

The Baltic states and the euro

Two issues

1. Balance of pros and cons of quick adoption of the euro
2. The *formal* convergence criteria

Pros and cons of adoption of the euro

- Trade and income effects
 - today: 40-45 % of EU-15 GDP per capita
 - 2050: 60-65 % of EU-15 level
- Stabilisation policy effects
 - already fixed exchange rates
 - other adjustment mechanisms
 - higher productivity growth (5-6 %) imply larger possibilities of wage adjustment
 - weak trade unions (15-30 % union density and coverage of collective agreements) and decentralised wage bargaining
 - migration
 - smaller stabilisation policy risks with the euro
 - capital flow reversals
 - political instability

Output gap

	2003	2004	2005	2006
Estonia	0.0	-0.2	-0.5	-0.5
Latvia	0.4	1.3	0.5	-0.7
Lithuania	1.7	2.0	1.7	0.8
Sweden	-1.6	-0.3	0.0	0.1
Euro area	-1.1	-0.9	-1.2	-1.2

Current account balance (percentage of GDP)

	2003	2004	2005
Estonia	-13.2	-12.9	-12.1
Latvia	-8.2	-12.4	-10.5
Lithuania	-6.9	-8.3	-8.8
Sweden	5.9	7.8	7.5
Euro area	0.6	0.6	0.6

Formal convergence criteria

- Little to do with how well a country will fare with the euro
- The Baltic states, especially Estonia, are better fiscal performers than the average EMU country
 - but demographic strains
- Inflation criterion is unnecessarily strict
 - Balassa-Samuelson effect
 - higher inflation because higher productivity growth in tradables (manufacturing) sector drives up wage and price increases in non-tradables (service) sector
 - risk of too contractionary demand policy
 - revise inflation criterion?

Net lending (percentage of GDP)

	2003	2004	2005
Estonia	3.1	1.8	0.9
Latvia	-1.5	-0.8	-1.6
Lithuania	-1.9	-2.5	-2.4
Sweden	0.2	1.4	0.8
Euro area	-2.8	-2.7	-2.6

Gross debt (percentage of GDP)

	2003	2004	2005
Estonia	5.3	4.9	4.3
Latvia	14.4	14.4	14.0
Lithuania	21.4	19.7	21.2
Sweden	52.0	51.2	50.3
Euro area	70.8	71.3	71.7

The effects of ageing on per capita output

	Dependency ratio		Relative output per capita	
	2004	2050	No ageing	Ageing
Estonia	0.24	0.57	3.04	1.72
Latvia	0.24	0.56	3.04	1.76
Lithuania	0.22	0.43	3.04	2.22
Sweden	0.27	0.47	2.44	1.77
Euro area	0.24	0.49	2.44	1.64

Source: EEAG

Change in harmonized index of consumer prices

	2003	2004	2005	2006
Estonia	1.4	3.0	3.3	2.7
Latvia	2.9	6.2	5.6	3.6
Lithuania	-1.1	1.1	2.9	2.6
Sweden	2.3	1.0	0.4	1.4
Euro area	2.1	2.1	1.9	1.5