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Review paper

THE BALTIC STATES JOIN THE EUROZONE

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Abstracts

The new ongoing world economy processes and political events have affected the Baltic countries. All these countries faced in a short time the complex of environmental conditions as the pressure of EU debt crisis, weak euro against the dollar, the Russian-Ukraine conflict, sanctions against Russia, prices of oil and gas. However, all Baltic countries have had quick recoveries from the recent recession, while their economies had different shape before the crisis. The object of this research is the short time effects on Baltics 'by joining the single currency system. The method used for investigation – comparative statistical analysis using the Eurostat database and national statistics. The study is directed at investigating the impact of changeovers of the national currency to the euro on macro trends and consumer and business expectations. For this purpose, the changes in macroeconomic indicators during the time before and in the aftermath in each country are presented in the context of integration. The result of this study suggests that statistically significant positive effect on macroeconomic and expectation indicators show the importance of joining the single currency system.

Keywords: *Baltic States, currency regime, Eurozone, indicators*

JEL Codes: *E3, E5, F4.E58*

1. Introduction

The global economic crisis in the last decades of the 20th century influenced the economic development, and the international financial system changes not only in advanced countries but in the emerging economies in Eastern and Central European countries as well. These countries' ongoing financial integration processes in the context of globalization are the subject of numerous studies. Each Baltic state obtained experience from different currency board models (Estonia, Lithuania) and Latvia have been able to maintain low deficits without currency board. (Hanke, S.

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(2002), Żuchowska (2015), Korhonen (1999), Ghosh, Ostry (2009), Pilinkus, et. (2011)). Central banks have a key role to play in most transparency transmission joining process and mitigating of social effects. It is important to keep mutual understanding and responsibility since all public institutions were involved in the preparation campaign before and after.

This article analyzes the impact of the currencies' regime change on the convergence processes. The currency changeovers have always caused the negative social and inflationary effects, and they have motivated many research papers. This paper contributes to the literature by analyzing how the euro changeover has affected the main macroeconomic indicators' trends and expectations in Estonia, Latvia, Lithuania. The range of macroeconomic indicators such as inflation, unemployment, investment, and savings are not presented. Then the recovery dynamic should be compared with other countries as Poland, Nordics.

The institutional and functional regulation ensures that central banks understand each others' reaction to current processes and economic outlooks. This action provides the context within which they can set their policies in a manner relevant to their internal political principles and financial and price stability objectives. For the purpose of analysis of the developments in the Baltic countries after joining eurozone, reference was made to statistical data provided by Eurostat and national databases and convergence reports, working papers and research reviews.

The logic of the article covers the following steps: a) description of the currency exchange models as the basis for the national financial system; b) impact on macro indicators, and c) confidence factor analysis.

2. Initial points of view in the Baltic countries

All three countries started a new age of their Independency since 90 ties. All developments took place under influences of external and internal conditions: political/militarypressure by the break down of the Soviet System, institutional and legal establishments, economic and social reforms towards the "free market" terms, restructuring, and dramatic changes in social attitudes. From the political and socio-economic integration of the Soviet system in a short time, all Baltic countries – Lithuania, Latvia, Estonia were compelled to build a new state status and basic developments of their economies. After 25 years of independence, the new stage of developments is unfolding within the eurozone. The basis of the financial system in each Baltic country is rather similar: Estonia and Lithuania adopted the Currency board model, Latvia with similar monetary policy pegged the national currency to the SDR (managed fixed regime). There are some significant dates in the monetary system in each Baltic country (Table1).

Table 1. The currency regime changeovers in Baltic countries

Year	Lithuania	Latvia	Estonia
2015	euro zone	euro zone	euro zone
2014	pegged	euro zone	euro zone
2011	pegged	Pegged	euro zone
2004	ERM II	ERM II	ERM II
	Currency board in 1992. The Estonian kroon was pegged to German mark at rate 1DEM = 8EEK.	No Currency board. Managed floating regime, 1994. Latvia pegged the Lat (national currency) to the SDR basket.	Currency board in 1994. The litas was pegged to the US dollar at a rate of 1USD = 4LTL

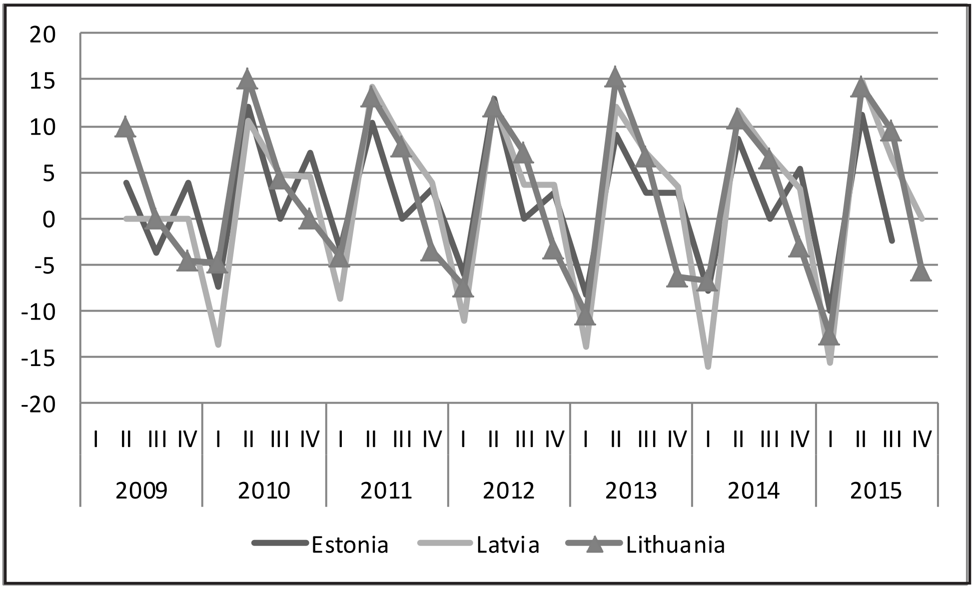
Source: DNB

There are discussions about the efficiency of the currency board in case of unsustainable conditions such as hyperinflation, transition time, crisis, and recession. All three Baltic countries obtained valuable experience of the fixed exchange regimes using the currency board model (Pilinkus,et.(2011). Other countries are adopted the currency board model – Argentina, Bulgaria, Bosnia-Herzegovina, Hong Kong have similar public finance discipline and sustainability effects (Hanke S. (2002). Most of academics and researchers (Ghosh,Ostry (2009), Baliño, T., Enoch (1997), et.) focus on currency board model's advantages and weaknesses analyzing the monetary policy independence level, stability and discipline aspects. One significant macroeconomic effect of the currency boards has been their disciplinary effect on public finances. As currency board prohibits central bank financing of the public sector deficit, it can probably be credited with the relatively low deficits in Lithuania and Estonia. All three Baltic countries became EU members in 2004 and accepted convergence requirements ERMII.

3. Single currency union impact on the Baltic States

The Baltic economies have performed well in the last two decades compared to other transition and emerging market economies. They face some common challenges which warrant national and regional policy responses. These challenges relate to their ability to sustain economic growth going forward, particularly as members (or prospective members) of the euro area.

Figure 1. GDP Growth in the Baltic States



Source: DNB

Estonia has had a quick recovery from the recent recession and its economy is now in a better shape than before the crisis. After a sharp contraction, during which GDP contracted by over 14 percent in 2009, GDP growth rebounded quickly, growing at a rate of 3.1 percent in 2010 and 8.3 percent in 2011. Labor productivity has grown faster than real wages, which has increased the competitiveness of Estonian firms in the world markets. Estonian exports grew 22 percent in 2010 and 25 percent in 2011. It should be mentioned that this is a result of the rapid increase in high value-added exports by the manufacturing sector, which was the main job creator since the crisis. Indeed, export growth has been the primary driver of the Estonian economic recovery.

In **Latvia** complications are possible in the field of transit, where both the speed of recovery of the euro-zone and geopolitical considerations, including the policy pursued by Russia and the Latvian industrial capacity, will play significant roles. During the next two years, overall growth might remain at 4.8%, which indicates that in many fields, improvements will be gradual and uneven. The increase in economic activity continues to push wages up by 5.1% in the third quarter, as compared to the same quarter of the previous year. The increase in wages in the public sector was 5.3%, including the general government sector, where it reached 6.2%. It was closely followed by the private sector, where the increase was 5%. The slightly larger increase of wages in public administration is in line with projected trends, and there is no reason to believe that a similar pattern will continue in the future as well. The strong grip of austerity loosens, and preconditions for the wage increases improve Lithuania and Latvia stood out in Europe in 2013 with 3.3 and 4.1 per cent GDP growth, respectively. Private consumption was one of the main growth drivers and this trend is likely to continue, given increasing demand from the eurozone and recovering business sentiment. The economic performance of all three Baltic States is more directly exposed to trade with Russia than in other central European countries. For this reason, the export/import structure was highly influenced by EU/US decision to put the wide range of sanctions against Russia. Recession and geopolitical conflict in Russia will affect the outlook of Baltic economies this year. The region will benefit from accelerating the new EU support program. This year Lithuania's GDP will grow by 2.6 percent, Latvia's – 2.8 percent and Estonia's – 2.2 percent. As a result of euro expectations, there was a hustle in Lithuania in real estate and durable goods purchases last year. These segments were slow in 2015. Another sector - Lithuanian exports –benefited from the recovery in Lithuania's principal trading partners in the EU.

With the entry into the euro zone, **Lithuania** improved its investment environment and should gain in the long run. Latvian economy will be driven by domestic demand. Solid growth in wages, low inflation, and falling unemployment will boost household consumption. Similar factors are at play in Lithuania and Estonia. Latvia's loan portfolio is still contracting, which restrains economic growth. Estonia's external environment is worsened by struggling Finnish economy. Favorable borrowing environment and weaker euro should help Baltic countries to adjust to changing export markets and return to faster economic growth path next year. GDP per capita (€, 2012) in stood at 13,495 Euros; in Latvia 10,858 Euros, and, Lithuania 11,025 Euros.

Table 2: Comparison of macroeconomic developments and forecasts

Lithuania	**2013**	**2014**	**2015**	**2016**	**2017**
Real GDP, annual change, %	3.3	2.9	1.6	3.0	4.0
Average annual inflation,%	1.2	0.2	0.0	1.5	2.0
Average gross monthly earnings, annual change, eop, %	4.8	5.4	4.0	5.0	5.0
Unemployment rate, eop, %	11.5	10.1	9.0	8.2	7.5
General government budget balance, ratio to GDP, %	-2.6	-0,7	-1.7	-1.0	-0.5
Current account balance, ratio to GDP, %	1.6	0.1	-0.5	-2.0	-2.0
Latvia					
Real GDP, annual change, %	4.2	2.4	2.8	3.5	4.0
Average annual inflation, %	0.0	0.7	0.5	2.0	2.5
Average gross monthly earnings, annual change, eop, %	4.8	6.6	4.0	5.0	6.0
Unemployment rate, eop, %	11.5	10.4	9.0	8.0	7.5
General government budget balance, ratio to GDP, %	-0.9	-1.0	-1.0	-1.0	-0.5
Current account balance, ratio to GDP, %	-2.3	-3.1	-2.5	-3.0	-3.0
Estonia					
Real GDP, annual change, %	1.6	2.1	2.2	2.8	4.0
Average annual inflation,%	3.2	0.5	1.5	1.7	2.0
Average gross monthly earnings, annual change, eop, %	7.6	5.4	4.0	5.0	5.0
Unemployment rate, eop, %	8.7	6.5	6.5	6.0	5.5
General government budget balance, ratio to GDP, %	-0.5	0.6	-0.5	-0.5	0.0
Current account balance, ratio to GDP, %	-1.1	-0.1	-1.0	-1.5	-1.5

Source: DNB

The Baltic countries have to continue to work on the recovery of their economies under new conditions faced by Russia-Ukraine crisis. Latvia, Estonia, and Lithuania still suffer from high unemployment, reviving credit growth—as well as improving export competitiveness and reducing high structural unemployment—which are essential to sustaining economic growth in the Baltics. Lithuania's main export markets include Russia (20 per cent), Latvia (10 percent), Estonia (8 percent), Poland (7 percent), andGermany (7 per cent).Estonia's - Finland, Sweden.Latvia's- Lithuania, Russia, Estonia, Germany, and Sweden.

The next sectors: export and investment (FDI) depend on the level of openness, integration, competitiveness, and attractiveness. Export volume growth has come down sharply from the double-digit rates achieved in the early years of the post-crisis recovery phase. The Baltic economies have also been less successful in attracting FDI in recent years—their share of global FDI declined by about 0.4 percent during 2005–07 (before the crisis) to about 0.2 percent during 2010–12 (after the crisis) (Fig. 2).

The Baltic's post-crisis recovery has been characterized by high export growth. Export-to-GDP ratios have grown rapidly in Latvia and Lithuania and have remained very high in Estonia. However, despite this favorable outcome, some aspects of the Baltics' export performance—including a high concentration in labor-intensive goods—raises questions as to how well positioned they are to extend their good export performance.

Figure 2. Baltic States: Export

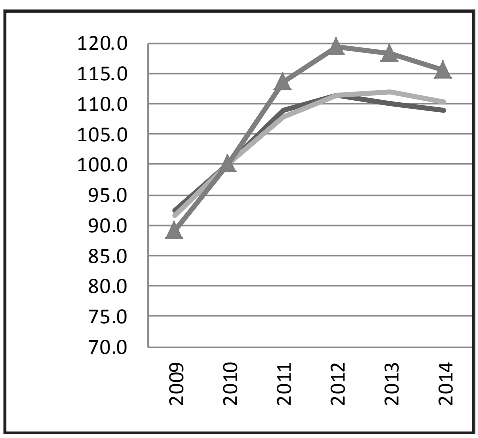
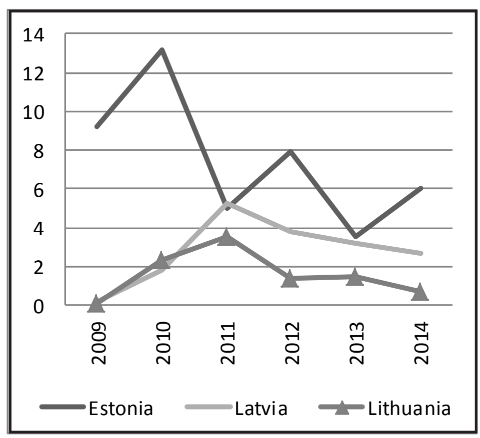


Figure 3. Baltic States: FDI



Source: DNB

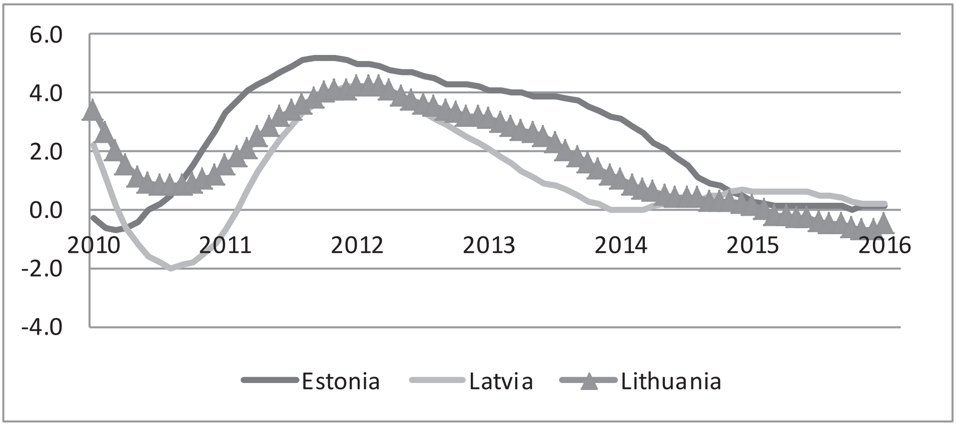
Latvian and Lithuanian exporters have increased their world market shares by 100 and 150 percent, respectively, while Estonia, which had already secured a very strong position before 2000, managed a 70 percent increase. Market share gains were broad-based for Latvian and Lithuanian exporters, but more confined to the Nordics and the United States in the case of Estonia. Market shares are lower when focusing on the domestic value-added component of exports, but the trend in market share gains is similar to the one for gross exports. Increases in the export-to-GDP

ratio, especially in the post-crisis period since 2011, were also impressive Fig. X).The Baltics aspire to move into high-skill, high value-added, exports in rapidly growing markets, but they are competing with other countries in search of the same markets. National policies to improve education and training would help, but collective efforts to improve infrastructure links to the rest of the European Union are also necessary in order to strengthen competitiveness. The Baltic countries, as many other countries, highly depend on external cross connected terms. European debt crisis (Greece case), sanctions against Russia and Ukraine crisis created in a short time new risks and uncertainties for countries' developments. The Russia-Ukraine crisis has a significant impact as the three Baltic States' trade and investment links to Russia and Ukraine are significant, and financial contagion may deepen because the dependency on Russia's gas and oil.
Nordic subsidiary banks fell further, according to a separate IMF report. Latvia's economy still stands out within the region. It entered the euro area in 2014 with the fastest growth rate in all of Europe, helped by robust consumer demand and higher real wages. The unemployment rate fell to 11.3% at the end of 2013, while inflation slid to an average of zero last year, the IMF said.

Estonia's economy is expected to expand 2.4% this year—a significant improvement from the 0.8% growth in 2013—and will head toward potential growth of 3% to 3.5% in the medium term. Its economy has benefited from private consumption and a decline in its elevated unemployment rate to 8.6% last year, but Estonia still needs to boost competitiveness, including by diversifying its infrastructure, the IMF said. Similarly**,** **Lithuania's** economy is on a positive trajectory, and the economy grows to remain the fastest among the Baltic countries.

Fall in the prices for resources is pushing Lithuania towards deflation. Therefore, inflation forecast for 2015 has been revised from 0.4 to -0.4 percent, and for 2016, from 0.7 to 0.3 percent. The weak euro helps in restoring the competitiveness of European goods in dollar countries, i.e., the United States and Southeast Asia. The Euro depreciated by 25% y/y, The weak euro has a positive effect on the euro area's economy and should help the Baltic exporters in their mission of redirecting exports and finding new markets. Although consumer confidence has increased in Lithuania compared to the recent past, this optimism was affected by declining prices of energy resources that enabled households to divert funds and purchase other goods, or simply, save. Furthermore, retail trade data analysis of January-February 2015 (first months after the euro implementation) shows that the yearly turnover growth of most goods has slowed down. It was significantly affected by people getting used to the new currency. Consumer confidence can be sustained by the growth of the average wage and unemployment reduction. Economists (SEB Outlook 2015) predict that in 2015 and 2016 the average wage will grow by 4.2 and 4.8 percent respectively. On the other hand, due to predicted deflation, the real wage should grow more than the nominal wage - this would increase the purchasing power and consumption in coming years. The impact on the Baltic states from the Russia-Ukraine crisis is so far limited to a few companies and sectors, but it will lead to bigger problems for sectors connected to export/import production, and it will produce social effect as well.

Figure 4. HICP in the Baltic States



Source: DNB

The information on price levels allows us study the inflationary effects of the new currency adoption on the structure of prices (food, oil,etc.). The prices of products that were cheaper on average o than the other euro area countries increased by more around the time of the euro changeover.

3.1 Confidence factors

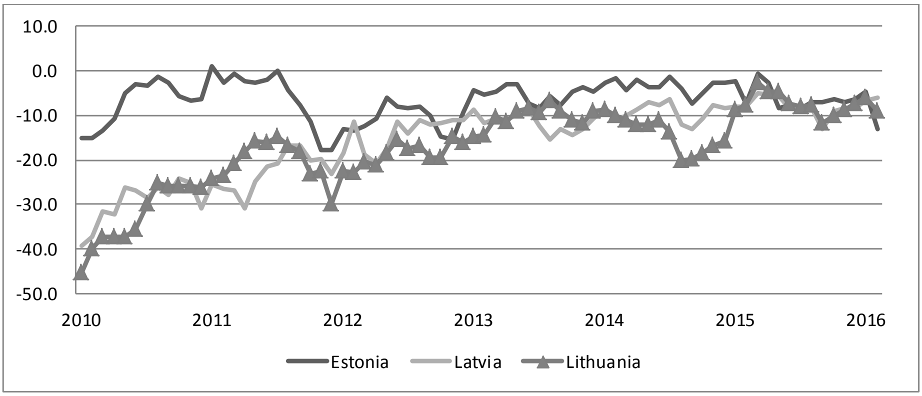
The macroeconomic trends have influenced consumers behavior and expectations. The lessons and experiences gathered from these activities are taken into account for EU/ECB policies support and advice, with particular regard to global economic developments and their potential effects on EMU, the international role of the euro, the reform of the international/regional monetary system, the evolution of global external imbalances. The confidence factor is important for private consumption and business activities.

Figure 5. Estonia - average wages

Source: DNB

Most successful in all achievements among the Baltic States – Estonia. The increase in wages (Figure 5) put the country on high-rank rate among advanced countries.Average monthly gross wages in 2015 – Estonia:€1082; Latvia: €735; Lithuania: €735. Based on Eurostat data the comparisonof main indicators show significant differences in Baltics.

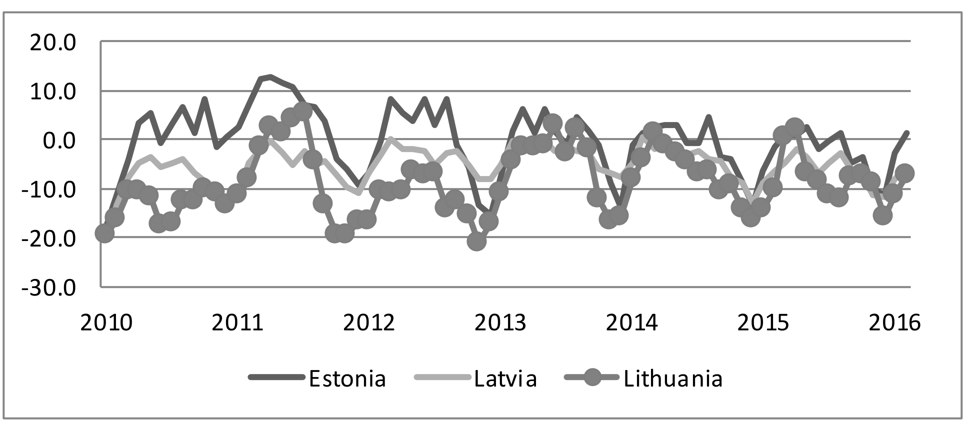
Figure 6. Consumer confidence indicator



Source: DNB

Consumer Confidence in Estonia decreased to -13.70 in the beginning 2016. The same trend in Lithuania. In Latvia increased to -6 in February from -6.70 in January of 2016.

Figure 7. Industrial confidence indicator



Source: DNB

Business confidence trends show the high level in Estonia. Joining the eurozone in 2011 could explain it, then export and investment conditions were almost changed.

Table 3. Consumer confidence indexes in Baltic and selected countries

Country/Area	Consumer Confidence	Reference	Previous	Highest	Lowest	Business Confidence
Euro Area	-5.50	May/15	-4.60	2.40	-34.30	0.28
France	93.00	May/15	94.00	128.94	80.09	103.00
Germany	10.20	Jun/15	10.10	16.80	-3.50	108.50
Italy	105.70	May/15	108.00	124.19	84.70	104.10
Netherlands	6.00	Jun/15	2.00	27.00	-44.00	4.10
United Kingdom	1.00	May/15	4.00	10.00	-39.00	3.00
United States	94.60	Jun/15	90.70	111.40	51.70	52.80
Latvia	-5.60	May/15	-5.50	-5.00	-30.80	-3.60
Lithuania	-5.00	May/15	-5.00	9.00	-56.00	-6.60
Estonia	-8.80	May/15	-3.80	12.80	-38.00	95.90
Russia	-32.00	Mar/15	-18.00	1.00	-59.00	-6.00
Switzerland	-7.00	Jun/15	-0.70	25.30	-53.60	93.10
Turkey	64.29	May/15	65.35	111.90	64.29	109.00

Source: DNB

4. Conclusion

This article examined the trends of developments in Baltic countries affected by joining the eurozone. When a small and open economy as that of each of the Baltic States is experiencing an economic downturn during the recession there are not many options for maneuver between monetary and fiscal policies to find a relevant decision for recovery of the economy and future developments. Each Baltic country is buildng its own way to achieve the recovery goal. Mandatory reserves better equipped Estonia, Latvia asked for an IMF loan, and Lithuania used internal capacity through cutting wages and salaries and using other fiscal instruments. Estonia joined the Eurozone (2011), Latvia and Lithuania followed the Estonia in a stage of recovering from recession. At the same time political sanctions against Russia influenced the import/export flows in all Baltics.

Joining of the eurozone influenced FDI and export position in the balance of payments. The joining of the eurozone had profound social effects illustrated by confidence indicators. Despite differences between Baltic countries, consumer and industrial expectation after joining the eurozone increased. All three Baltic states are converging toward advanced economies. Similar to all other Eurozone economies, the prices of goods/services and production costs were affected by joining the single currency market. Estonia, being the most successful, shows stable growth and positive social respond to wealth improvement.

The challenges raised by the institutional impact of the Eurozone's construction requested proper calibration of locals strategies. The continued success of the Baltic development within the eurozone export sectors will hinge on their ability to adapt to a fast-changing global economy.

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