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ECFIN Economic Brief

The Tale of the Baltics: Experiences, Challenges Ahead and Main Lessons

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The Baltic countries, Estonia, Latvia and Lithuania, are currently rebalancing their economies in a highly uncertain environment. After having experienced, even by the standards of emerging economies, unusually high growth in the mid-2000s, they have been undergoing the sharpest recessions in Europe; with a series of uncertainties surrounding their longer-term prospects.

The story of the Baltic economies since transition is one-of-a-kind. The combination of extremely rapid real and financial convergence, institutional improvements, and fast integration with more advanced economies that characterized the process of catching up in these countries has been unique among medium-income countries. However, the rapid convergence it generated came at the price of increasing macroeconomic and financial imbalances; and eventually led to an unprecedented boom-bust cycle.

Although the three Baltic economies were all characterised by strong growth during catching up followed by the build-up of macroeconomic imbalances and major recessions, there were remarkable differences in terms of enacted policies. While the financial consequences of the subsequent recession for Latvia were so severe that it had to be assisted by the European Union, the IMF and other donors, financial tensions were more limited in Lithuania and Estonia largely thanks to more prudent policies before the crisis. In light of relatively prudent fiscal policy behaviour, abundant foreign exchange reserves, and capital buffers for the banking sector, Estonia managed an orderly transition through the acute phase of the financial crisis and thanks to its nominal convergence qualified for the adoption of the euro in 2011.

The aim of this Economic Brief, largely based on a recently published cross-country study (European Commission DG ECFIN, 2010), is to take stock of *past experience* and draw *lessons for the future.*

Summary

This brief reviews the main economic developments since transition in the three Baltic economies and highlights challenges for the future. Although the three economies went, in an almost synchronous fashion, through similar stages of catching up and financial convergence-driven booms and busts, outcomes and prospects ahead differ considerably due to different policy frameworks in place. While Latvia had to be assisted by an official financing programme by the EU and the IMF, the financial consequences of the crisis were less severe for Estonia, which is currently a candidate to join the euro area in 2011. In the coming years the main challenge for these countries is to re-launch their potential for growth while completing the rebalancing of their economies. The present Economic Brief also identifies a series of lessons from the experience of the Baltics regarding the role of financial and macro-economic policy in managing overheating and dealing with the building up of imbalances.

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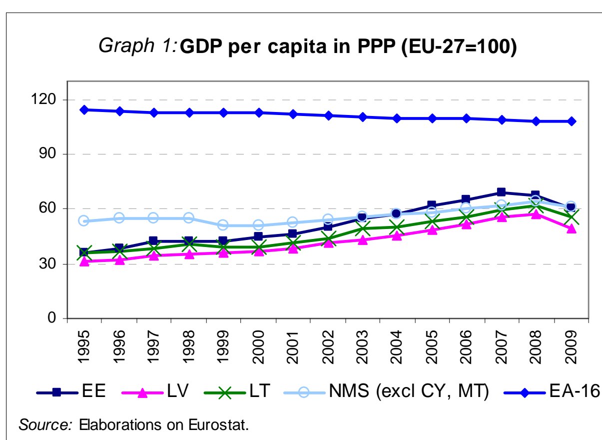
1. How did we get there?

1.1. Rapid catching-up: From transition to EU integration

As other former centrally-planned economies, the Baltic countries underwent sharp output contraction and rampant inflation in the *early stage of transition* to a market economy. The recovery, however, was relatively fast, and led to a sustained growth which was interrupted only by a short-lived slowdown in 1999-2000 due to the Russian crisis.

Graph 1: **GDP per capita in PPP (EU-27=100)**



Source: Elaborations on Eurostat.

There are several factors that explain the rapid *catching up* these economies. First of all, the economic structure of the Baltic countries provided more opportunities for rapid growth, than in other New Member States. As in other emerging economies, there was ample room for sectoral reallocation of resources, and adoption of modern technologies, creating a huge potential for gains in total factor productivity (TFP) at the aggregate level. Moreover, per capita incomes among the lowest in New Member States coupled with a comparatively well-qualified labour force and the need for major restructuring after transition led to high returns on investment and sustained capital accumulation. Reflecting this, investment rates were high and rising until 2007, and TFP gains, were among the highest among emerging economies in recent times. Due to transition-related restructuring, the performance of the labour market was initially rather weak, as reflected in high unemployment rates and outward migration, but starting from the early 2000s, increased labour inputs were also among the factors contributing to the catching up.

Rapid growth was also underpinned by a successful trade re-orientation towards EU countries stimulated by the integration process. This created strong demand for exports from the Baltic economies. Regarding sectoral transformation, the shrinking of agricultural and, to a lesser extent, manufacturing, was accompanied by a rapid expansion of services, boosting growth, and raising employment as well as productivity.

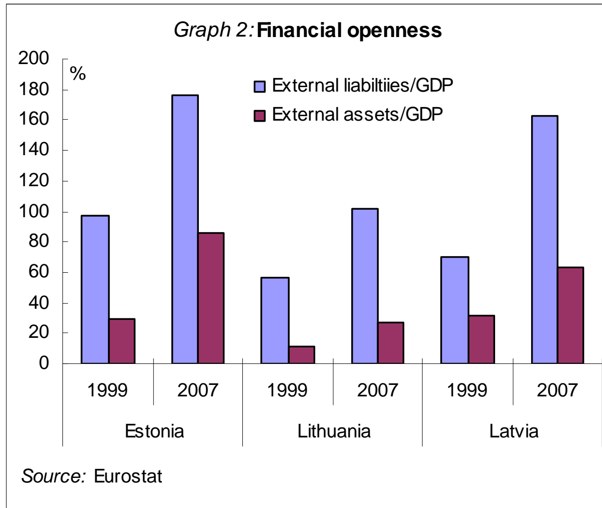
The *reform process* was highly successful in reducing the role of the state and reorienting the Baltic economies towards a market system, and thus helping these countries meet the Copenhagen criteria and become eligible for EU accession. Overall, institutional convergence was more rapid in the Baltic countries, and notably in Estonia, than on average in other New Member States, as shown by standard indicators of governance and institutional quality.

On the front of *macroeconomic governance*, all Baltic States introduced their own currencies and adopted hard peg exchange rate arrangements relatively early in the transition. These arrangements, together with low government debt and tight fiscal policy, were an important factor contributing to the rapid stabilisation of the macroeconomic environment in the 1990s. Sound public finances and a contained tax burden provided important support to a rapid catching-up. Government gross fixed capital formation grew well above the EU average, while the tax burden was kept particularly low especially for what concerns direct taxes on capital income. Pension reforms enacted in past years, shifting government pension liabilities into private pillars, have catered for the impact of ageing populations on government finances, though some budgetary risks from the demographics remain, in particular for Lithuania.

Strong capital inflows also played an important role in the catching-up process. Ample room for restructuring, the prospect of EU accession, successful institutional convergence, and stability-oriented macroeconomic frameworks are among the factors that made these economies a particularly desirable destination for foreign investment, mostly in the form of FDI and inter-bank loans. FDI in the financial sector, which led to rapid financial deepening and integration, was a particularly noteworthy characteristic of the catching up process in the Baltics. Neverteless, the financial sector remained largely bank-dominated, leaving little role to direct financing in the corporate sector. Rapid bank credit expansion was fuelled by

FDI in the banking sector, dominated by Nordic-owned banks. Financial integration and convergence lead to rapid financial deepening, a sizable drop in risk premium and thus a rapid convergence of domestic interest rates to euro-area levels, and increased holdings of foreign assets and liabilities (Graph 2).

Graph 2: **Financial openness**

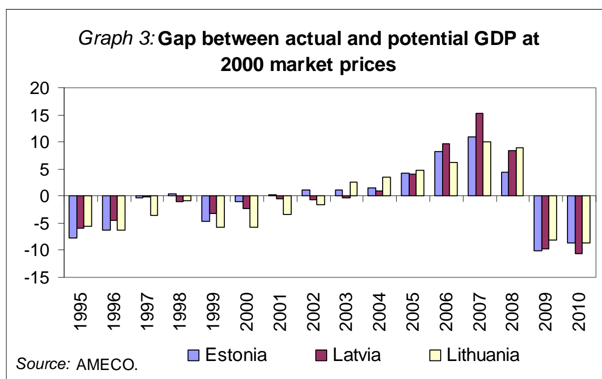


Source: Eurostat

1.2. Building up imbalances

By the mid-2000s, protracted strong growth in the Baltic economies started to be accompanied by growing imbalances and other signs of *overheating*.

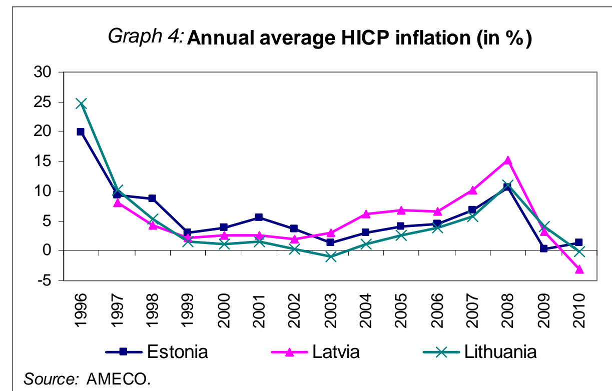
Graph 3: **Gap between actual and potential GDP at 2000 market prices**



Source: AMECO.

Estimates of potential output show that by 2004 all three Baltic economies recorded positive output gaps and that by 2007 those gaps were very wide, reaching double digit figures for Estonia and Latvia. Reflecting essentially overheating, oil price increases and EU accession, inflation picked up strongly in the three Baltic economies after 2004, reaching double digit levels in Latvia by 2007. Due to tightening labour markets, real wage growth outpaced productivity further fuelling inflation.

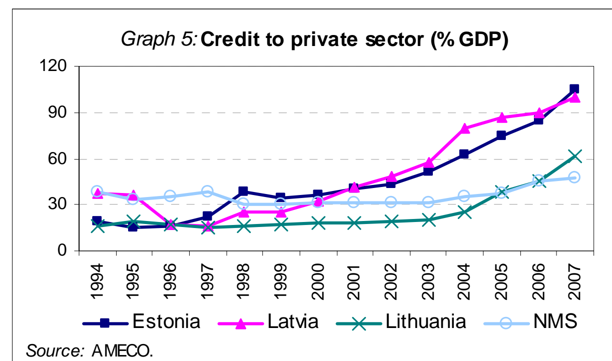
Graph 4: **Annual average HICP inflation (in %)**



Source: AMECO.

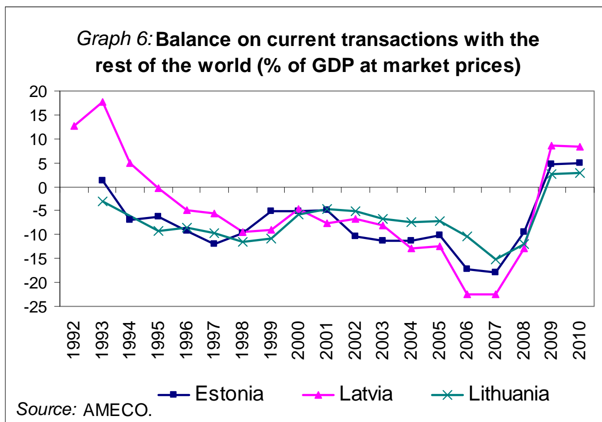
Financial convergence in a global environment of excessively low risk premia was among the key factors that contributed to the overheating. Falling risk premia on interest rates and improved access to cross-border bank finance permitted large and sustained investment rates and fuelled consumption expenditure. Private credit, starting from a relatively low level, quickly reached a level that was higher than what fundamentals would have justified. This had major implications for asset prices, most importantly real estate prices. Easy credit fuelled housing demand which, despite a residential construction boom, led to skyrocketing housing prices, especially in Estonia and Latvia,. FDI, tilted towards non-tradable and real estate activities, gave an additional impetus to the housing and consumption bubble.

Graph 5: **Credit to private sector (% GDP)**



Source: AMECO.

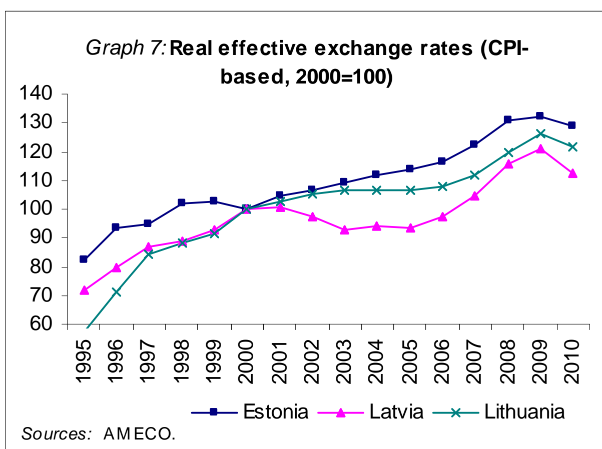
Strong domestic demand resulted in large *current account imbalances* and the rapid accumulation of large net foreign liabilities. Current account deficits, which were relatively high throughout the whole catching up period, exceeded 15% of GDP in Estonia and Lithuania and 20% in Latvia by 2007.



Graph 6: **Balance on current transactions with the rest of the world (% of GDP at market prices)**

Source: AMECO.

The deterioration in current account balances was accompanied by a sustained *real appreciation of the currencies*. Real effective exchange rates increased at very fast rates in all the Baltic economies since the mid-nineties, albeit from undervalued levels at which nominal exchange rates were well below purchasing power parity. The growth of the non-tradable sector, notably the construction sector, strongly contributed to rising price level in the Baltic economies compared with competitors. The rising price level fed into wage dynamics out of line with productivity and into rising unit labour costs. In spite of rising real exchange rates, the share of Baltic countries' exports of goods and services in world exports rose until 2006 for Estonia and until 2008 for Latvia and Lithuania, mostly thanks to successful export re-orientation to the EU and fast-rising export markets, and overall less dynamic prices in the export sector than in the overall economy. However, real currency appreciation was accompanied by fast rising import penetration and increasing value of imports, which was also driven by cyclical factors, changing preference, and structural transformations during catching-up.

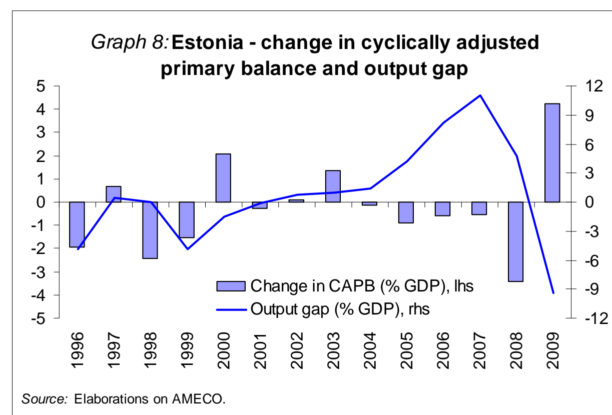


Graph 7: **Real effective exchange rates (CPI-based, 2000=100)**

Sources: AMECO.

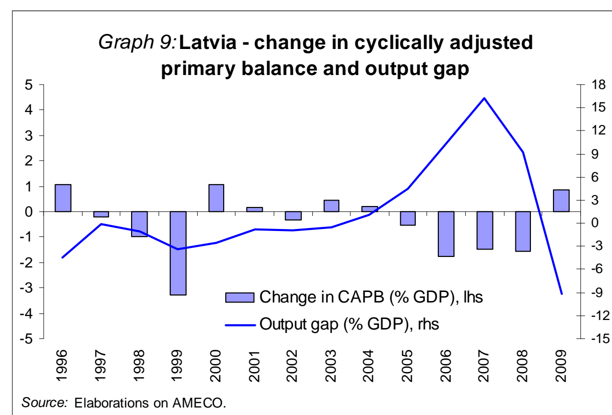
Regarding *policy action to reduce overheating*, policy makers could have used more effectively the available tools and introduced new ones.

With very little room for independent monetary policy because of the hard exchange rate pegs, and relatively small automatic stabilisers because of small governments and a low degree of tax progressivity, the authorities were left with discretionary fiscal policy and prudential regulation and supervisory policies on financial markets as the major tools for macroeconomic stabilisation.



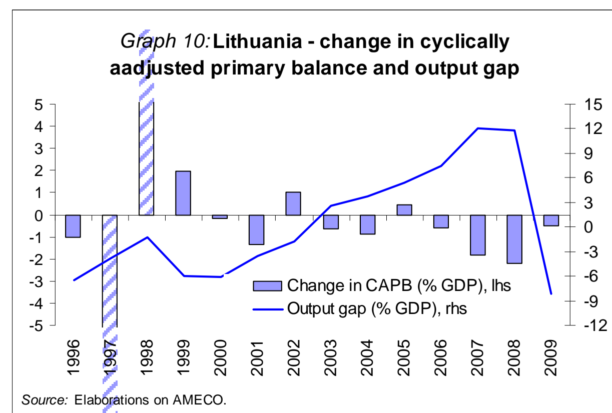
Graph 8: **Estonia - change in cyclically adjusted primary balance and output gap**

Source: Elaborations on AMECO.



Graph 9: **Latvia - change in cyclically adjusted primary balance and output gap**

Source: Elaborations on AMECO.



Graph 10: **Lithuania - change in cyclically aadjusted primary balance and output gap**

Source: Elaborations on AMECO.

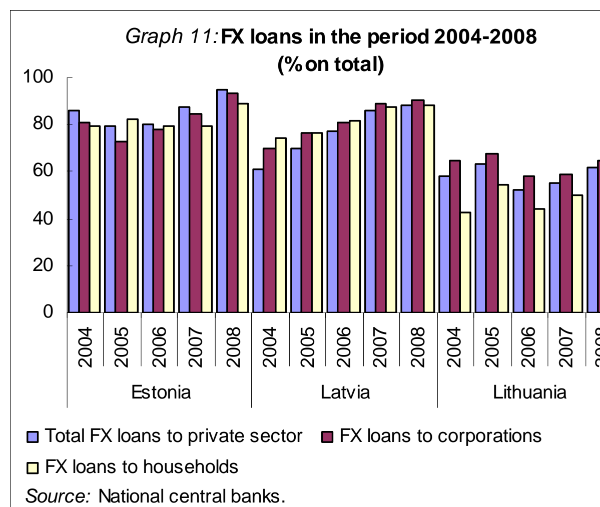
However, discretionary fiscal policy delivered only partially on its assignments. With the benefit of hindsight, it is now clear that fiscal policy was strongly pro-cyclical in 2007 in all the three countries, and in Latvia already in 2006. There are inherent difficulties involved in tracking the cyclical position and properly measuring the fiscal stance in real time, particularly in volatile economies that underwent significant fiscal reforms like the Baltics. ([1]) Nevertheless, mid-year budget amendments allocating windfall revenues were an unmistakable sign of pro-cyclicality, a measure repeatedly criticized by international institutions carrying out surveillance, including the European Commission.

As regards prudential and supervisory policies, action with a view to managing rising financial stability risks and counter the formation of asset price bubbles was taken by the authorities in all the Baltic States. Starting from 2005, minimum reserve requirements have been raised and the rules for the computation of capital adequacy for banks have been tightened. Direct measures to curtail the real estate boom and the recourse to foreign exchange borrowing were also introduced. In light of the largely foreign-owned banking sectors, the cooperation among supervisory authorities in the Baltics and in countries home to parent banks was gradually and successfully strengthened. However, belated implementation and strong cross-border links of the banking sector in the Baltics rendered these measures insufficient to harness explosive credit supply and cool the economy.

1.3. The crisis

By 2007, the overheating reached its peak. Large current account deficits were compounded by new *types of vulnerability*. Galopping private credit, mostly in euro, was increasingly financing a housing bubble, heightening the bottlenecks and distortions on the supply side of the economy, including in terms of available skilled workforce and products. Financing to the private sector was increasingly dependent on a small group of common (foreign) lenders, dominantly Scandinavian banks, who themselves were increasingly dependent on market financing. At the same time, domestic banks (most notably Parex Bank in Latvia) at the zenith of the global financial crisis experienced major difficulties with rolling over their foreign loans in the face of extreme exposure to the housing sector.

Graph 11: **FX loans in the period 2004-2008 (% on total)**



Source: National central banks.

At the peak of the boom, most of the typical ingredients of a "boom-bust" cycles were present, albeit to different degrees, in the Baltic economies. Growing awareness of mounting credit risks stemming from an unsustainable domestic demand boom and the increasing non-performing loans led foreign and domestic banks to progressively tighten lending standards. This slowed the housing market which in turn led to declining equity of households and difficulties for construction companies, and eventually to deteriorating credit quality, which then forced banks to further tighten lending standards, creating a vicious circle. The macroeconomic implications of tightening credit conditions have further enforced this process.

The adjustment, which started before the financial turmoil began to unfold in September 2008, was reinforced by global developments. *Economic contraction* driven by domestic financial developments was indeed accelerated by the falling asset prices, widespread deleveraging, and flight to safety in financial markets that followed the global financial crisis. An increase in risk aversion in global financial markets, reinforced by a subsequent fall in international trade, hit particularly hard small-open economies that were highly dependent on foreign financing, like the Baltics, leading to a very deep and sudden drop in GDP. Falling exports were accompanied by a major drop in domestic demand, possibly also triggered by a major downward revision of the private sector's expectations about the growth

([1]) The European Commission itself, based on the jointly agreed methodology, estimated in its autumn 2007 forecast that there would be a fiscal tightening of one percent of GDP in Latvia in 2007 (European Commission, 2007).

potential of the economy. The economic contraction was initially stronger in Estonia and Latvia, reaching year-on-year rates of about -10% in the fourth quarter of 2008, but it got into full swing by 2009 in all three countries. According to the Spring 2010 European Commission Forecasts (European Commission, 2010), GDP contracted by 14.1% in Estonia, 18.0% in Latvia and 14.8% in Lithuania.

In light of the *worsening access to foreign credit* and the global reassessment of risk, required returns on financial assets, including those denominated in local currencies, soared, especially for Latvia, amid downgrading by rating agencies. Tthe increasing financial difficulties in Latvia and the continuing sizeable external deficits coupled with large losses suffered by Parex, the major domestic bank, which required recapitalisation by the government, led to the emergence of balance of payment financing gap that required significant (around 30% of GDP) international financial assistance in December 2008, from the European Union, the IMF and other lenders. The international lenders' willingness to provide liquidity assistance and the European Banking Coordination Initiative (promoted by the Commission, the EBRD and the IMF) has facilitated an orderly deleveraging in the region, also reinforcing the commitment of foreign banks to inject the necessary capital in their Baltic branches and subsidiaries and maintain adequate exposure in these countries.

As a result of a combination of a slowdown in government revenues and a continuation of rapid expenditure growth in line with the budget that was based on strong growth projections, the fiscal position deteriorated rapidly in 2008, by 5.7 percentage points of GDP in Estonia, 3.6 percentage points in Latvia, and 2.2 percentage points in Lithuania. However, given that the budget was in a surplus before the crisis, the level of the deficit remained moderate in Estonia. Budget surpluses accumulated by the Estonian government in the past also permitted setting up a reserve fund which helped avoid tensions in financial markets as the government depended less on market financing during the acute phase of the financial crisis. The *rapidly deteriorating fiscal position* coupled with increasing risks of losing access to financial markets to finance the growing deficits left the authorities with little choice but to undertake consolidation measures. While a reversal of the budgetary position was expected, and for example the Commission repeatedly warned the three countries that the underlying budgetary positions were likely to be worse than available methodologies were suggesting, the extent of the fiscal reversal was a significant surprise for all.

Financial assistance to Latvia

The crisis faced by Latvia at the end of 2008, prompted by the rescue of Parex Banca, led the Latvian authorities to turn to the EU, IMF and regional neighbours for financial assistance. The Community medium-term financial assistance for Latvia totals €3.1 billion and is provided in conjunction with a loan from the International Monetary Fund of SDR 1.5 billion (1200% of Latvia's IMF quota, around €1.7 billion) under an IMF Stand-by arrangement. Nordic countries (Sweden, Denmark, Finland, Norway and Estonia) committed to contribute €1.9 billion together, the World Bank €0.4 billion, and the European Bank of Reconstruction and Development, the Czech Republic and Poland for a total of €0.4 billion, bringing the combined total to €7.5 billion available over the period until the end of 2011.

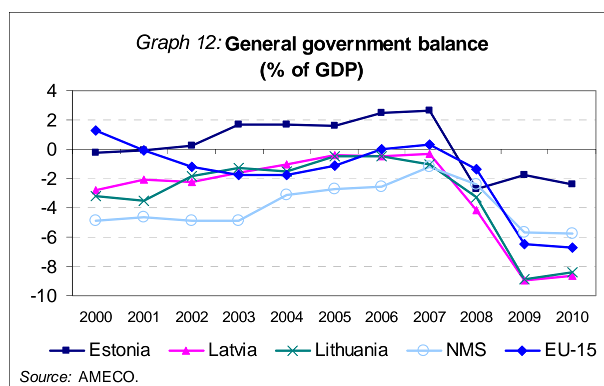
The international financial assistance underpins the implementation of the "Economic Stabilisation and Growth Revival Programme" adopted by the Latvian authorities. The assistance is provided following compliance with a number of specific fiscal, financial sector and structural reform conditions spelled out in successive Memoranda of Understanding signed with the Commission and in Letters of Intent sent to the IMF.

The policy reaction was in general somewhat belated, reflecting an only progressive adjustment in policy thinking to the emerging imbalances and the realisation of the exceptionality of the growth performance of the previous years. However, there were important differences across countries. While Estonia took steps clearly in the right direction already in the course of 2008, in both Lithuania and Latvia budgetary policy was still expansionary, reflecting the end of the electoral cycle in Lithuania, and a still exceptional growth of many budgetary items in Latvia, including in the 2009 budget.

Eventually, the fiscal correction turned very strong in 2009. Supplementary budget measures were introduced in each of the three Baltic economies by end-2008, and additional very large consolidation measures were introduced by mid-2009. The size of these measures was about 8 and 7% of GDP in

Estonia and Lithuania respectively, while in Latvia – which faced the largest fiscal deterioration – the largest part of a similar adjustment took place only in the middle of 2009.

These measures served to contain the deficit at around 9% of GDP in both Latvia and Lithuania, and to below 2% in Estonia, which increased significantly the chances of the latter to qualify for euro adoption. The adopted budgets for 2010 entail the continuation of a very big fiscal consolidation in the three countries, to face deteriorating revenues (due to the growing negative output gap) and increasing interest payments, while strongly reducing the underlying fiscal deficits. According to the Commission Spring Forecasts, deficits in 2010 would reach 2.4% of GDP in Estonia, 8.5% in Lithuania and 8.6% in Latvia. The improving international environment and tight budgetary implementation suggest that results may be somewhat better.



Graph 12: **General government balance (% of GDP)**

Source: AMECO.

In light of still high wage inflation until end 2008 and the need to regain price competitiveness to foster external adjustment, as well as to reverse recent large and unjustified increases in wages and employment levels, the fiscal packages in all three Baltic economies included considerable cuts in the government sector wage bill.

2. Challenges ahead

2.1. Short-term prospects differ markedly across the three Baltics…

The Baltic countries are rebalancing their economies in an uncertain environment. They have been undergoing recessions among the sharpest in Europe, and their future prospects, while improving thanks also to a significant pick-up in exports, are subject to various risks. The situation is the most critical in Latvia, which is undergoing a hefty adjustment in line with the programme agreed with international institutions. While significant steps – including major reforms – have been taken to overcome the crisis, Latvia has not yet regained access to international financial markets, although several indicators, including the improved outlook by credit rating agencies, suggest this may happen in the near future. The prospects for 2010 still indicate negative growth below 3 per cent, but the return to positive rates in 2011 may be stronger than initially expected.

Lithuania is in a better position. A successful international sovereign bond issue by the former signals a positive assessment of its consolidation efforts by financial markets. The recession appears to rapidly coming to an end, FDI interest is reappearing and there are increasing signs that positive growth may come already in 2011.

The prospects for Estonia are by far the brightest, mainly thanks to stronger policy frameworks and prudent policies enacted before the acute phase of the crisis. Fiscal authorities managed to keep surpluses until before the burst of the financial crisis. The accumulation of fiscal buffers, abundant foreign exchange reserves, and a relatively high capitalisation of the banking sector, and its strong institutions contributed to an orderly transition through the acute phase of the crisis and were key for the significant progress made by the country in view of qualifying for euro adoption. As a coronation of this positive policy record, on 12 May 2010 the European Commission concluded that Estonia, alone among the EU countries not yet in the euro-area, meets all the requirements for joining the euro in 2011 and made a proposal to the Council to this effect (European Commission 2010b).

2.2. …and a series of longer-term challenges loom ahead

Notwithstanding these important differences, strong economic and financial ties and potential spill-overs magnify the transmission of shocks to and through the region as a whole, but at the same time facilitate the spreading of the positive effects of the current structural adjustment in each of the three countries.

The governments of the Baltic countries remain strongly committed to *maintaining* their long-standing monetary and *exchange rate arrangements*, also because it

is continued to be viewed essential to achieve the strategic objective of introducing the euro (for which the target date has been officially set to 2011 by Estonia and to 2014 by Latvia, while Lithuania considers 2014 or 2015 as possible entry dates). Fixed exchange rate regimes have been a central element of the Baltic model since transition: credible pegs fostered policy discipline and were among the attractive features for foreign investors. The crisis however has shown how critical it is to have in place consistent flanking policies in other areas. Therefore, going forward, it will be critical to continue to pursue prudent wage policies and foster productivity growth to restore export price competitiveness; keep a tight fiscal stance to stabilise public debt and; and promote reforms that help keep in check domestic demand.

Looking forward, the Baltic countries face major policy challenges on other fronts as well. A primary goal for policy will be to increase *growth potential,* as in the absence of reforms, it is likely to be significantly reduced as a result of the crisis.

Regarding investment, restoring a normal functioning of financial markets is key to ensuring an adequate supply of capital, while the re-emergence of boom-bust dynamics needs to be avoided. TFP growth can be enhanced by shifting resources towards technology-intensive activities, adopting up-to-date production technologies and strengthening innovation performance. In this respect, a tax structure fostering investments in new technologies, stronger incentives towards R&D activities, enhanced investment in physical infrastructure and human capital, including via frontloading, fully and effectively absorbing EU structural funds, and improved governance and effectiveness of education systems, appear to be key ingredients of a supportive policy framework.

Adjusting external imbalances may imply subdued dynamics of domestic absorption for some years. In particular, external adjustment and tight external financial conditions could imply low investment rates compared with past trends. Albeit a sizable part of investment in the past fuelled asset bubbles and added little to the economy's growth potential, such constraints on investment could also impinge on potential growth for years to come. Moreover, fiscal tightening, a necessary ingredient of the ongoing rebalancing, could also limit growth-enhancing public expenditure. Nevertheless, the ongoing structural adjustment should have a positive impact in the longer term. Wage moderation and the significant disinflation already achieved are helping to restore not only export price competitiveness but also the attractiveness of Baltic economies for FDIs. Many of the structural policies that contribute to price competitiveness and upgrade the product structure of exports also help foster potential growth in the medium-to-long run via enhanced TFP growth. Moreover, the process of external adjustment implies shifting resources towards tradable activities, where the prospects for demand growth are better and lasting TFP gains are more likely. The remarkably high contribution of the EU structural and cohesion funds to the Baltics within the 2007-13 cycle is now contributing to these transformations as projects are reaching the implementation phase. Finally, part of the adjustment to preserve sound external positions will have to happen on the import side, where action to reduce the value of imports could contain the necessary adjustments elsewhere.

At the current juncture, a tight *fiscal stance* is essential to reduce fiscal imbalances in Latvia and Lithuania, and to overcome external imbalances. Although protracted fiscal tightening would be pro-cyclical in light of the deep recession and would possibly reduce the room for supporting potential growth via public budgets, a structural adjustment of budget balances seems inevitable at this stage. In achieving this, putting the focus reducing current expenditure would help avoid the crowding out of necessary public investment, and support the effort of the governments to preserve capital accumulation supported by the EU structural funds. Moreover, a successful and durable budgetary adjustment is central to improve market expectations regarding macroeconomic stability.

3. The Tale of the Baltics: lessons

First, the Baltic experience clearly demonstrates how *pervasive* the *effects of financial convergence* can be on small open emerging market economies, even at relatively low income levels and financial development and with relatively strong institutions.. This experience does not question the overall positive effects of financial integration for EU economies. Downhill capital flows are a major driver of economic growth in catching-up countries, also in Europe, both directly via improved investment finance, and indirectly, by fostering better governance and

institutional convergence. However, the experience of the Baltics underscores the growing consensus that enhanced growth prospects allowed by rapid financial convergence could also bring about major risks to macro-financial stability, especially in countries with limited capacity to ensure that capital inflows are channelled to investments

Second, it is essential for countries that enjoy large capital inflows – including EU countries where capital inflows are further boosted by the prospects of rapid economic and political integration – to put in place *policies that can help direct capital and labour towards productive investment and activities*. Such policies are crucial to enhance the growth potential and the capacity to service foreign debt in a sustainable manner. Policies that promote a favourable business environment, the adoption of advanced technologies, and innovation, would help build a strong productive base and thus reduce the risk of boom-bust cycles. Moreover, the gradual loss of price competitiveness witnessed by the Baltics during their boom phase underscores the relevance of appropriate wage policies, including by the government sector, and policies aimed at easing possible labour market bottlenecks and upgrading the skills of the workforce.

Third, boom-bust dynamics could be mitigated by *appropriate financial policies*. Notwithstanding the limitations a high degree of financial integration puts on these policies, the strengthening of prudential regulation and supervision is an essential flanking measure in this regard. The central role played by cross-border financial intermediation for the Baltics stresses the importance of cross-border co-ordination and co-operation in financial supervision and that of adequate macro-financial surveillance at the international and EU level. Progress in the latter respect is an agreed priority among EU Member States. The Baltic experience is encouraging in this regard.

Fourth, the story of the Baltics underscores the increased importance of *fiscal policy as a macroeconomic stabilisation tool* in countries that adopt a hard peg and have massive capital inflows. The apparent differences in the performance of the Baltic economies show that a prudent fiscal policy stance in good times can make a difference in testing times. Unlike Latvia and Lithuania, Estonia maintained substantial government budget surpluses from 2003 onward and pursued a less pro-cyclical fiscal policy during the boom years. This financial buffer, on top of central bank reserves in excess of the minimum level required by the currency board arrangement and relatively high level of capitalization in the banking sector, helped contain financial market tensions in Estonia after the outbreak of the crisis. The Baltic experience also underscores the need for tax reforms that help prevent house price bubbles. On the surveillance front, improving methodologies to track the cycle position in real time and adjust fiscal variable for the impact cyclical fluctuations in economic activity and asset prices would help better assess the appropriateness of fiscal stance. In addition, given the remaining uncertainty on structural budget balances, fiscal policy should follow a prudent, precautionary approach with respect to potential growth and revenue elasticities. Improved fiscal governance, including the introduction of properly-designed numerical fiscal rules and medium-term frameworks, could promote counter-cyclical fiscal policies, especially in good times.

Finally, the experience of the recent years in the Baltics also provides an interesting *test case of enhanced multilateral surveillance* for countries undergoing balance of payments difficulties. The assistance programme for Latvia shows that, besides providing financial assistance, the EU and in particular the Commission can bring an in-depth policy advice through an extensive monitoring and dialogue which can support governments in formulating a proper adjustment strategy.

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