member states, the candidates should expect the enlargement to be in a state of fluidity.

☐ Second, the fact that uncertainty cannot be completely eliminated before accession does not mean that there is nothing for the EU or candidate countries to do at the present time. The candidates should decide what they want fixed above all: the date of entry, the derogations they wish to have at the negotiations or the entry criteria? They need to prioritise the issues to be tackled by both the EU and themselves.

☐ Third, the analysis above suggests that they should aim for the entry criteria because vague criteria have a much greater potential to stall the enlargement process on both sides.

☐ Fourth, the EU should begin identifying the pre-commitments that can be made by its members now in order to facilitate their bargaining later on.

☐ Fifth, although the identification of viable pre-commitments is not an easy or riskless process, the dangers of inaction are even greater because the existing member states may use their veto on accession of new members to protect their broader interests. Ironically, the success of the IGC that is supposed to pave the way for enlargement may make it even more tempting for member states to use their vetoes. The reason is that the IGC aims to make it more difficult for individual member states to obstruct collective decisions. Hence, as happened on several occasions in the past, they would naturally tend to rely on the few instances that they can wield a veto in order to apply pressure on their partners to make concessions on other, perhaps completely unrelated, issues of vital interest to them.

No one can predict with any high degree of accuracy how enlargement will progress in the next couple of years. It is nonetheless possible to surmise that there are circumstances that will make that progress easier and circumstances that will slow it down. This article has identified conditions that can do either.

George J. Viksnins*

Baltic Monetary Regimes in the XXIst Century

The accession of Estonia, Latvia and Lithuania to the European Union would mean that they would join the Economic and Monetary Union in the status of "countries with a derogation". They would remain committed to adopting the euro eventually and to this end to joining ERM II. The following article examines the present monetary regimes of the three countries and the progress made so far in their preparation for EMU.

In looking at the decade of transition in East and Central Europe, even economists seldom focus sufficiently on the enormous extent of the decline in exports, output and income which has taken place in the countries of the old Comecon (or CMEA, as it was also known in Europe). This collapse has been much sharper than the Great Depression of the 1930s in North America and Western Europe. While real output in the USA fell by about one quarter in the 1929-1933 contraction, real GDP in most of the former Soviet Union has declined a lot more. For example, output in Russia itself fell by one half in the 1989-1996 period and has not recovered very much since then. In Georgia, beset by civil war and hyperinflation, 1996 output was only 25% of the 1989 level, and statistics for Turkmenistan are not yet available.[1] To be sure, some of the decline in output was both to be

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expected and beneficial. The classical socialist system was based upon "physical success indicators" – on exceeding, but only slightly, the annual target quota. Now things have changed – tons of potatoes produced no longer include rocks, a splash of water and all of the rotten ones in order to maximize the weight indicator and make the *kolkhoz* chairman look like a good manager. Cows no longer giving milk can nowadays be culled from the herd. Also, petty cheating in the reporting of output statistics has probably declined – if anything, sales and production are likely to be understated for tax reasons.

The three Baltic countries of Estonia, Latvia and Lithuania were especially exposed to disaster in the early part of the transition decade. All of them exported about two thirds of the "Gross Republic Product", according to Soviet statistics, and 95% of these exports went to the rest of the USSR or the "brotherly socialist republics". This trade was based upon the poorer areas of the USSR providing subsidized or nearly free raw materials for Baltic industries, especially in Estonia and Latvia, and receiving finished products in return. The collapse of the Comecon trading system led to a fall in real output of about 50%. Today, ten years later, Baltic export destinations have been switched toward the west, mainly the EU and the Scandinavian countries. Although exports to Russia today constitute less than 20% of the total, all three countries continue to be vulnerable to potential economic sanctions applied to raw materials, especially energy. The ports of the region have all experienced some recovery in income levels in recent years, but Russia's planned efforts to bypass the Baltics states as far as possible in foreign trade and to build a pipeline and port facilities near St. Petersburg are a matter of concern, particularly to Ventspils.

Among the countries of East and Central Europe, ten are currently considered candidates for formal accession negotiations by the European Commission. In only three of these ten – Poland, Slovenia and Slovakia – does real GDP currently exceed the 1989 level. As Hans Pitlik concludes, "..It seems that both supply-side and demand-side responses to the policy changes as well as bad initial conditions contributed to the dramatic output losses during the early years of reform. Countries that initiated comprehensive reforms were able to return to positive growth rates. Delays in policy changes and the failure to continue with reforms after some minor initial steps appear to be the central causes for the ongoing bad performance in a number of transition economies".[2]

It is true, of course, that in much of eastern Europe there exists a substantial amount of what is called "shadow economy" activity, often estimated at 20-25% of GDP, which is not included in the official statistics. This includes illegal activities (smuggling and prostitution), but also barter and the exchange of services. Moreover, some economic activities favoured by people in the Baltic area – recreational fishing and hunting, gathering mushrooms and berries, and the growing of vegetables and flowers on private plots – are completely outside the standard UN system of national income accounts, which makes these three countries appear to be much poorer than they are. In much of Western Europe, on the other hand, most food is bought in stores or markets – and mushrooms and berries cannot be collected from nature to any great extent due to pollution and forest death. Few people would go mushroom-hunting in the woods surrounding the Frankfurt airport, for example.

The European Union's decision to open negotiations with Latvia and Lithuania was announced shortly after the Helsinki Summit in mid-December 1999. The EU macroeconomic indicators, often called the "Maastricht criteria", do not appear to present a serious problem to the three Baltic countries. Most of them have already been reached. The central government budget deficit came in at about 3% of GDP in all of them in 1999 (actually, 3.8% in Latvia, but there had been a rough balance in the budget in 1998). Foreign debt is well under 60% of GDP (only slightly more than 10% for Latvia) and inflation targets are being approached quite successfully. The dollar exchange rate for the Latvian lats was certainly a good deal stronger than the euro in 1999, and the other two countries operate currency board arrangements.

[1] See Martha de Melo, Cevdet Denizer, and Alan Gelb: Patterns of Transition from Plan to Market, in: World Bank Economic Review, September 1996; Holger C. Wolf: Transition Strategies: Choices and Outcomes, Princeton Studies in International Finance No. 85, June 1999; and Hans Pitlik: Explaining Economic Performance During Transition: What Do We Know?, in: INTERECONOMICS, January/February 2000, pp. 38-45.

[2] Hans Pitlik, op. cit., p. 45. See also A. Berg et al.: The Evolution of Output in Transition Economies: Explaining the Differences, IMF Working Paper No. 73, May 1999.

Moving Toward the EU and the Euro

The motivation for the Baltic states to join the EU is probably mainly political. Joining the EU "would cement Latvia's westward alliance, providing greater assurance against the risk of Russian intervention than there would otherwise be".[3] Given that assumption, it is still important to assess the economic benefits and/or costs of membership – to ensure that appropriate policies can be followed, ..."so as to maximize potential benefits and/or to minimize the costs". It is also important that the case for joining be "sold" to the public by being able".. to demonstrate significant economic benefits from joining ...the political argument by itself may not be enough".[4]

The Baltic states are likely to receive significant benefits from formal integration with Europe through trade, financial and fiscal channels. Access to a large market and growth in trade are likely to spur real growth. Interest rates are likely to decline significantly from present levels – the bank lending rate is 8.7% in Estonia, 14% in Latvia, and 13% in Lithuania, while corporate bonds in the Euro-11 area are at 6%. There are likely to be significant fiscal transfers, beginning with ISPA and SAPART projects already in 2000. However, there are also likely to be significant costs. As a recent IMF working paper points out: "...There will be demands for additional expenditure, largely on account of the required investments in the environment and infrastructure sectors, which could result in a notable increase in the share of public expenditure to GDP. To the extent that an expansionary effect on domestic demand ensues, spurring imports of consumer products and project-related investment goods, the current account position could be significantly affected. Lower interest rates which tend to boost domestic investment could compound an eventual widening of the external imbalance..."[5]

The primary focus of the Eurosystem is on price stability, and it is being stressed that accession will be a step-wise continuum. First, applicant countries are expected to implement important elements of the "acquis communautaire", a set of obligations deriving from treaties, legislation and judicial rulings by the Court of Justice. In the financial field, central bank independence and integration in the ESCB are stressed. Upon accession, the candidates enter a second stage, joining the Economic and Monetary Union (EMU) in the status of "countries with a derogation". They remain committed to adopting the euro eventually (no opt-out clause) and to this end to joining ERM II.

In this connection, an interesting question has been raised recently by an IMF Discussion Paper: "...However, it still needs to be examined whether currency boards are compatible with participation in ERM II. During this phase, EMU countries are envisaged to establish central rates for their currencies against the euro, and to limit fluctuations of their exchange rates to a band of up to ±15 percent around the central rate. Participation in ERM II can be seen to fulfill several objectives: facilitating nominal convergence (meeting the Maastricht criteria); allowing a market test for exchange rate stability; helping to ensure that countries enter the euro zone at an appropriate exchange rate; and preparing central banks for operating within the euro zone."[6]

Billed as "...the most far-reaching change in the global monetary system since the Bretton Woods conference of 1944,"[7] the EMU will challenge American dominance in the financial markets by setting up a new entity of roughly equivalent size. However, a successful monetary union in Europe will benefit the United States and the rest of the world by extending the sphere of "democratic peace" to Central and Eastern Europe, "...where instability might otherwise require American resources and intervention".[8] Phase I of preparations for the EMU took place from mid-1997 to the end of 1998, and featured the establishment of the European Central Bank and the European System of Central Banks. Phase II began on January 1, 1999, with an

[3] Barry Lesser (ed.): Latvia and the European Union, Halifax, Canada, pp. 1-3.

[4] Ibid.

[5] Rene Weber and Gunther Taube: On the Fast Track to EU Accession: Macroeconomic Effects and Policy Challenges for Estonia, International Monetary Fund, (WP/99/156) November 1999, p. 35; see also Julian Berengaut et al.: The Baltic Countries from Economic Stabilization to EU Accession, IMF Occasional Paper 173, 1998. For a discussion of the gains and losses in the EU itself, see Phedon Nicolaides: The Economics of Enlarging the European Union: Policy Reform versus Transfers, in: INTERECONOMICS, January/February 1999, pp. 3-9.

[6] Anne-Marie Gulde, Juha Kahkonen and Peter Keller: Pros and Cons of Currency Board Arrangements in the Lead-up to EU Accession and Participation in the Euro Zone, International Monetary Fund, PDP/00/1, 2000, p. 17; see also Luis A. Rivera Batiz and Amadou N. R. Sy: Currency Boards, Credibility, and Macroeconomic Behavior, International Monetary Fund, WP/00/97.

[7] See C. Randall Henning: Cooperating with Europe's Monetary Union, Institute for International Economics, May 1997, pp. 1-5.

[8] Ibid.

"irrevocable fixing of the conversion rates of national currencies to the euro" and the conversion of European Currency Units (ECUs) into euros on a one-to-one basis. The euro has been introduced only in a non-cash form, and has been used to establish the new TARGET payments system. Only 11 of the 15 member countries opted to join EMU, although Greece is in the process of trying to meet the criteria and is expected to expand "Euroland" of 1999-2000 to "Euro-12" on January 1, 2001. The changeover to the euro as the only monetary unit is expected to be completed by January 1, 2002, with the minting of coins and printing of notes, and national currencies will lose their legal tender status by July 1, 2002.[9]

The introduction of the euro should be a positive development for the single EU market as well as its trading partners. International price comparisons have already become more transparent, and considerable savings on transaction and hedging costs should be possible. The elimination of exchange-rate exposure takes a significant risk out of both trade and investment across national boundaries. The adoption of the Maastricht criteria in the near future should lead to a convergence of inflation and interest rates to "Euroland" levels in the ten Central and Eastern European candidate countries and serves to reaffirm the importance of conservative fiscal and monetary policies. These criteria include:

☐ an average inflation rate for a year before joining that does not exceed the average price increase in the three best performing member states by more than 1.5%;

☐ participation in the EMS exchange-rate mechanism and observance of the normal fluctuation margins for at least the last two years;

☐ an average nominal long-term interest rate on government bonds for a year that is not more than 2% above that of the three best performing member states in terms of price stability;

☐ government budget deficit of 3% of GDP and government debt of 60% of GDP at most, with a small amount of discretion being available in determining the reference value;

☐ several other criteria, including market integration, the current account, and the trend in unit labour costs and other price indices, will be considered, but no quantitative terms of reference are prescribed.[10]

Regarding monetary policy and exchange rates, many independent experts regard the prescriptions of the European Central Bank in Frankfurt in this area as quite inappropriate for the Baltic states. The ECB envisages a formal two-year transition period during which the exchange rates of the candidate countries would be allowed (required?) to float freely, in order to reach an equilibrium level. For countries that have been employing currency board regimes *de jure* (Estonia and Lithuania) or even a very similar arrangement *de facto* (Latvia), this suggestion is tantamount to saying, "let's deliberately destabilize exchange rates and challenge the credibility of the local central bank, and see what happens". This policy might be called a period of "mandatory instability", which would not be gladly received by the monetary authorities in the Baltic states. Partly as a result of this misguided suggestion, the Lithuanian litas may be floated in 2001, getting rid of its successful (and politically painful!) six-year link to the US dollar. During 1999, as the dollar appreciated and the euro fell (by some 20%), Lithuanian exporters lost and Estonian exporters won market share, with the Latvians in between. It may well be that the Lithuanians abandon the dollar and begin a peg to the euro just when it bottoms out and starts appreciating. Exiting from a currency board arrangement prematurely may be hazardous to your financial health.[11]

At the present time, EU law requires at least a two-year gap before the candidate country joins the monetary union. In a widely cited report published by the European Commission (in charge of accession talks) in October, it was strongly implied that "attempts at too early adoption of the euro could be highly damaging". At an enlargement seminar held in November 1999, the message was the same: "rush at your peril".[12]

However, at an April 13, 2000, press conference President William F. Duisenberg appeared to soften the stance of the ECB with respect to currency board arrangements (CBAs), saying that their

[9] Ibid.

[10] Deutsche Bank Research: EMU Watch: Eastern Europe and EMU, February 28, 2000; see also Inna Steinbuka: The Alignments of Latvian Economy in the Context of European Integration; and Seija Lainela: Baltic Accession to the European Union, both in: Journal of Baltic Studies, Summer 2000, pp. 193-216.

[11] Further discussion of the Lithuanian case can be found in: Thomas Grennes: The Development of Banking and Financial Markets in Independent Lithuania, in: Journal of Baltic Studies, Summer 2000, pp. 172-192.

[12] The ECB heads for turbulence, in: The Economist, January 29, 2000.

appropriateness would be assessed on a case-by-case basis. The Governing Council of the ECB "...neither encourages nor discourages the adoption of euro-based CBAs. In any event, such arrangements cannot be regarded as a substitute for two years' participation in ERM II". In typical bureaucratic double-speak, he goes on to say that countries with currency board arrangements "...deemed to be sustainable might not be required to go through a double regime shift in their strategies to adopt the euro".[13] Furthermore, "...a *common accord* would have to be reached on the central parity against the euro". This does not address the case of Latvia, however.

There are also the so-called "Copenhagen criteria", which are not easily quantifiable. These include stable institutions guaranteeing democracy, the rule of law, human rights, and respect for the protection of minorities. The existence of a market economy, capacity to compete and the ability to take on the obligations of membership are also prominently mentioned.

Baltic Monetary Policies

As all three Baltic countries left the ruble zone in 1992 (often contrary to the recommendations of foreign experts) and began to re-orient their economies toward the free market and the West, optimism abounded. Many felt that the only prerequisites for rapid growth and development were conservative macroeconomic policies – a balanced budget and a moderate rate of growth in the money stock – and that everything else could and should be left to private initiative. After all, Baltic living standards had been roughly similar to those in Scandinavia before the Soviet occupation and it was hoped that a healthy economy could be rebuilt in a few years. Estonia moved first to establish a rigorous currency board regime (8 EEK = 1 DM) -with no central bank loans to either the government or commercial banks – and to liberalize its foreign trade and payments. According to Norgaard and Johannsen, these policies "...carried a politically hazardous price, however, because it involved consigning a significantly larger share of its population to a life in poverty, accepting greater social inequalities than the other two countries and – particularly – destroyed a larger part of the economy than a less radical strategy would have done".[14]

After rather brief periods of experimentation with temporary currencies in 1992 – the Talonas in Lithuania, which actually depreciated against the Russian ruble, and the Latvian ruble, which appreciated (to 8 Russian to 1 Latvian in the spring of 1993) – stable monetary regimes were established in both neighbouring countries as well. Lithuania opted for a currency board in 1994 (1 US$ = 4 litas), but is intending to move to a traditional currency peg to the euro in mid-2001 – although it may be advisable to phase out the link to the dollar gradually, perhaps over several years. Latvia re-introduced the lats in March 1993 at a conversion rate of 200 Latvian rubles ("repsisi") to one lats. The average exchange rate of the lats was $1.48 in 1993, but it appreciated to an average of nearly $1.90 for the year 1995, mainly due to the weakness of the US dollar. In the 1993-94 period, the lats was the "strongest currency unit in the world", in the sense that it rose against the US dollar by somewhat more than even the Japanese yen, which reached its all-time high early in 1995. In February 1994, the Bank of Latvia decided that the appreciation of the lats was becoming a negative influence on the export sector and pegged against the SDR basket at a rate of LVL 0.7997 = 1 SDR.[15]

A brief digression on the SDR seems to be in order, since the management of the Bank of Latvia intends to maintain this peg until switching to the euro, in 7-9 years time. The SDR is an international reserve asset created by the IMF in 1969 to supplement existing reserves of members, to serve as a unit of account in the Fund and to be used for IMF transactions and operations. At the outset, one SDR was defined as having the same gold content as a US dollar – they were called "paper gold" in the media. In August 1971, after the first Nixon devaluation, the link to the US$ was broken, and the dollar price rose to $1.10 (and about $1.20 after the second devaluation in 1973). A very complex weighting scheme involving 16 currencies was used in the 1970's, but since 1982, the SDR basket has included the currencies of the five member countries of the IMF "with the largest exports of goods and services during the preceding five-year period ". The weights are adjusted every five years, and have been as shown in Table 1.

[13] Further details can be found at www.ecb.int/key/00/sp000413.htm.

[14] Ole Norgaard et al.: The Baltic States after Independence, Second Edition, Edward Elgar, 1999, p. 108. More economic analysis can be found in the Spring 1997 issue of the Journal of Baltic Studies, particularly in George J. Viksnins: Monetary Policy in Latvia.

[15] Ibid., pp. 130-131. It seems amazing that a book published in 1999 fails to mention the SDR, but cites a fellow Danish "expert" who believes that the lat is overvalued.

On January 1, 1999, DM 0.446 was replaced by 0.2280 euro and the French franc at FF 0.813 was equated to 0.1239 euro. Thus, today a little more than 30% of the SDR – and, hence the Latvian lats – already tracks the euro.[16] As has been pointed out by the Bank of Latvia in the press, about 44% of Latvia's trade is valued in dollars (39% of SDR basket) and 35% is in euros (32% of the basket). The Bank of Latvia continues to point out that stability and transparency in foreign exchange rate management are very important values, and that annual changes in valuation to reflect the precise trade weights for each foreign currency would be very destabilizing.

Table 1

SDR Weights

Currency	1981-1985	1986-90	1991-95	1996-2000
US dollar	42	42	40	39
Deutsche mark	19	19	21	21
Japanese yen	13	15	17	18
French franc	13	12	11	11
Pound sterling	13	12	11	11

Table 2

Macroeconomic Indicators, Baltic States, 1994-2000

	1994	1995	1996	1997	1998	1999
Estonia						
GDP % growth	-2.0	4.3	3.9	10.6	4.7	-1.1
Inflation	41.7	28.9	14.8	12.5	6.5	3.9
Latvia						
GDP % growth	0.6	-0.8	3.3	8.6	3.6	0.1
Inflation	26.3	23.1	13.1	7.0	2.8	3.2
Lithuania						
GDP % growth	-9.8	3.3	4.7	7.3	5.1	-4.8
Inflation	45.1	35.7	13.1	8.4	2.4	0.3

Source: Bank of Finland: Baltic Economies – The Quarter in Review, No. 2/2000, 26.5.2000.

Table 3

Major Monetary Indicators, Baltic States, 1993-1999

	EE		LV		LT	
	1993	1999	1993	1999	1993	1999
Reserves[1]	397.2	853.1	504.4	912.6	412.2	1242.1
M2	6140.2[a]	25,926.9[a]	464.3[b]	1038.1[b]	2673.2[c]	8972.0[c]
Currency outside banks	2440.6[a]	5741.3[a]	152.8[b]	377.4[b]	791.3[c]	2738.7[c]
Lending rate	27.3%	8.7%	86%	14%	92%	13%
SDRs per capita M2 balances	212	837	219	530	134	442

[1] US$ million. [a] EEK million. [b] LVL million. c LTL million.

Source: IMF International Financial Statistics, April 2000.

As can be seen from Table 2, the growth performance of all three states weathered the problems of structural adjustment and major bank failures in the early 1990s,[17] and began to grow rapidly in the 1996-98 period. Then the Russian crisis hit, and 1999 turned into a serious decline for Lithuania. Of perhaps greater importance is the steady decline in inflation, bringing price increases down to OECD levels. Table 3 tracks the growth of major monetary aggregates. Money holdings, measured in SDRs per capita, have shown a steady increase, but are still well below other EU candidate countries: Slovenia (around SDR 3200), the Slovak Republic (at SDR 1700), Hungary (SDR 1500), Poland (SDR 1200), and the Czech Republic (around SDR 900) are all above Estonia's SDR 837. A standard measure of monetization and financial sector development is also the currency ratio. In Estonia, this has fallen from 40% to 22% over the period shown; in Lithuania, it has remained constant at 30%, but in Latvia it has risen from 33% to 36%. Estonia shows the largest relative increase in M2, followed by Lithuania and Latvia. A certain lack of trust in the domestic currency, and perhaps local banks, is shown by the rise in foreign currency deposits in Lithuania, from 25% to 30% of M2. In Latvia, the percentage of deposits denominated in lats actually fell slightly – from 54.4% in 1998, to 51.8% in 1999.[18] Perhaps the pronouncements of self-styled experts from the West, who register for a week at the most expensive hotel in Riga and pronounce the lats as over-valued, do resonate in the public's expectations (a couple of local newspapers have also been endorsing the devaluation prescription). Perhaps we can invite some advisers from the Ukraine and Belarus – they would certainly be cheaper.

[16] Further detail is available at http://www.imf.org/external/np/exr/facts/sdr.htm. An amendment was proposed in September 1997 to increase the global supply of SDRs from SDR 21.43 billion to SDR 42.87. This expansion needs to secure approval by 85% of the voting power; as of March 2000, a little less than 50% had been secured. The future role of the IMF as a development leader is beyond our scope here. An excellent summary is provided by Otto G. Mayer: The IMF Debate, in: INTERECONOMICS, March/April 2000, pp. 53-54.

[17] See Alex Fleming, Lily Chu and Marie-Renee Banker: The Baltics – Banking Crises Observed, Policy Research Paper 1647, The World Bank, 1996.

[18] A formal analysis of this issue is in Vadims Sarajevs: Econometric Analysis of Currency Substitution: A Case of Latvia, BOFIT Discussion Papers, No. 4, 2000.