Choppy Waters in the Baltic

The Baltic economies of Latvia, Lithuania and Estonia have been growing. However, there are problems. The economies are overheating, inflation and the current accounts of each country are soaring and speculators are running the rule over the fixed exchange rate systems operated by these countries.

Latvia is in the worst situation. Inflation is currently 11.4% and the current account deficit represents 20% of GDP. Board members of the European Central Bank have said that these countries face substantial challenges before being able to join the Euro. Others have publicly questioned the ability of these countries to keep inflation under control while maintaining fixed exchange rates, a stance that means adopting what is *de facto* the Eurozone's monetary policy.

But is a devaluation necessary? A reduction in foreign lending will curb credit expansion and hopefully lead to a cooling of the property market and a cut back in construction, thus taking some heat out of the economy. Also, speculating against Baltic currencies is difficult. The market is thin and the Latvian central bank has enough reserves to buy back every single lat in circulation. Also with little national debt, these economies could easily borrow funds from overseas.

The real problem for these economies is that they lack monetary policy tools. The currency peg means it cannot raise interest rates. Even when banks cut back on their lending, other financial entities, such as leasing companies, can fill the gap. That leaves only fiscal policy; yet the government, an uninspired coalition stronger on business practice than economic theory, has shied away from the big surplus that might slow the economy and reassure outsiders. The 2008 budget foresees a surplus of only 1%, rising to 1.5% in 2010. Outsiders think 3% would be a good start.

A forced devaluation in Latvia would be ruinous for the middle class—at least for those who stayed to experience it. Tens of thousands of Latvians have gone to work abroad already. Any gain in nominal competitiveness might well be counterbalanced by an even tighter labour market.

Questions

1. Explain why monetary policy is limited under a fixed exchange rate regime?

2. Why might the Baltic countries find a fixed exchange rate attractive?