From MR ARDO HANSSON and PROFESSOR JEFFREY D SACHS.

Sir, The article by Philippe Legrain, 'Baltic states' varied roads to freedom' (June 21) included a misinformed criticism of Estonia's currency board system, in which the exchange rate of the Estonian kroon is pegged to the D-Mark, and the central bank abjures domestic credit expansion. Legrain alleged that Estonia's currency arrangements were leading to high inflation and currency overvaluation. This is an odd charge, since similar currency systems, such as in Argentina and Hong Kong, have underpinned price stability.

Legrain seems to have extrapolated from a single month's price increase, 8.9% in March, to reach broad and unfounded conclusions. The March price increase resulted mainly from the elimination of subsidies on various service-sector prices, such as public transportation. Since March, Estonia's inflation has been among the very lowest of the post-communist economies, registering just 0.7% in the month of June, and just 5% for the entire second quarter.

The fact is that the currency board has performed as expected, as we have shown in a detailed comparison of the Baltic state's monetary arrangements. The Estonian currency board has provided a firm anchor to Estonia's traded goods prices, which cover a large proportion of Estonia's small open economy. As expected, non-traded goods prices have risen faster than traded goods prices, partly as the result of the end of price controls, and partly as the consequence of rapid productivity improvements in the tradeable sector, which have pushed up Estonia's wages in D-Mark or dollar terms.

The kroon is hardly becoming overvalued as a result of these wage increases, however, especially since dollar wage levels were remarkably low at the start of Estonia's reforms. Estonia's average industrial wage is currently about $120 a month, making Estonia highly competitive in attracting foreign capital, especially as an export platform to western Europe. This is why European, and especially Scandinavian, investors are setting up production operations in Estonia at a remarkable pace.

What Mr Legrain failed to recognise is that Estonia's currency stability and strict monetary discipline have contributed to solid investor confidence, low interest rates and renewed economic growth, the highest in the Baltics and perhaps the highest of all the economies in transition in 1994. It is no wonder that Lithuania changed over to Estonia's currency board arrangements in April, and that Latvia has also recently abandoned its floating exchange rate policy in favour of a pegged exchange rate, though without the firm backing (and thus the main benefits) of the stricter currency board system.

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