

## Doing Business in the Baltics – a World Bank Perspective

by Thomas Laursen and Roger Grawe

### Background

The Baltic countries have grown rapidly since the mid-1990s, but income levels remain at less than one-half of those prevailing in Western Europe. The overarching question now is whether the high growth rates of recent years can be sustained over the medium-long term, thus allowing for rapid convergence toward average EU income levels. There is little doubt that part of the recent dynamics reflects the very low starting level a decade ago, with strong productivity growth owing partly to continued labour shedding and the reallocation of resources toward more productive sectors and with high investment rates responding partly to the need for upgrading a depleted capital stock. More recently, rapid credit growth has fuelled a boom in domestic demand, resulting in large current account deficits, which cannot be sustained indefinitely. At the same time, however, investment and productivity growth also reflects the general improvement in the investment climate and substantial inflows of foreign direct investment, augmenting not only investment but also transferring know-how and new technology. It is difficult to disentangle the relative importance of all these factors, but looking more closely at the business and investment climate may help.

### Business and investment climate

The Baltic countries generally compare favourably with other new Central European EU member countries on various indicators of doing business and investment climate (Annex). Among the Baltic countries, no consistent ranking seems possible. While Estonia leads according to several indicators (economic freedom according to the Heritage Foundation index, competitiveness according to the World Economic Forum and IMD indices and overall transition according to the EBRD transition indicators), Lithuania comes out on top according to the World Bank assessment of ease of doing business. In fact, Lithuania now ranks among the Top 20 globally in this assessment, with the other two Baltic countries close behind. Slovakia is the only other country in the region included in this group, one place behind Lithuania.

The same is true when looking at other aspects of the investment climate such as macroeconomic stability, production costs and financial sector development. The Baltic countries — in the context of their fixed exchange rate regimes — have all pursued prudent fiscal policies and have low levels of debt and inflation. Estonia and Lithuania were in the first group of countries (along with Slovenia) to join the ERM-2 — the “waiting room” for Euro adoption — and Latvia is expected to follow soon, despite a burst in inflation following EU accession. Nevertheless, rapid credit expansion and high current account deficits remain a source of concern. Production costs are relatively low in the Baltic countries, with average wages around EUR 400 per month (some 30% lower than the largest Central European countries) and effective corporate tax rates are also among the lowest in the region. In terms of financial sector development (as measured by assets or credit to the private sector as a share of GDP) Estonia and Latvia are broadly in line with the average for the region (although far behind the EU15), while Lithuania has only come about half as far.

Looking at foreign direct investment inflows (FDI), the Baltic countries again seem relatively attractive, with FDI in Estonia for example, amounting to an average of 7% of GDP in 2002-03 compared to an average of 4% of GDP in Poland, Hungary, and the Czech Republic during the same period. However, available evidence suggests that most of this foreign investment has gone into relatively low-value added and low-skill labour intensive industries

### Key challenges

Looking ahead, even with the relatively conducive investment climate, the Baltic countries face a number of important challenges in order to sustain high growth rates in the face of increasing competitive pressures, both from other countries in the region and from countries further East. While the prospects for maintaining macroeconomic stability are favourable, the risks from continued rapid credit expansion and large current account deficits should not be underestimated. Perhaps the most important area where further reforms are needed is privatisation of the remaining large state-owned enterprises and strengthening competition, particularly in the energy sector. Banking and financial market development remains a key priority, not least in Lithuania, with easier access to finance for new, entrepreneurial, small- and micro-enterprises a top priority. Additional efforts are also required to increase flexibility in the labour market, including reducing the tax wedge. Finally, there is ample room to improve the legal system, especially relating to bankruptcy, creditor rights and enterprise restructuring, as well as regulations affecting land registration and use, the latter certainly in Lithuania. Corruption remains an important challenge, especially in Latvia and Lithuania. In the longer run, improving further the quality of education and building national innovation systems will be crucial to develop a knowledge-based economy and move up the technology ladder in production and exports. Nevertheless, if the dynamism of recent years is a good indicator, there is the fundamental commitment of both private and public sectors in all three countries to a successful reunion with the European family, which suggests that doing business in the Baltics will continue to be a winning proposition.

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## Annex (Doing Business in the Baltics – a World Bank Perspective)

## INDICATORS OF DOING BUSINESS AND INVESTMENT CLIMATE

	scale (high - low)	Estonia (rank)	Latvia (rank)	Lithuania (rank)	Other EU8 countries average*
<b>Index of Economic Freedom 2004</b> (the Heritage Foundation)	1-5	1.76 (6)	2.36 (29)	2.19 (22)	2.60
<b>Growth Competitiveness Index 2004</b> (World Economic Forum)	7-1	5.08 (20)	4.43 (44)	4.57 (36)	4.45
<b>The Business Competitiveness Index Ranking</b> (World Economic Forum)	Ranking	27	49	36	
<b>IMD - World Competitiveness Ranking 2004</b>	U.S.=100	68.43 (28)	n.a.	n.a.	53.71
<b>EBRD Transition Indicators 2004</b>	4.3-1				
<i>Large scale privatisation</i>		4.0	3.7	3.7	3.7
<i>Small scale privatisation</i>		4.3	4.3	4.3	4.3
<i>Governance &amp; Enterprise restructuring</i>		3.3	3.0	3.0	3.2
<i>Price liberalisation</i>		4.3	4.3	4.3	4.2
<i>Trade &amp; Forex systems</i>		4.3	4.3	4.3	4.3
<i>Competition Policy</i>		2.7	2.7	3.0	2.9
<i>Banking reform &amp; interest rate liberalisation</i>		4.0	3.7	3.0	3.6
<i>Securities markets and non-bank financial institutions</i>		3.3	3.0	3.0	3.2
<i>Overall infrastructure reform</i>		3.3	3.0	2.7	3.2
<b>Doing Business 2005</b> (IBRD/The World Bank)				17	
<b>Starting a Business</b>					
<i>Number of procedures</i>		6	7	8	9
<i>Time (days)</i>		72	18	26	47
<i>Cost (% of income per capita)</i>		7.5	17.6	3.7	14.5
<i>Min. capital (% of income per capita)</i>		49.7	41.4	62.8	86.6
<b>Hiring and Firing Workers</b>					
<i>Difficulty of hiring Index 0-100</i>		11	78	33	19
<i>Rigidity of hours Index 0-100</i>		80	20	40	52
<i>Difficulty of firing Index 0-100</i>		40	50	40	28
<i>Rigidity of employment Index 0-100</i>		44	49	38	33
<i>Firing costs (weeks)</i>		33	42	38	29
<b>Registering Property</b>					
<i>Number of procedures</i>		4	10	3	5
<i>Time (days)</i>		65	62	3	164
<i>Cost (% of property value)</i>		0.5	2.1	0.9	3.3
<b>Getting Credit</b>					
<i>Cost to create collateral (% of income per capita)</i>		43.0	1.5	4.1	7.7
<i>Legal rights Index 10-1</i>		..	8	4	6
<i>Credit Information Index 6-0</i>		5	4	3	4
<i>Public registry coverage (per 1,000 adults) **</i>		0	6	44	10
<i>Private bureau coverage (per 1,000 adults) ***</i>		95	0	0	132
<b>Protecting Investors</b>					
<i>Disclosure Index 7-0</i>		4	5	6	5
<b>Enforcing Contracts</b>					
<i>Number of procedures</i>		25	23	17	27
<i>Time (days)</i>		150	189	154	647
<i>Cost (% of debt)</i>		10.6	11.0	14.1	11.5
<b>Closing a Business</b>					
<i>Time (years)</i>		3.0	1.1	1.2	4.2
<i>Cost (% of estate)</i>		8	4	8	19
<i>Recovery rate (cent on the dollar)</i>		40.0	85.0	52.4	35.8

\* Czech Republic, Hungary, Poland, Slovak Republic, Slovenia

\*\* Number of individuals and firms listed in the public credit registry with current information on repayment history, unpaid debts or credit outstanding. The number is scaled to country's adult population (per 1,000 adult population). If a public registry does not operate, the coverage value is 0.

\*\*\* Number of individuals or firms listed in the private credit bureau with current information on repayment history, unpaid debts or credit outstanding. The number is scaled to the country's adult population (per 1,000 adult population). If a private bureau does not operate, the coverage value is 0.