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Divergent Baltic paths to the EU: Estonia and Lithuania compared

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Abstract

The issue of economic growth has been addressed in numerous frameworks by various authors, such as Kornai, Kolodko, Csaba, Aslund, Ellman, etc. The countries of post-communist camp have passed a long way since the collapse of the centralized command system, which determined certain type of economic relations between states and its agents and political structure. Some states were more successful and managed to surpass the soviet heritage and joined the EU in short term (the Baltic states, Visegrad countries), the others still face numerous problems. The experience accumulated by the "winners" provides useful hints in what way the policies should be conducted. However, it is apparent that as long as all countries are different, a single approach cannot be applied to all of them. Therefore, the analytical approach, which will take into account country's peculiarity, is needed. The present work will examine the Baltic success in historical perspective as well as in the light of financial crisis. The main claim of the work is that it is not correct about path/ trajectory optimality, since both "shock therapy" and gradualism proved to be efficient. The tactic of transformation does not matter a lot; it is the commitment to the structural reforms what determines the successful transition.

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Introduction

All the countries of the former Soviet Union faced the same problem after the dissolution of the USSR – how to put national economies on the capitalist rails because socialist system with command, central-planned economy proved to be inefficient. Moreover, the system left the countries in the state of economic decline, high interdependence between former Soviet republics but without solid grounds to recover national economies. There have been written a lot about the theories of transition, transformational reforms, their social costs and the extent of the success different post-communist countries, in particular Visegrad countries, have achieved. Moreover, there is a rich debate on the topic - which path of transition is the most efficient and fruitful without a definite answer to this question.

The accession to the European Union (EU) by a number of post-socialist countries with the different tactics and pace of the reformation process implies that both ways are worth attention because both ways can be efficient in overcoming the Soviet heritage and put the countries to the new rails of development. However, recent financial crisis called in question the sustainability of macroeconomic results achieved by both groups of the countries, those that followed “big bang” strategy and those that supported gradualism. In this light the research question of the thesis is why both approaches (“shock therapy” and gradualism) are equally efficient to overcome the Soviet legacy and to achieve meaningful economic progress what makes difficult and hardly possible to speak about the trajectory optimality. Consequently, the objective of this work is to prove that both approaches are valid for surpassing the Soviet heritage, but further structural reformation is still needed in order to address new challenges the countries face, first, after joining the EU and, second, due to the current world economic crisis. Our main claim is that the notion of trajectory optimality is not valid because “shock therapy” (radical way of reforming) and gradualism will eventually converge, if the country shows strong conviction to the reforms. In order to prove that, we will pay special attention to two countries from the Baltic region, Estonia and Lithuania, which were exceptionally successful in transforming their economies and implementing market reforms. The choice of these countries is justified by the fact that representing the same region, analogous historical heritage, they opted for the different strategies of economic transformation but both demonstrated significant achievements comparing with the other states from post-Soviet area. Consequently, the comparison of the two will provide not only a new insight into the theories of transition but will enable us to contribute to the debate by delivering analysis of the economic performance of Estonia and Lithuania, the countries, which selected different tactics of transition, after the accession to the EU and in the light of world breakdown.

In order to answer the question posed in the thesis, I will make an analysis of both countries' (Lithuania and Estonia) economic performance since the collapse of the ex-USSR till 2004 –the year of joining the EU- and will compare the initial conditions of the countries in question as well as relevant reforms having been undertaken in order to transform national economies, i.e. paths of economic reformation in Estonia and Lithuania. Then, I will examine current economic performance of Lithuania and Estonia, i.e. from 2004 till 2009 comparing them in order to reveal communalities and dissimilarities between them as well as important problems to be resolved, thereby testing the hypothesis about the EU limitations and possible benefits and back sides resulting from it. In order to analyze the countries' performance the statistical method, the examining of empirical data – macroeconomic indicators - such as Gross Domestic Product (GDP), foreign direct investment (FDI), inflation, unemployment, etc. will be used. It is useful for testing theories of transition as well as the EU limitations. Moreover, in order to test the validity of the hypothesis I will use the method of agreement, which will enable me to set the start point of my subsequent research.

The thesis consists of seven chapters, introduction and conclusion. The work is organized as follows. The first chapter discusses the existing debate as well as the factors needed for successful transition and sustainable growth. Second chapter will expose hypothesis testing, which will be confirmed using the method of the most similar and empirical data. The third and forth chapter are devoted to the concrete transition stories, i.e. Estonian and Lithuanian. The fifth chapter will be discussing the rejection of both countries in question to the eurozone, bearing in mind that their adopting euro in 2007 was scheduled in 2004. The next chapter will discuss the performance of the countries in the situation of the current financial crisis distilling the lessons to be learnt. The contribution to the debate of transition theories as well as path dependency will be provided in the last chapter. The results of the research and conclusions about path optimality will be made in the concluding part.

Chapter 1. Overview of the major analytical trends in examining of post-socialist transition

Before analyzing empirical data, which will be exposed in the following chapters, it is necessary to provide a theoretical foundation for the practical purposes. There have been said a lot about the ways of transition – “shock therapy” and gradualism. However, in the light of future research, it is worth to deliver the overview of the debate on the two main theories of transition – radicalism and gradualist approach. Moreover, in the addition to the debate one should bear in mind some prerequisites that can be useful for analyzing the empirics. Therefore, it is useful for the purposes of the present work to define the essential components, which should be in place in order to proceed with the transition and to achieve full transformation of the economy of a country as a result. In this light, I will examine essential points related to the transformation process relying on a number of theoretical sources on the end of the present chapter.

Starting with the general overview of the transition process as well as its assessment and the post-transition perspective it is worth addressing the article by Kornai “The great transformation of Central Eastern Europe: Success and disappointment”. The article examines the transformation of the Central Eastern European region locating it within the world history. Kornai shows that transition experience accumulating by post-communist states, representing it as a unique process in the history because it took place peacefully and quickly at the same time (some of the countries are particularly successful). Moreover, there is an important observation made by Kornai, who says that the changes, which took place in Central Eastern Europe (CEE), coincide with the mainstream political and economic development processes of Western

Europe[1], what might evidence that there are certain regimes and types of economies that proved to be more efficient than others.

In order to proceed with the claim that the transformation of the CEE was a unique process in the world history the author distinguishes the six most crucial features of the transformation of the Central Eastern European region within the period of fifteen years.[2] They are the unidirectional changes in the CEE and Western Europe in respect of economic (capitalism) and political (democracy) aspects; a complete transformation, simultaneously realized in all the spheres; the transformation was peaceful, great speed of transformation processes in the CEE. This was plausible for numerous reasons. The authors points out a number of them, such as "restoration" argument meaning that it is easier to rebuilt something that construct a new thing, the spirit of entrepreneurship which some individuals possess, the absence of strong resistance to transition, the positive experience and influence of the external world, which gave incentives to radical changes in the system, and the possibility to receive or purchase modern technology.[3]

Kornai clams that transformation from old command system to a market one during such a short period of time in CEE was a great achievement for the countries of the region in question because transition yielded positive results such as production growth, technical innovation, entrepreneurial spirit which contribute to the overall prosperity and welfare in the region.

However, transformation brought about a number of problems, which were touched upon in the articles concerning transition costs. They are poverty, unemployment, insecurity of jobs, prices influx, corruption, disorders in the political arena, cognitive problems, etc. It means that

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[1] Janos Kornai, "The great transformation of Central Eastern Europe. Success and Disappointment," *Economics of Transition* 14, no. 2 (2006): 217.
[2] Ibid.
[3] Ibid., 223-225.

the process of transformation is a painful process. There are a lot of winners of transformation, in particular, in the best performing states but transformation also entails a lot of economic and social problems to be handled. Therefore, one cannot speak about entirely successful transition from the socialist system to more progressive capitalism. Transition always brings about certain costs.

To sum up, the author makes a valid claim asserting that in spite of the common features that characterized all the countries, all the transformations are different and country-specific and the only approach to study transition properly is comparing different countries' experiences. The transition of CEE enriched the debate providing exceptional cases of success and failure.

Speaking about the factors needed to sustain growth the issue of FDI (in particular, marginal) should be addressed. All of the countries of ex-communist camp needed FDI after the collapse of the socialist economies and still require significant amounts of investment. But, not all of the countries in question are attractive for the foreign investor in terms of securing property rights, stable political situation in a country, the conditions of deportation of revenues, etc. There are a lot of possible factors that affect and determine a country's attractiveness for FDI. Some of them are as follows: governance, economic freedom, and corruption perception.[4] In other words, the level of FDI invested to a country is highly dependant on the degree of the reforms undertaken.[5] The authors distinguish nine factors of it, among which "the extent of liberalization and deregulation of business activities, the provision a stable and predictable legal environment, and improved corporate and public governance"[6] are the most important and meaningful.

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4 Murat M. Kenisarin and Philip Andrews-Andreews-Speed, "Foreign direct investment in countries of the former Soviet Union: Relationship to governance, economic freedom and corruption protection," *Communist and Post-Communist Studies* 41, (2008): 301.
5 Ibid.
6 Ibid., 303.

The general conclusion that follows is that the countries should implement relevant reforms in order to improve investment climate. The argument about the mere reliance on the attractive energy sector is not sustainable because although these countries can be attractive in terms of FDI in short run, the reforms bringing about governance, economic freedom, etc. are crucial for the country's long-term economic development.

The article "Growth, reform indicators and policy complementarities" by Macedo and Oliver-Marines addresses the important issue of policy complementarities as an important factor to foster and sustain growth. Due to the interdependence of reforms, they have to be coherent meaning that reform package should be balanced and integrated aimed at influencing interdependent variables in one direction.[7] The authors offer a lesson to be drawn from the experience accumulated - it is necessary to concentrate on the key barriers to growth, such as, lack of effective economic and political institutions, inflation, unemployment, etc. rather than implement all kinds of possible reforms.

Applying the theory to the transition process several important observations should be made. In terms of the distorted post-Soviet economies, the same package of reforms was offered in order to achieve the most appropriate allocation of resources and, consequently, create the conditions for growth. However, one thing of successful implementation of the reforms was undermined, which is the internal coherence of the reforms undertaken, meaning that when policies are interdependent, they have to be implemented in parallel in order to achieve the maximum benefits from its undertaking. Therefore, the interdependence and complementarity in implementing reforms is a crucial factor affecting the result of the reform and its sequence.[8] To

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[7] Jorge Braga de Macedo and Joaquim Oliveira Martins, "Growth, reform indicators and policy complementarities," *Economics of Transition* 16, no 2 (2008): 142.
[8] Ibid., 146.

sum up, the following conclusion should be made – the level of reforms and their complementarity (increasing changes in its degree) have a positive impact on growth.[9] Furthermore, the authors of the article suggest that the research about the usefulness of the complementarity concept in understanding economic growth during policy cycles is needed. Now it is necessary to define the debate in order to proceed with the research.

To start with, it is worth mentioning that there are two transition theories: shock therapy and the gradual approach. The latter can be defined as a way of radical and extensive reforms while the other implies a more steady way of transformation from central planned communist economy to a market one. Interestingly, there are different views on the effectiveness and appropriateness of both. It is a well-known fact that after the dissolution of the USSR when certain reforms had been undertaken, the drastic fall of industrial output in post-communist countries was observed. There were contesting opinions on the reasons why it had happened and the views on the negative consequences of shock therapy were expressed. However, the fall of output was a widespread phenomenon that affected all the countries regardless the policies having been undertaking.[10] Many researches claimed that "shock therapy might lead to worse performance than gradual transition"[11]. There are a number of diverse explanations of that phenomenon: from deregulation of prices, to the absence of competitive markets and high rates of unemployment.[12] However, there is a fallacy within these explanations. The main weakness of them is that, although theoretically plausible, they do not seem to reflect the basic facts of

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[9] Jorge Braga de Macedo and Joaquim Oliveira Martins, "Growth, reform indicators and policy complementarities," *Economics of Transition* 16, no 2 (2008): 158

[10]Jan Winiecki, "An inquiry into the Early Drastic Fall of Output in Post-communist Transition: an Unsolved Puzzle," *Post-Communist economies* 14 no. 1 (2002): 1

[11] Vladimir Popov, "Shock therapy versus gradualism reconsidered: lessons from transition economies fifteen years after," *Comparative economic studies*, (March 2007), http://www.accessmylibrary.com/coms2/summary_0286-30758459_ITM (accesses May 14, 2009).

[12] Ibid.

transition, but only marginal effects. The significant fall of industrial output was caused neither by the disorganization, nor unemployment insurance payments, nor monopolization effects that drove output down in transition economies during the transformational recession. The nature of the recession was basically an adverse supply shock caused by the change in relative prices, which due to deregulation of prices framework explains the varying impact of economic liberalization on performance at the recession stage and during economic recovery.[13] Kolodko can also fit into this debate, which considers the transition of the post-Soviet republics. He argues that the slower reforms and less dramatic recession do not mean better economic performance in future, taking as an example Belarus where the GDP growth was astonishing-10% in comparison with the modest 1% growth in the Czech republic which followed the way of radical reforms (so did Estonia). Kolodko argues that "the more extensively socialist centrally planned economies were reformed, the shallower and shorter was the transitional period"[14]. This means that post-Soviet economies needed deep structural change, which, although having been painful, contributed to the subsequent economic transition and growth.

Generally there are two camps, those who are in favor of radical approach and those who are against. At the early stage of transition, policy makers were supporting the radical paradigm of the reform implementation.[15] The three groups of economic policy thinkers welcomed the radical approach. First group consisted of leading Western economists, such as Jeffrey Sachs, Stanley Fischer, Lawrence Summers, and David Lipton; economists from the East (Leszek Barcerowicz, Vaclav Klaus, Egor Gaidar, Mart Laar) comprised the second group. International

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[13] Vladimir Popov, "Shock therapy versus gradualism reconsidered: lessons from transition economies fifteen years after," *Comparative economic studies*, (March 2007), http://www.accessmylibrary.com/coms2/summary_0286-30758459_ITM (accessed May 14, 2009).
[14] Grzegorz W. Kolodko, *The Political Economy of Post-Socialist Transformation* (Oxford: Oxford University Press, 2000), 76.
[15] Anders Åslund, *How capitalism was built. The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007), 30.

financial institutions, the IMF mainly, represented the third group.[16] The radical reforms worked out for Eastern Europe followed the postulates of Washington consensus.[17] There are a lot of arguments in defense of speed and comprehensiveness. The proponent of radical reformation was arguing that rapid, radical reforms were needed in order to achieve meaningful results. This will decrease social costs and brings about economic recover earlier. This argument was founded on a confluence of certain ideas. All of them supported the necessity of radical reformation due to the fact of the previous failure of the Soviet economy, understanding that only "shock" can deliver meaningful yields and change the mentality and expectations of the people.[18] Moreover, it was believed that macroeconomic stabilization must be accomplished rapidly in order to prevent high inflation rates. Radical reforms are also considered to be useful in fighting corruption, misappropriation of public funds, and encouragement of entrepreneur's spirit within the society.[19]

The second camp of gradual approach proponents suggested more steady reform implementation. The major difference between the two lied in the perception of market and state failure.[20] The main differences between gradualists and radicalists can be described as follows: the former underestimated the economic crisis after the collapse of the Soviet Union, they refused to admit that the Soviet state was highly corrupted, argued for the stimulation of demand through output and took the achievements of market economy for granted while the adherents of "big bang approach" realized the complexity and riskiness of the task.[21]

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[16] Anders Åslund, *How capitalism was built. The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007), 31.
[17] Ibid., p.32
[18] Ibid., p.35
[19] Ibid., p.36
[20] Ibid., p.37
[21] Ibid.

Many Western economists supported the gradual approach criticizing radicalism for downplaying the primary role of institutions. Furthermore, they attributed drastic output declines to the consequences of “shock therapy” trying to develop an evolutionary theory for postcommunist economic transition.[22] The critique of the radical reforms was especially strong after the Russian financial crash.

Aslund itself throughout his work develops the idea that it is “big bang” that was needed in order to sweep away the Soviet legacy and built up a market economy in the countries of Central and Eastern Europe. In contrast with this opinion, Kolodko’s argument about “insane shock without therapy ” stands. In other words he argues that radical reformation brought about a lot of social costs as well as affected the economic performance of Central and Eastern European countries dramatically.[23]

It is worth mentioning that having undertaken two different ways of reformation/ transition both of them was a success, what testifies the examples of Poland and Hungary, Estonia and Lithuania. Therefore, in the end of the day both approaches provide certain convergence in the path of development meaning the recent accession of all above mentioned countries to the EU. In this light further research is necessary in order to figure out what determines the success of transition reforms as well as to explain the puzzle of further slowdown of the countries in question meaning Estonia and Lithuania.

[22] Anders Åslund, *How capitalism was built. The Transformation of Central and Eastern Europe, Russia, and Central Asia* (New York: Cambridge University Press, 2007), 42-43.
[23] Grzegorz W. Kolodko, ed., *The Polish Miracle. Lessons for the Emerging Markets* (Burlington, VT: Ashgate, 2005), XVII.

Chapter 2. Setting the premises of the following research: hypothesis testing

Having analyzed the existing debate as well as the literature written on particular cases, I have made the following *hypothesis* that paths, **shock therapy (radical way of reforming) and gradualism, will eventually converge if the country shows strong conviction to the reforms.** In my case, I will argue that Estonia and Lithuania, although having opted for different paths of reformation, converged in their transformation process having joined the EU.

In order to test the hypothesis I will use the method of agreement. Classically, this method worked in the following way: selected cases have all similar characteristics but one, which determines the outcome. In my case the method of agreement will disprove the argument that only radical reforms entail successful transformation. In contrary the method of agreement will demonstrate the opposite, which means that, *ceteris paribus*, strong commitment to the reforms accounts for the results obtained (in our case successful transformation of the national economy and the accession to the EU) while the strategy matters less.

The method of agreement is suitable in this case because Lithuania and Estonia are the countries with very similar features in terms of history, size, geographical position, etc. The only difference that can be mentioned is the tactics of the transformation process. The table 1 demonstrates the application of the method of agreement on the cases of Estonia and Lithuania.

Table 1. The application of the method of agreement for Lithuania and Estonian case

Features	Estonia	Lithuania
1. size	very small	very small
2. the Soviet legacy	yes	yes
3. the possession of resources	no	no
4. the FDI at the early stage	insignificant	insignificant
5. dependence on Russia (resources, trade)	yes	yes
6. strong commitment to the reforms	high	high
7. EU oriented	yes	yes
8. the reformation of the national economy via shock therapy	yes	no
Result: successful transformation, meeting the criteria to join the EU, consequent accession	**Yes**	**should be No but, in fact, it is Yes**

I have chosen seven independent variables for the table, which are common for Lithuania and Estonia and which determined or constrained the success of reforms, quick recovery and economic growth. However, the independent variable - the reformation of the national economy via shock therapy differs, in the case of Lithuania "big bang" was not used in order to reform the national economy. Following the method of agreement the consequence (dependant variable) for Lithuania should correlate with the determining variable. However, our empirical data testifies the opposite meaning that, although Lithuania did not adopt the same strategy but, in the end, it enjoyed the same results. To support my claim I will provide some empirical data, which characterizes some of the independent variables and the economic performance of Lithuania and Estonia in dynamics from 1994 till 2009.

It is worth mentioning that Lithuania and Estonia cannot be characterized by good initial conditions. Both countries are small in size, which means that they do not possess a big market. They represent small economy that had not been open economy by the time and right after when the Soviet Union collapsed. Moreover, they did not dispose of rich natural resources to rely on at the first stage when the re-orientation of enterprises was needed (especially in the case of Lithuania). The high trade and resource dependency on Russia aggravated the situation because besides political influence, which Russia exercised over the Baltics, they encountered a problem of re-orientation of industrial sector (that was the concern of Lithuania) and suffered from the price increase for the energy resources because they could hardly afford them in the situation of economic crisis.

The Soviet heritage was another defining factor because, as it will be discussed in detail in chapters 3 and 4, the Soviet Union has left hardly anything besides ruined economy, bad institutions, no incentives and the lack of entrepreneurial spirit.

All the above mentioned features cannot be called prerequisites for successful growth. Furthermore, the expectations were negative – the Baltics were more likely to collapse than to recover because they exposed too few prerequisites to succeed and so many to fail. The dynamics of the Lithuanian and Estonian economic performance will be represented in the tables below.

Table 2. The growth in the GDP (in per cent) from 1994-2004

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Estonia	-2	-4.3	5.0	11.7	6.7	-0.3	9.7	7.7	7.8	7.1	7.5
Lithuania	-9.8	3.3	5.1	8.5	7.5	-1.5	4.2	6.7	6.9	10.2	7.4
All transition countries average	-5.6	-0.1	0.2	3.5	-0.1	1.8	6.2	1.8	4.5	5.8	7.2

Source: EBRD Economic statistics and forecast. http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009), EBRD Transition Report 2003 http://www.ebrd.com/pubs/econo/5790r.pdf (accessed May 15, 2009).

Table 3. The growth in the GDP (in per cent) from 2005-2009

	2005	2006	2007	2008 estimate	2009 projection
Estonia	9.2	10.4	6.3	-3.6	-10.5
Lithuania	7.8	7.8	8.9	3.0	-11.8
All transition countries average	6.3	7.2	6.9	4.2	-5.2

Source: EBRD Economic statistics and forecast. http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009).

Table 4. Inflation (change in annual average retail/consumer price level, in per cent) from 1994-2004

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Estonia	47.7	29	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0
Lithuania	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.5	0.3	-1.1	1.2
All transition countries median	131.6	41.6	24.1	17.4	10.5	9.2	10.0	7.7	5.2	5.0	6.4
mean	1254.5	176.3	85.6	67.2	19.1	28.6	23.6	16.2	9.1	7.0	6.3

Source: EBRD Economic statistics and forecast. http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009), EBRD Transition Report 2003, http://www.ebrd.com/pubs/econo/5790r.pdf (accessed May 15, 2009).

Table 5. Inflation (change in annual average retail/consumer price level, in per cent) from 2005-2009

	2005	2006	2007	2008 estimate	2009 projection
Estonia	4.1	4.4	6.6	10.4	-0.6
Lithuania	3.6	3.9	8.0	6.1	2.7
All transition countries median	5.9	6.3	8.2	10.7	4.9
mean	6.6	6.5	7.5	12.0	6.1

Source: EBRD Economic statistics and forecast. http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009).

Table 6. Investment (net inflows recorded in the balance of payments) in US million dollars from 1996-2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Estonia	111	130	574	222	324	343	153	763	698
Lithuania	152	328	921	478	375	439	714	142	510

Source: EBRD Economic statistics and forecast, http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009).

Table 7. Investment (net inflows recorded in the balance of payments) in US million dollars from 2005-2009

	2005	2006	2007	2008 estimate	2009 projection
Estonia	2,249	673	1,115	1,044	50
Lithuania	689	1,551	1,409	1,459	200

Source: EBRD Economic statistics and forecast, http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009).

Table 8. Transition Indicators from 1989-2008 for Estonia and Lithuania

	Year	Large Scale private-zetion	Small scale priva-tization	Enterprise restructu-ring	Price liberaliza-tion	Trade and Forex system	Banking reform and interest rate liberalizatio n	Securities markets and non-financial institutions	Overall infra-structure reform
Estonia	1989	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	1990	1.00	1.00	1.00	2.33	1.00	1.00	1.00	1.33
	1991	1.00	1.00	1.00	2.67	2.00	1.00	1.00	1.67

	Year	Large Scale private-zetion	Small scale priva-tization	Enterprise restructu-ring	Price liberaliza-tion	Trade and Forex system	Banking reform and interest rate liberalization	Securities markets and non-financial institutions	Overall infra-structure reform
	1992	1.00	2.00	2.00	2.67	3.00	2.00	1.00	2.00
	1993	2.00	3.00	3.00	4.33	3.00	3.00	1.67	2.33
	1994	3.00	4.00	3.00	4.33	4.00	3.00	1.67	2.33
	1995	4.00	4.00	3.00	4.33	4.00	3.00	1.67	2.33
	1996	4.00	4.33	3.00	4.33	4.00	3.00	2.00	2.33
	1997	4.00	4.33	3.00	4.33	4.00	3.33	3.00	2.33
	1998	4.00	4.33	3.00	4.33	4.00	3.33	3.00	3.00
	1999	4.00	4.33	3.00	4.33	4.00	3.67	3.00	3.00
	2000	4.00	4.33	3.00	4.33	4.33	3.67	3.00	3.33
	2001	4.00	4.33	3.33	4.33	4.33	3.67	3.00	3.33
	2002	4.00	4.33	3.33	4.33	4.33	3.67	3.33	3.33
	2003	4.00	4.33	3.33	4.33	4.33	3.67	3.33	3.33
	2004	4.00	4.33	3.33	4.33	4.33	4.00	3.33	3.33
	2005	4.00	4.33	3.67	4.33	4.33	4.00	3.33	3.33
	2006	4.00	4.33	3.67	4.33	4.33	4.00	3.67	3.33
	2007	4.00	4.33	3.67	4.33	4.33	4.00	3.67	3.33
	2008	4.00	4.33	3.67	4.33	4.33	4.00	3.67	3.33
Lithuania	1989	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	1990	1.00	1.00	1.00	2.33	1.00	1.00	1.00	1.00
	1991	1.00	1.00	1.00	2.67	1.00	1.00	1.00	1.00
	1992	2.00	2.67	1.00	2.67	2.00	1.00	1.00	1.00
	1993	3.00	3.33	2.00	4.00	3.00	2.00	1.67	1.00
	1994	3.00	4.00	2.00	4.00	4.00	2.00	2.00	1.00
	1995	3.00	4.00	2.00	4.00	4.00	3.00	2.00	1.67
	1996	3.00	4.00	3.00	4.00	4.00	3.00	2.00	2.00
	1997	3.00	4.00	2.67	4.00	4.00	3.00	2.33	2.33

Year	Large Scale private-zetion	Small scale priva-tization	Enterprise restructu-ring	Price liberaliza-tion	Trade and Forex system	Banking reform and interest rate liberalization	Securities markets and non-financial institutions	Overall infra-structure reform
1998	3.00	4.00	2.67	4.00	4.00	3.00	2.33	2.33
1999	3.00	4.33	2.67	4.00	4.00	3.00	2.67	2.33
2000	3.00	4.33	2.67	4.00	4.00	3.00	3.00	2.67
2001	3.33	4.33	2.67	4.00	4.33	3.00	3.00	2.67
2002	3.67	4.33	3.00	4.33	4.33	3.00	3.00	2.67
2003	3.67	4.33	3.00	4.33	4.33	3.33	3.00	2.67
2004	3.67	4.33	3.00	4.33	4.33	3.33	3.00	2.67
2005	4.00	4.33	3.00	4.33	4.33	3.67	3.00	2.67
2006	4.00	4.33	3.00	4.33	4.33	3.67	3.00	3.00
2007	4.00	4.33	3.00	4.33	4.33	3.67	3.33	3.00
2008	4.00	4.33	3.00	4.33	4.33	3.67	3.33	3.00

Source: http://www.ebrd.com/country/sector/ econo/stats/index.htm for the period 1996-2004 (accessed May 15, 2009).

Note: "+" and "-" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. Averages are obtained by rounding down, for example, a score of 2.6 is treated as 2+, but a score of 2.8 is treated as 3-.

From the tables above can be inferred that both countries started their transformation under conditions of low GDP rates, high inflation, almost inexistent FDI. Moreover, it follows from the last table that both countries have gone trough all the path of reformation process beginning from the low transformation indicators by sectors ending up with one of the best ones in the region of Central and Eastern Europe.

The pessimistic forecasts have not proved true. In fact, both Baltic countries regained the growth from 1994 and managed to achieve stabilization by 1995 while it is known that the remaining NIS have managed to restore positive growth rates only since 1999. From the tables one can deduct that both countries were implementing measure to fight high inflation rates what evidences constant decrease of the indicators. As it was mentioned above, but should be repeated in order to stress early success of Estonia and Lithuania, the breakthrough year was 1994.

The FDI inflows were poor at the beginning of transition period while they have increased significantly after the states expressed their willingness to join NATO in 1999 working out membership actions plans, what made the countries more reliable in political terms and demonstrated the true orientation to the West.

To sum up, overall performance of Estonia and Lithuania represent an excellent example of successful transformation. However, despite general conclusions followed from the tables that were made above, it is necessary to stress that the data for Lithuania and Estonia differs. Estonia demonstrates better indicators what can be explained by the radical reforms it undertook, consequently, enjoyed earlier improvement in the economic performance. It is indisputable fact that radical transformation bears fruit earlier. However, it is necessary to emphasize that although Lithuanian performance was lagging behind Estonian one, it achieved the same results. Two different paths, more and less radical have met at certain point. The last but not the list point regarding the countries' performance is that recent economic data support the argument that Estonia, although having reformed the economy more rapidly owing to the selected approach of shock therapy, illustrates more derailments during the period of 2007-2009, than Lithuania, which was reforming more slowly. The chapter 5 will discuss some aspects of Estonian and Lithuanian economic performance revealing the derailments but focusing on the Baltics accession to the EMU (the difficulties and prospects). However, before jumping to the period after joining to the EU, it is necessary to analyze the transition period in more detail. Next two chapters will discuss the peculiarities of the two ways explaining why each country opted for the approach it applied eventually.

Chapter 3. Estonia: the story of successful transition by following the path of "shock therapy"

This is a well-known fact that Estonia was the best performer from the economic point of view among all the countries from communist bloc until October 2008 (before the financial crisis started). It is worth mentioning that the Baltics had similar start at the onset of the transformation process but managed transition in a different ways, in particular, Estonia choose shock therapy while Lithuania opted for a gradualist approach.

The Baltic states were fully integrated into the Soviet system of command central planning when all economic activity was determined by Russia including the assortment of production, economic ties, etc. Foreign trade decisions were also a privilege of all-Union foreign trade associations. Because of the system the Baltics trade with outside world was insignificant and constituted around 2-3 per cent of its GDP in the late 1980s. Moreover, the major part of its export was sold to COMECON countries.[24] Consequently, Baltics ties with the West were very weak and poor. All this evidences that after regaining its independence the Baltics and, in particular, Estonia and Lithuania, encountered a problem of developing economic relations with Western Europe and being integrated to the Western camp of states, a part of which they conceived themselves. However, it is worth mentioning that the Baltic states have not lost their comparative advantage during fifty years of the Soviet rule meaning that after liberalization, the Baltics partially regain their comparative advantages reminding the independent Baltics before

[24] Magnus Feldmann and Razeen Sally, "From the Soviet Union to the European Union: the political economy of Estonian trade policy reforms, 1991-2000," *BOFIT Online,* no. 1 (2001), under "Bank of Finland Institute for Economies in Transition, BOFIT" http://www.bof.fi/NR/rdonlyres/E8725894-597E-4745-8F53-4164231C201C/0/bon0101.pdf (accessed May 3, 2009): 6.

the WWII. It was obvious in the sectors which production based on the Baltic natural resources, such as wood and wood manufacturing.[25]

Coming back to the question what determined the success of the Baltic republics compared to remaining thirteen countries and, first of all, Estonia one should answer a number of minor questions such as what was political situation in a country, what economic grounds Estonia was disposed of at the very beginning of transition process as well as what public attitude prevailed within the country, and whether Russia could have affected the policies in Estonia. After having answered these questions one will be able to imagine the picture, which dominated the overall situation in Estonia at the outset of transformation as well as it will reveal the peculiarities of Estonian transformation process. The latter is extremely important in order to explain why Estonia opted for the way of transformation it had implemented, thereby determining its destiny.

Before starting analyzing all the factors, it is crucial to say that the success of Estonia is not an issue of one separate factor, which enabled Estonia to regenerate so quickly. There is a combination of determinants, which turned out to be crucial and were leading the country in the right direction.

In this light, it is necessary to start with the political situation of the country what will also shed some light at public sentiments reigning in Estonia. In Estonian case, it was obvious that people did not praise Soviet times and even one can say that Estonians still could recall the times of independence they were dreaming of under communist rule since 1940. Since Estonia was in economic hardship after the dissolution of the Soviet Union (trade, energy resources

[25] OECD, Regional Economic Assessment: The Baltic States "Policy insights from a decade of Baltic transition," (2000), under OECD, http://www.oecd.org/dataoecd/35/1/1864879.pdf (accessed May 6, 2009): 18.

dependence on Russia, poor infrastructure, problems with logistics), it needed decisive internal changes, that is why during the first independent republican elections, the most radical reform-minded government was chosen.[26] It was the moment of "extraordinary politics" as Lescek Balcerowicz named it, which was the period of time when radical reforms were to be implemented as quickly as possible in order to be accepted among the public.[27] Estonian government took advantage of the desperate public sentiments during the crisis, which hit Estonia at that time when Estonian people were ready to accept the most severe reforms, which gave the chance to policy-makers to implement them. Although this period of "transition politics" does not usually last for a long period of time, Estonian policy-makers were able to use that time to launch the most radical program. It is worth mentioning that Estonian government (Mart Laar, the Estonian prime minister during the periods 1992-1994, 1999-2002) as well as specialists of the major ministries, such as the Ministry of Foreign Affairs (MFA) as well as Ministry of Economics and Ministry of Finance were composed of young people who did not have much Soviet rule experience and opted for neo-liberal policies,[28] what explains the decisions taken in the field of macroeconomic policy and, as a whole, the course selected for the country. Moreover, there were not leading, no reformist social-democratic party taking its roots from the communist system in Estonia unlike in some other Eastern European states (neighboring Lithuania or Poland). The other important issue that distinguishes Estonia is that

[26] Mart Laar, "The Estonian Economic Miracle," *Backgrounder* no 2060 (August, 2007), under "The Heritage Foundation," http://www.heritage.org/Research/WorldwideFreedom/upload/bg_2060.pdf (accessed May, 9, 2009): 2.

[27] Ibid., 2.

[28] Magnus Feldmann and Razeen Sally, "From the Soviet Union to the European Union: the political economy of Estonian trade policy reforms, 1991-2000," *BOFIT Online,* no. 1 (2001), under "Bank of Finland Institute for Economies in Transition, BOFIT" http://www.bof.fi/NR/rdonlyres/E8725894-597E-4745-8F53-4164231C201C/0/bon0101.pdf (accessed May 3, 2009): 15.

there was Estonian elites' consensus on the further economic course - economic liberalism[29] what contributed to favorable political conditions for economic transformations. As M. Laar puts it, it is necessary "to take care of politics first and then to proceed with economic reforms."[30]

As it was noted above, Estonian economy was deteriorating suffering from escalating crisis at the beginning of transition period. Estonia started reforming only in 1992, which means later than some other Central European republics did. The loss of time was a crucial reason why Estonian economy was in a poor condition. Immediate intervention was needed in order to tackle social problems and improve standard of living in the country. In these terms a number of economic reforms were implemented, such as liberalization, especially trade liberalization, monetary reform and macro stabilization, institution building, privatization, tax reform.

First of all, it is worth mentioning that the Bank of Estonia was re-established in 1989. In a year state trading monopoly was abolished and law on small-scale privatization was passed. The next step was the adoption of the basic laws on property rights (law on ownership, law on private ownership).[31]

The issue which has not been paid due attention so far is the monetary reform. Estonia did not accept the advice of the IMF to stay in the ruble-zone and introduced its own currency – the kroon in 1992. At the same time the government took the decision to accept currency board agreement (CBA) what provided full coverage for the entire stock of broad money and was as

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[29] Magnus Feldmann, "Free trade in the 1990s. Understanding Estonian Exceptionalism," *Demokratizatsiya* (Fall 2003), under "BNET" http://findarticles.com/p/articles/mi_qa3996/is_200310/ai_n9310220/pg_2/?tag=content;col1 (accessed May 5, 2009).
[30] Mart Laar, "The Estonian Economic Miracle," *Backgrounder* no 2060 (August, 2007), under "The Heritage Foundation," http://www.heritage.org/Research/WorldwideFreedom/upload/bg_2060.pdf (accessed May, 9, 2009): 3.
[31] European Bank for Development and Reconstruction. 2002. Transition Report 2002, London: The Bank, 142.

transparent and reliable as golden standard.[32] [33] As a result, the Estonian new currency was pegged to the deutsche mark what can be explained by the ultimate aspiration of Estonia to join the EU. Although the choice of exchange rates is not the most crucial decision for the authorities to be undertaken, the introduction of national currency and CBA in Estonia enabled the country to achieve a stable macroeconomic situation by effectuating tough decisions for the country, which were also related to the exchange rates, such as keeping the budget balanced, liquidation of insolvent banks, aggressive privatization, etc. Moreover, it was of a paramount importance from the political point of view because introduction of national currency symbolized rapid detachment from Russia, which Estonia was conceiving of as a potential threat, and the Soviet past.[34]

At the same year Estonia liberalized the majority of consumer prices and launched privatization of large enterprises via tender methods.[35] The year of 1994 was the year of the adoption of several legal documents, which regulated property issues and privatization. Estonia was the only country that opted for total liberalization of trade having abolished remaining trade tariffs in 1994 and non-tariff limitations in 1995. [36]

To achieve sustainable results in Estonian performance, it was necessary to create special environment where people would be interested in activating their skills on one hand and a

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32 Fredo Arias-King, "Estonia: Little Country that Could," Demokratizatsiya (Fall 2003), under "BNET", http://findarticles.com/p/articles/mi_qa3996/is_200310/ai_n9310197/pg_5/?tag=content;col1 (accessed may 10, 2009).
33 Adalbert Knobl, Andres Sutt, and Basil Zavoico, "The Estonian Currency Board: Its Introduction and Role in the Early Success of Estonia's Transition to a Market Economy," IMF Working Paper (May 2002), under IMF, http://www.imf.org/external/pubs/ft/wp/2002/wp0296.pdf (accessed May 4, 2009): 11.
34Ibid., 21.
35 European Bank for Development and Reconstruction. 2002. Transition Report 2002, London: The bank, 142.
36 Ibid.

favorable conditions for functioning of the enterprises. The solution was found by introducing flat tax system in 1995.[37] The same year Estonia introduced full current account convertibility.[38]

The purpose of this chapter is not to describe all the reforms undertaken by Estonia in detail but rather to pinpoint what factors determined the success of the reforms. First of all, it is worth mentioning that crisis which swept the country was one of the catalyzers of the radical economic reforms. Crisis opened the window of opportunity for Estonia because the radical reforms, which might not be feasible in other situation, were highly welcomed and played an important role for adopting liberalization policy.[39] However, although the situation of crisis pushed the country into reforms, it cannot explain totally such an extent of trade liberalization as it was designed in Estonia. Interestingly, Estonia was the only country that has gone all the way to free trade abolishing almost all tariffs without introducing any non-tariff limitations instead. "Estonian puzzle" as Feldmann put it meaning the country's rapid reorientation towards West and implementation of unilateral free-trade regime is explained by a number of reasons. There were two groups of factors: exogenous and external factors, political economy ones. The first group accounted for initial conditions in Estonia, which were more favorable to introduce rapid reforms that, for example in Latvia. Among external factors there are the following aspects, commonalities of history and culture. Then, historically Finland played a decisive role for Estonian development, even during Czarist Russia.[40] Therefore, culturally and mentally Estonian people had strong affiliation towards the West in face of Finland for Estonia and later on to the

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[37] Ibid.
[38] Ibid.
[39] Magnus Feldmann, "Free trade in the 1990s. Understanding Estonian Exceptionalism," *Demokratizatsiya* (Fall 2003), under "BNET" http://findarticles.com/p/articles/mi_qa3996/ is_200310/ai_n9310220/pg_2/?tag=content;col1 (accessed May 5, 2009).
[40] John Haog and Mark Kasoff, "Estonia in transition," *Journal of economic issues*, (December 1999) http://findarticles.com/p/articles/mi_qa5437/is_4_33/ai_n28747990/ (accessed April 26, 2009): 926.

European Union (the EU) and NATO.[41] But the political economy factors were those, which determined the Estonia economic pathway. Three of them must be addressed - interests, institutions and ideas.[42] Interest groups were not very powerful in Estonia, which can be related to the lack of big industrial units there as well as less percentage of Russian population in Estonia than in two other Baltic countries.[43] Institutional factor had also a paramount importance for policy choices in Estonia. It is worth saying that institutions were built up from scratch what resulted in dump out of old elites. This factor proves to be vital because creating totally new institutions Estonia benefited from that more than those republics, which created them on an old foundation. Estonia succeeded in that respect because it accumulated a new young generation of professionals avoiding old experiences and memories to be revitalized (it is a well-known factor that it is very problematic to make people adopt a new way of thinking from the physiological point of view).[44] The last but not the least factor is ideas and their role. Regarding economic ideas it was obvious that socialist system proved to be highly inefficient and Estonia was aspiring to create market economy, for which purpose significant structural changes were in need. Moreover, there were no parties in Estonia that did not support neo-liberal economic course to this or that extent. In terms of political ideas, which are related to economic ones, the primary target for policymakers was reintegration with the West. Economic benefits and even to

[41] Magnus Feldmann "Understanding the Baltic and Estonian Puzzles, the political economy of rapid external liberalization in Estonia and Latvia," *BOFIT Online*, no. 11 (2000), under "Bank of Finland Institute for Economies in Transition, BOFIT", http://www.bof.fi/NR/rdonlyres/21283421-A3CE-44D4-9DDC-FF7875C457C5/0/bon1100.pdf (accessed May 10, 2009): 14, 18.
[42] Ibid., 18.
[43] Ibid.,19.
[44] Magnus Feldmann, "Free trade in the 1990s. Understanding Estonian Exceptionalism," *Demokratizatsiya* (Fall 2003), under "BNET" http://findarticles.com/p/articles/mi_qa3996/is_200310/ai_n9310220/pg_2/?tag=content;col1 (accessed May 5, 2009).

greater extent political objectives were at stake. Speaking about the latter, security issue was in the focus since Estonia perceived Russia as a potential threat.

The results of Estonian economic performance can be distilled from the following table, which shows the dynamics of some economic indicators during the period of 1992 till 2004. It can be inferred from the table that during the period from 1992 till 2004 Estonia was improving its performance rapidly what again testifies the success of the implemented reforms.

Table 9. Estonian basic economic indicators during the period from 1992 till 2004

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP growth, %	-14.2	-8.8	-2	-4.3	5.0	11.7	6.7	-0.3	9.7	7.7	7.8	7.1	7.5
Inflation, %, end-year	1076	89.8	47.7	29	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0
Current account balance,% of GDP	N/a	1.3	-7.2	-4.4	-9.2	-12.1	-9.2	-5.8	-5.4	-5.4	-10.6	-11.3	-11.7
Unemploy-ment, end of period, registered	0.9	5.5	5.1	5.0	5.5	4.6	5.1	6.5	13.6	12.6	10.3	10	9.7
Exports, USD million	430	766	1211	1660	1764	2275	2674	2437	5320	5620	6040	7840	8690
Imports, USD million	397	1556	1557	2398	2876	3516	3928	3430	5940	6192	6970	9360	10,12

Sources: EBRD Economic statistics and forecast, EBRD Economic statistics and forecast. http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009), OECD http://stats.oecd.org/wbos/viewhtml.aspx?queryname=18183&querytype=view&lang=en (accessed May 27, 2009).

Continuing the topic of the Estonian success, it is worth addressing the issue of compatibility of reforms. The Baltic experience and Estonian case in particular represent the mixture of policies that were sound but at the same time incompatible form the point of view of their implementation and maintaining.[45] The success of Estonia maintaining the fixed exchange rates, free capital movements and high current account deficit can be explained by the lack of markets that could have caused the instability for Estonian economy.[46] The small size of the country and, therefore, of a financial market, the policy of fiscal restraint, lack of bank credibility, what decreased the possibility of big capital flows, were the reasons why Estonia managed incompatible policies so well. This evidences that practice always can introduce corrections into theory referring to the theoretical framework suggested by Macedo and Oliver-Marines. Furthermore, this fact reiterates the idea that there is not a single valid recipe of success; each country should be examined thoroughly taking into consideration its peculiarities. Due to the special case of Estonia regarding the incompatibility of policies, which were sustained effectively, it is difficult to say if Estonian experience can be applied fully to the other countries in transition.

Finally, it is worth noting that despite great indicators of Estonian economic performance, it is worth mentioning that the cost of transition was very high in Estonia. Poverty, unemployment, the problem of aging of the nation, etc. constituted an acute concern for the Estonian government which entailed the situation of public lack of trust in reformist policy and the accuracy of the government policies because despite high growth rates living standards were not improving among population.[47]

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[45] Pekka Sutela, "Combining the incompatibles: fixed exchange rate, liberalization and financial development in Estonia," *BOFIT Online*, no. 8 (2002), under "Bank of Finland Institute for Economies in Transition, BOFIT," http://www.bof.fi/NR/rdonlyres/206647B6-4D7F-4EC7-A101-926C8E2B1F89/0/bon0802.pdf (accessed April 29, 2009): 15.

[46] Ibid., 14

[47] Marju Lauristin, "Social Contradictions Shadowing Estonia's "Success story"," *Demokratizatsiya* (Fall 2003) under "BNET", http://findarticles.com/p/articles/mi_qa3996/is_200310/ai_n9310188/pg_2/?tag=content;col1 (accessed May 2, 2009).

Estonian transition is an excellent example of country success over the Soviet legacy. It was predetermined not only by the situation of crisis, which all the fifteen Soviet republics experienced after the collapse of the Soviet State, but the success was brought about by the combination of factors that cannot be considered separately. Estonian case also proves that human factor is highly important meaning that all the reforms undertaken were the result of the decisions made by the people with fresh views and firm actions.

Conceiving transformation as a package of coherent reforms to be implemented Estonia and Lithuania were offered the same "recipe to recover" as to other transition countries. However, the Baltic experience evidences an important insight into transformation theory - transition is not a set of independent reforms, which means that only coherent mutually supportive macroeconomic reforms can bring fruit. Moreover, the Baltic transition confirms the fact that transition is not only about macroeconomic stabilization. The true result will be achieved only when structural reform has reached certain progress.[48]

[48] OECD, Regional Economic Assessment: The Baltic States "Policy insights from a decade of Baltic transition," (2000), under OECD, http://www.oecd.org/dataoecd/35/1/1864879.pdf (accessed May 6, 2009): 2-3.

Chapter 4. The gradual economic transformation of Lithuania: main reforms and their results

In this chapter I will present the case of Lithuanian economic transformation. I have chosen Lithuania as a second case study because Lithuania, although declared similar goals as Estonia did, reveals significant differences in the tactics of the reforms (pace and direction). Moreover, Lithuania is also considered to be a successful story in terms of overcoming the Soviet legacy, rapid, peaceful and efficient transformation towards market economy, what makes it valuable to study as another example of successful reformation. However, the cases of Estonian and Lithuanian transition are not identical. It is worth mentioning that although both of the countries belong to the same geographical region and among the Western CIS countries, they had different affiliations, meaning that Estonia has been always maintaining close relationships with the West in the face of Finland, first of all, while Lithuania had been tied historically and economically to Russia for a long period of time. Furthermore, Lithuania has a lot of commonalities with the countries of Eastern Europe.[49] Due to all these reasons Lithuania provide an interesting case, and, therefore, further comparison of Estonia and Lithuania will give new insight into transformation process bearing in mind that the country's different paths has finally produced the same results.

Speaking about economic transformation in Lithuania it is necessary to start with the political situation in the country when the reforms were first launched. The major peculiarity of political environment of Lithuania was frequent changes in the government, thereby bringing about the changes in economic policy. After Lithuania declared its independence in 1990, the

[49] Verena Fritz, *State-building: A Comparative study of Ukraine, Lithuania, Belarus, and Russia* (Budapest, New York: Central European Union Press, 2007), 244.

governing party announced a radical shift in economic policy. Since Lithuania was seeking the alignment with the West, it adhered by the policies which were in line with those envisaged by the major international agencies. However, it is important to note that unlike Estonians, Lithuanians in terms of their national identity and in the light of its close historical links with Russia have not strongly opposed to Russia and defined its destiny in the Western club emphasizing their "European-ness".[50]

The defeat of the first independent government was dictated by its commitment to rapid liberalization what caused hyperinflation and hampered significantly the standard of living. Lithuanians did not support rapid privatization and restitution and the ideas of anti-communism and de-Sovietization did not find public support among numerous rural working class.[51] The same situation repeated with the ex-communist government, which deserved public support by promising improvements of social welfare. However, as it was mentioned above, the ex-communist party had no conviction to the old order. Although, the pace of liberalization and privatization was slowed down, the purpose remained the same – to convert Lithuania's economy into a market one. Next government was more committed to improvement of social well being of the population promising to increase government spending in social programmes and to reduce taxes.[52]

The other remarkable feature of the Lithuanian political situation is that there was a lack of public trust in the government in power what resulted, as it was mentioned before, in frequent changes in the government. Public trust in the government was restored only in 1997 with the

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50 Rawi Abdelal, *National Purpose in the World Economy. Post-Soviet States in Comparative Perspective*, (New York: Cornell University Press, 2001), 86.
51 Thomas Lane, *Lithuania. Stepping westward*, (London, New York: Routledge, 2001), 140-141.
52 Ibid., 146.

election of Adamkus who was a progressive politician completely supporting democratic values, free markets and integration of Lithuania with the West.[53]

To sum up, the political situation was much more unstable in Lithuania than in Estonia what predetermined frequent changes in the priorities of economic policy, thereby affecting the general pace of the reforms. Moreover, Lithuanians were less determined about the necessity of flash-like reforms due to the serious impoverishment of the living standards. Consequently, although the government realized that the economy needed to be transformed rapidly, it was prevented from taking radical decisions due to the lack of public confidence. Apparently, the moment of "extraordinary politics" could not have been taken advantage of to a full extent.

The legacy of the Soviet Union made the economic situation in Lithuania quite complex, meaning that the initial conditions were tough there. Except for bad macroeconomic indicators (there was high inflation, GDP in decline, etc.) and low standard of living, Lithuanian economy (in particular, heavy industry) experienced a high dependency on Russian resources because Lithuanian industrial enterprises did not have any other substitutes for them and could not function properly. The situation was exacerbated by Russian political manipulation of Lithuania using the supply of resources as a bargaining chip to achieve desirable political goals there [54] and related partially to that the introduction of the world prices for energy and raw materials for Lithuania.[55] Since independence on Russian resources was of a critical importance for Lithuanian economic growth, Lithuania started cooperating with Williams later on what hampered Russian hegemonic position in the Lithuanian energy market. The problem Lithuania faced was that there were too many industrial enterprises, which were a part of the industrial

53 Thomas Lane, *Lithuania. Stepping westward* (London, New York: Routledge, 2001), 148-149.
54 Thomas Grennes, "The Lithuanian economy in transition," *Lituanus* 40, no. 2 (Summer 1994), http://www.lituanus.org/1994_2/94_2_03.htm (accessed May 4, 2009).
55 Rawi Abdelal, *National Purpose in the World Economy. Post-Soviet States in Comparative Perspective*, (New York: Cornell University Press, 2001), 86.

complex of the former Soviet Union, which means that they were linked with the other enterprises of the Union through manufacturing links.[56] The other detail, which made the detachment form the Soviet Union more difficult, was the system of planned by the regions of the Soviet Union economy that determined the orientation of the economy of Lithuania.[57]

It is worth mentioning that several essential reforms were launched in 1990-1991 – monetary reform, privatization, and fiscal reform under the first independent government (*Sajudis*) when they still enjoyed public support.[58] However, as the political situation was not stable and no government managed to stay in power till the late 90s, the reforms were implemented with different pace and faced certain resistance. At the onset of the 1990s transformation was intended to accomplish with significant social cost. However, the first wave of reform, it was obvious that social cost will be paid. Lithuania suffered from meaningful decline in GDP, increase in unemployment.

Coming back to the process of transformation itself, it is worth mentioning that there were other reasons why Lithuania was behind Estonia. Lithuania faced resistance from the bureaucracy and the management of the large industrial enterprises that wished to mitigate the process due to the drastic decrease in living standards.[59]

There are several reasons why Lithuania opted for more gradualist approach. First of all, Lithuania had a larger industrial sector, as it was mentioned above and due to the economic dependence they wished to keep good relations with Russia to maintain constant supplies of materials and preserve a huge market. The second reason is that although Lithuania chose

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56 TDS, "Lithuania Europe," under "TDS" http://www.traveldocs.com/lt/economy.htm (accessed May 5, 2009).
57 Bertelsmann Stiftung, BTI 2008 - Lithuania Country Report. Gutersloh: Bertelsmann Stiftung, (2007), http://www.bertelsmann-transformation-index.de/fileadmin/pdf/Gutachten_BTI_2008/ECSE/Lithuania.pdf (accessed May 28, 2009): 2.
58 Verena Fritz, *State-building: A Comparative study of Ukraine, Lithuania, Belarus, and Russia* (Budapest, New York: Central European Union Press, 2007), 244.
59 Thomas Lane, *Lithuania. Stepping westward* (London, New York: Routledge, 2001), 164.

reorientation towards the West, there was a consensus that Russia was a threat for Lithuanian security like in Estonia, but it was agreed that it would remain one of the major trading partners.[60] Third, since Lithuania gave voting rights to Russian minorities unlike Estonia, which often were also opposed to such radical reformation. Moreover, Lithuanians themselves sometimes demonstrated ambivalence to the destiny of transition process.[61] All these factors contributed to Lithuanian slower speed of economic transformation.

Speaking about the reforms as such, although opting for a gradualist pathway, Lithuania passed through the same stages: liberalization, privatization and stabilization.

The major institutional changes were as follows: first of all, in 1990 right after the independence Central bank was established. At the same year the tax reform started with the introduction of personal income tax. The next step was adopting privatization and restitution law in 1991, which began with voucher privatization. The first stage of privatization was completed in 1995.[62] By the year 2001 Lithuania was about to finish large-scale privatization although keeping in state property strategic enterprises.[63] However, certain steps were undertaken to improve the situation, for example, in 2002 Mazeikiu oil refinery was privatized. In the 1992 Lithuania liberalized most prices.

The major reform of stabilization period aimed at fighting high inflation rates, which caused a drastic falls in real income, was monetary and fiscal reform. In 1993 Lithuania introduces national currency – litas. In 1994 the litas (Lithuanian national currency) was pegged

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[60] Thomas Lane, *Lithuania. Stepping westward* (London, New York: Routledge, 2001), 140.
[61] Ibid.,165.
[62] European Bank for Development and Reconstruction. 2002. Transition Report 2002, London: The Bank, 174.
[63] European Bank for Development and Reconstruction. 2001. Transition Report 2001, London: The Bank, 170.

to the dollar at LTL 4 per 1$.[64] At the same year Lithuania liberalized trade regime and signed the free trade agreement with Russia. The major achievements of the liberalization and later on of stabilization stage except for freeing prices was the reorientation of export and import markets to the West decreasing economic dependence of Lithuania on Russia by the conclusion of trade agreements with European countries and the United States.[65]

The period from 1994 till 2002 was characterized by a number of crucial reforms. In 1994 the currency board agreement (CBA) was made, which was a success and achieved its main goal - price stability. In order to keep pegging compatible with the Lithuanian trade structure, the litas were repegged to the euro in 2002. [66] Moreover, that was an important step to the further accession to the EU and entering the eurozone.

For the reason of large fiscal shortfalls Lithuania effectuated fiscal reform in 1994, what resulted in avoiding large budget deficits and produced significant contribution to stabilization.[67] Fiscal reform was also introduced with the view to be consistent with the EU accession requirements.[68] The VAT was introduced in 1994 followed by the adoption of the capital gains tax. Moreover, at the same period of time the full currency convertibility was introduced as well as export duties were abrogated.

The other challenge Lithuania experienced was the acute necessity to change the mentality of people and to find and prepare qualified, business-like and skillful managers to

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[64] Patricia Alonso-Gamo et al., "Lithuania: History and Future of the Currency Board Arrangement," IMF Working Paper (August 2002), under IMF, http://www.imf.org/external/pubs/ft/wp/2002/wp02127.pdf (accessed May 4, 2009): 5.

[65] Encyclopedia of nations, "Lithuania overview of the economy" under "Encyclopedia of nations" http://www.nationsencyclopedia.com/economies/Europe/Lithuania-OVERVIEW-OF-ECONOMY.html (accessed April 20, 2009).

[66] Patricia Alonso-Gamo et al., "Lithuania: History and Future of the Currency Board Arrangement," IMF Working Paper (August 2002), under IMF, http://www.imf.org/external/pubs/ft/wp/2002/wp02127.pdf (accessed May 4, 2009): 7.

[67] Thomas Lane, *Lithuania. Stepping westward* (London, New York: Routledge, 2001), 172.

[68] Marek Dabrowski, Ben Slay, and Jaroslaw Neneman, *Beyond transition. Development perspectives and Dilemmas* (Burlington, Hants: Ashgate, 2004), 167, 173.

work according to the laws of market who were in scarcity at that period of time. The other problem of Lithuania was corruption, which was fought by the adoption of a national anti-corruption plan and creation of monitoring and enforcement instruments.[69]

Regarding foreign investment Lithuania began attracting it in the beginning of 1990s, but the inflows became significant since 1996, 1997 onwards (however, Lithuania was lagging behind its Baltic neighbors), which can be explained by the positive results of stabilization, in particular, monetary and fiscal reform.[70]

To sum up, Lithuanian transition also achieved successful results, although Lithuania opted for gradualist approach.

As a conclusion, it is important to say that Lithuania, although was the only country, which after having received independence from the communist rule, was again governed by the ex-communist party, demonstrated great commitment to the market reforms and liberal values. This testifies that Lithuania was heading in a new direction in terms of economic course. The adoption of new rules and political regime occurred early and firmly there.[71] The country passed through the classical stages of the transformation process, although slower, but achieving significant positive results. This implies that there is no the only pathway to surpass the Soviet legacy and built up a market economy and democratic statehood. Lithuania was also renovating its economy from scratch what explains partially its successful performance.

In terms of economic transformation, the comparison of Estonia and Lithuania demonstrates that Estonian rapid, although painful, implementation of reforms proves the fact

69 European Bank for Development and Reconstruction. 2003. Transition Report 2003, London: The Bank, 174.
70 Verena Fritz, *State-building: A Comparative study of Ukraine, Lithuania, Belarus, and Russia* (Budapest, New York: Central European Union Press, 2007), 244.
71 Ibid., 248.

that the recovery will come earlier. [72] The comparison of Estonian and Lithuanian experience evidence that Estonia realize that high inflation, unemployment and drastic decline in the GDP was the prerequisite of early economic recovery and growth. Moreover, Estonian fast success can be explained by, first, less economic dependence on Russia, and, second, that it managed to free completely external trade what played a significant role in Estonia reorientation.

The window of opportunity, which enabled Estonia to implement radical reform, was opened wider there than in Lithuania due to a number of preventive reasons and public sentiments as such.

[72] Thomas Lane, *Lithuania. Stepping westward* (London, New York: Routledge, 2001), 143.

Chapter 5. The difficulties of the post - accession period or why Lithuania and Estonia were rejected to the eurozone?

The next crucial step for the new member states after the accession to the EU was successful entering the eurozone. However, it is important that all new member states adhere by the right sequence for economic integration with the European Union.

It is worth mentioning again that Estonia and Lithuania were among the best performers during the transition, what implies that their economic performance were promising rapid joining the EMU. The data of the adoption of euro for the countries in question was set for January 2007.

The accession to the EMU entails a variety of advantages for the new comers, such as improvement of macroeconomic efficiency through elimination of transaction costs (important for trade relations) and exchange rate uncertainties, higher price stability and productivity, and greater inflows of FDI.[73] These benefits are especially important for small open economies as Estonia and Lithuania represent. The other crucial reason for joining the EMU can be conceived of through the fact that medium developed and medium indebted countries are more vulnerable than the others.[74] Therefore, entering the eurozone implies protection for the economies of the new member states.

Technically speaking the candidate country must comply with Maastricht criteria in order to be accepted to the EMU. There are five monetary policy criteria which are a must. They concern inflation (must not exceed average rate of the three EU member states with the lowest rate); interest rate (must not exceed average long-term interest rate of the three EU member

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[73] Mart Sorg, "Estonia's accession to the EMU," *Institute for Finance and Accounting, University of Tartu*, http://deepthought.ttu.ee/majandus/tekstid/TUTWPE_05_133.pdf (accessed May 18, 2009): 11. (5-19)
[74] László Csaba, *Crisis in economics? Studies in European Political Economy* (Budapest: Akadémiai Kiadó, 2009), 89.

states with the lowest rate); exchange rate (must not fluctuate more than +/-15% against the euro); government budget (annual deficit of the candidate country must not exceed 3% of the country's annual GDP); public debt criterion (general government debt of the candidate country must not exceed 60% of the country's annual GDP). The major problem for both states remains to be higher that it must be rates of inflation. However, due to the good results the CBA has produced since it was introduced in Estonia, such as successful stabilization of inflation what was predictable bearing in mind the openness of Estonian economy, full trade liberalization and capital mobility regimes[75] as well as it did in Lithuania, both countries were supposed to handle inflation problems and it was expected that they would join the eurozone in 2007. However, both Estonia and Lithuania were rejected by the ECB to join the eurozone in 2007. The first answer that comes to our mind is that both countries have not met the inflation criteria for introducing euro in 2007 (was almost two times higher the necessary level), which cannot be related to poor monetary policies in the case of the Baltics because the CBA deter the countries from implementing independent policies. In order to answer the question fully, it is necessary to carve out the reason which causes the increase of inflation rates in both countries instead of steady decrease as it was in the years from 2001 till 2004 (when the prospect to enter the eurozone in 2007 was so real). In this regard the important issue that must be addressed is why both countries being the best performers of transition period slow down their expansion (what the recent economic indicators show). However, there have been no external reasons for derailment – those that usually are considered to be the causes of economic slow down - such as external nominal shocks, etc.[76] [77] Furthermore, the new member states enjoy quite favorable position in

[75] Marten Ross, Raoul Lattemae, "EMU Accession Issues in Estonia," *Comparative Economic Studies* 46 (2004): 148. (146-158).
[76] See table 2,3.

the international financial markets what testifies the absence of harsh measures in order to handle frequent and quite high current account deficits[78], which Estonia and Lithuania demonstrate. The table 10 contains the statistical data on the dynamics of current account deficits of the respective countries.

Table 10. Current account balances (in per cent of GDP) in 1997-2009.

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008 estimate	2009 projection
Estonia	-11.4	-8.6	-4.4	-5.3	-5.2	-10.7	-11.4	-11.8	-9.9	-16.8	-18.0	-9.4	1.2
Lithuania	-9.8	-11.6	-10.9	-5.9	-4.7	-5.2	-6.9	-7.6	-6.9	-10.7	-14.6	-11.9	-2.6
All transition countries average (unweighted for the region)	-7.8	-9.0	-5.7	-3.0	-4.0	-4.4	-4.7	-5.0	-3.7	-4.3	-6.5	-7.1	-6.2

Source: EBRD Economic statistics and forecast, http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009).

77 László Csaba, *Crisis in economics? Studies in European Political Economy* (Budapest: Akadémiai Kiadó, 2009), 87

78 László Csaba, *Crisis in economics? Studies in European Political Economy* (Budapest: Akadémiai Kiadó, 2009), 87

It follows from the table that current account deficits are quite high in Lithuania and Estonia. They were impressively high in the 2007 (two three times higher then acceptable level), the year for which the accession to the EMU was planned.

Surprisingly, the accession to the EU has not brought about large-scale marketizing reforms; instead after the accession, the countries followed the tendency to adopt populist reforms. Consequently, it resulted in the impoverishment of economic performance with poor improvement of institutional infrastructure what in its turn prevented the countries in question from entering the eurozone, what could have created favorable conditions for long-lasting growth.[79] At the moment, it is difficult to predict when Estonia and Lithuania will join the EU complying with all the criteria of the EMU.

Looking for a reason of Baltic slowdown one cannot find the direct reasons which are normally considered to affect the economic performance negatively, such as expansionary fiscal policies, etc. All that means that the main reason for the phenomenon observed in the Estonian and Lithuanian performance originate from the populist policies of new generation meaning that those policies represent a complex of too simplistic and "good for all" measures, which have been not reflected upon critically.[80] Moreover, since the countries in question do not have fiscal imperfections the populist policies in their regard might be understood as "… continued extension of redistributive policies".[81] From the considerations presented above can be deducted that the absence of strong institutions, in the case of the Baltics concerning the inflation, independent monetary policy instruments can be the reason of the problems with stabilizing inflation rates what mainly caused the rejection of the ECB Lithuania and Estonia in the EMU.

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79 László Csaba, *Crisis in economics? Studies in European Political Economy* (Budapest: Akadémiai Kiadó, 2009), 87

80 Ibid., 88

81 Ibid., 90

Both Estonia and Lithuania were adhering to the restrictive fiscal policies, cutting taxes as much as possible what generated overheating of the respective economies. Therefore, fiscal measures as well as structural measures are urgently needed in order to tackle the problem.[82] Moreover, the CBA, although having produced positive result, such as macroeconomic stabilization, back in time proved to be inefficient lately because the economies in question needed development as well as more sophisticated instruments of monetary policies, which cannot be offered immediately due to the internal restrictions. However, the delay in taking concrete steps might only aggravate the problem, cost more and turn out to be less efficient.[83]

To sum up, the major factors which are at the root of economic derailment of Estonia and Lithuania are as follows. First of all, both countries were shifting their focus from the "…economic/consolidation point to the social redistributive point". Therefore, sometimes the simple economic logic was neglected or even misapplied.[84] Second, upon the accession the Commission could use effective measures to push the countries into structural reforms. However, the time was lost and the countries in question applied quite simplistic polices, which were not helpful in handling structural lapses.[85] Third, the loss of transparency in politics and economics can be also an explanation of the derailments. Changing public and business perceptions might result in the respective changes in mainstream policy line, thereby reducing the chance for the success. Forth, the demographic factor is also in the picture meaning that the aging of the population might affect the policies. Since the older generation tend to be more conservative, the structural reforms, which normally entail social costs, are less likely to be approved of and

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[82] László Csaba, *Crisis in economics? Studies in European Political Economy* (Budapest: Akadémiai Kiadó, 2009), 90.
[83] Ibid., 107.
[84] Ibid., 108.
[85] Ibid.

implemented because young people tend to have less voice during the elections showing disappointment with the mainstream politics. The outcome of that is postponing of major structural reforms but following the populist policies aimed at pleasing the active voters – pensioners. [86]

Estonian as well as Lithuanian example testifies that successful transformation is not the only condition to expand further. The success of early transition is accounted for the appropriate timing of the reforms, due implementation of them as well as strong conviction to the values of market economy. After the accession to the EU both countries should have been chosen the same orientation meaning that certain reforms still were needed in order to achieve convergence between new members of the EU and the old ones. However, both and Lithuania have failed to undertake necessary changes. In our case (due to the constraints of the research) we speak about the reforms, which were needed to improve inflation rates what predetermined the failure to join the eurozone in 2007 as it was presumed in 2004. In this light we can make a conclusion that the absence of further structural reforms due to the adoption of a number of populist policies was the primary cause of the Baltic failure to accomplish the ambitious plan to join the eurozone in 2007. As it was mentioned above, the delay in delivering structural reform aimed at providing much convergence with the EU-15 will cause additional cost to Estonian and Lithuanian economies especially in the light of unraveling financial crisis. The next chapter will discuss the important lessons, which economies in transition might learn from the current crisis, in terms of past developments.

[86] László Csaba, *Crisis in economics? Studies in European Political Economy* (Budapest: Akadémiai Kiadó, 2009), 110.

Chapter 6. Lessons to be learnt from the current crisis

The end of the year 2008 was difficult for world economy as it was hit by financial crisis. Although it affected all national economies, some countries are in better position than the others. In this chapter we will not talk about such difficult cases as Ireland and even Hungary represent but we will try to distill some lessons from the Estonian and Lithuanian story in the light of current economic crisis.

First of all, it is necessary to start with some statistical data. As we have already noticed, the accession to the EU has not brought large-scale reforms to Estonia and Lithuania but instead of it a number of inefficient policies has been adopted what led to the impoverishment of macroeconomic indicators of the both countries. Statistical insight proves it. The GDP in Estonia after steady growth from 2004 till 2006 from 7.5% till 10.4 contracted drastically in 2007 to 6.3 in 2007 and according to the estimations amounted to the negative figure of -3.6% in 2008.[87] The results of financial crisis are evident. The same tendency is observed in Lithuania; however, the scale of contraction there is less than in Estonian case. The GDP growth during the period of 2004-2006 has changed from 7.4% to 7.8%, which is remarkably less than in Estonia, but, interestingly, in 2007 Lithuania kept growing and concluded the year with 8.9% GDP growth. The contraction came in 2008 but still, although the percentage decreased from 8.9% till 3.0%, the figures remained positive. As projection tells us even deeper GDP fall is expected in 2009.[88]

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[87] See tables 2,3
[88] Ibid.

The trend is analogous in respect of inflation rates observed in both countries, but there have been said a lot about the reasons and proclivities in the chapter 5, so, there is no necessity to repeat it once again.[89]

The other issue that should be mentioned here is the situation with the FDI inflows. Estonia after having become part of the EU experienced great inflow of foreign investment into the country. The rapid growth of investment was observed from 2004 till 2005 when the figures of FDI to Estonia jumped from 690 million US dollars to 2 249 million US dollars. However, the period of investment boom has not lasted for a long period of time. The drastic decline characterizes the year 2006 when the level of foreign investment to the country achieved the indicator of 2004 even a little bit less.[90] This might be connected with the impoverishment of the investment climate at the country. The Lithuanian situation with FDI differs. Although the increase of FDI into Lithuanian economy was not so impressive as Estonian one, Lithuania managed to attract stable amount of FDI into the country during the period of 2006-2008.[91] The huge decrease of FDI to both Estonia and Lithuania is expected for the year 2009.

The statistics shows that the most radically reformed country Estonia is suffering greater extent of decline than Lithuania, which has implemented more gradual approach.

Speaking about the drastic recession of Estonian and Lithuanian economy one cannot but mention that the EU membership has not turned out to be a panacea for the countries in question. It is indisputable fact that the EU helped meaningfully to both Baltic countries during the years of transition and after their incorporation to the EU as well. It helped the countries to develop trade by diversifying the markets and concluding bilateral agreements with the EU countries.

[89] See the tables 4,5.
[90] See the tables 6,7.
[91] See the table 7.

Moreover, one can say that after the reorientation of trade, Lithuania and Estonia exported mainly to the countries of Western Europe and healthy western economies contributed to the rapid Baltic reanimation. The previous crisis in 1998 resulted in the consolidation of banking sphere. Scandinavian financial institutions became the owners of big local banks. All this contributed to the restoration of trust to capital markets and stimulated new inflows of capital into the countries in question.[92] Furthermore, the CBA with the euro anchor has led to monetary stabilization and stabilization of the inflation rates. In the present situation, when Europe itself suffers from the world economic turmoil, the assistance it can provide cannot amount to that, which is needed in the situation of Estonia and Lithuania.

There are a number of causes of the implosion the countries in question experience. They are of internal and external nature. One of the reasons is the unsustainability of growth even during the period of constant increase of growth rates. The EU opened trade markets for the new comers but also exposed them to greater foreign investment and brought foreign banks into the Baltics. As a result of it, the governments created big deficits and several economic bubbles were built up, in particular in real estate, construction and retail.[93] Nowadays, due to the world crisis, local banks (usually the branches of Scandinavian ones) are forced to reduce credits lines because external markets have disappeared.[94]

The other concern of the Baltics is devaluation of the national currency. The peg, which has been efficient for a decade, is under constant pressure now. The Baltics are advised to adopt free-floating, thereby allowing devaluation of the national currency in order to prevent from

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[92] Taxblog PwC, "Estonia's economic overview," (March 2009), under "BBN The leading Estonian business News Channel" http://www.balticbusinessnews.com/Default2.aspx?BlogID=bf793fb8-80b2-46d0-9565-b278f97c8aac&open=four (accessed April 28, 2009).

[93] Marge Tubalkain-Trell, "How the Baltics melted down," (March 2009), under "BBN The leading Estonian business News Channel" http://www.balticbusinessnews.com/Default2.aspx?ArticleID=16eb7ff2-d5b4-4d0b-a981-75484912f27d&open=four (accessed May 6, 2009).

[94] Ibid.

exhausting all reserves.[95] The result of the above said is destabilization. The main danger is that the collapse of one of the Baltics will originate the breakdown of two other countries because they will not be apt to compete with cheaper currency of the country-neighbor.[96]

The variant of national currency depreciation can be a way out for the Baltic recovery in the present situation. In this case the EU should agree to introduce euro without joining formally the eurozone as the International Monetary Fond suggested. It might be helpful in order to regain investors' confidence and resolve the foreign debt problem.[97] This variant seems to be more plausible. However, currently the EU is against unilateral adoption of the euro by any of the newcomer member states because it might make vulnerable the EMU as such. The EMU is unprepared to run such a risk.[98]

To sum up, Estonia and Lithuania are suffering from the financial crisis heavily because it has weak monetary institutions and, therefore, does not dispose of necessary monetary instruments to handle the situation. In this case the EU is incapable to rescue them.

The importance of institutions is indisputable. The economic performance is less dependent on the resources disposed of, but is highly correlated with the quality of institutions.[99] The other factors matter too, but it is institutions created from scratch along with the corresponding policies, which played the major role in the early Baltic recovery. In this light the

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95Marge Tubalkain-Trell, "How the Baltics melted down," (March 2009), under "BBN The leading Estonian business News Channel" http://www.balticbusinessnews.com/Default2.aspx?ArticleID=16eb7ff2-d5b4-4d0b-a981-75484912f27d&open=four (accessed May 6, 2009).

96 Marge Tubalkain-Trell, "How the Baltics melted down," (March 2009), under "BBN The leading Estonian business News Channel" http://www.balticbusinessnews.com/Default2.aspx?ArticleID=16eb7ff2-d5b4-4d0b-a981-75484912f27d&open=four (accessed May 6, 2009).

97Marge Tubalkain-Trell, "Hands up if you'd like to use the euro," (April 2009) under "BBN The leading Estonian business News Channel" http://www.balticbusinessnews.com/Default2.aspx?ArticleID=b4b175d6-8ac5-4c3e-8b68-2909d8a034ab&open=four# (accessed May 5, 2009).

98 Ibid.

99 Jan Winiecki, "Determinants of catching up or falling behind: Interaction of formal and informal institutions
" National Bank of Poland (October, 23-24, 2003), http://www.nbp.pl/konferencje/radisson/Mowcy/Winiecki/winiecki.pdf (accessed May 2, 2009): 4, 6.

strengthening of institutions as a result of structural reform is needed in order to fight the present financial breakdown. It is also worth mentioning that the creation of efficient institutions is not the issue of one day. It is a steady and evolutionary process.

To make a final point, it is also necessary to add that the economic situation is highly related to the political situation in a normal democracy. The severe programs that the governments of the Baltic countries have launched in order to struggle the crisis met public discontent and frustration. The politicians are seen as incompetent policy-makers.[100] Therefore, in addition to the economic breakdown, the Baltics are likely to suffer from the lack of public trust.

The purpose of the chapter was to extract lessons from the current crisis. They are as follows. First, it is necessary to restore the confidence of the investors to the national currencies because both countries might suffer even more if the foreign inflows are not resumed. The other issue is public trust, which is crucial for the policy-makers in order to implement certain reforms. Therefore, shortly, the confidence should be restored. Second, both countries need the combination of macroeconomics policies to manage the crisis. There is not an easy answer what to do. The steps must be well considered and balanced bearing in mind the idea of the complementarity of the reforms. Third, efficient institutions are the prerequisite of the sustainable growth. They cannot be created in a day. It takes time to create new rules, laws and regulations to abide by, which accompanied by the policies yield expected results.

The other question, which is worth attention, is whether the crisis might scrap the existing theories of transition. It means that, although there have been not a definite answer to the

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[100] Marge Tubalkain-Trell, "How the Baltics melted down," (March 2009), under "BBN The leading Estonian business News Channel" http://www.balticbusinessnews.com/Default2.aspx?ArticleID=16eb7ff2-d5b4-4d0b-a981-75484912f27d&open=four (accessed May 6, 2009).

question which approach is more reliable in terms of successful overcoming the Soviet past and maintaining sustainable growth, the crisis called in question the validity of the approaches as well as transition theories as such. This question arises from the statistical inquiry in the economic performance of the transition economies with the onset of the crisis and its progressing. Both groups of the countries, those which opted for the gradual path of transformation and those that followed “shock therapy” are affected by the world breakdown. Moreover, it is worth mentioning that the example of the most drastic impoverishment of economic performance can also be noticed in both groups, for example, Estonia, which is one of the best representatives of radical reformation, and Hungary, the gradualist reformer, have been affected heavily by the crisis. However, it is overlooking to claim that both theories proved to be inefficient. They appeared when the communist system turned out to be inefficient in both terms political and economic. As it was mentioned before, the countries opted for different paths taking into account the prerequisites which had been created in the countries. Both approaches did a good job in terms of economic transformation of the countries from the command, central planned economy to the market one, thereby enabling the countries to join the EU in record-breaking time. Our research on Estonia and Lithuania support these reflections. It means that initially both ways accomplished the task they had been implemented for. The next trouble, which appeared, is the sustainability of the results achieved, but this is the question not only of the selected course of the reformation but it is rather the issue of further progressing with structural reforms to cerate efficient and reliable institutions in order to proceed to catch up. Apparently, it has not been the case with the countries in question as it follows from the statistical data, which illustrates the consequences of poor institutions functioning. The rejection of Lithuania and Estonia to the eurozone is another confirmation of the countries' lack of solid grounds to proceed with further economic development.

Now it is necessary to look at the same issue from a different angle because, having taken into consideration only that above mentioned, one might make narrow-minded and misleading conclusions. It is indisputable facts that due to the present crisis Lithuania and Estonia experience a slump and harsh impoverishment of living standards. However, if to look in a broader perspective meaning to compare the countries' performance with the most developed country from the camp of the former Soviet countries – Russia then different conclusions can be drawn up. In order to support the latest claim, it is worth comparing the following basic indicators which are reflected in the table 11.

Table 11. The dynamics of GDP, inflation, HDI in Russia, Estonia, Lithuania in 2004-2008

	Russia					Estonia					Lithuania				
	2004	2005	2006	2007	2008 estimate	2004	2005	2006	2007	2008 estimate	2004	2005	2006	2007	2008 estimate
GDP	7.1	6.4	7.4	8.1	5.6	7.5	9.2	10.4	6.3	-3.6	7.4	7.8	7.8	8.9	3.0
Inflation	10.9	12.7	9.7	9.0	13.0	3.0	4.1	4.4	6.6	10.4	1.2	2.7	3.8	5.7	11.0
HDI	-	-	-	-	0.806	-	-	-	-	0.871	-	-	-	-	0.869

Source: Human Development Report (HDR) United Nations Development Programme (UNDP) http://hdr.undp.org/en/statistics/, EBRD Economic statistics and forecast http://www.ebrd.com/country/sector/econo/stats/index.htm (accessed May 15, 2009).

From this table can be inferred that both countries are ahead in terms of inflation rates indicators and human development index (HDI). It is worth mentioning that HDI is composed by three factors a long and healthy life, knowledge and a decent standard of living. Russia occupies the 73rd place, Estonia and Lithuania – the 42nd and 43rd respectively out 177 countries surveyed.[101] The only superior indicator is GDP growth rate. However, it can be explained easily by the fact that Russia exported natural resources in abundance recently. Therefore, looking from the comparative perspective, one can conclude that both countries, which were reform-oriented, although undergone different path of reformation, are still a success. Moreover, it is worth noting that Baltic recession is cyclical and Russia owns its recession to structural reasons. That makes valid the following claim that the crisis can hardly overturn the validity of preexisting transition theories as such because the countries that implemented the postulates of them still are better off than those countries that remained silent to the massive reform implementation. However, the crisis brought to light the shortcomings of the policies the transition countries followed rather than the theories of transition themselves. It is worth reiterating that structural changes entailing efficient institution building and prudent macroeconomic policies are a recipe for the success.

To sum up this chapter, the main conclusion is that the expansion of growth cannot occur without certain grounds to rely on. These grounds are efficient institutions. In the situation of weak institutions the rapid growth is possible if the external world (the economies of other countries of the EU) are healthy and prosperous. In the opposite case, the weak foundation of accelerated growth will become evident and will obstacle further development. The crisis

[101] United Nations Development Programme (UNDP), Composit indices – HDI and beyond. *Human Development Report (HDR)* http://hdr.undp.org/en/statistics/indices/ (accessed May 7, 2009).

revealed the weaknesses of the transition countries in this respect, although it is worth mentioning, the preexisting theories of transition are still in force.

The EU cannot protect small open economies in the situation of the current crisis offering an easy bail out for Estonia and Lithuania in the form of the unilateral introduction of the euro. This might endanger the stability of the EMU spreading the risk over the sixteen countries, participants of the eurozone. Therefore, currently, the EU can offer a limited assistance to the Baltics.

Chapter 7. Fresh insight into the theory of transition and path dependence: contribution to the field

Before touching upon the contribution of the previous reflections to the theory of transition and path dependence, it is worth mentioning that out of fifteen countries of the Soviet Union only three are considered to be normal countries. They are three Baltic republics. The normalcy in our case is determined by the quality of institutions meaning that if the quality of institutions is likely

to converge with the Kuznets curve (a confluence of the parameters that determine the quality of institutions of modern democracies – voice and accountability, control of corruption, rule of law, political stability, government effectiveness, regulatory quality).[102] The Baltic countries, although having constituted the integral part of the Soviet Union for almost fifty years, differed from the onset of transformation, i.e. right after the Soviet Union collapsed. The institutions of the Baltics demonstrated a different quality of performance in comparison with the remaining ex-Soviet Union states. That can be explained by different reasons and the role of path dependency can be also recalled but not in the traditional interpretation that of the Soviet legacy but the strong Western influence, which is the case for Estonia and Baltic experience of being independent. The better quality of institutions and, therefore, earlier transition account for the rapid normalization of the Baltics, what explains the categorization of the countries in question as a "new accession to the EU countries" but not the former Soviet Union counties, although they belong to both groups formally.[103]

[102] Michael Keren and Gur Ofer, "Are transition economies normal developing countries? The burden of the socialist past," in *Transition and beyond*, ed. Saul Estrin, Grzegorz W. Kolodko, Milica Uvalić (New York: Pelgrave Macmillan, 2007), 62, 63.
[103] Ibid., 63.

Speaking about the normalization of post-Soviet economies, it worth reiteration that the former Soviet Union states including Russia are far from being normal according to the criterion exposed above, while "new accession to the EU" countries are progressing meaningfully and almost reached normality by 2004.[104] The inclusion of the Baltics to the latter group and at the same time slow normalization of the other post USSR countries suggests that path dependence still matters. It might account for the way of further development the countries opted for meaning that it determined not the way of transformation but the general direction or course of transformation.

In the light of previous analysis, one can draw several fundamental conclusions that might contribute to the field of the transition theories and path dependence. First of all, it is worth emphasizing that long-term path dependence might matter. It is the case of the former Soviet countries, which almost had no experience of democratic rule and market economy, were heavily dependent on Russia and, therefore, did not aspire to meaningful changes (since they have never enjoyed different governance and way of living). The Baltics tell a different story because, first, the period of the Soviet rule was much shorter there and, second, the Baltics enjoyed foreign influence and had some memories of a different political organization and type of economy. Consequently, almost fifty years of the Soviet reigning could not have ruined those memories.

Second of all, in the case of Lithuania and, especially, Estonia geography was an important determinant of the path selected. Scandinavian countries and Finland, in particular, kept strong links with Estonia in the form of investment, etc. Moreover, since Estonia and

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[104] Michael Keren and Gur Ofer, "Are transition economies normal developing countries? The burden of the socialist past," in *Transition and beyond,* ed. Saul Estrin, Grzegorz W. Kolodko, Milica Uvalić (New York: Pelgrave Macmillan, 2007), 75.

Finland had nearly the same levels of development before the Soviet occupation, Estonia saw a real example of what it could have become and might become. In this light, one can say that in our case geography played a vital role not in the sense of rich natural resources but because it created the conditions under which the country reinforced its strengths.[105]

The above-suggested factors cannot be the only prerequisites of the successful transition. It is worth mentioning that these factors are important, however, one should not undermine the importance of policies. Only a combination of the factors including efficient institutions and corresponding policies (paraphrasing the famous claim that institutions matters, but so do policies[106]) can produce necessary structural changes, thereby contributing to the economic transformation of a country.

Looking from a different angle, one can ask whether successful transformation continues yielding fruit of no further structural reforms are in place, if the reliance on healthier outside economies might save the transition countries from the breakdown. Apparently, in out case, it cannot. The EU, although being a locomotive of success in Europe, is not a panacea for the countries in transition meaning that once the latter are accepted, they should not stop improving. The EU is a chance to grow and develop but not an exact recipe of success.

To sum up, it is worth reiterating that the choice of a way of transition cannot be separated from the historical, cultural, external conditions, which determine the path. Our analysis suggests that the most crucial of them are the impact of long path dependence and geography. However, policies and institutions are as vital as initial conditions. New path within

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[105] Paul Krugman, "The role of geography in development" paper for the Annual World Bank Conference on Development Economics (April 2008) http://www.worldbank.org/html/rad/abcde/krugman.pdf (accessed May 11, 2009): 24.
[106] Oleh OH Havrylyshyn, Ron Rv van von Rooden, "Institutions Matters in Transition, But So Do Policies," *Comparative Economic Studies* 45, no. 1 (March 2003): 1.

the EU, although affects the policies and performance of the transition countries, does not solve all the economic difficulties they encounter.

Conclusion

There have been said a lot about economic transition in post-Soviet countries concerning macroeconomic policies needed in order this transition be a success, lessons to be learnt from the experience of Central European states for those countries that are still in process of transition, the importance of effective institution building and the relevance of the complementarity between good policies and institutions making reference to the Havrylyshyn's and von Rooden's claim that "institutions matter in transition, but so do policies."[107] This implies that despite the importance of developing of institutions, macroeconomic policies aimed at revitalizing sustainable growth and higher standard of life, such as classical trio – liberalization, privatization, stabilization are the major determinants of recovery after transformation and further economic growth. Therefore, institution building should go hand in hand with appropriate economic policies. These two components are indisputably interdependent meaning that liberalization as well as privatization is grounded on effective institution basis, e.g. enforced laws and legislation, courts, Central banks, etc. The following conclusion for the NIS countries can be drawn up from these reflections – the package of macroeconomic policies should rely on valid institutions. The policies themselves should be undertaken immediately, at the early stage of transformation process, since they are primary passport to success. Moreover, structural reforms accompanied by corresponding policies do not lose its value with the development of the countries in transition. The accession to the EU, joining the club of healthy and powerful economic giant, does not solve structural problems, which have become more evident from on

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107 Oleh OH Havrylyshyn, Ron Rv van von Rooden, "Institutions Matters in Transition, But So Do Policies," *Comparative Economic Studies* 45, no. 1 (March 2003): 1

hand and more acute, on the hand with the onset of financial crisis. This implies that the EU is not the means to better off economically, it is a chance for further development and speaking in economic terms, to sustainable growth, improvement of living standards, resolution of social problems.

Coming back to the transformation process itself, the following conclusion is drawn up – there is no definite answer which trajectory, "shock therapy" or gradualism, is optimal. The claim that successful transformation can be achieved by following different ways proves to be valid. The strong commitment to the reforms is the issue that really matters.

Coming back to the question of the optimality of the pathway, it is worth mentioning both of the ways proved to be efficient n achieving its primary goal-the accession to the EU. However, the other issue, which arises, is that nowadays the EU itself came to certain degree of stagnation of economic growth and institutional efficiency.[108] Therefore, the clear-cut end point cannot be predicted definitely meaning that after the incorporation to the EU the new member states face new challenges, which require further structural improvements. Taking this into account as well as the factor of path dependence and, moreover, of different public choices, one can conclude that the question of trajectory optimality is not valid.[109] This implies that there are a variety of transition paths, which combine the elements of both transition theories depending on the countries peculiarities.

[108] László Csaba, "Optimal transition trajectories?" in *Transition and beyond*, ed. Saul Estrin, Grzegorz W. Kolodko, Milica Uvalić (New York: Pelgrave Macmillan, 2007), 273
[109] Ibid., 275.

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