMF forecast for 2007.

Source: EBRD (2007) and IMF (2007d) for 2006 and 2007.

in 2007, while Lithuania's deficit has been in the range of 1-2 per cent of GDP. Fiscal policy is difficult to assess in a situation with high economic growth. Many observers have argued that especially Latvia and Lithuania should tighten their fiscal policies under the present circumstances, cf. IMF (2007d). In 2007, the two countries indeed began to tighten fiscal policy. The Latvian authorities have thus made a commitment to balance the budget for 2007 as an element of a major stabilisation package. Lithuania suspended the supplementary budget for 2007, and in November 2007 a new act came into force, stipulating that as from 2009, the government budget must always be balanced.

Other measures may also help to stabilise the economies. Estonia has on several occasions raised the reserve requirements imposed on the banks, in order to dampen lending growth and thus the inflow of foreign capital. Latvia, too, has raised the lending requirements for the banks and introduced requirements for better risk assessment of borrowers. In addition, Latvia is planning to impose tax on increases in the value of real property, while also preparing measures to increase the supply of labour. Lithuania has taken the unconventional step of seeking to dampen inflation through direct negotiation with the retail sector.

CONCLUSION

Denmark's Baltic neighbours have experienced remarkable changes since regaining independence in 1991. They have been on a ride on the economic roller coaster with a deep recession, a short upswing, a new downturn in connection with the Russian crisis, and then again full speed ahead since 2000.

These countries' economic success has given rise to a number of imbalances in recent years, including rising inflation and considerable current-account deficits. This represents a dilemma for policy-makers. The objective of rapid income convergence with Western Europe is a high priority in view of the countries' low income levels and the risk of extensive emigration. Against this background, it is perhaps not surprising that policy measures to counter these imbalances have been initiated at a relatively late stage.

It is important not to let the imbalances overshadow the fact that the countries have shown very high growth rates for many years. If growth rates of at least 6 per cent can be sustained, the three countries' income levels will catch up with the Western European average within 15-20 years. By then, the economic wounds left by 50 years of planned economy and the subsequent transition period will have healed. In this connection, subsidies from the EU social and regional funds can prove valuable if applied efficiently.

Short-term uncertainties are primarily associated with the developments in the financial markets and the issue of when inflation will fall to a level that enables the countries to join EMU. In the slightly longer term one of the greatest risk factors is probably the development of the countries' economic and political institutions. In this respect there is still a need to combat corruption and abuse of power, ensure rule-based decision-making by the authorities and strengthen public administration. Another concern is the development in Russia, which potentially has great economic significance to the Baltic States. From time to time, Russia has imposed trade restrictions, reduced transit transport and interrupted oil supplies to the Baltic States, cf. IHT (2007a). Nowadays, such shocks have less economic significance than previously, but hinder the expansion of economic relations with the eastern neighbour of the Baltic States.

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