Floor Discussion of the Sorsa Paper

The Identity of the Baltic States and Sub-Regional Cooperation

The discussion began with various ideas on how the Baltic states should be viewed. Franz-Lothar Altmann asked about Estonia and its relations with CEFTA and Russia. "Why is Estonia not interested in CEFTA while Latvia and Lithuania are? Also, Russia has concluded MFN negotiations with Latvia and Lithuania; why haven't MFN negotiations between Russia and Estonia been concluded? Is Estonia trying to find its own way or is there a lack of concerted behaviour between these three countries with regard to sub-regional behaviour? My second question concerns the Baltic Sea Council. It is a rather young programme, but I would be interested in knowing what programmes it has developed so far and whether they appear promising?"

Friedemann Müller questioned the pessimism regarding Baltic integration. "The Baltics together have fewer inhabitants than the Czech Republic or Hungary; why shouldn't it be possible to put a little bit of healthy pressure on them to compromise among themselves so that they can present themselves in a more common way toward Europe? When the three Baltic foreign ministers come together, they receive much more attention than one alone does. What is the rationale behind not asking them to be more integrated?"

Mats Karlsson disagreed and supported the distinct identity of the Baltic states. "It is true that the Baltic states are doing themselves a disservice by not cooperating on various political and economic issues. But when I hear this formulation of the question, I jump to the other side. Smallness is part of what they are, and there are many small countries in the world; we have to make room for them and recognise their differences. We cannot expect these countries to creep out of Soviet domination and then be grouped into some kind of in-between entity. They must live out their identity, and that is just part of the process. It is not surprising that countries adopt different attitudes toward regional and sub-regional cooperation."

Franz-Lothar Altmann suggested the usefulness of sub-regional cooperation arrangements such as the Baltic Sea Council. "It is unique in that some countries such as Germany or Sweden are EU members while others are not. It would be interesting for these non-member countries to have links via the member countries. I would argue in favour of these sub-regional cooperation arrangements as interlinking instruments. Other

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instances of these overlapping circles exist, and from membership in smaller cooperation schemes, you can gain access to larger arrangements."

Inna Šteinbuka observed that the Baltic Free Trade Agreement had aroused much discussion in the Baltic countires. "In fact, in Latvia there was a lot of discussion about the possible outcome of the agreement. Latvia is somewhat more expensive, so there was naturally concern that a free trade agreement, particularly in agriculture, would result in disadvantages for the domestic Latvian producer. While the first official figures seemed to indicate that trade flows had not changed much, unofficial flows told a difference story. In 1994, we conducted research on informal import flows to Latvia in different commodities and we realised that one example, the informal import of eggs to Latvia, was 100 times greater than officially indicated in customs statistics. So these free trade agreements in the Baltic states contribute to changes in our GDP and in our exports because every country tries to find space for improvement and growth."

Currency Boards versus a Fixed Exchange Rate

Roberto Rocha recalled that when they became independent in 1992, many people suggested that the Baltics needed a currency board. "The same advisors suggested that Bulgaria, Romania and Slovenia needed currency boards because they were unskilled and the central banks were technically unprepared to cope with monetary policy. But none of the three success stories has a currency board. Slovenia experienced capital inflows and managed to bring down inflation to one-digit levels. At the same time, Estonia introduced a currency board and has not been able to substantially reduce inflation. Many of those who advocated a currency board are now embarrassed by the fact that the countries who introduced them have a poorer record in reducing inflation than those who did not. What is the story behind inflation? We have been expecting it to drop to international levels in the Baltics for a long time now, but it has not."

Inna Šteinbuka explained the case of Latvia. "We have no currency board but a fixed exchange rate. Even when our money supply was going down as a result of the banking crisis and low demand, we still had some price increase because of fiscal adjustment and liberalisation of services. So the story behind inflation is different and unrelated to monetary issues."

Ricardo Lago dwelled on the issue of banking crises, arguing that they are a necessary evil "because you have non-performing loans inherited from the old enterprises which are non-viable. Also, you are moving in that environment where all relative prices are re-accommodating, the rules of market entry and exit are changing and the rules of competition with the rest of the world are changing. It is a problems of stocks and flows and sig-

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nalling who is ultimately the viable borrower. This puts the commercial banking system in these countries in a course of recurring crisis – this is inherent in transition."

He then compared the benefits of a currency board to a fixed exchange rate policy. "The benefit of having a currency board in countries like Estonia and Lithuania is that the government is obviously putting its reputation on the line. It is making a commitment to a very restrictive policy of deposit insurance. If banks go bankrupt, the treasury will have to pay the depositors. Also, it is tying its hands in terms of using the lender of last resort function. The banking crisis in Estonia was managed in a very orthodox way – depositors lost money but macroeconomic stability was preserved. Obviously, if you have a massive banking crisis, the worst thing that could happen is that you have to violate the rules of the currency board. Whenever you make a commitment to a fixed exchange rate or pre-announcement, then you tie your hands in the form of a currency board. If the worse situation develops and you have to reverse the convertibility and abolish the currency board, you are going to lose credibility. It is a gamble which has worked fine in Argentina and Hong Kong, and I think it works fine in Estonia. The Lithuanian case remains to be seen."

Stephany Griffith-Jones was not convinced that banking crises were necessary in transition countries. "Recent IMF studies show that the number of banking crises in the past few years has been absolutely astronomical in all countries that have undertaken rapid financial liberalisation. This is a serious problem, but I would not accept that it is inevitable because the same kinds of avoidable mistakes have been repeated. For example, liberalisation has been too fast or there has been insufficient emphasis on regulation and supervision, and these put unacceptable pressures on the banking system. There are cases where a crisis doesn't have to happen, and avoiding crises is important because they arecostly fiscally and in terms of lost output, regaining confidence and so on. Ricardo Lago's view of the success of the Argentinean currency board is controversial. I don't think that 18% unemployment is an acceptable result, and this is what Argentina has at the moment. Other benefits exist as well, but it is at the cost of possibly lower long-term growth because of problems of competitiveness."

Ricardo Lago rephrased his view of the inevitability of a banking crisis, "The likelihood of a banking crisis is very high whenever the real sector of the economy is changing drastically because the signals in the system are changing." He then added some comments on the case of Latvia. "The issue with regard to currency boards is one of credibility. In the case of Latvia, there was no banking supervision. Discussing monetary regimes and exchange rate regimes when you don't know what – if anything – is on the other side of the balance sheet is financial fiction. You must tell the

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depositors that they will lose money if things go wrong. When one bank goes under, you need to be tough. You must ensure, by law, that the central bank has no possibility of bailing out anybody. If the government wants to pay, they should increase taxes. This is what they did in Latvia and why exchange rate stability was preserved. Depositors lost money, it is tough, but so is transition."

Roberto Rocha related the Slovenian experience with regard to the currency board issue. "This discussion on currency boards was very intense in Slovenia right after independence. They argued that they didn't need a currency board, and they could achieve the same result by using the exchange rate as an anchor and developing independent central bank law. Central bank law in Slovenia reveals a very independent central bank. Everything that has been said about Estonia could be replicated in Slovenia, however, they managed to have greater success in reducing inflation and retaining some degree of flexibility in monetary policy, which proved very useful during the 1993 banking crisis. This needs to be on record because those who doomed Slovenia back in 1992, saying that it would not be able to reduce inflation, were just proved wrong."

Mats Karlsson wrapped up the discussion with an overview of cooperation and integration and reiterated his plea for recognising the distinct identities of Central and Eastern European countries. "There are two big clubs in Europe in the Northern Atlantic region, the EU and NATO. Regardless of the reasoning behind NATO enlargement or changing security cooperation, I certainly hope that when it comes to the EU, we will have transparent criteria and a transparent process. I wouldn't like to see the creation of clubs of friends or spheres of influence. We are actually creating a changing Europe, and we have started on a transparent basis with the Copenhagen Criteria. Each country should be accorded equal and individual treatment, and they should face the demands of the *acquis communautaire*. There should be a complementary accession strategy in support of all these countries that will eventually determine who gets in in the first round. If it is perfectly reasonable to assume that the Czech Republic could get in without Slovakia getting in, despite their intrinsic, historical relation, why is it not reasonable for Estonia to get in without Latvia when there isn't a strong link between the two?"

He then responded to Franz-Lothar Altmann's inquiry at the beginning of the discussion on the Council of Baltic Sea States. "First, we need to note that this kind of regional or sub-regional cooperation has a lot of potential because we are not talking about specific trade regimes but about the political muscle in creating a movement in other organisations. Perhaps this simply concerns the political energy in the region in building an identity because we are close to each other, but we are not that close,

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and there is a lot of learning to be done and a lot of wounds to be healed."

Response by Piritta Sorsa

"First, in response to Franz-Lothar Altmann's question regarding Estonia, I would not say that Estonia is not interested in CEFTA, but it is a matter of priorities. The three Baltic states are extremely small countries, and they have very few individuals who are able to negotiate these treaties. I have spoken with some Estonians who say that their time was initially spent on the EFTA-EU agreements and that CEFTA got less priority because of the smaller markets of the member countries. They have concluded trade agreements with the Czech Republic and Slovakia, and they are negotiating with Poland and Hungary. For CEFTA membership, you need to have a free trade agreement with all of these countries, plus you need to be a WTO member. These WTO negotiations are time-consuming. For Lithuania it is obviously much more important to have an agreement with Poland, for example, as a neighbouring country. On the Russia MFN question, Estonia would like an agreement, but the Russians have been very vague, and it is a highly politicised issue.

There is very little potential for increased trade in the Baltics, since these are similar countries with moderate incomes. Of course, these agreements are not a bad thing to do, but they are not going to solve their problems. There has been a free trade agreement in industrial goods in the Baltics since 1994, and now they have one in agricultural goods, but in reality there has not been much trade. Economically, it would be a step backwards for Estonia to join any kind of a customs union. In this sense, their interest might be beyond Europe because by maintaining zero duties, they create an efficient base in industry, services or agriculture and they can export elsewhere as well.

Estonia's inflation is very much the same as in Latvia. If you look at the increases in traded goods prices, it is much less than in non-traded goods prices; the latter are still adjusting, and that is the major source of high inflation. As a result, they are not that worried about it.

On the currency board question, Lithuania is a good case to explain where a currency board was the right choice. They did not initially decide on a currency board, but the Central Bank was not independent, and they were unable to restrict monetary policies on their own because of constant political interference. They established a currency board to rid themselves of this political interference of requesting credits from the central bank to finance either state enterprise deficits or some other government expenditures. In Estonia, the Central Bank has been quite independent, and whether they could have conducted tight monetary policy without the cur-

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rency board is a good question. In Latvia, the inflation rate initially came down with the flexible exchange rate because they had an independent central bank which maintained monetary tightness and their fiscal balance was ok.

I would like to make two points in conclusion. I agree that if Estonia enters and the others don't, it doesn't really matter that much – Sweden is a member and Norway is not. Europe has lived with these kinds of arrangements before. With regard to the low figures for FDI, there is still a perceived transition risk in general, but there are factors which are specific to the Baltics as well. In Lithuania, for example, you cannot own land and there are other regulations which prevent foreign investors from investing. There are also certain aspects of the trading arrangements with the EU that may have restricted access and prevented companies from investing there for export-oriented activities – the hub-and-spoke nature and some policy uncertainty. So there is a host of factors which affect investment performance."

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