

Different Paths of Transition in The Baltics

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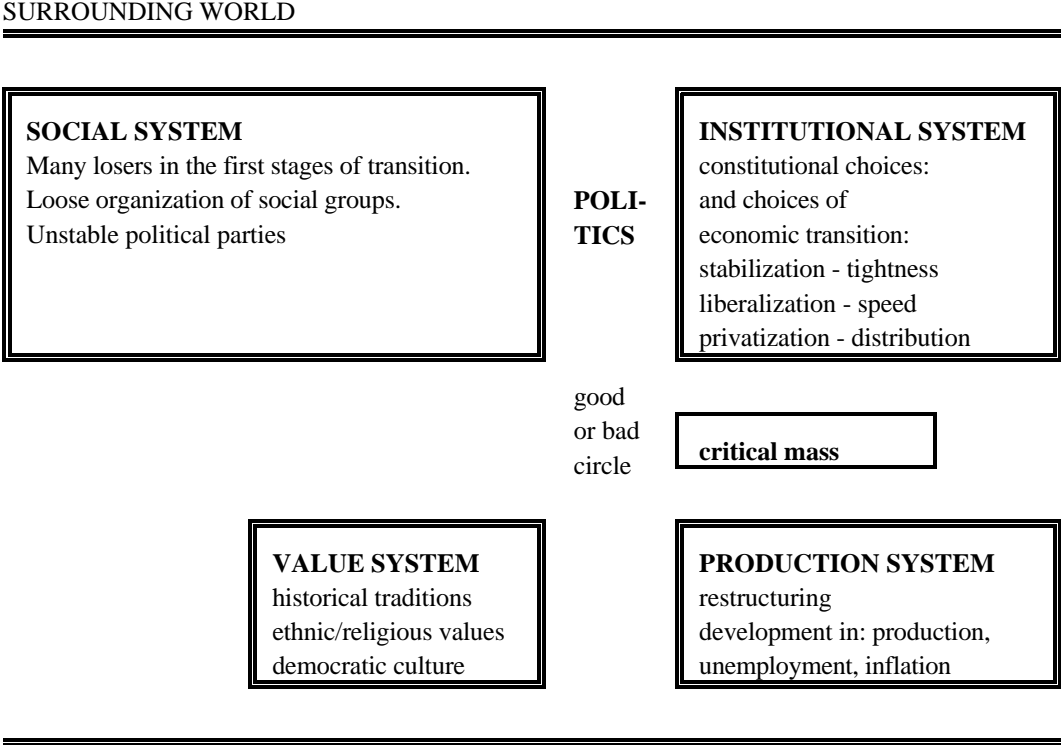
1. Introduction - the dynamics of transition

The choices for the countries in transition in Eastern Europe has been compared with the situation for a person with a specific disease. A specific disease needs a specific treatment. However, it can be questioned whether the "patients" in Eastern Europe in fact are in the same situation. Although the transition certainly has a lot of elements in common there are also important differences between the countries which makes specifically adjusted cures more relevant. The specific disease and the treatment depends on the specific conditions at the start of the transition. Furthermore, the culture, preferences of the population and the relative strength of social groups are different and will open up for different paths of transition.

An analysis of the transition process will, therefore, have to consider not only the specific economic conditions for the process, but also the specific culture, the specific geographical and technical conditions and first of all the specific distribution of power between different social groups. To analyse this it is necessary with a holistic analysis of the transition process. In the book "Societies in Transition" (Mygind, 1994) I have developed such a holistic model. The model have been used for an analysis of the transition process in the Baltic Countries (Mygind, 1996a). This article is a short version of this analysis.

Figure 1 illustrates the society with four sub-systems and the surrounding world and it shows the main dynamic relations between these elements. The *institutional system* is the formal rules governing the political processes and the coordination of the economy. The *production system* is the resources of society - nature, physical means of production and human knowledge. It is also the structure and the results of production. The *value system* is the basic culture of society. The values, norms and preferences of the inhabitants and the informal coordination of society. The *social system* is the different social groups and their interaction with each other. This system includes the distribution of power, income and wealth. The social groups can change the institutional system. This happens in *politics*, also shown in the figure. The barriers of the transition can be found in each of the subsystems and in the interaction between them.

Figure 1. The interaction between different subsystems.



(NB: DUE TO TECHNICAL PROBLEMS THE ARROWS IN THE FIGURE ARE MISSING, SORRY!
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SURROUNDING WORLD

The most important change will take place in the **institutional system**: On the political level this includes a new democratic constitution with rules for the distribution of political power between president, parliament, central and local governments and the rules for election to these bodies. On the economic level the transition from plan to market includes **liberalization**, that is: decentralization of decision, information and motivation to independent market units. This includes liberalization of prices, international trade, banking etc. and it includes the legislative framework for the operation of private enterprises. Parallel to liberalization will it be necessary to make **stabilization** to secure macroeconomic conditions without inflationary pressure. Finally is it necessary to change the incentive structure in the state owned enterprises. This includes **privatization**, and it has turned out to be the most difficult task in the transition process.

Both the change of political and economic institutions involves serious social conflicts because these institutions will make the framework for the future distribution of power, income and wealth. This is especially the case for privatization

with change of ownership of productive resources. But also the economic policy connected to stabilization and liberalization means drastic changes in distribution and economic cuts for many social groups. Therefore, there is a high risk that the new democracy will be exhausted by the heavy burden of creating the legislative framework for the new system in a situation of drastic social change. The institutional change not only meets social barriers. There are also serious technical and practical problems in creating and implementing the new legislation. The ideal situation would be to implement all the new institutions in one step. But this is impossible since many of the elements of transition take time. Some steps must be taken before others, meaning that many solutions will only be partial. There will be many holes in the system that can be exploited by entrepreneurial people in the new private sector and in the state bureaucracy. Much effort will be used in speculation on the lack of consistency in legislation instead of using the human resources to restructure production.

The barriers in the institutional system is very much connected to the barriers for change in the **social system**. Although the change in the political institutions will mean a change of persons in the upper level of the state bureaucracy, many administrators from the old nomenclatura will continue on important positions. They will themselves be the administrators of the transition of power away from the state bureaucracy. They will to a certain extent have the possibility to use their positions to convert their power resources to fit into the new system. The "wild privatization" is an example where the former power resources connected to the planning-institutions are converted to economic power resources. The people belonging to the former elite use their positions and personal relations to transfer the assets of the state owned firms to new private firms owned by themselves. This can be done by favorable contracts for these private firms in transactions of goods and assets with the state owned firm.

The change in the rules involves social conflict, and at the same time it takes time to develop a system for balancing different interests. This system of interest representation and negotiation covers both the institutional and the social system. The social system fills out the framework set by the institutional system. But the lack of stability in the social system influence the development in politics and the change in the institutional system. After the initial shift in power and the victory for the groups favoring democracy and market, the expectations of the majority have often been unrealistic. Experience from other countries in transition shows that the social groups who have been the backbone of the social pressure for change will be losers in the initial stage of transformation (Rosati, 1992). How will these groups react

when they realize that their economic situation is worsening?

Closely connected to this question is the problem of organizing different interest groups both in the form of unions and political parties. The social situation is changing rapidly for many people, and it is difficult for them to define their own interests and political opinions. These problems are extended by the lack of knowledge of the consequences of different strategies in the process of transition. This explains the instability in the party-system in many countries in transition. Voters, party members and even many parliament members realize in the process that the proposed strategy of their party has other consequences than they expected, and then they shift to another strategy. This is not only the result of lack of political experience. This is rather the result of the lack of transparency of the complex process of transition. There is no clear theory or former experience to learn from. Unfortunately the lack of stability in the social system might imply a lack of stability in politics and for the strategy of economic transition. This can be the start of a "bad circle" illustrated in figure 1.

The reaction of different social groups can be expected to depend on the development in production, that is the development of the **production system**. Also in this system very important barriers can be found: The structure of production in the typical command economy was based on large monopolistic firms mainly in sectors of heavy industry and military production. The best resources were used in military production. In other industries the technology were often outdated and especially in the heavy industry extensively energy-consuming. The service sector and especially the trade system were underdeveloped and the infrastructure for transport and telecommunication were also in a very bad shape compared to the standard in developed market economies. The production system was fit for a special basket of goods chosen by the bureaucracy. When the market system is implemented, the production system shall produce a very different basket of goods, now governed by the preferences of the consumers in the domestic market and the competitiveness of the enterprises in the world market. The transition from the "plan-basket" to the "market-basket" will mean a drastic change in production. When the world market prices are introduced it will be evident that some firms have turned valuable inputs (energy and other raw materials) into less valuable outputs. These firms have not made production but destruction according to the measure stick of the world market (Hare and Hughes, 1992). Other firms produce positive value added, but not enough to cover their cost of labor and capital. The remaining firms make a profit, and some perhaps a huge profit because they possess a monopoly position in the local market, or the demand initially exceeds the supply so that there will be a bottleneck for a

long period.

The restructuring of the production system will take time and it will demand a huge amount of capital. Unprofitable production units can be closed down quickly, but it takes time and investment to build up new areas of production. In this barrier lies one of the main reasons behind the drastic fall in production seen in all the countries in transition. It is a paradox that the low priority of consumption in the former command economy will continue for some time due to the need of investment to build up a competitive sector for consumption goods. Initially there will be a strong pressure for imports of Western consumption goods and technology. This has resulted in a very low initial valuation of the currencies of the Eastern countries. Both the restructuring of the physical structure of production and the upgrading of market skills will meet barriers in the social system. Employees will resist the close down of their production units, and managers will not voluntarily leave their positions although other persons are better qualified.

Also in the **value system** there will be barriers for the transition. This is not because the basic culture must change in the transformation process. Such change can take many generations. Different cultures will make different conditions for the transition and the resulting structure of society. It is important to stress that there can be different types of values attached to different social groups. This is especially the case in the Baltic countries. This has important implications for the development of the social system. Contradictions between different ethnic or religious groups can create social instability and be a barrier for the economic transition. At the same time the transition can affect different groups differently and this might attenuate the conflicts.

The surrounding world might cause some barriers for the societies in transition. The dissolution of CMEA and the USSR caused many links between firms to be cut. The Baltic countries were fully integrated in the specialized system of the USSR. The break down of the Soviet system caused severe problems for many firms. But the surrounding world also gives new possibilities to overcome some of the barriers. The West can supply: positive influence to the democratic culture in the value system, supervision about political and market institutions in the institutional system, organizational experience in the social system, transfer of know-how and capital in the production system etc.

Figure 1 illustrates some of the main lines of interaction between the subsystems summarized in a "good" or a "vicious" circle. The **good circle** appears when there

is such a stability in the social system that the main institutional changes can be decided by a stable majority with broad support in the population. This will result in clear rules for the political institutions and open up for a consistent economic policy in the area of stabilization, liberalization and privatization. If this policy is successful it will have positive influence on the production system. An initial fall in production will be accepted because the restructuring is apparent. This will stabilize the situation in the social system. There will be support for the continuation of the transition, and so on. The value system can support this process if the values are well fit for the democratic development. The surrounding world can support the process if it gives sufficient supervision for the development in the social and institutional system, if there are the necessary inflow of know how, capital and entrepreneurship in the production system, and if the surrounding world gives access for export from the countries in transition.

However, there is a risk of a **vicious circle** where the social system is very unstable and different social groups confronts each other without any clear results. There can be conflicts concerning the constitutional choices, where the competence of different institutions remain unclear, and it can concern the economic transition resulting in an unclear policy. The economy might be stabilized in some fields but not in others resulting in continuing lack of balance. Liberalization might be inconsequent so that the agents do not expect the market mechanism to start working. The policy does not surpass the "critical mass" to make the agents start behaving on market signals. They do not stop hoarding goods, they do not invest in new production etc. Finally, privatization can be blocked by conflicts about the distributional effects. Such policy failures will also have a negative effects on the production system. This will increase the social and the political struggle and so on. The value system can enforce this bad circle by destabilizing the social system because of conflicts between different cultural groups, and the surrounding world can destabilize the situation by interaction with different sides in the conflict, by restrictions on trade, by making unrealistic expectations in the population and by holding back the needed support of know-how and capital.

In this article I will stress both the special situation for the Baltic countries as a group and the differences between them. The analysis starts with some background information about the situation for the three countries before transition. I will show how these differences to some extent can explain important differences in the political development in the three countries and thus different paths of transition. The balance of power between different social groups is an important factor explaining the strategies of transition. These strategies will be explained through the main

elements of stabilization and liberalization and even more pronounced in the different methods of privatization in the three countries.

2. Background conditions.

There are many parallels in the history of the three Baltic Countries. That is why they are often taken as a group. However, there are also important differences as well in the value system as in the other subsystems.

The production system in the three Baltic countries is heavily influenced by 50 years under Soviet rule. That means an underdeveloped service and trade sector and an industry mainly based on very large firms built to supply the whole Soviet Union with specialized goods. Compared to the other republics in the Union the Baltic Countries, especially Estonia, have more weight on light industry (Hanson, 1990). Both Estonia and Latvia were industrialized before the Soviet occupation. Tallinn and especially Riga were important trade centers already in the beginning of the century. Lithuania, on the contrary, had a large population in agriculture after the second World War. The industry here was mainly built up under Soviet rule. In Lithuania and Latvia employment in agriculture were still high with 18% of the workforce in 1990. In Estonia with 13% is still much higher than in Scandinavian countries with around 4%.

The institutional system was integrated in the Soviet command economy. Most economic activities were governed from the center in Moscow. Therefore, the basic economic institutional conditions was quite similar for the whole Soviet Union. However, the Baltic countries and especially Estonia was in the period of perestroika used as a place for experiments with new forms of enterprises and elements of market economy. The Baltic countries and especially Estonia had the highest density of new cooperatives - small semi-private firms - and the highest numbers for "individual employment" and joint-ventures (Aage, 1991). This was the first steps toward a market economy.

The social system in the Baltic countries was characterized by both the dominance of the communist nomenclatura and the dominance of Russians. In the period just before the Soviet occupation many people emigrated to the West. During the Soviet period many Baltic people were deported to Siberia and there was massive immigration of especially Russians, but also Ukrainians, Belorussians etc. The immigrants from the rest of the Soviet Union got their jobs in new large-scale industrial enterprises build to fit into the overall Soviet command network. In Lithuania there were still enough surplus labor from agriculture to supply labor to the

new industries. This is the main reason why here was only little immigration from the rest of USSR. In Estonia and Latvia the Russian immigrants moved to the new suburbs surrounding the big cities. They constituted about half of the industrial labor force, and especially in Latvia they also had some of the highest positions in the management of the enterprises. In Estonia the titular nationality had only 43% of industrial employment, in Latvia only 38% and in Lithuania 71%. In Latvia other nationalities had also a strong position in sectors like transport and construction, and even in administration titular Latvians made only 56% of employment. In agriculture the titular populations dominated in all three countries.

Figure 2. Background conditions - before 1989.

	Estonia	Latvia	Lithuania
Production System population (mill) ¹ land area (1000 km ²) ¹ NMP/cap USSR=100 (88)	1,57 45,1 117	2,67 64,6 119	3,72 65,2 110
industrialization	early	early	Soviet industrialization
Institutional System history, foreign dominance During Perestroika centers for experiments	especially Estonia many new cooperatives and "individual firms"		Strong state in the Medieval times
Social System ² ethnic change during Soviet occupation titular nationality / total 1939 1945 1989 in industry state farms transport construction administration	emigration to the West and deportations of Estonians, immigration of Russians to new industries 92% Estonians 94% 61% 43% 84% 67% 81% 72%	emigration to the West and deportations of Latvians immigration of Russians to new industries 77% Latvians 83% 52% 38% 69% 38% 46% 56%	emigration of Lithuanians but low immigration of Russians, labor from agri- culture to new industries 76% Lithuanians 80% 79% 71% 84% 47% 61% 78%
Value System language religion foreign influence	Finnish/Ugrarian protestant mainly german	Baltic protestant mainly german	Baltic catholic mainly polish/traditional
Surrounding world	close contact with Finland		

1) EIU country profile 1992/93, 2) Hanson, 1990.

The value system is very much connected to the social system, because the social groups are closely related to ethnic divisions. During centuries the special cultures of the three Baltic nationalities have survived foreign occupation. They were

independent between the two world wars, but after 1945 the Soviet occupation challenged the Baltic cultures. The russification process did not happen only in the form of Russian immigrants. Russian was in practice the official language and the main language in the educational system. Therefore, there was a strong nationalist reaction from the titular populations in all three Baltic countries.

It is a mistake to understand the three Baltic Countries as one culture. There are important differences of language and religion: The Estonian language is quite similar to the Finnish language. Estonians are mainly protestants. Latvians and Lithuanians have a specific Baltic language, but the two languages are so different that direct communication is not possible. Latvians are mainly protestants, while Lithuanians are mainly catholics. This difference is connected to Lithuania's historic ties to Poland. Estonia and Latvia were more influenced by Germans (Andersen, 1992). This is also part of the explanation for the early industrialization of the two most Northern countries. The percentage of respondents having a "positive attitude" toward cooperative and individual activity was higher in Estonia than in the other Baltic Countries and the rest of the former Soviet Union (Aage, 1991). These differences reflect the fact that the Estonians had more experience with market-orientated firms. It might also reflect a higher degree of individual values in Estonia versus more collective and equalitarian values in Lithuania.

The higher degree of market-orientated values in Estonia can also be connected to influences from **the surrounding world**. The close linguistic relationship with Finland made the Estonians able to follow Finnish television and radio. Many Estonians lived in exile in Sweden, Finland and North-America. This was to a certain extent also the case for Latvians and Lithuanians but the language barrier implied that the influence of Western style of living was smaller in these countries. This has especially been the case in Lithuania with the most traditional agro-oriented culture. The economic ties between the Baltic Countries and the West were quite small, and in political and military matters they were completely dominated by Moscow until the democratization period under Gorbachyov.

3. Main political developments

As illustrated in figure 1 the development in the social system and the political changes of the institutional system are important conditions behind the economic transition. This section gives an overview of the political development with emphasis on the differences between the three countries. Up to the independence after the failed August-coup in the USSR the development in the three Baltic Republics had the same pattern, but Lithuania followed the most radical line of confrontation. This might be explained by the more homogenous Lithuanian population and by the strong role of the catholic church in Lithuania. In Estonia and Latvia there was the large

Russian speaking population to modify the confrontation. Estonia followed a more pragmatic strategy, and Latvia was in a mid-position.

Figure 3. Trends in the political development.

Balticum	Estonia	Latvia	Lithuania
I Fight for independence National Popular Fronts Communist parties 1990 republic elections, independence referendum	pronationalists 77% pro Russian 23%	Oct. 1988 Popular Front split, strong pro Russian part pronationalists 65% pro-Russian 30%	Sajudis strong independent line pronationalists & CP 95% pro-Russian 5% confrontation with Moscow
II After independence - before elections split of popular fronts	no citizenship and voting- rights to Russians, liberal economic policy, privatization slow, pressure for cutting ties with Russia => June 1992 intro- duction of KROON shift in trade 1991-92	no citizenship and voting rights to Russians, privatization only fast in agriculture (no Russians), government-parliament in deadlock on citizenship and economic policy. disputes with Russia.	introduction of citizenship law includes minorities, good relations with Russia, high equalitarian values => voucher privatization, weak stabilization, IMF-pressure => stronger stabilization in autumn 92
III After elections more homogenous and well defined interests, Russian troops out Aug 1993 in Lithuania Aug 1994 in Estonia and Latvia	election, September 1992 center-right government program: ultraliberal, focus on the West, hardline nationalism, election, March 1995 reaction on government, new center-government, slightly modified economic policy and national policy	election, June 1993 center-right government program: continued reform, pragmatic nationalism, often political deadlock, banking crisis summer 1995, election, October 1995 reaction on establishment, victory for left-wing and extreme nationalists. coalition, cont. deadlock	early reform reaction: parliament election Nov. 92 presidential February 1993 center-left government, continuation of reforms moderation on stabilization, continued IMF-pressure, problems in government, autumn 95, banking crisis, parliament election Nov. 96 conservative government.

The majority-sections of the communist parties in all three countries changed their policy to support more independence. Most radically this happened in Lithuania when the local Communist Party in 1989 declared itself independent from the Soviet Communist Party. The strength of the Popular Fronts and the change in the local communist parties resulted in a change of policy of the Baltic Supreme Soviets: In the end of 1988 the titular languages were declared the official languages in all three countries. They started to use their traditional flags, and in 1988-89 there was a "war of laws" with Moscow about which legislation had the supremacy - the republican or the all Soviet.

The independence-movement had broad popular support. In August 1989 two mill. people formed a 600 km human chain stretching from Tallinn to Vilnius. In the spring of 1990 the first free elections for over 50 years took place in all three republics. The Popular Fronts and pro-independent groups won a majority in the

three soviet republics. Shortly after the election, declarations of independence were adopted. Lithuania made the most radical declaration and this was answered by Moscow by imposing an economic blockade. In Russia, the beginning dissolution of the Union strengthened the conservative forces, and the tensions between Moscow and the Baltic republics increased during the rest of 1990 culminating in January 1991 when Soviet troops seized the Radio and Television Center killing 13 civilians. In the spring an overwhelming majority voted for independence in referendums in Estonia and Lithuania. In Estonia around 50% of the non-estonian speaking people also voted for independence (Andersen, 1992).

After the failed coup the Baltic Countries were recognized as independent states not only by Western countries, but also by the other States of the former Soviet Union. When the chains to USSR were removed, there was more room for differences in the economic and political development in the three countries:

Since the election in 1990 the new government in **Estonia** were dominated by experts working for Estonian independence. Many leading officials had a past in the communist party. They were working for a gradual but comprehensive economic transition, and they followed a quite soft line in the confrontation with the Russians. Although the economic reforms with price liberalization and partial indexation of wages meant hardship for the population, the government was not met by resistance from the public or the parliament in 1990 and 1991. It was quite clear that the government, until the independence in 1991, had limited room for their decisions, and in many respects the Estonian economy was developing quite well compared to other Soviet republics. The price reforms meant high inflation but also more goods in the shops and improvements in the terms of trade with Russia. However, when Russia liberalized prices in January 1992 and adjusted the prices of exported raw material to the world market level this meant a severe shock for the Baltic economies. The result was hyperinflation for the first months in 1992, and a sharp reduction of supply of energy and other essential raw materials.

The government was changed in early 1992, but the new government continued the economic policy, culminating with the introduction of the KROON in June 1992. The new government followed a more nationalistic line. The 1938-citizenship law was reinstated. Citizenship was only given to citizens from before 1940 and their descendants. For later immigrants it was rather difficult to get citizenship. This meant that the Russian minority had no voting rights at the referendum in June 1992, when the new constitution was approved, and no voting rights at the parliament election in September 1992. At this election the national question still had a high

priority. The nationalist parties won, and a center-right government was formed. The economic policy was neo-liberalistic leaving little scope for the role of the state and the tough economic policy was continued. The "aliens law" passed by parliament in June 1993 escalated the conflict with the Russian speaking minority. There were protests both from East and West, and the president denied to underwrite the first draft of the law. After some adjustment giving the Russian speaking population right to stay in Estonia it was passed (Andersen, 1994). The law considered the Russian speaking minority to be foreigners, and gave them only limited rights. Thus, the national question dominated the political scene giving the government greater scope in the economic policy. However, the government's popularity continued to fall and was met by increasing apathy by the titular Estonians while the Russian speaking people were more active. At the local elections in October 1993 where most of the Russian speaking population had the right to vote, parties supported by Russians got relatively high votes and an influential position both in the North Eastern part of Estonian and in the Tallinn area. In September the primeminister had to step down in favor of a caretaker government for the period up to the election in March 1995.

This election can be interpreted as a reaction toward the tough economic policy and its consequences for broad social groups in the population. The winners had some relations back to the Estonian communist party, but they were also leading figures in the first years after the Estonian independence. Their party can more correctly be described as a center party. However, in relation to the former right-wing dominated parliament the election was in fact a turn toward the left. A center coalition made up the government. In the summer of 1995 an Estonian "Watergate" scandal was the cause for a change in government in favor a the more liberal (right wing) Reform party. This party was headed by the president of the Central Bank, one of the architects behind the liberal economic reforms. In the national policy the government followed a more pragmatic line. The troop withdrawal treaty which was signed back in July 1994 and mainly implemented with the withdrawal of nearly all Russian troops in August 1994 was finally ratified by the parliament in December 1995. Estonias application for EU was formally submitted in November. This turned out to be the main path for Estonian integration with Western Europe.

The political development in **Latvia** had many parallels to the development in Estonia. However, the Latvians met more obstacles: Latvia and especially Riga was the stronghold of the Soviet troops, the Russians had a stronger position at the management level of the industrial enterprises (EIU,2:93), and Latvia had not so close links to the West as did Estonia in relation to Finland.

After the election in 1990 a government was formed based on the Popular Front. This government had increasing troubles to get a majority behind its policy, because the Popular Front was split on how to solve the problem of citizenship and on economic policy. Citizenship was restored for people living in Latvia before 1940 and their descendants. This covered 72% of the population including about 20% non-titular Latvians. The question about possible citizenship for the big group of postwar-immigrants was postponed to after the election which was postponed until June 1993 because of a political deadlock.

The first election after independence was like in Estonia a victory for the nationalist center-right. The leading party in government became "Latvian Way" with 36% of the parliament seats. They wanted a quota-system for integration of the Russians in the Latvian society. Their coalition partner, the Peasant's Union, got 12% of the seats. The government gave a high priority to closer integration with the West and fast privatization, but at the same time the Peasant's Union wanted import-control on food (EIU, 2:93). The national question continued to have a high priority on the political agenda. The debate on citizenship continued for months after the election. In the spring of 1994 a proposal was passed which would set very restrictive quotas. However, the international community protested and the Latvian president vetoed the law. In July, a new law without strict quotas were passed. This law gave residents born in Latvia possibility to apply for citizenship, but the administration of the law was quite restrictive. An Association agreement with EU was finally settled in July 1995.

The second parliamentary election after full independence took place on October 1995. The leading party in the Latvian government, Latvian Way, had after a low period gained back some of its support, but were then weakened because of the bank-crisis which swept the country from the spring of 1995. The crisis at the same time put extra pressure on the state budget. Massive spending cuts meant very bad relations between government and growing numbers of public-sector workers, such as the increasingly militant teachers. They went on strike in December 1994, and after a week the government gave in to their wage demands (EIU,95:1).

The banking crisis had a big effect on the results of the election in September 1995. The government party Latvian Way lost more than half of their 36 seats but they were still with 17 seats the second largest party in the Latvian parliament with a total of 100 seats. The election was like in Estonia a reaction toward the results of the reform process. The election marked a move to the left. But also extreme nationalist parties had a surprisingly large support. The new parliament showed in this specter

a left-right divide with nearly equal halves and a strong divide according to the relations to the Russian minority. The political deadlock became an even more strong element in Latvian politics and it took months of negotiations to form the new government. At the end of December 1995 an unusual coalition of 6 parties representing 68 seats was formed. The coalition consisted of both left and right-wing parties and pragmatic and hard core Latvian nationalists. The formation of the government was based on allocation of ministries more than on compromises on policies. However, the coalition parties agreed about their commitments to membership of EU and NATO and increased Baltic cooperation.

In **Lithuania** the citizenship question was not so important because the titular population made a comfortable majority. The citizenship legislation was quite strict in the demands for residency etc. but a flexible introduction gave the possibility for most of the non-titular minority to be citizens. Although Lithuania had the strongest conflicts with Moscow it was possible for Landsbergis to sign an agreement for withdrawal of Russian troops to be finished by August 1993. Therefore, the national question had a relatively little role in the political debate.

The Democratic Labor Party with roots in the former communist party was quite popular contrary to the case in the other Baltic Countries. The Lithuanian communist had followed a quite nationalistic line in contradiction to Moscow already from 1989, so the party and its leader, Brazauskas, was not identified with Soviet suppression as it was the case in Estonia and Latvia. The period of Soviet rule was not considered an economic disaster to the same extent as in the other more developed Baltic countries. There was no threat from a big Russian minority with close links to the communist party. The early market reforms in Lithuania was a failure especially in the countryside, and the economic disaster was being linked to the policy of Sajudis. Therefore, the Labor Party had a victory at the election in October/November 1992, and because of the system of half of the candidates elected in constituencies the Labor Party won an absolute majority in the Lithuanian parliament. At the presidential election Brazauskas won 60% of the votes. Especially in the countryside and among the non-titular Lithuanians the labor party won its support. Thus, the introduction of citizenship to all residents of Lithuania contributed to the victory of the former communists.

The victory of the Labor Party did not signal a radical shift in economic policy. Lithuania started already in 1991 a fast privatization program based on a voucher system. This system signalled a commitment to turn away from state ownership, and at the same time it favored a rather equal distribution of wealth. The stabilization

policy was quite weak in 1991 and 1992. This can partly be explained by the chaotic leadership of the ruling conservative coalition and partly by the fact that there was not a nationalistic shield over the economic policy. The people to be hit by the tough incomes policy made a big part of the voters. In Estonia and Latvia a big proportion of the workers belonged to the minority without voting rights. The lower priority to nationalism was also one of the explanations behind the relatively slow introduction and stabilization of an independent Lithuanian currency. However, especially pressure from IMF resulted in more tough stabilization policy from the autumn of 1992, and this policy was continued by the labor government. Although the labor party had a comfortable majority in parliament the government was not so stable. There were several shifts of ministers. The opposition was constantly attacking the government for corruption.

Brazauskas kept his quite high popularity in Lithuania and in spite of scandals among his minister there was for a long period a relatively stable political situation in Lithuania compared to its Northern neighbors. However, the government gradually lost its popularity partly because of the low living standards and because of the continuing corruption charges raised against the government from the opposition. A banking crisis in the end of 1995 and the forced resignation of the prime minister in early 1996 weakened the Labour Party further and at the parliamentary election in November 1996 the conservative party won the majority. Also in Lithuania there was a reaction from the population because of disappointment of the results of transition. The economic policy followed also in Lithuania the tough model used in the other Baltic countries. In all three countries we have seen popular reactions against the government, no matter whether they declared themselves to be left or right wing.

4. Stabilization and liberalization.

The transition to a market economy already started in the end of the 80's in the Baltic Countries. The fight for independence was closely connected to the objective of transforming the command economy. Economic independence meant that the administrative control from Moscow was abolished. The Baltic Republics wanted to manage their economies themselves. The idea of decentralization led to the idea of a market orientated economy.

These ideas were first developed in a comprehensive way in the **Estonian** "IME" plan from May 1989. It was an outline for an independent Estonian economy with its own currency, central bank and a mixed ownership structure consisting of public

firms, private joint stock companies and private employee-owned firms. During 1989 some of the "plans" in the program were approved in the legislation, and one of the leading authors of the program were appointed the first chairman of the new Bank of Estonia. Also in implementing Gorbachyov's Perestroika Estonia was in the front line. The Baltic countries, and especially Estonia, had in the end of the 80's the biggest proportion of employment in private firms in the form of "cooperatives" and "individual enterprises", (Hanson, 1990). In 1990 Estonia was in front with Western investment. It had nearly as many joint ventures as did the much larger Russia (World Bank, 1992)

From January 1991, Estonia had its own state budget. This meant initially that the net transfers to the Soviet budget was cut away, and Estonia like Latvia and Lithuania had a substantial surplus on the budget (Saavalainen 1995) Already from 1991 many important elements in the new tax-system were implemented. The fiscal policy was rather strict. The currency board meant that the state could not finance a deficit by "printing money". Financing by selling state bonds was not feasible in the first years of transition. This became possible later in the process, but shifting Estonian governments have kept the discipline so there were balanced budgets up to 1995 and the budget approved for 1996 also follows the strict line (EIU,96:1). From January 1994 the tax system was simplified and included less redistribution since the progressive tax system varying from 16 to 33% was changed to a flat rate of 26% for all incomes (EIU, 1:94). This was an example of the right-wing policy followed in this period also including very low minimum-wage, pensions and other social benefits.

Monetary policy had only limited scope when Estonia were still in the Rubel-zone, but during 1991 the interest rate was gradually increased to match inflation. Before that time the real interest rate had been strongly negative. In June 1992 Estonia introduced its own currency the KROON. Following the "currency board" principle the amount of KROONs was strictly tied to the Estonian reserves of hard currency and gold. The exchange rate of 8 EEK = 1 DM has been fixed since 1992. The other side of the coin is a limited supply of money and a very tight credit policy. There is no room to expand the amount of money to stimulate investment. The central bank cannot control credits and it cannot make open market operations. The interest rate is set at the market outside the control of the central bank (Bennett, 1993, Lainela & Sutela, 1993). The KROON was made internally convertible, but there were still strong restrictions on capital movements.

Most of the liberalization of prices took place from the second half of 1990 to the

beginning of 1992. In 1990 much of the subsidies on food were cut down. Prices increased 2-300% (1993). In 1991 further liberalization took place for a broad range of goods. In 1991 inflation in general was more than 200%. The biggest inflationary push came in the first months of 1992 following the liberalization of prices in Russia. Prices on raw materials imported from Russia were adjusted toward the level on the world market. However, after the introduction of the KROON in the summer of 1992 inflation per month fell to single digit numbers, and in April 1993 it was down at 2,3%. For 1993 as a whole inflation was 90%, but with a falling trend. In the beginning of 1994 there was increased inflationary pressure because of rising prices on energy, rent and public transport. Regulations in these administrated prices was also the main explanation behind the inflationary pressure in 1995. Also, the government's continuing shift towards taxing consumption had resulted in some inflationary pressure. In the autumn of 1995 excise duty on petrol and diesel was increased by 200% and also higher duties on alcohol came into effect. High foreign capital inflow because of the currency board resulted in an increase in the supply of KROONS. Therefore, the objectives for inflation in 1994 and 1995 were not fulfilled. Average inflation for 1995 was 29% with a slightly falling tendency, see figure 4.

Figure 7. Economic results in the three Baltic countries.

	Estonia						Latvia						Lithuania					
	1990	1991	1992	1993	1994	1995	1990	1991	1992	1993	1994	1995	1990	1991	1992	1993	1994	1995
GDP growth %¹	-8	-11	-14	-9	-3	3	-3	-8	-35	-16	1	-2	-5	-13	-38	-24	1	3
unemployment average²	0	0		4	4.1	4.0	0	0	1.2	5.2	6.2	6.6	0	0		4.4	3.8	6.1
inflation (CPI)¹	23	211	1076	90	48	29	11	224	951	109	36	25	8	225	1021	410	72	40
average wage \$ Dec³		16	65	77	178	272		12	52	118	188	213		10	27	70	115	167
budget balance¹ % GDP	2.9	5.2	-0.3	-0.7	1.3	-0.8	2	6.4	-0.8	0.6	-4.0	-3.3	-5.4	2.7	0.8	-3.1	-4.2	-3.3
foreign investment m \$¹			58	162	214	204			43	51	155				10	23	60	55

1) EBRD, 2) National Statistics, 3) Based on The Baltic Independent.

The development of the banking sector played an important role in the development in Estonia. The first commercial bank was established in 1988. By mid 1991 there were 12 commercial banks in Estonia. In 1992 the number had grown to 43. Many of these banks were in a difficult financial situation. During 1992 the Bank of Estonia strengthened the reserve requirements and in November three of the biggest banks were put under administration. The crisis resulted in mergers and bankruptcies. The number of banks in the spring of 1993 fell to only 23. However,

in this way Estonia succeeded in developing a relatively sound banking sector at a quite early stage of transition. The development in Estonia shows the determination of the authorities to strengthen the conditions not only of the banking sector, but for all firms. A change from a regime of "soft" to a regime of "hard" budget constraint. If the banks themselves have a hard budget constraint they will pass this constraint to their debtor firms. In 1993 Estonia implemented a rather strict bankruptcy law giving quite strong possibilities for creditors to start bankruptcy procedures. In the summer of 1994 26 industrial enterprises had been declared in bankruptcy and by mid 1995 around 1000 enterprises had been through bankruptcy procedures. Bankruptcy have been implemented more rigorously in Estonia than in nearly all other countries in transition (EBRD 1996). The development of a securities market had not a high priority in Estonia. With no budget deficits to finance there was no need to issue Treasury bills. However, the voucher privatization with large public offerings in the autumn of 1995 created a need for an equity market which was established in 1996.

The liberalization of foreign trade has been quite fast and comprehensive. In 1993 nearly all goods could be freely imported and exported. On December 1991 Estonian made a free trade agreement with EFTA on industrial goods and on May 1992 an agreement with EC liberalizing trade with most industrial goods. In the summer of 1994 a free trade agreement was concluded with EU for all the Baltic Countries and in the summer of 1995 association agreements - "Europe agreements" - were signed. Different from the case in Latvia and Lithuania the Estonian free trade for industrial goods could start without an adjustment period because Estonia from the beginning had a very liberal trade regime.

The disintegration of the Former Soviet Union and the opening up for trade with Western countries have resulted in a remarkable switch in foreign trade. In the 1980'es Estonia's trade with Western countries were negligible. Already in 1992 Finland was the most important trading partner and in 1995 it counted for 31% of total trade (EIU, 96:1). The KROON and the fast liberalization process were the main factors behind this remarkable switch. But the switch to Western trading partners was also a strong objective in the economic policy. This can be seen: in the exchange rate policy; in the fact that foreigners were allowed to buy Estonian land connected to production units already in April 1993; and in the privatization policy emphasizing foreign investments, see section 5.

Figure 5. Overview over stabilization and liberalization - 1990-95

STABILIZATION	Estonia	Latvia	Lithuania
fiscal policy	tight policy, high discipline, restricted by currency board.	1991, Latvian budget (balance), autumn 1992, tight policy	92 cuts in taxes and expenditures, 1993 moderately tight policy,
monetary-policy	in 1992 positive real interest, Central Bank no interference due to currency board,	from 1992 tight money policy very high interest rates, end 1993, treasury bills issue,	quite loose 1991-92 tight from spring 1993
exchange rate-policy	KROON from June 1992 currency board, fixed to DM then real terms appreciation	July 92 independent floating LVR appreciates to Rubles, later to USD from 94 quite fixed to SDR	May 1992, start issuing Talonas June 1993, Litas legal tender 1994 currency board, 4Lit=1USD
price liberalization	spring 1990, start liberalization 1991, further lib. also wholesale 1992, fuel, transport, rent not free 1994, nearly completed,	Jan. 1991, start liberalization Dec. 1991, free prices on food Jan. 1992, on industrial goods 1992 public utilities, rent not free	Jan. 1991, start liberalization October 1992, 15% controlled (energy, transport, tele, housing) 1994 stop for remaining subsidies
bank system	Dec. 1988, first semiprivate bank 1992/93 strict control => commercial banks 43 -> 20	By 1994, 64 commercial banks, 1995 largest bank bankrupt, July 95, stock exchange reopens.	Start of capital market with Investment Funds (vouchers) Sept. 1993 start stock exchange
foreign trade agreements with EFTA Dec 91, full 95 EU May 92, July 95	liberal trade regime from 1992 July 1992: free trade with Norway, Sweden and Finland. Jan. 1995, free trade with EU.	Jan. 1992 deregulation import, from license to tax on export, Sept. 1993, 15-30% tariffs, 4 years EU adjustment period,	1992, import quite liberal, July 1993, tariffs 10-30% July 1994, higher tariffs on food, 6 years EU adjustment period,
foreign investment	Sept. 1991, amended Dec. 1993, law on foreign investment, few restrictions, tax benefits	Nov. 1991, amended March 1993, law on foreign investment, tax benefits, phased out 1995,	December 1990, legislation February and June 1992, further liberalization,

The **Latvian** economic transition has similarities with the development in Estonia, but slower and not so successful in switching towards Western markets. Like in Estonia, Latvia got quite high financial autonomy from 1991, when a new tax system was introduced including, tax on property, land and profits, progressive incomes tax, social security paid on payroll, and a turnover tax, from January 1992 transformed to a VAT. Like in Estonia the state budget in Latvia had a considerable surplus in 1991, but the situation turned around because of a deteriorating taxbase in 1992 after the negative development in the terms of trade with the increase in Russian prices. After pressure from IMF the finance-policy was strengthened. The stabilization program for July 1992 to July 1993 included elimination of all subsidies on consumer goods, reduction of subsidies for agriculture, cuts in employment in the public sector and a 15% tariff on imports (WB 1993). After the election in 1993 it became clear that the budget deficit was increasing. As a response the VAT was increased. In 1994 the government just succeeded to keep the budget deficit within the 2% prescribed by IMF. In 1995 a tough budget was approved but strikes among the public workers resulted in higher wage increases than budgeted. With the tax

arrears still increasing the budget came under increasing pressure.

Because of the deadlock in Latvian politics, the stabilization policies of the government were not so consequently implemented in Latvia as in Estonia. Therefore, the monetary policy played a more important role. A more active monetary policy was also both needed and possible because Latvia later chose a regime with floating exchange rates. The bank of Latvia followed a line even more tight than the policy in Estonia. Interest rates were held quite high. The Latvian Rubles were introduced in May 1991 as a parallel currency to the Russian Ruble. In July the Latvian Rubles (LVR) were declared sole legal tender. From the same time LVR were made internally convertible and the exchange rate were floating also against Rubles (Bleskina, 1993).

Because of the continuing high inflation LVR depreciated against hard currencies in the following months, but it appreciated strongly against the Russian Rubles. From the winter of 1992/93 LVR also appreciated against DM and USD. Inflation in Latvia fell to only 0,3% in April 1993 (Shteinbuka 1993). In March 1993 LVR started to be phased out by "Lats" for the exchange rate of 1 Lat = 200 LVR, and in July 1993, Lats were declared full legal tender. The introduction of Latvian currency was more gradual than it was the case in Estonia, and in this way it was easier to continue trade relations with former partners in Russia, Ukraine etc. (Bleskina, 1993). Latvia liberalized restrictions on convertibility faster than Estonia. Riga became one of the main centers for currency trade in the whole former Soviet Union (Lainela & Sutela 1993).

The price liberalization in Latvia was a little behind the development in Estonia. In December 1991 the liberalization of farm procurement and retail food prices were completed. In January 1992 prices on industrial goods were liberalized, so the main prices still regulated were for public utilities and rent. By 1995 electric tariffs charged by the state owned utility covered only around 60% of the cost. Adjustment to the market level were not envisaged before 2005 (EBRD 1996). The bankruptcy law was not effectively implemented.

The growth of the financial sector in Latvia took off in 1992 when the financial ties with Russia were broken and the new banking legislation were implemented. The new commercial banks were in the start quite small and many of them were mainly servicing their owners, large state owned enterprises. However, in spite of the economic depression in the rest of the economy the banks developed quite rapidly and increased their reserves. In 1993 the capital of commercial banks increased four-

fold. At the end of 1993 61 commercial banks were registered (Baltic Independent 15-4-1994). The banking crisis in 1995 followed after international auditing had revealed the critical situation of many of the banks. Only 15 banks had been profitable in 1994. First of all it was uncovered that the largest bank, Baltija, was in a critical situation. Baltija had around one fifth of the Latvian population as depositors. The government tried to rescue the bank, but after some month it was finally declared bankrupt in December 1995. The state covered personal depositors for up to 200 Lats. The collapse spread shock waves all around the Latvian economy, to the state budget, to other banks and enterprises, to the general consumer so the effect was a strong dampening of the economic recovery.

Foreign trade was gradually liberalized. In the beginning of 1992, all controls on imports were taken away. All export quotas and licensing were abolished on June 1992 and replaced with a system of export taxes. (IMF-Survey, Nov 1992). A general 15% import tariff on finished goods was introduced in 1993. Custom duties on food have been increased to around 50% to support agriculture. Like for Estonia free trade agreements have been settled with EU, EFTA and the other Baltic countries. The free trade according to the "Europe agreement" from the summer of 1995 had a four year adjustment period.

Some of the general trends from Estonia and Latvia can also be found in the economic development in **Lithuania**. This is because of the common conditions in relation to the surrounding world. Price liberalization in Lithuania in 1991 and the liberalization in Russia in 1992 and especially the increase in energy prices gave in Lithuania the same terms of trade effects that has already been shown for Estonia and Latvia. Terms of trade improved in 1991 and worsened sharply in 1992. Steeply falling foreign trade with the former Soviet Union and falling production belong also to the common picture. Also in Lithuania the conditions set by IMF gave a strengthening of the stabilization policy in the second half of 1992. The special feature of Lithuania was a quite weak stabilization policy with delayed stabilization of wages and money-policy compared to the other two Baltic States. Hyperinflation continued well into 1993.

Fiscal policy and introduction of a new tax system was similar to the other Baltic republics. The Lithuanian government also succeeded in having a surplus on the budget in 1992 because of tough expenditure cuts (WB 1993). The tax system was quite similar to the Latvian system, but it took longer time to make a more efficient tax-collection system in Lithuania. The tax revenue in relation to GDP was 8-10 percentpoint lower in Lithuania in 1993 and 1994 than it was in Estonia and Latvia

(Saavalainen, 1995). Tax collection improved in 1995 so the pressure on the state budget was released to a certain extent.

Unlike the other Baltic Countries real wages were not cut in 1991. First after IMF-pressure real wages were cut in the second half of 1992. The target was a fall around 30-35%, but according to the World Bank (Lit-1993) the fall was even steeper. This was bad timing for the Landsbergis government. The election was held at a time with sharply falling real wages and with inflation still out of control. The new government promised both to stop inflation and to improve real wages. In the spring of 1993 wages were increased nearly to follow the inflation.

The main stabilizing element came from a change in the monetary-policy in the summer of 1993. Lithuania stayed in the Ruble zone a few months longer than the other Baltic Countries. In May 1992 it introduced its parallel currency, "Talonas", to cover the deficit on Russian rubles. On October the Talonas were declared "sole legal tender" with a floating exchange rate toward other currencies. In the first months the Talonas followed the depreciation of the Russian rubles. This can be explained by the relatively weak stabilization policy up to the end of 1992. The monetary policy was quite loose. The central bank gave cheap credits to the firms without enough security. In the Spring of 1993 a new chairman of the Bank of Lithuania was appointed, and the government was committed to stabilize the currency before the introduction of the new Lithuanian currency the "Litas". Credits to firms were cut down and reserve requirements were increased. The inflation was halved every month from 25% in April 1993 to 3% in July. The Litas were introduced on June 25 and made sole legal tender. From April 1994 Lithuania introduced a currency board linking the Litas to the dollar. The background was not so clear as in the earlier Estonian case since at this point the Litas had a quite high credibility and was relatively stable. However, it was a signal to the surrounding world of commitment to a tough stabilization policy.

Price liberalization started in February 1991, and by October 1992 only 15% of prices were controlled. This included housing, energy, telecommunication and public transport. In September 1992 a bankruptcy law was introduced but real enforcement was not in place before in 1996 (EBRD 1996). In July 1993, 10-30% tariffs on imports substituted the earlier licensing system. In July 1994, tariffs were increased on food products. In the association agreement with EU from June 1995 Lithuania got a 6 years period for reducing the tariffs.

The development of the banking system was quite similar to the other Baltic

countries although a little slower. Not so many new banks were established. In 1995 Lithuania had 19 banks of which 3 were majority owned by the state. Since 1993 6 banks had lost their licenses. Early 1995 the central bank introduced stricter loan provisions and reserve requirements. In September the eighth largest bank were suspended. Operations of two of the largest banks Innovation bank and Litimpex bank were suspended in December 1995 starting a banking crisis with many parallels to the Latvian case. The waves from the financial sector spread and dampened the whole economy. In September 1993 the first Baltic stock exchange opened in Vilnius mainly based on shares in privatized companies.

5. Privatization

In all economies in transition privatization turned out to be the structural reform that caused most problems and takes most time. There are many different methods of privatization and each method means a specific set of opportunities for different social groups in the society. The choice of privatization path is a fundamental political choice reflecting the actual distribution of power and determining the future distribution. To understand the political background also the national dimension must be included. This is especially the case for understanding the different privatization paths in the three Baltic Countries, and it is connected to the fact that the Russian speaking minority is much more important in the two countries to the North. The policy changed as the relation to USSR and later Russia changed. Privatization was in Estonia and Latvia closely related to the fight for independence and for increasing the titular population's control of productive resources.

This relation seems to be most clear in **Estonia**. In the period when Estonia was still dependent on Moscow's goodwill and on the whole population living in Estonia the strategy for privatization was to transfer ownership from the USSR to Estonia. The workers were good allies in this process, and at the same time the claims for market economy were not so radical. Therefore, employee-ownership in the form of "peoples enterprises" played an important role in the IME program from 1989. The idea of "peoples enterprises" "was seen as an intermediary step between all-union and republican subordination, and was designed to make the desired transfer of control less threatening to Moscow and the current directors" (IMF-Survey, 1991 p.234). In "peoples enterprises" the work-collective leased the enterprise, so the workers had an important role in the first privatization. However, only seven large enterprises became "peoples enterprises" (Elenurm et.al.,1993).

Figure 6. Overview over privatization, 1989-95.

	Estonia	Latvia	Lithuania
wild privatization	"experiments" from 1987 SOE-subsidiaries from 1989	Institutional control unclear, high autonomy for managers,	high speed of privatization can give lack of control
reprivatization	Dec. 1990 law: April 1992 200000 claims February 1994 100000 validated, compensation vouchers,	deadline: land - June 1991 firms - July 1992 for housing - October 1994, compensation vouchers,	only "immoveable" property, deadline for claims Jan 1992, no trade of land for 5 years,
small privatization	Dec 1990 law, amended May 92 Oct. 1991 only 95 (IMF) April 1993, 50% privatized 1993 sold 243, 125 mill EEK, 1994, sold 1500, nearly all,	law Nov. 1991, municipalities, below 10 employees, auction trade, catering, service 85% privatized 1994 some to employees.	vouchers and cash quotas can be used in auctions, 1992 1993 1994 1995 sold 57% 70% 76% 100%
large privatization	1989 IME: Peoples enterprises 1991: 7 SOE experiments 1992: THA-model <u>mill EEK</u> 1993 1994 1995 enterprises 88 207 142 salesprice 340 1277 937 1000 job guar. 9 25 17 <u>investment</u> 220 808 1003 Public auction of minority shares for vouchers started autumn 1994,	1991, 6 SOE sold to employees, sale decentralized to ministries, April 93, 20 SOEs sold/leased, Jan. 1994, 46 SOEs sold/leased, 1994, ca. 150 SOE sold/leased, March 1994, new law, centralization of authority at Latvian Privatization Agency Nov. 94 1st international tender 1995 start sale for voucher/cash Aug. 1994 start voucher market,	1991, LIPSP privatization law, sale of shares through vouchers and cash quotas, the share employees can buy at preferential terms increased 1991:10%,1992:30%,1993:50 % 1992 1993 1994 1995 sold 38% 62% 75% 99% of LIPSP 2926 enterprises, tenders of min. shares utilities, 46 SOE hard currency sale,
banks	most commercial banks started as private, state sells out 1994-96	Bank of Latvia's commercial branches merged in Unibank 93 privatized 1995-96	20 private commercial banks some with min. state shares 3 state commercial banks,
land/property /housing	April 1993 law, vouchers for each year worked in Estonia, payment per squaremeter, July 94, 10.000 out of 460.000	restitution 40% 1995 main part to be sold for vouchers: 1/2 m2 = 1 voucher, slow process 1995-1999	restitution or sold for vouchers and cash Dec 92, 89% private, finish 93 1994 large real estate market,
agriculture	1991, law on land-reform quite slow privatization mainly through restitution, only 10.000 private farms 1993 June 1993, preferential rights to farmer-coops for food industry	start in 1989, restitution Nov. 90,land reform, usufructus June 1991, Property reform collectives and state farms -> joint stock companies, shares to em- ployees and former owners, 1993, 2/3 land private, 57500 mainly through restitution	1989 law on land rights, usufructus to 6000 former owners. July 1991 Land law, restitution compensation also possible, Sept 1992, 500000 applicants ult 1993 only 1/5 settled green vouchers to farmers,
foreign investment	Sept 91: foreign investment law April 93 foreigners can buy land but not trade it, tax benefits	Dec. 1994 foreigners can own land with production facilities, tax benefits,	only Lithuanians can own foreigner 99 years lease, open for the West, 1996,
new firms	rapid development, barrier: lack of finance, 10.000 upstarts in 1993 (ME)	not widespread in industry, but in trade, construction, services, most non-Latvian entrepreneurs.	not widespread in industry, but in trade, construction, services,

Most of the workers were not titular Estonians, and at the same time the workers' union was losing its legitimacy, so the policy soon changed giving less influence to employees. In October 1990 it was made possible to sell up to 20% of the shares to the employees by preferential conditions (Terk, 1993), but privatization should

mainly be based on direct sale with voucher systems in a secondary role. In this way the interests of the workers were phased down in a quite early stage when the independence movement started to get some momentum. An exemption from this trend was the privatization of another seven large enterprises in 1991 on an experimental basis. In some of these enterprises the employees got a majority of the ownership, but the shares were often divided in non-voting shares for the majority of employees and voting shares for management.

The legislation for "small privatization" was passed in December 1990. Firms with less than 500.000 Rb in book value could be privatized for cash. There were special preemptive rights for employees giving them the first option to buy. The law was amended in May 1992, and the special rights of insiders were abandoned. There was, however, a fear among dominant Estonian parties, that direct sale of assets could attract big amounts of Rubles from all over the former Soviet Union. Therefore, privatization was quite slow in this stage. In January 1992 only 208 units had been sold (Frydman et. al. 1993). Privatization did not take off before the introduction of the KROON in June 1992. The KROON functioned as a shield against a massive inflow of Rubles, and gave Estonian citizens a stronger position. During the rest of 1992 and in 1993 the small privatization accelerated and at the end of 1994 nearly all of 1500 small enterprises had been privatized (Baltic Independent, Jan. 13, 1995).

The Estonian governments followed a strong West-orientated policy also in relation to privatization. The government supported sale for cash and wanted foreign capital to play an important role in the process. The majority in parliament initially wanted stronger emphasis on vouchers also for large privatization. In the summer of 1992 the climate toward sale of enterprises for cash changed because of the successful introduction of the Estonian KROON. The government developed a new scheme for sale of enterprises inspired by the method used by Treuhandanstalt in Germany, and the parliament passed resolutions supporting this scheme just before the election in September 1992. The parties behind the new government decided to continue the new policy of privatization. The first tender for a group of enterprises were made in November 1992. The bids were not only chosen on the criteria of the highest price, also investment plans and job-guarantees were given considerable attention. In 1993 the process of privatization gained momentum. The government continued the Treuhand-strategy with 4-5 tenders a year, with the total number of announced enterprises around 500 and covering 120,000 employees. The actual settlement of contracts also gained speed in the end of 1993 and in 1994. Then it began to fall in 1995 because there was not much more to privatize (EIU, 95:4). The shift of

government in 1995 did not mean any essential change in privatization policy. The speed of sales were impressive but not the selling prices and the guarantees. Most of the enterprises were sold without debt. Thus the net revenue for EPA was often negative (WB 1994). This is similar to the results of Treuhandanstalt which ended up with a negative balance. Of the first tender the enterprises sold as whole units had employment guarantees varying from 17%-120%. For the total sold at the end of 1995 the job guarantees were less than half of the employment at the time of privatization.

The director of EPA estimated that 20% of the privatized capital were sold to foreigners, and if the foreign capital behind some Estonian buyers were included the percentage would increase to about 40% (Baltic Independent 29-4-1994).

Although vouchers had been discussed as a possibility, and the idea had quite strong support in the parliament in the early stage of transition the government succeeded in giving voucher systems a limited role. In April 1993 a law was passed that entitled residents over the age of 18 to vouchers in proportion to the number of years they had worked in Estonia. These vouchers should mainly be used for the purchase of their apartments. The distribution of vouchers in relation to working years meant that immigrants got less than the typical titular Estonian. Young citizens got a minimum of vouchers higher than if they had got vouchers only based on their working years. However, this was not the case for the main part of young people from the Russian speaking minority (Andersen 1996). The vouchers were mainly supposed to be used for privatizing housing, but in 1994 the idea about selling minority shareholdings of large enterprises for vouchers was supported by parliament. Vouchers were distributed from May 1994. By December 1995 approximately 480,000 voucher-account with a nominal value of around 8,5 billion EEK were opened in the banks (Kein, 1995). The vouchers could substitute cash in nearly all types of privatization. The main use of vouchers for enterprise privatization was in the large privatization with public offerings of which the first took place in the winter 1994-95. It was only minority shares offered for sale for the public - from 20% to 49% of the shares. Before the offering the dominating part of the shares had been taken over by a core-owner.

The nationalistic orientated parties in parliament emphasized restitution of property nationalized after the Soviet occupation. In June 1991, legislation about restitution was passed. First priority was to give back the assets to the former owners or their descendants. If this was not possible they got the special compensation-vouchers. Restitution was especially important in agriculture. Before the Second World War

Estonia had 140.000 private farms (EIU, 2:93). Because of complete dominance of titular Estonians in this sector there was no national problem, but the complications concerning restitution delayed the process. According to the Ministry of Economics (1994) instead of 360 collective farms there was in November 1993 4313 private farms, 1218 share holding farms and 769 cooperative farms. Only 1700 farming properties had been returned to former owners, because of the problems of restitution.

In **Latvia** the national question also played a major role for privatization but large privatization was more slow and hesitant than in Estonia. It was not speeded up before 1994 and 1995 and higher priority was given to vouchers. However, privatization of agriculture was quite fast and foreign investment play a smaller role compared to Estonia. Although the political landscape of Latvia has many similarities with the situation in Estonia, there are differences that gives some understanding of the different paths of privatization. More than half of the industrial workers in Latvia have Russian as their main language like in Estonia, but unlike Estonia a dominant part of the industrial managers and most of the new private capitalists are non-titular Latvians. This can be an important explanation behind the higher priority given to vouchers in Latvia. The voucher system was designed so that the immigrants after 1945 get a relatively little share.

On the other hand, it could be expected that the state tried to make stronger control with "wild privatization", because many of the managers were Russian-speaking. This does not seem to be the case. Large privatization was rather slow, and at the same time commercialization gave the managers of the enterprises much freedom of action. The managers could even buy and sell assets, and it can be assumed that "asset stripping" took place in a quite large scale. After the election in June 1993 and the strengthened position of Latvian national parties the control with "wild privatization" was enforced. Much of the small privatization was decentralized to local municipalities, the responsibility for many of the large and medium firms were placed in different often sectoral oriented ministries. This gave the management of the enterprises in cooperation with their contacts in the bureaucracy good opportunities to arrange deals including privatization for their own benefit. Most of the large privatization made according to the old legislation was of the type of leasing with the option to buy. When the "cream was skimmed" they did not resist the centralization of the organization of privatization. This was decided by the law of privatization of March 1994. The Latvian Privatization Agency became the new centralized authority for privatization.

Small privatization proceeded relatively fast. The legislation was passed in November 1991, and it covered firms below a certain size defined with different measures - most important below 10 employees. These firms were sold for cash through auctions. This should favor the new private capitalists belonging to the group of non-titular Latvians. However, the national Latvian interests were stressed in the fact that bidders had to have at least 16 years of residence in Latvia. The small privatization proceeded quite rapidly, so that 60% of the firms were privatized in November 1992 (World Bank, Lat-1993) and according to IMF (1995) 85% of the total number of 4000 enterprises were privatized by 1995. Mostly the assets were not sold but leased with an option to buy after 5 years. Many of the firms were sold or leased to the employees who up till an amendment of the law in February 1992 had the first right to buy (Vojevoda & Rumpis, 1993).

The employees also got a part of the ownership in some of the few large enterprises that were privatized in the period 1991-92. In June 1992 a privatization schedule was passed by parliament, but the procedure for formulating and approval of privatization plans for each enterprise was very cumbersome and the administration decentralized to various ministries was very slow so that only 46 large state owned enterprises had been privatized in January 1994. Before the responsibility of privatization was taken over by the newly established Privatization Agency the ministries speeded up the process so around 200 enterprises had been privatized following the method of leasing with the option to buy (Shteinbuka, 1996).

Estonia served to a high extent as a model for the new privatization law passed in February 1994. The government shall approve the transfer of enterprises to the Privatization Agency. This was done for 240 enterprises in 1994. The first international tenders was announced in November 1994 and more tenders followed in April and September 1995 and the process accelerated somewhat in 1996.

In November 1992 a law on vouchers were passed, but the vouchers did not start to be distributed before September 1993 and most were distributed in the summer of 1994. The people got one voucher for each year of living in Latvia after the War. Prewar citizens and their descendant got on top of this 15 vouchers while 5 vouchers were deducted from people immigrated after the War as "payment for the use of Latvian infrastructure". Thus, 87% of the vouchers were eligible for Latvian Citizens (EIU, 2:93). By July 1995, 96,5% of the population had received 104 mill. vouchers with a nominal value of 2.9 billion Lats (IMF 1995). It is possible to sell the vouchers and trading started by August 1994. The market price was in the first months less than 10% of the nominal value of 28 Lats. Like in Estonia this reflected

partly the lack of clarity about what the vouchers could be used for. Only very few investment funds had been formed; the legislation about voucher-privatization of housing was not passed before July 1995; and there was also much uncertainty about the privatization of enterprises for vouchers for a long period. Like in Estonia a concentration of wealth took place in the first months of voucher trading when especially poor people sold their vouchers at a low price.

The strategy of the Privatization Agency have like in Estonia been first to find a core investor in a tender process and then to sell minority shareholdings for vouchers in public offerings. Three enterprises were sold by this method in the first months of 1995 and another 13 companies were privatized during the second round in mid 1995 (IMF 1995). The legislation about foreign ownership of land was in the first years quite restrictive giving foreigners only the possibility to lease for 99 years. But except for this the legislation has been quite liberal and in December 1994 the law allowing foreigners to buy land was ratified (EIU,95:1).

Of the 10 largest banks 34% of the capital was owned by state owned enterprises in June 1994. Often the banks functioned as agents for their owners to organize the short time finance of trade flows (World Bank July 1993). In the first years the Bank of Latvia covered the major part of the commercial banking through special commercial branches. In December 1992 the commercial branches were transferred to the Bank Privatization Committee. In late 1993 21 of these commercial branches were merged in the new "Unibank". Nonperforming loans were replaced by long-term government bonds in April 1994 and a four-stage privatization program were implemented 1995-96.

Reprivatization was delayed because the question of citizenship was so difficult to solve. The deadline for claims on enterprises was set to July 1992 and for housing to March 1994. By the end of 1995 350,000 restitution claims for land in cities had been submitted. Of these only 20% had been settled (EBRD 1996). Restitution was most important in housing and agriculture and like in Estonia restitution claims have been a barrier for a fast privatization in nearly all fields. Around 40% of housing was privatized by autumn of 1995. The main part of housing will be privatized by vouchers. The legislation was not passed before in 1995 and housing privatization is expected to be extended up to 1999 (IMF 1995).

Privatization of agriculture was quite fast in Latvia. In this sector there was not national problems, because nearly all the farm workers were titular Latvians. Privatization of land was mainly based on restitution, but there was also an element

of employee-ownership. The process started in November 1990 by the land reform with rules for restitution of land. Deadline for claims were June 1991. There were around 300,000 claims for farms and small plots of land. By the property reform, in the same month, the collective farms and state farms were transformed to joint stock companies. The shares were divided between the workers and former owners, and many of the large units were split up into smaller units (Abele 1996). In the spring of 1992 about 1/3 of land was restituted, divided into 41.000 private farms with an average area of 15 HA and 71.000 small plots with an average of 4,5 HA. At the end of the year the numbers were 50.000 and 100.000 respectively. Some of the collectives and state farms continued for a period as employee-owned firms with farming and some small food-processing industries. But because of the special legislation unfavorable for continuation of such units most of them were split into many independent enterprises.

The privatization process in **Lithuania** was quite different from the development in Estonia and Latvia. The privatization was much faster and more comprehensive. In fact, privatization in Lithuania has been one of the fastest in Eastern Europe. Already at the end of 1992 56% of all assets had been privatized (EIU, 1:93). Vouchers and employee-ownership had a more important role, and direct sale and foreign investment have had a smaller role. Consideration for a fair distribution of ownership was stronger, and the policy put more emphasis on the interests of the workers. The main explanation behind this development lies in the fact that non-titular Lithuanian groups played a limited role. Nearly the whole population was united in the fight for independence. Once this fight was won, the nationalist parties had a much weaker position than it was the case in Estonia and Latvia, and economic problems and questions concerning distribution were in focus instead of the problem of a big Russian minority. The workers were politically stronger because they were not split in a Lithuanian and a Russian-speaking group. The independent Lithuanian communist party had a quite strong position also in the parliament of 1990 to 1992, and the victory of its successor, the Democratic Labor Party, at the election in 1992 showed the strength of left wing political forces.

The first privatization was in the form of transfers of shares of leased enterprises to employees. Almost 60 enterprises were included in this program. Another early transfer to employees was included in a law from December 1990. Enterprises with capital exceeding a certain amount could sell up to 10% of their capital to employees. Part of this could be paid by vouchers. 50-60% of the state enterprises used this method in the start of privatization until July 1991, when another program started (Frydman et. al. 1993).

The cornerstone in the fast privatization in Lithuania was the voucher scheme. The Law on the Initial Privatization of State-owned Property (LIPSP) was passed in February 1991 at a time when the result of the fight for independence was far from clear. The privatization plan was one of the elements in the fight for independence in Lithuania. The scheme signalled determination in the struggle for economic self-management. It included privatization of enterprises formally owned and controlled by the central authorities in Moscow. The vouchers and the cash quotas, described below, were given only to residents. This made an effective barrier for rubles flowing from the rest of the former Soviet Union.

The voucher scheme was probably inspired by the Czech discussion and plan for a similar system, but the Lithuanians were the first to implement the system. The vouchers were distributed in April 1991, the sale of enterprises started in September 1991 and investment funds were approved in December 1991 at the time when the Czech-voucher started. The distribution of vouchers were dependent on the age of the citizens. The vouchers could be used both in the auctions for the small enterprises and in the share subscriptions for the large enterprises, and in privatization of housing. The assets were sold for a combination of cash and vouchers. A cash quota set a limit for how much cash a person could use to bid on the assets to be privatized. The cash limits were softened, when existing tenants bid on their apartment, or when enterprises were not sold in the first auction.

Small privatization of enterprises with a book value below a certain amount was done by auction, where vouchers and cash quotas could be used. By August 1992 1300 small enterprises were privatized (WB-Lit-1993), by October 1994 the number was 2498, and in July 1996 it was 2727 (Ministry of Economics).

From the start 10% of the shares in large enterprises could be sold to the employees at concessionary prices. This percentage was increased to 30% in April 1992 and in February 1993 the new labor government increased the percentage further to 50% of which 20% without voting rights. According to data from the Ministry of Economics 510 large enterprises were privatized in the first period when employees did not have special preferential treatment. In the next period, from April 1992 to February 1993, 945 large enterprises were privatized of which employees did not use their preferential status in about half of the cases. In about one third of the cases the employees got 30% or more of the share capital. From February 1993 to December 1995 in 83% out of 1473 large enterprises employees took over the majority of the share capital. These enterprises represented 63% of the capital privatized in this period.

In August 1992 a list of 114 state owned enterprises/objects for unrestricted sale for foreign currency were published. By July 1995 the list had been reduced to 71 enterprises and of these were 46 sold for 27 mill Litas. This type of privatization was relatively slow and foreign sale could only be considered as a supplement in Lithuania. Especially the conservative opposition resisted sale to foreigners especially concerning enterprises considered to be of strategic importance. The opposition feared Russian take-overs. They also resisted strongly liberalization of foreigners right to buy land. They could bloc changes because liberalization in this field needed a constitutional two-thirds majority.

After the termination of the voucher privatization Lithuania followed in the end of 1995 the example of the two Northern countries by establishing a Privatization Agency which should implement the privatization of the remaining assets for privatization. According to the agency director there were assets for 3.8 billion Litas to be privatized. The method would be privatization for cash. According to government decision the first objects to follow this line of privatization were left-overs from the earlier programs and small state shareholdings in enterprises which had already been privatized. Also parts of the public utilities was on the list for cash privatization (Lithuania Today: Politics & Economics, Jan. 1996).

Privatization of housing was very fast in Lithuania. The voucher system played an important role in this process. Already in December 1992, 89% of the apartments were in private hands (EIU, 1:93). By December 1993, 94% of the apartments planned for privatization had been privatized (Martinavicius 1996). The fast privatization opened up for a rapidly developing real-estate market in the cities.

Restitution was an element in privatization of housing, but it was most important in agriculture. Privatization of agriculture had many similarities with the process in Latvia. In 1989, there were 835 collective farms and 275 state farms in Lithuania. The same year a new law on Land Rights transferred the rights to farm 6000 small plots of land to the farmers, typically to those with known claims on the land. In the first round it was only the usufructus rights that was given to these new private farmers. They were not allowed to trade the land. The Land law from July 1991 opened up for full private ownership of agricultural land, and it gave priority to former owners or their descendant to take over the land. There was a maximum limit of 80 HA, the new owner was obliged to farm the land and could not sell it within 5 years. According to Frydman et. al. (1993) the reorganization of the farms began in November 1991 and by fall 1992 it was almost complete. The collective-workers got special green-vouchers in relation to the number of years worked for the

collective. In some cases the actual workers took over the collective or separate units e.g. large dairy barns. The privatization of agriculture was quite chaotic. Many inefficient small scale farms with unskilled people from the cities were established resulting in a drop in production, and the uncertainty of the future for the collective farms and the state farms resulted in bad planning and falling production. This development caused dissatisfaction in the countryside which turned out to be strongholds for the Democratic Labor Party at the election in 1992 (EIU, 2:93).

6. Different paths of the transition

The three Baltic Countries cannot be taken as a single model of transition. Although there are many similarities they had different starting conditions and they followed different paths of transition.

Estonia had an advantage since the first experiments of the market orientation of Gorbatsjovs "Perestroika" took place here. Estonians close links to Finland also eased the transition toward Western type market economy. Both Estonia and Latvia had a quite well developed market economy and a quite strong light industry already in the interwar period. However, on top of the distributional conflicts of transition Estonia and Latvia also had the conflict between the titular population and the big minority of Russian speaking people mainly employed in the large industries that had the highest unemployment in the period of restructuring. From the start of the transition Lithuania was in many respects a little behind the two Northern Countries, but the more homogenous population meant that the "Russian problem" did not play an important role here.

The political development is the main transmitter of the background conditions into the actual policy of transition. In Estonia the independence in 1991 meant a significant change of policy from a pragmatic compromise oriented policy toward Russia to a rather strong nationalist oriented policy giving the Russian minority only limited political role. This nationalism was combined with a quite liberal market oriented economic policy. Although the different governments were quite unstable the economic policy was both relatively consequent and effectively implemented. Although the basic political conditions were similar in Latvia concerning the Russian minority, the national question to a higher degree paralyzed the political discussions and the actual formulation and implementation of the economic transition was often delayed by a deadlock situation in the political system. In Lithuania much of the essential elements of the reform policy eg. privatization was formulated already before the full independence. The workers were in a stronger position not divided in ethnic groups, and the reaction toward the early negative results of the economic

police was not distracted by the national question. The labor party took power 1993-1996, but this did not delay the economic reforms. In fact, the stabilization of the economy and essential elements of liberalization and privatization took place in this period.

In Estonia stabilization and liberalization was closely connected to the early introduction of the KROON and the currency board in 1992. The stable currency worked as a nominal anchor effectively stabilizing the economy. The currency board meant especially in the first years of transition a very narrow margin both for monetary and fiscal policy. Later in the process inflow of foreign capital resulted in a less restrictive monetary situation since it more than covered the deficit in trade resulting from high imports of machinery and equipment for restructuring production. The stabilization and liberalization in Latvia followed some other paths than in Estonia. Liberalization was not so consequently implemented especially concerning the hard budget constraint and foreign trade. On the other hand the currency regime was more liberal. Stabilization through fiscal policy was not so strict, but the monetary policy connected to the floating exchange rate regime was very tough. The banking crisis in 1995 hit the Latvian economy hard and dampened the recovery. Lithuania had a somewhat more hesitant stabilization and liberalization than was the case in Estonia and Lithuania. The politicians were under harder pressure from the groups bearing the burden of transition. However, pressure from the IMF, a relatively balanced fiscal policy and a tough monetary policy resulted in a quite effective stabilization from 1993.

In the first years privatization was quite slow in Estonia but in 1993 and 1994 there was a considerable acceleration. It was an area of political conflict and the development was closely related to the national question. Privatization was not speeded up before the Russian-speaking part of the population had got limitations on their possibilities to benefit from privatization. This is an important explanation why employee-ownership played a limited role in the later stages of the Estonian privatization. The parliament made much emphasis on restitution and different governments gave high priority to the participation of foreign capital in privatization. In combination with the close ties to Finland and the successful stabilization and liberalization policy this explains why Estonia belongs to the countries in Eastern Europe with the highest foreign investments per capita.

In Latvia there was plenty of room for wild privatization where managers and the new capitalists played a major role. In some take-overs in industry employees played an important role, but industrial workers were in a weak position, because of threats

of unemployment, weak unions and low political power for the big proportion of Russian-speaking workers. In agriculture, dominated by titular Latvians, restitution was important, and also the employees got some possibilities. The voucher scheme gave Latvian citizens a preferential position in relation to the group that did not get full citizenship rights. In the early stages of privatization the industrial lobby had good opportunities. With the centralization of authority at the Latvian Privatization Agency in 1994 and the combination of selling for cash and vouchers the process accelerated in 1995 and 1996.

Privatization in Lithuania proceeded at a high speed both for small and large privatization, and for privatization of housing and agriculture. Privatization of public utilities and sale to foreigners had low priority compared to Estonia and Latvia. The transition of the legal structure and basic institutions did not follow the same speed, however, and restructuring were proceeding quite slowly and the inflow of foreign capital was rather low. Insiders got a big share of the ownership in Lithuania. It will be interesting to see whether this will only make employee-ownership a temporary type of ownership, or whether employees participation will be a permanent feature of Lithuanian economy, (see Mygind 1996b).

The interaction between the different systems seems to be closer to the good circle than to the vicious circle. In all three countries there have been some political reaction from the population. In Estonia and Latvia the national conflict has to a certain extent weakened and postponed this reaction, which was quite strong in Lithuania with the victory of the labor party in 1992/93. However, this left-wing turn did not lead to a weakening of the reform process. In all three countries the elements of the good circle have been dominant and they have all implemented the critical mass of reforms. There have been a successful stabilization and a comprehensive liberalization in all three countries with Estonia as the frontrunner. Privatization has been quite fast especially in Lithuania, but Estonia has by 1996 surpassed Lithuania also in this field leaving Latvia as the latecomer. In Latvia and Lithuania the banking crisis was a warning that the economy is still not in a stage of stable growth. Also the influence of organized criminality in all three countries is an element telling that there are still important elements diverging from a well functioning market economy. There are threats and there will still be a long period ahead of transition and restructuring of the economy. The three countries have followed different paths, but they are all on the same broad way which in spite of some uphill driving in the first years now looks more smooth and promising.

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