# The economy of the Baltic states: good trend performance - but uncomfortable trade imbalances

In general terms, one may say that the Baltic States achieved really an impressing performance since their independence in the early 1990s. Nobody thought at that time that EU membership could be possible already in the year 2004. Indeed, the EU adaptation process meant a lot to the economic development in the past ten years or so.

Reforms were speeded up, particularly in the legal and microeconomic area, including institutions. Applying the legal and institutional framework of the EU in Estonia, Latvia and Lithuania nowadays means a lot to the activities of foreign companies, especially to smaller and medium-sized foreign companies. It is one of the most obvious competitive advantages of the three Baltic States compared to other competing nations.

It certainly should be worth-while mentioning that the Baltic States usually get good *microeconomic* rankings in the lists that are prepared by the World Bank, the World Economic Forum, etc. Estonia usually is in the top of these rankings among the three Baltic states. But Latvia and Lithuania are not bad either in this context.

There is not much doubt in Europe about the fact that the three Baltic countries mainly are confronted with *macroeconomic* imbalances – apart from public debt which is in a very healthy shape. In all three countries, there is the same kind of problems these days like

- high CPI inflation (Apr 2008: Estonia 11.4 %; Latvia 17.4 %; Lithuania 11.7 %), asset price inflation (homes)
- too big deficits in the current account (2007, per cent of GDP: Estonia 17, Latvia 23 , Lithuania 14 )
- rapidly slowing GDP growth in the first quarter 2008 (in brackets Q1 growth 2007, yoy):

| | | |
|---|---|---|
| Estonia: | 0.4 | (10.1) |
| Latvia: | 3.5 | (11.2) |
| Lithuania: | 6.8 | (8.1) |

- - high wage rises and overvalued currencies in all three countries while having sort of fixed exchange rate.

Many areas have been organized very successfully since democratization. However, one major decision now turns out to be a failure: the premature entry of the three countries' currencies in the ERM II which is the so-called waiting room for the EMU. ERM II is a formal linkage to the euro, though maintaining the national currency – like Denmark has applied for many years. This means that the three Baltic States have no independent monetary policy anymore which has been very unfavorable in recent times of overheated credit markets / asset prices and huge amounts of domestic loans in euro. The fact that Estonia and Lithuania still apply a currency board system, make things even worse.

There is good reason to forecast clearly dampened economic growth for some quarters or even years ahead. There is potential for coming back. By now, the three Baltic States need some cooling down. But will this be enough to get less worrisome trends in the current account? Despite all the positive developments since independence: The exchange rate will remain a critical topic for quite some time. Neither Estonia nor Latvia and Lithuania will have a chance to join the euro any time soon.

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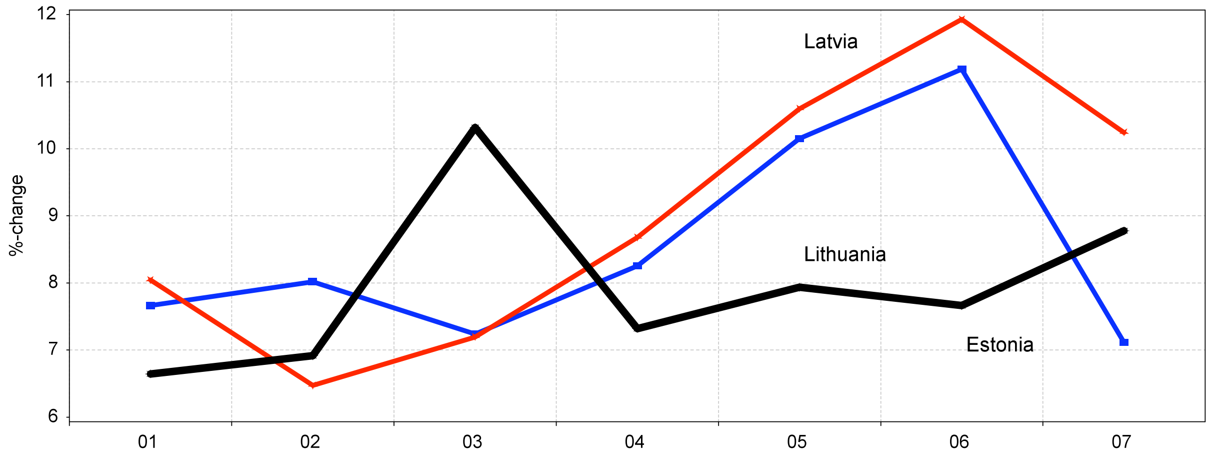
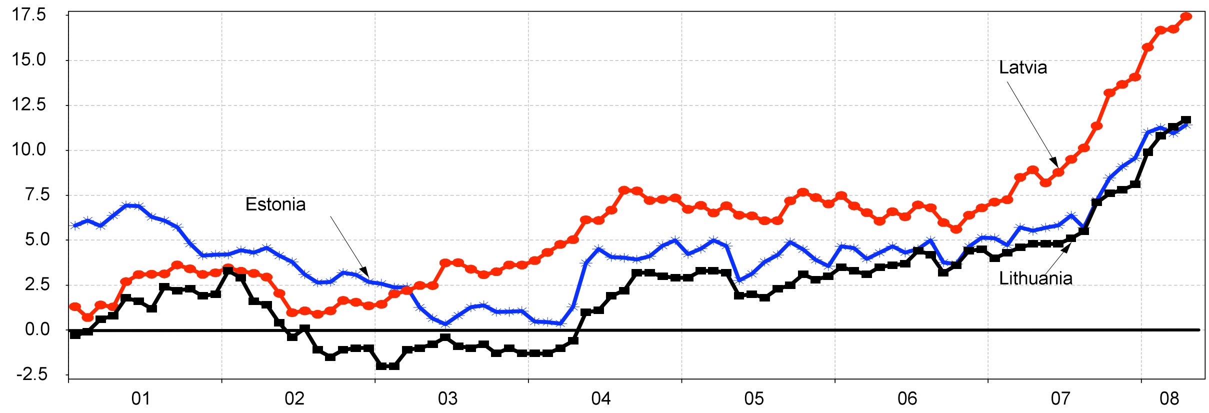
## GDP growth in the Baltic States



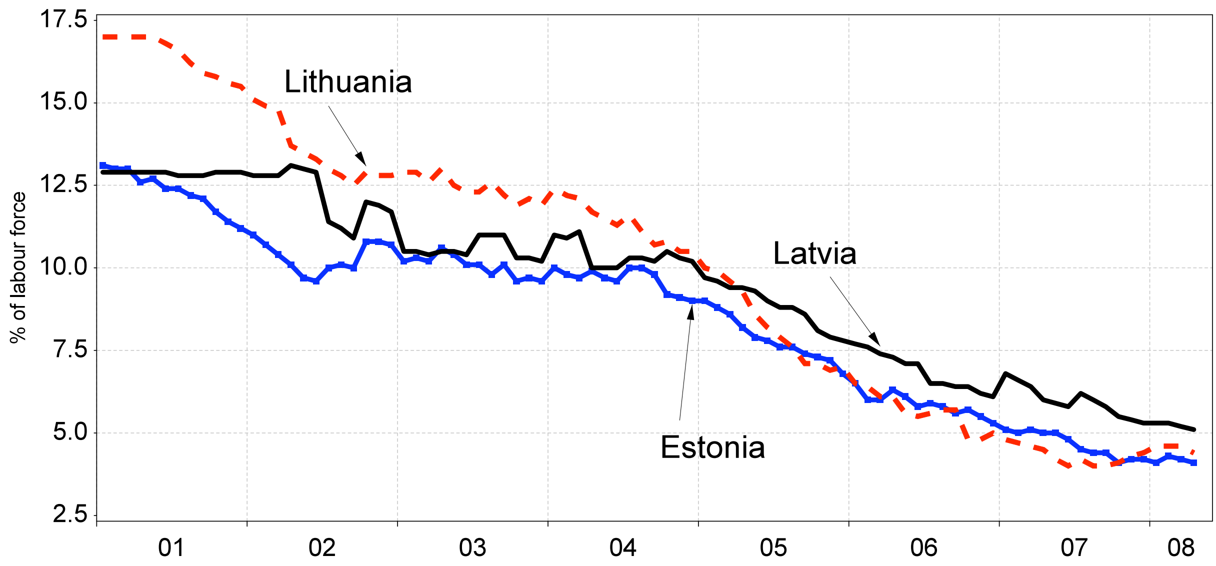

*Source: Reuters EcoWin*

## Inflation



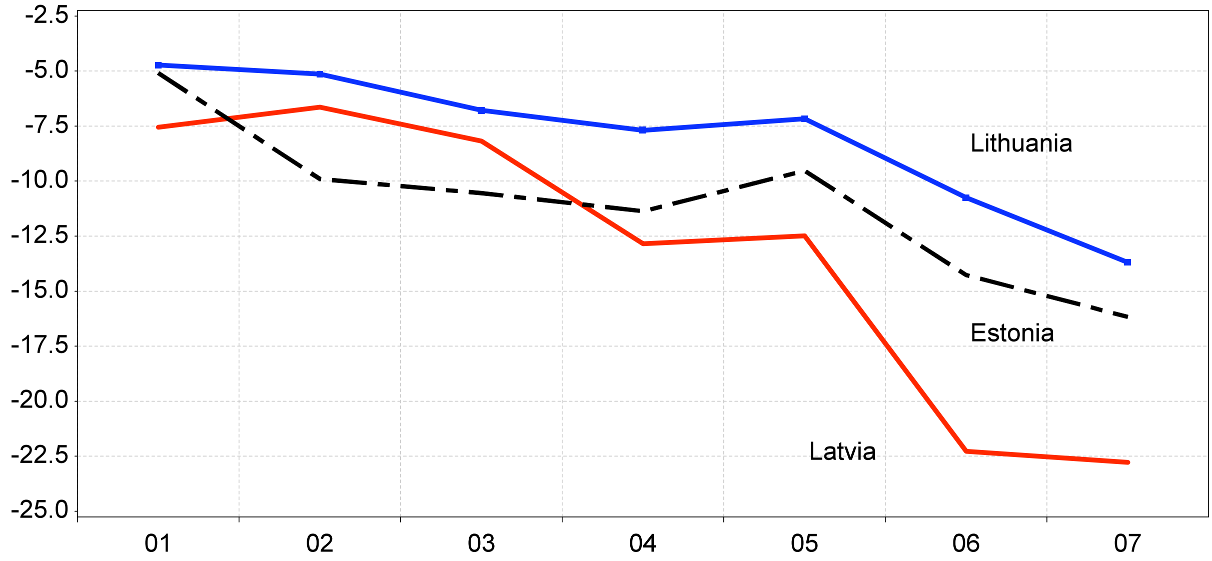

*Källa: Reuters EcoWin*

## Unemployment rate, % of labour force



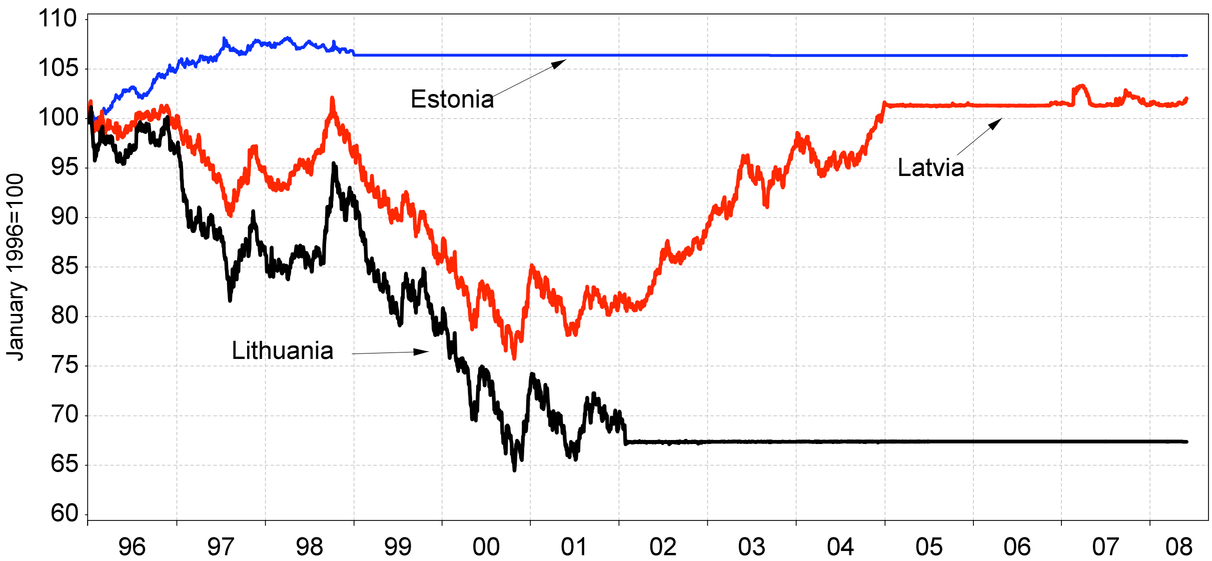

*Source: Reuters EcoWin*

## Current account deficit, % of GDP




*Source: Reuters EcoWin*

## Currencies in the Baltic States against the euro, January 1996=100




*Source: Reuters EcoWin*