



Macroeconomic Trends in the Baltic States Before and After Accession to the EU

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7.1 INTRODUCTION

The three Baltic states, Estonia, Latvia and Lithuania, joined the European Union on 1 May 2004 in the first round of enlargement to include countries from Central and Eastern Europe. Developments in the Baltic states have however been intricately linked with those in the EU since the

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countries regained their independence in 1991 and this also applies particularly to the macroeconomic trends in the three countries.

This chapter discusses key macroeconomic and structural developments in the Baltic states before and after they joined the EU. The experiences of the Baltic states are particularly interesting because they are the only EU members from the former Soviet Union. The macroeconomic developments are a consequence of the Baltic states having small and open economies, but they also arise from the institutional frameworks and economic policies of the countries. It follows that there are numerous ways in which the EU has directly or indirectly affected macroeconomic developments in the Baltic states.

The Baltic states aspired to join the European Union at an early stage after they regained their independence, since economic and political integration with Western Europe was widely seen as a cornerstone in the nation building process. The countries joined the EU in May 2004, but their admission was merely the culmination of a gradual process of integration that had first started in the early 1990s. This means that it is often difficult to identify the exact or direct effects of the EU on macroeconomic developments in the countries. Moreover, although there are many similarities between the three countries, there are also important differences that are rooted in history, geography and economic structures, including differences that are important for the relationship of the countries with the EU (Poissonnier 2017).

The rest of the chapter is organised as follows. Section 7.2 discusses briefly the EU accession process of the Baltic states. Sections 7.3, 7.4, 7.5 and 7.6 consider key macroeconomic developments from the early 1990s up to 2019, by which time the countries had been members of the EU for 15 years. Section 7.7 considers selected broader long-term developments. Finally, Section 7.8 provides some perspectives on the key macroeconomic challenges facing the Baltic states.

7.2 JOINING THE EU

The Baltic states regained their independence from the Soviet Union in August 1991 and the newly elected governments articulated shortly afterwards the ambition of their countries to join the European Union.¹

¹The *European Union* was known as the *European Community* before 1993 and even earlier as the *European Economic Community*. This chapter uses the terms the *European*

Alongside the processes of nation building and post-communist reform, the countries also took measures to prepare for membership by taking part in a number of EU programmes for the post-communist countries in Central and Eastern Europe. As early as December 1991 the Baltic states joined PHARE, a programme that provided aid and technical assistance, and that initially targeted Poland and Hungary (Kerikmäe et al. 2016). Other agreements on trade and economic and commercial cooperation with the EU were signed in 1992 and extended in early 1995.

Many countries from Central and Eastern Europe aspired at the time to join the EU so a common framework for admitting new members was warranted. This was provided by the Copenhagen criteria of June 1993, which set out the broad requirements for membership. They stated that a country wanting to join the EU had to adhere to democratic principles and exhibit a market economy that was deemed able to cope with the competitive pressures it would face within the EU. Moreover, membership required that applicants comply with the *Acquis Communautaire*, the legal set of rules of the EU. These were divided into 21 thematic *chapters*, each of which was to be negotiated and closed individually.

The Baltic states entered into the *Europe Agreements* with the EU in 1995. The agreements spelled out numerous areas of cooperation and meant that the Baltic states became associated countries and therefore possible future members of the EU. Estonia was in the first wave of countries that were invited to start membership negotiations in December 1997, in part in recognition of the momentum of the reforms in the country. Latvia and Lithuania were invited to start the negotiations in December 1999 as part of the second wave. The negotiations that followed were relatively straightforward for the Baltic states and the chapters were closed without any major administrative or political issues; arguably the thorniest issues were found within the energy, environmental and taxation chapters.²

A Council meeting of heads of states held in Copenhagen in December 2002 acknowledged the preparations of the Baltic states and the other applicant countries and confirmed the accession of 10 countries to the EU

Union and its abbreviation *EU* as shorthand also when it refers to the earlier forms that existed before the term was adopted in 1993.

²Staehr (2011) uses proxies for the “closeness” of the post-communist countries to the EU, one of which is the proportion of the chapters that were closed each year during the negotiations, and finds that closeness to the EU helped strengthen democratisation in the countries, while the economic reforms appear to have become more government-centred and less market liberal.

by 1 May 2004. The final preparatory step was for referendums on membership to be held. In total 91 per cent of the votes cast in the Lithuanian referendum in May 2003 were in favour of membership, while 67 per cent were in favour in the Latvian and Estonian referendums, both held in September 2003 (Kerikmäe et al. 2016). The referendum results cleared the way for the countries to join the EU on 1 May 2004.

The Baltic states have been full members of the EU since May 2004 although they were subject to some temporary rules for labour movements, agricultural support and other areas. Their membership marked a return to Europe for the Baltic states as they became integral parts of the economic and political structures of the European Union.

7.3 TRANSITION AND ASPIRATIONS

The 1990s was a decade of rapid change in the Baltic states. The transition reforms established the underpinnings of a market economy, but unlike in the transition countries of Central Europe, the process also encompassed nation building, as independent national administrations and institutions had to be established. The three countries were small in size and had only recently become independent, so administrative and institutional capacities were limited. The three countries chose in consequence reforms that led to a liberal-market economic model where the role of government was limited and policies were rules-based or easy to administer (Laar 2002; Staehr 2017).

International trade is of key importance for small open economies, and trade policy and the supporting domestic policies have helped define developments in the Baltic states. The countries chose from an early stage to have open trading regimes and low duties (OECD 2000). The countries entered into a Baltic Free Trade Agreement in 1993 and extended its scope over time. Trade was also liberalised within the grouping of Baltic Rim countries and increasingly with the EU countries, as this was part of the Europe Agreements. Estonia and Latvia joined the World Trade Organisation in 1999 while Lithuania did so in 2001.

Estonia went the furthest and independently introduced a very liberal trading regime with no duties and no quantitative restrictions on international trade for virtually all products, including agricultural products (Feldmann 2003). This meant that agricultural prices in Estonia were close to world market prices and the agricultural industry was exposed to substantial competitive pressures, while Latvia and Lithuania retained

protection of the agricultural sector. The Estonian experiment with having no trade protection was gradually rolled back in the late 1990s as the EU negotiations gained pace.

The introduction of national currencies and the choice of exchange rate regime were important milestones in the process of nation building and of regaining economic independence. The small size of the economies and concerns over administrative capacity were important factors in the choices made (Levenko and Staehr 2016; Staehr 2015b). In June 1992 Estonia became the first of the Baltic states to replace the Soviet rouble with its own currency. The currency was from the outset tied to the German mark at a fixed rate through a currency board with full reserve coverage of the monetary base.

Lithuania initially introduced temporary currencies that circulated alongside the rouble, but these were replaced by a national currency in September 1993. The currency floated at first, but after a period of exchange rate instability and inflation pressure, Lithuania introduced a currency board and tied the currency to the US dollar. Latvia also used a temporary currency for a while before introducing a national currency in March 1993. The exchange rate was tied to the Special Drawing Rights of the IMF using a traditional fixed exchange rate regime, but in the end the exchange rate regime became very similar to those of Estonia and Lithuania since the reserve coverage was very large. The countries liberalised their capital accounts at an early stage, although Latvia and Lithuania in particular retained restrictions on foreign direct investment for longer to encourage domestic ownership of businesses (OECD 2000, ch. 7).

The Baltic states had introduced new national currencies within a few years after they regained their independence. The fixed exchange rate systems and the institutions that gave a high degree of credibility meant that inflation came down gradually, while trade and other international transactions were facilitated. The fixed exchange rate regimes also meant that the exchange rate could not operate as a shock absorber if or when the countries were hit with external shocks.

The Baltic states saw large declines in production in the early 1990s although deficient data mean that the magnitudes of the declines are uncertain. The declines resulted in large part from the dismantling of central planning, the disruption of trade links, and the uncertainties that surrounded the transition process. The economic climate improved from the mid-1990s however, as all three Baltic states exhibited fast economic growth and improved employment prospects.

The upswing was short-lived because of the spill-over from the Russian crisis, which erupted in August 1998 when the Russian government defaulted on its debt obligations and allowed the rouble to float. Economic growth declined in 1998 and came to a halt in Estonia and Lithuania in 1999. The downturn was in large part due to a dramatic decline in exports to the Russian market, but losses in the financial sector also played a role. The knock-on effects from the Russian crisis underscored how vulnerable the Baltic states were to economic developments in their neighbourhood given their small economies and limited options for independent economic policy.

One notable consequence of the Russian crisis was a further reorientation of the Baltic economies away from their traditional trading partners in the former Soviet Union and towards Western markets. The crisis also provided an impetus to the on-going negotiations on EU membership. In the end the downturn proved short-lived and it was followed by a boom that lasted until the global financial crisis.

7.4 THE ACCESSION BOOM

Economic growth had already bounced back by in 2000. Figure 7.1 shows the annual GDP growth rate in the three Baltic states and for comparison also for the EU15, the group of the first 15 EU countries including the UK, all of which were from Western Europe.³ The rate of growth in the Baltic states exceeded five per cent in every year from 2000 to 2007. Moreover, the growth rate was trending upwards until the outbreak of the global financial crisis, and in the process reached levels that had previously been seen most commonly in the Asian tiger economies. Indeed the Baltic states were occasionally referred to as the Baltic tigers in this period.

Economic growth was broadly based in the beginning of the boom but at later stages it stemmed mainly from rapid expansion in the construction, retail, transport and financial sectors, while the primary and manufacturing sectors were less dynamic (Kuusk et al. 2017).⁴ This pattern suggests

³The data presented typically start in 1995. By this time the countries had established market-economy systems and the immediate effects of the transition reforms had waned. Moreover, reliable data that comply with Eurostat requirements are typically only available from this year.

⁴Results from decomposition analyses reveal that the contribution to overall economic growth from the sectoral reallocation of employment was very small or even negative during the boom (Kuusk et al. 2017). The boom in demand in sectors such as construction and

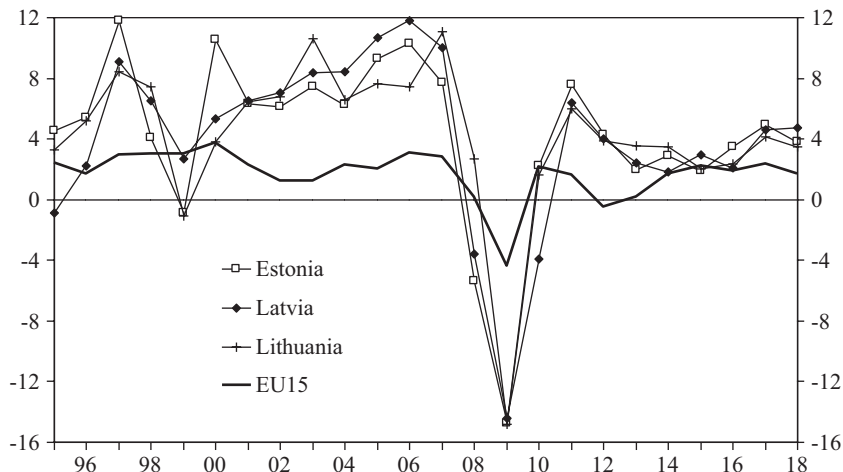


Fig. 7.1 GDP growth, per cent per year, 1995–2018. (Source: Eurostat (code: *nama_10_gdp*), Ameco (code: *OVDG*) for 1995)

that the boom was in large part driven by demand, but several factors are likely to have contributed.

The effects of the Russian crisis faded over time and exports from the Baltic states to Russia regained momentum. Economic developments were also benign in Western Europe including in the Nordic countries, and this bolstered exports and financial ties. Moreover, the economic reforms of the 1990s had helped establish dynamic private sectors with substantial growth potential.

The EU negotiations at the beginning of the period and the eventual membership in 2004 may also have played a role. Foreign investors started seeing promising investment opportunities in the Baltic states as regulation was harmonised and growth prospects were seen to improve. Confidence also improved domestically in the Baltic states and this led to increased consumption and greater demand for investment.

A key feature of the boom was the substantial inflows of foreign capital. At the beginning of the 2000s these inflows were mostly of foreign direct investment, driven in some years by Nordic banks buying up domestic

retail meant that in some cases resources were moved from sectors with high productivity to sectors with lower productivity.

banks or establishing new banks. From the mid-2000s however, the capital inflows consisted increasingly of loans and other forms of non-equity credit. The capital inflows were in part mediated by the banking sectors in the three Baltic states, and rapid growth in domestic credit helped finance the consumption and investment booms (Brixiova et al. 2010).

Figure 7.2 shows the current account balance in per cent of GDP. The current account deficits were already substantial in the 1990s but they started growing even wider from 2000 and throughout the boom period. The current account deficits at the height of the boom were exceedingly large, especially that in Latvia. The large and increasing current account deficits were signs at the time that the pre-crisis boom may not be entirely sustainable.⁵

There were other signs of overheating in the Baltic economies towards the end of the boom. The unemployment rates fell markedly and real wage growth was substantial and outstripped productivity growth. The accession to the EU in May 2004 may have contributed to the labour market

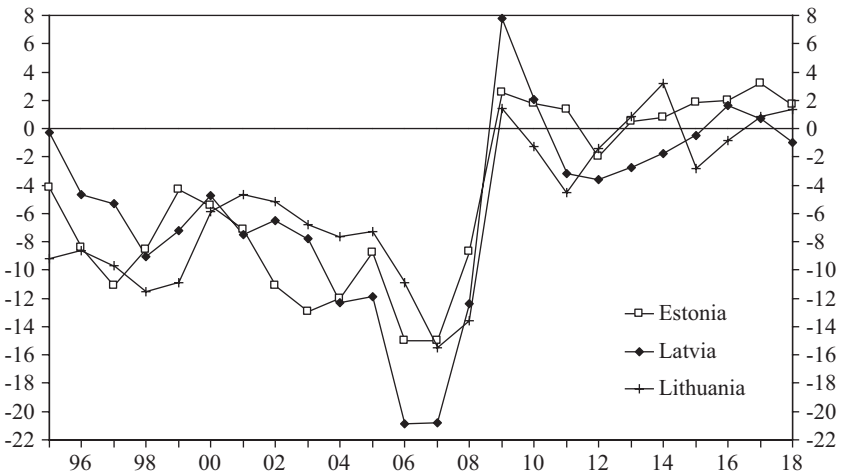


Fig. 7.2 Current account balance, per cent of GDP, 1995–2018. (Source: WEO (label: Current account balance))

⁵ It is notable that the developments of GDP growth shown in Fig. 7.1 are broadly mirrored in the current account developments in Fig. 7.2. Economic growth goes hand-in-hand with current account deficits, and this pattern appears to apply to most Central and Eastern European countries (Stachr 2018).

pressure. The free movement of labour is one of the four freedoms of the internal market, although temporary restrictions on labour movements were permitted after the enlargement of 2004. In May 2004 Ireland, Sweden and the United Kingdom opened their labour markets fully, while some other countries operated with quotas or other restrictions. As wage levels in the Western European EU countries were so much higher, the opening of the labour markets was followed by substantial labour outflows from the Baltic states. This was especially the case for Lithuania where net emigration reached 1.5 per cent of the population in 2005. The net emigration from the Baltic states at the height of the boom may have contributed to labour shortages and higher wage growth.

The boom and the increasing overheating in the years before the global financial crisis reflect the susceptibility of the Baltic states as small open economies to changes in fundamentals and sentiments. The accession negotiations and the eventual membership of the EU changed the prospects and perceptions of the Baltic states and may thus have been one of the factors behind the unprecedented growth.

7.5 THE CRISIS YEARS

Financial markets in the USA and some Western European countries started showing strains in 2007 and this culminated with the bankruptcy of Lehman Brothers in September 2008. The ensuing global financial crisis affected the Baltic states severely as GDP began to shrink in 2008 in Estonia and Latvia, and it fell by around 14 per cent in 2009 in all three countries. These declines in GDP were much larger than those in Western Europe (see Fig. 7.1).

The fallout of the global financial crisis demonstrated once again how vulnerable the Baltic states were to economic shocks. The countries experienced severe *sudden stops* as the current account balances swung from very large deficits to surpluses within only one year (see Fig. 7.2). The sudden stops crippled the financial sector and the provision of domestic credit dried up. Export volumes contracted as the downturn in the trading partners cut foreign demand for goods and services from the Baltic states. Exports of goods and services dropped from 2008 to 2009 by 20.5 per cent in real terms in Estonia, by 12.3 per cent in Latvia, and by 12.8 per cent in Lithuania (Ameco, code: *OXGS*). Finally, the financial crisis also badly damaged confidence as firms and governments encountered financing problems, unemployment shot up, and the outlook worsened.

The crisis had a profound impact on unemployment in the Baltic states. Figure 7.3 shows the quarterly unemployment rate for those aged 15–74. The unemployment rates were falling rapidly during the boom before the crisis, but they started to rise dramatically from the end of 2008, peaking at 18–20 per cent in 2010 before starting to come back down. The unemployment rate stayed above 10 per cent until the third quarter of 2012 in Estonia and until the first quarter of 2015 in Latvia and Lithuania.

Another consequence of the crisis in the Baltic states was that emigration ticked upwards. The economic hardship and the unemployment caused by the crisis coincided with several EU countries opening up fully for labour migration and with others relaxing their requirements. Figure 7.4 shows the net emigration from the three countries in per cent of the population at the beginning of the year.

While net emigration reached striking levels in 2009–2010 in Latvia and Lithuania, it changed only modestly in Estonia. The difference may have arisen partly because unemployment was typically lower in Estonia than in the other two countries, and partly because wages in Estonia were somewhat higher than those in Latvia and Lithuania (Eurostat, code: *nama_10_gdp*). Moreover, geographical proximity meant that Estonians

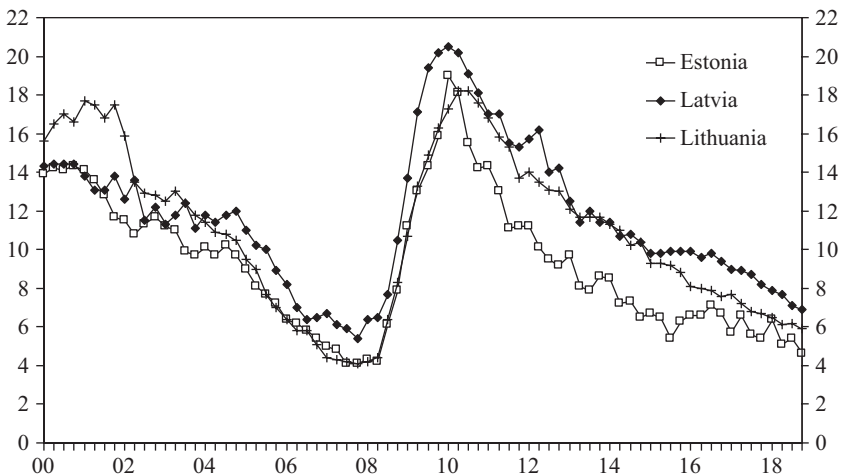


Fig. 7.3 Unemployment rate, 15–74 years, per cent of labour force, quarterly data 2000:1–2018:4. (Note: The quarterly unemployment rate is from labour force surveys. Source: Eurostat (code: *une_rt_q*)

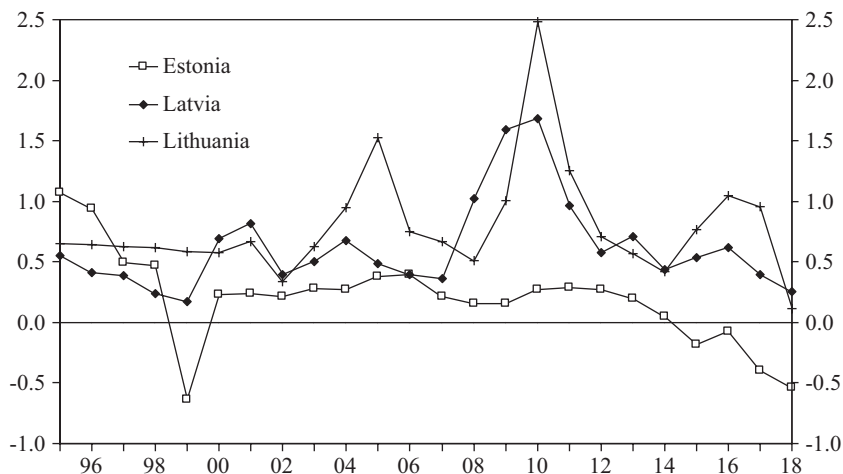


Fig. 7.4 Net emigration, per cent of population, 1995–2018. (Source: Eurostat (code: *demo_gind*))

were able to work in Finland while still living in their own country. Outward migration may have led to overheating during the boom, but it is likely that it helped reduce unemployment and hardship during the crisis, though at the cost of substantial declines in population in Latvia and Lithuania.

The net emigration relative to the population size has generally been larger from the Baltic states, particularly from Latvia and Lithuania, than from most other EU countries in Central and Eastern Europe. The economic crisis was very deep in the Baltic states and this may have strengthened the emigration incentives. Surveys of the motives of emigrants from the Baltic states suggest that outward migration was a strategy for coping with low incomes, high unemployment and limited welfare payments, and also with a perceived lack of prospects for the future (Hazans 2016). Moreover, the countries are small and culturally open, and so the younger generations in the Baltic states may have felt comfortable moving to another country. Finally, the Soviet occupation of the Baltic states meant that there were communities of migrants from the three countries in many Western European countries, and this might have facilitated emigration to those countries.

The crisis affected all three countries severely but Latvia the most. The government faced acute financing problems in the autumn of 2008. Parex bank, the second largest bank in the country, encountered severe liquidity problems after the outbreak of the global financial crisis, and the Latvian government decided to inject capital into the bank and take it over. Meanwhile the fiscal stance deteriorated as the steep downturn hurt tax revenues. Given the disruptions in international capital markets at the time, the Latvian government could not borrow the budgetary shortfall on commercial terms and therefore had to request financial assistance from international public lenders.

In December 2008 the Latvian government signed an assistance programme led by the IMF and the European Union with the participation of the World Bank and a number of north European countries, including Estonia. The agreement contained a total loan commitment of 7.5 billion euros and stipulated a number of *conditionalities*, including requirements for structural reforms and limits on future budget deficits. Latvia's membership of the EU played a key role in Latvia receiving the international assistance, as witnessed by the European Union being a lead organiser of the programme and contributing more than 40 per cent of the total loan commitment. The active role that the EU took reflected solidarity with a new member but was also meant to reduce the risk of contagion from the crisis to other EU countries.

Latvia became a strong proponent of austerity policies in the wake of the global financial crisis (Aslund and Dombrowski 2011). The authorities moved assertively to contain the budget deficit and make structural reforms while at the same time retaining the fixed exchange rate. After a total loss of around 21 per cent of GDP over the years 2008–2010, with soaring unemployment and large budget deficits, Latvia eventually turned the corner in 2011 as economic growth picked up, unemployment continued its decline from 2010 and the budget deficit returned to manageable levels. A total of 4.5 billion euros of the total loan commitment were paid out to Latvia by the lenders. The programme expired in January 2012 and Latvia had repaid the IMF loan by the end of that year, and the loans from the other lenders in the following years.

The economic policies in Estonia and Lithuania were in many respects similar to those in Latvia, and the Baltic states became the standard bearers of austerity policies in the years following the crisis (Staeher 2013). The countries retained their fixed exchange rate systems, pursued tight fiscal

policies, and implemented structural reforms that typically sought to improve efficiency and reduce employment.

The policy response to the crisis in the Baltic states was the subject of debate at the time (Aslund and Dombrovski 2011; Hansson and Randveer 2013). The deep recessions in the countries made some observers argue for expansionary measures to soften the impact on unemployment and living standards. Such anti-austerity policies would typically have meant devaluing the currencies or abandoning the fixed exchange rate regimes in order to improve external competitiveness, and using expansionary fiscal policies to stimulate growth in the short term.

The debates on the policy stance in the Baltic states mirrored broader debates on the appropriate policy mix during the downturn caused by the global financial crisis. Expansionary fiscal and monetary policies have increasingly been seen to support economic growth and prevent deepening of the crisis (Blanchard and Summers 2019). Expansionary policies may however be counterproductive if they lead to financial instability or increased uncertainty as might have been the case in some European periphery countries. Countries that pursued austerity policies in the wake of the crisis seem in many cases to have performed better than those that did not (Hansson and Randveer 2013).

In practice the policy options in the Baltic states were somewhat circumscribed. In spite of their austerity measures, the governments of Latvia and Lithuania were still running very substantial budget deficits in the years following the crisis, and although the Lithuanian government managed to borrow at commercial terms, the Latvian government was not able to do so. Altering the fixed exchange rate regimes would have risked negative repercussions since a very large part of private borrowing was denominated in euros or other foreign currencies, and so a rapid depreciation could have led to widespread debt servicing problems and new rounds of financial instability. This meant that expansionary policies could well have been counterproductive for the Baltic states after the crisis.

A factor that is often overlooked in debates on austerity in the Baltic states is that the countries had started receiving substantial funds from the EU after 2004. The bulk of the funding came from the Common Agricultural Policy and the structural and cohesion funds that were in place at the time. The European Commission exhibited substantial flexibility in the crisis years and expedited the distribution of the structural and cohesion funds to the Baltic states and other EU countries. The aim was

to help fund projects that stimulated economic growth without exerting additional pressure on the public finances of the member countries.

The total *net* transfer from the EU in 2009 and 2010 was around 4.2 and 4.9 per cent of gross national income (GNI) for Estonia, 2.5 and 3.7 per cent of GNI for Latvia (excluding the assistance programme), and 5.5 and 5.0 per cent of GNI for Lithuania (Danish Parliament 2019). These amounts are sizeable and potentially large enough to have macroeconomic impacts although they are relative small in comparison to the current account deficits which the countries had been running during the pre-crisis boom. Overall the transfers from the EU helped support the economy while relieving the pressure on the public finances in the Baltic states during the difficult crisis years.

7.6 THE RECOVERY

The crisis did not last. Estonia and Lithuania exhibited positive growth rates from 2010 and Latvia did so from 2011. Indeed 2011 saw an upswing in all three countries, as annual economic growth reached 6–8 per cent. This might have raised expectations of a return to the growth trajectory seen before the crisis, but this did not happen; growth rates dipped and hovered for the next five years in the range of 2–4 per cent, which was only slightly above the growth rates in the EU15.

The catching-up process was losing momentum at a point where the Baltic states had only just come out of very deep economic recessions and had income levels that were still substantially below those of most Western European EU countries. Many emerging-market economies in Latin America and Asia have at different times narrowed the income gap to the most developed countries, only to see their income stagnate and the gap start to widen again, leaving the countries trapped at middle-income levels.

The timid nature of the recovery in the Baltic states raised the question of whether the Baltic states risked being caught in a middle-income trap where structural, institutional or governance problems held back productivity growth and competitiveness so that the income gap to Western Europe narrowed only slowly or not at all (Staeher 2015a).

The rates of economic growth in the years after the crisis pale in comparison with the growth rates during the boom, but it must be remembered that the boom was in large part demand driven and unsustainable, with excessive credit growth and large capital inflows. During the recovery from 2010 onwards the current account was broadly in balance and credit

growth was moderate. As such the recovery, although timid, had stronger foundations than the boom before the crisis did. The concerns about growth lessened eventually after all three countries exhibited economic growth of around four per cent in 2017 and 2018. The recovery from the global financial crisis has brought a new degree of stability to the economies of the Baltic states with moderate changes in growth rates and few obvious signs of financial or economic imbalances.

A key event during the recovery was that the Baltic states successively joined the common currency area and adopted the euro. When the countries became members of the EU, they took on the obligation to join the euro once they had satisfied the requirements for doing so. The governments in the three Baltic states confirmed at an early stage their intention to join the euro area as soon as possible and thus participate fully in the European Economic and Monetary Union.

The economic rationale for the Baltic states to join the common currency seemed straightforward (Lättemäe and Randveer 2004). The countries have small, open economies and a large share of their trade is with countries in the euro area. They had operated fixed exchange rate regimes for a long time, with currency boards in Estonia and Lithuania and a tightly fixed exchange rate regime in Latvia. Adopting the euro would thus be a minor step that would eliminate any remaining exchange rate risk and reduce or eliminate some transaction costs.

The Maastricht Treaty sets a number of requirements or criteria that must be satisfied when a country is assessed for whether it can join the euro area. The budget deficit must be smaller than three per cent of GDP, the government debt must be smaller than 60 per cent of GDP, the exchange rate must have been relatively stable for a certain time, and the interest rate on government bonds and the inflation rate must be below reference values that are computed using data from all the EU countries. The Maastricht criteria have not changed over time but there is evidently some discretion in how they are applied.

The boom in the Baltic economies prior to the crisis meant that the countries did not at that time comply with the Maastricht criteria, particularly the inflation criterion. The boom was accompanied by relatively high inflation, and the assessments by the European Commission and the ECB in 2006 and 2008 concluded that none of the countries satisfied the inflation criterion. The ability of the authorities to steer the inflation rate was limited, so the political ambition of joining the euro area was put on hold. The crisis changed the outlook.

When the extent of the crisis became evident towards the end of 2008, the Estonian government reckoned that the crisis opened an opportunity for Estonia to satisfy all five Maastricht criteria at the forthcoming assessment in 2010, since the economic downturn and rising unemployment would exert downward pressure on inflation. However, the downturn would also reduce the tax intake and cause public spending to rise, so the main challenge would be to keep the budget deficit below 3 per cent of GDP.

The Estonian government set in motion a comprehensive package of fiscal consolidation measures with rises in the unemployment insurance contribution, value added tax, and excise duties, and wage cuts in the public sector and numerous other cuts to public spending. The fiscal consolidation in Estonia was successful in that the deficit for 2009 ended up at two per cent of GDP. Figure 7.5 shows the fiscal balance in per cent of GDP. The outcome of the Estonian consolidation is particularly striking when it is compared to developments in Latvia and Lithuania.

The convergence assessments by the ECB and the European Commission in 2010 concluded that Estonia had complied fully with all the Maastricht criteria, and the country was invited to join the euro area as the 17th member from 1 January 2011. The roll-out of the euro went

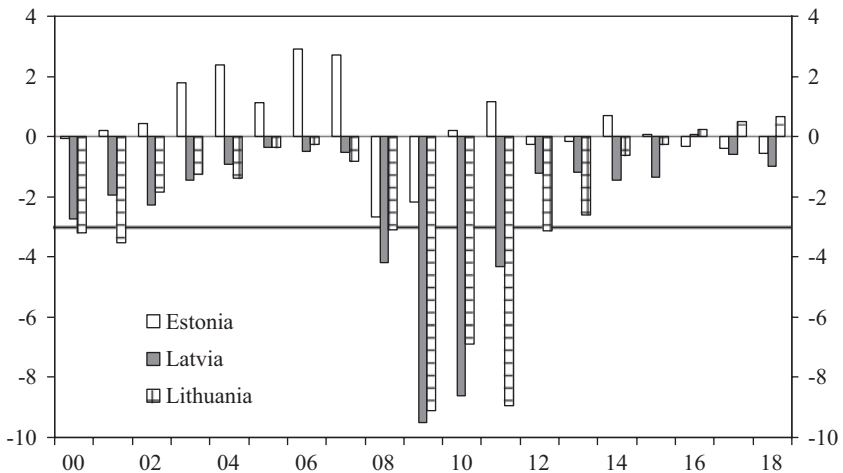


Fig. 7.5 Budget balance, per cent of GDP, 2000–2018. (Source: Ameco (code: UBLG))

smoothly and the fear that prices would rise does not seem to have been borne out by the data, although there may have been some minor price rises in the months before the euro was introduced (Meriküll and Rõõm 2015).

The strategy of Latvia and Lithuania for joining the common currency essentially followed that of Estonia. The crisis and the high rates of unemployment meant that inflation was kept in check and so the main challenge was to get the budget deficit below three per cent of GDP. Latvia became a member of the euro area in 2014 and Lithuania did so in 2015. The memberships were at the time seen as a sign that the Baltic states, even as they faced numerous economic challenges, had continued their work towards closer economic and political integration with the EU.⁶

7.7 LONGER-TERM TRENDS

The discussion so far has largely focused on cyclical dynamics and some key factors that help explain these dynamics, including the role of EU membership. This section considers some longer-term trends in the Baltic states from the mid-1990s.

Figure 7.6 shows GDP per capita in purchasing power terms (PPP) in per cent of the average level in the EU15. The most striking feature is the rapid convergence towards the EU15 average. The income level or GDP per capita PPP has grown from 25–30 per cent of the EU15 level in 1995 to 65–75 per cent in 2018. For comparison, the income levels in Greece and Portugal in 2018 were 63.6 and 72.3 per cent of the EU15 level (Ameco, code: *HVGDP*). However, Nordic countries such as Denmark and Sweden, which are often seen as peers for the Baltic states, have income levels that are 10–15 per cent above the EU15 average. The gap to the Nordic countries was still substantial in 2019, 28 years after the Baltic states regained independence and 15 years after they joined the EU.

The speed of convergence has varied markedly over time. The convergence process was halted briefly after the Russian crisis and went into reverse during the global financial crisis, but it resumed afterwards. This

⁶The euro has remained popular. According to the Eurobarometer for autumn 2018 the euro is backed by large majorities of the populations in the Baltic states. The statement “A European economic and monetary union with one single currency, the euro” gained support by 85 per cent of those interviewed in Estonia, 81 per cent in Latvia and 67 per cent in Lithuania (Eurobarometer 2018, p. 32).

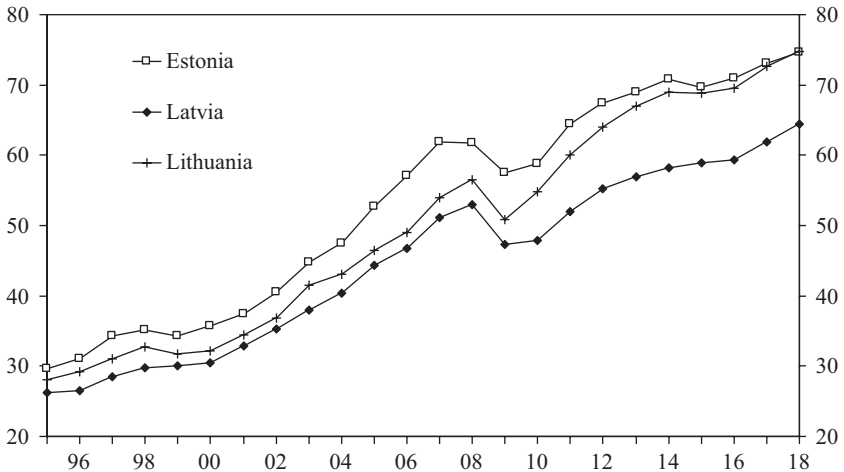


Fig. 7.6 GDP per capita PPP, per cent of EU15, 1995–2018. (Source: Ameco (code: *HVGDPR*))

pattern reflects the notable cyclical volatility in the Baltic states both before and after the countries joined the EU. It is notable however that the cycles have been quite subdued and the convergence relatively steady following the recovery from the global financial crisis.

The income levels in the three Baltic states are somewhat different. The GDP per capita PPP in Latvia has consistently been below those of the two other Baltic states, and the gap does not appear to have narrowed over time. Meanwhile, GDP per capita PPP in Lithuania has caught up with the level in Estonia since the global financial crisis, which is partly because the crisis affected Lithuania less than the other two Baltic states.

The longer-term trends in income reflect factors such as the structure of industry, the knowledge base and the business environment. Although there are areas with high value added in ICT, financial services and manufacturing in all three countries, there are also areas with relatively low value added that is based on exploitation of natural resources, simple mass production and manual services. The convergence process has seen resources shift from less productive to more productive sectors, but productivity growth within the sectors has been of greater importance (Kuusk et al. 2017).

The 2018 issue of the *Global Competitiveness Report* says the Baltic states stand out for their skilled labour force, flexible labour markets and

high levels of ICT adoption (World Economic Forum 2018). Moreover, the results from the OECD's Programme for International Student Assessment, PISA, indicate that the primary and secondary education system is of good quality (OECD 2016). There is also a relatively favourable business environment as witnessed by the generally good scores of the Baltic states in the *Doing Business Report* of the World Bank (World Bank 2019).

Economic growth may however have been held back by the limited innovation capabilities in the Baltic states. The level of R&D expenditures, especially those of the private sector, the state of cluster development and the quality of research institutions lag behind those of Western European EU countries (World Economic Forum 2018). According to the *European Innovation Scoreboard* the performance of the innovation systems in the Baltic countries has improved but is still below the EU average (European Commission 2019). Moreover, the financial systems in the Baltic countries are less developed than those in many other EU countries, potentially impairing the financing of small and medium-sized firms.

Another key feature with potentially important macroeconomic effects is the decline in population in the Baltic states. Figure 7.7 shows the population at the beginning of the year over several years. From 1995 to 2018 the population declined by more than 100,000 in Estonia, almost 600,000 in Latvia and more than 800,000 in Lithuania. These downward trends are partly the result of fertility rates that dropped sharply after the countries regained independence while the death rates declined only modestly, but net emigration has over time played a much larger role.

The depopulation in the Baltic states has been more severe in Latvia and Lithuania than in Estonia, but the issue and its longer-term economic consequences are on the policy-making agenda in all three countries. Population forecasts from Eurostat suggest that the decline will continue but the precise rate of decline will depend on demographic developments including trends in emigration and immigration. As discussed in Sect. 7.5, net emigration has been negative in Estonia since 2015 and declining in Latvia and Lithuania since 2017. These developments have been driven by increased return migration and the relatively benign economic climate.

The population declines in the Baltic states have been associated with increasing old-age dependency ratios. Figure 7.8 shows the old-age dependency ratio computed as the population aged 65 or older relative to the population aged 15–64. The ratio increased by around 12 percentage points from 1995 to 2018 in all three countries and this increase is forecast to continue given current trends.

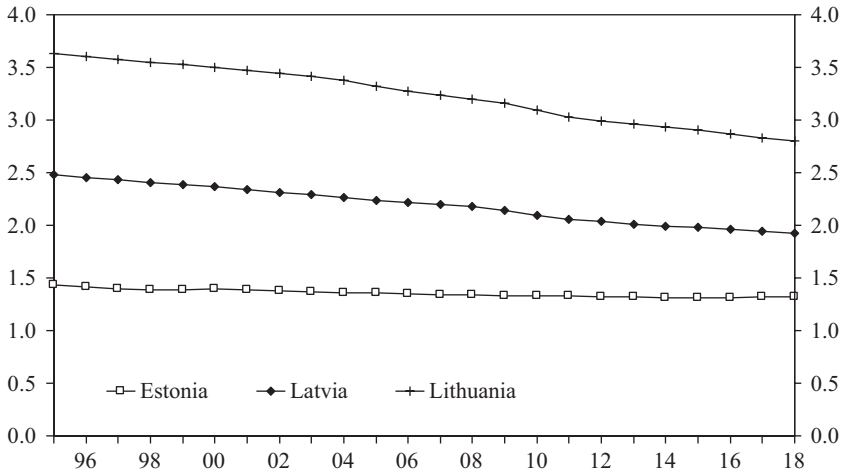


Fig. 7.7 Population at the beginning of the year, millions, 1995–2018. (Source: Ameco (code: *NPTN*))

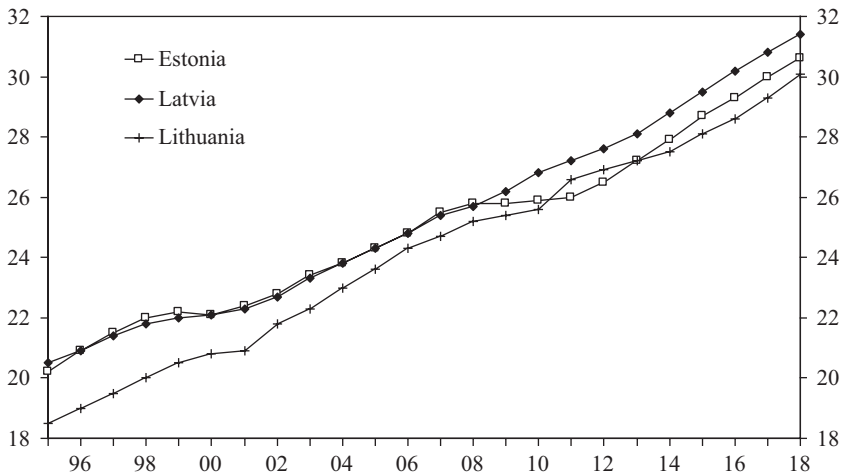


Fig. 7.8 Old-age dependency ratio, per cent, 1995–2018. (Note: The old-age dependency ratio is computed as the population aged 65 or older in per cent of the population aged 15–64 at the beginning of the year. Source: Eurostat (code: *demo_pjanind*))

The upshot is that the demographic structures in the Baltic states increasingly resemble those in Western European countries even though Baltic income levels are substantially below those in most of Western Europe. The increasing old-age dependency ratio and perhaps also the reduction in the populations will affect macroeconomic performance as the labour force declines and public finances come under strain, potentially jeopardising long-term growth in per capita income. The demographic changes in the Baltic states are profound and will affect societal developments and macroeconomic performance. The ageing of society will be a challenge for pension, health, education, employment and tax policies in the future.

7.8 SOME PERSPECTIVES

This chapter has discussed macroeconomic developments in the Baltic states before and after the countries joined the European Union. The countries regained their independence in August 1991, became members of the EU less than 13 years later, and celebrated 15 years of membership in May 2019. The Baltic states have become fully integrated in the EU, including the euro area, and they participate on equal terms in the policy-making processes (*The Economist* 2018). The membership of the EU is supported by large majorities in the three countries and the public generally trust the EU and its institutions.⁷

The Baltic states spent the 1990s establishing national institutions and setting up the foundations for a market economy. As they went through the transition process the countries were cooperating ever more closely with the EU, and this cooperation intensified after the Baltic states started negotiations on membership in the late 1990s. The gradual adoption of EU rules and increasing economic cooperation meant that joining the EU in May 2004 did not affect the economic trends in the countries abruptly, as any effects have been gradual and spread out over time.

The Baltic states have modernised their economies, and their income levels have converged quite rapidly towards levels in Western Europe. GDP per capita adjusted for purchasing power parity was around 65–75 per cent of the EU15 level in 2018. It remains however a key policy challenge for the countries to sustain the convergence process and reach the

⁷The populations in the Baltic states express greater trust in the EU than the average across the EU countries (Eurobarometer 2018, p. 6).

income levels of the Western European EU countries and eventually those of the peer group of Nordic countries. Higher income levels in the Baltic states will affect economic well-being directly, but they could also help stem emigration and entice migrants from earlier waves of emigration to return to their home countries.

The convergence process in the Baltic states will likely become more challenging over time. As the income gap narrows, the returns from capital deepening and technological adaptation will diminish. Moreover, the rapid ageing of the societies implies that an increasing share of the population will be outside the labour force while public spending on pensions and health care will increase. This makes it important to prepare for the ageing of society in ways that do not jeopardise economic development and macroeconomic stability.

The Baltic states must increasingly produce goods and services with high value added. This will require a switch towards a knowledge-based economy where innovation and agglomeration effects contribute significantly to income growth. Parts of this process are likely to emerge over time as businesses adapt to an environment of higher incomes, increased competition and rising demand for advanced products and services. As discussed in Sect. 7.7, the Baltic states have various competitive strengths and are generally conducive to business development. However, there is scope for more emphasis on research and development in the private and public sectors. Governments may also play a greater role in deepening innovation systems and in ensuring that the Baltic states are equal partners in international research and development cooperation (Alnafrah and Mouselli 2020).

An important factor in developing a knowledge-based economy is a workforce with appropriate skills and competences. Continued upgrading of education and training systems is therefore essential. It is in this context encouraging that the Baltic states are seen to have very good primary and secondary education systems (Schleicher 2019). There may however be potential for strengthening the tertiary education systems, including in IT and other technical fields. Vocational education is not always well funded in the three countries and is often seen as an unattractive career choice (Bünning 2016). These concerns are compounded by companies in the Baltic states being among the least inclined in Europe to provide training to their employees (OECD 2019). The quality of education and training at universities and other institutions of higher learning is arguably still to reach the levels in the Nordic peer countries (Staeher 2015a). This is a

process that requires reforms of management and financing and perhaps also changes in attitudes in society. Finally, the development of knowledge-based economies may also be aided by the return of people who had emigrated from the Baltic states and who have acquired appropriate skills abroad. The three countries have programmes in place to facilitate this and the resulting return migration may play an important role in future economic and societal development.

The EU plays important roles in the quest for economic growth and steady convergence in the Baltic states. Economic theory and empirical studies generally find that trade openness is conducive to economic growth. Some parts of the EU support programmes also aspire to strengthen economic growth by supporting infrastructure, innovation and education. Closer integration of financial markets within the EU may ease financing constraints in small and medium-sized enterprises and contribute to improving corporate governance in the Baltic states. Several empirical studies have found that EU membership has had substantial positive effects on economic growth (Badinger 2005; Campos et al. 2019).

The direct economic support that the EU gives the Baltic states through the Common Agricultural Policy and the structural and cohesion programmes has been substantial, and may thus have supported economic development and to an extent alleviated pressures on public finances. There is in this context some uncertainty about the amount of structural and cohesion funding the Baltic states will receive after the 2014–2020 funding round has been completed. The negotiations over the details of the 2021–2027 funding round were still on-going at the time of writing (the end of 2019), but Estonia and Lithuania may stand to lose part of their funding given their income levels. EU funding targets regional development in large part, and so funding cuts may over time have an effect on regional inequality.

Another key challenge for economic policy-making in the Baltic states is to ensure macroeconomic stability. The pronounced cyclical volatility has over time led to an uneven convergence process and, more importantly, it has caused economic and social problems, especially during downturns when lower incomes, higher unemployment and heightened uncertainty have brought hardship. Moreover, a more stable macroeconomic environment might also be conducive to long-term economic growth (Dabušinskas et al. 2012).

The Baltic states have generally exhibited relatively stable economic growth and no major macroeconomic imbalances during the recovery

after the global financial crisis. Experience shows however that small open economies are highly dependent on external developments and are susceptible to sentiment shifts, so vigilance is in order even in benign economic environments.

Measures that enhance financial stability and dampen excessive credit cycles are of key importance. Surveillance and supervision are vital in this context along with countercyclical reserve requirements. Their earlier experiences suggest that the Baltic states should also pay close attention to developments in their current account balances. The countries should aim to avoid a pro-cyclical fiscal policy and to ensure they have sufficient fiscal space for use in times of distress. This is particularly important given the outlook of reduced funding from the EU structural and cohesion programmes in the future. Labour market policies could also be used actively, for instance by ensuring that spells of unemployment are used for training and for acquiring the skills that will be needed during the next upturn.

The EU has taken numerous measures in the wake of the global financial crisis to reduce the risks of crises occurring in the future. The measures targeting the financial sector include three new European supervisory authorities and rules for the division of supervision between national and EU authorities. Other measures include a strengthened framework for fiscal policy formulation and a system for aiding countries with fiscal problems. The Macroeconomic Imbalance Procedure seeks to identify macroeconomic imbalances at an early stage. How effective these measures are depends in large part on how they are implemented and, equally importantly, how they are incorporated into domestic policymaking. The measures are, however, beneficial for the Baltic states in that they help create a more stable external economic and financial environment, and they may also provide useful frameworks for the policy measures of the Baltic authorities as they seek to reduce the risks of financial crises and deep downturns.

The Baltic states face the challenge of maintaining macroeconomic stability and steady convergence with the levels of income in Western Europe. Membership of the EU has led to increased openness and new opportunities for trade, capital movements and movement of labour. Support from the EU has aided the modernisation processes and has strengthened cohesion and thus the prospects for growth in the region. EU membership has also brought challenges by increasing the exposure of the three countries to external economic developments and by facilitating substantial emigration.

Entering membership of the EU in 2004 was a defining moment for the Baltic states, marking their return to Europe. The following 15 years were eventful, not least in terms of macroeconomic developments. The countries have seen strong economic growth but also episodes of economic and financial instability. It is to be hoped that the next 15 years will exhibit a calmer macroeconomic environment, allowing the Baltic states to narrow or close the income gap with Western Europe. The future is never certain, and it is bound to bring opportunities as well as challenges. However, after 15 years of EU membership the Baltic states are better prepared than ever to address the challenges facing them and to contribute to solving the challenges that face the entire European Union.

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