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The Baltic Conundrum

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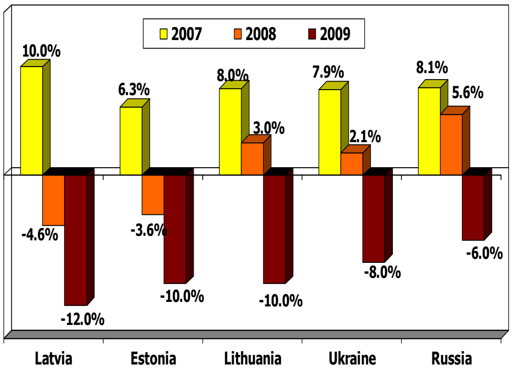
Introduction

After reporting very high growth rates as well as being seen as examples of successful economic transition, the "Baltic tigers" (Lithuania, Latvia and Estonia) are now among the worst victims of the global economic crisis. All three have reported large declines in GDP, income and employment, which threaten the significant development progress made since the mid-1990s.

What went wrong? What should have been done differently? What lessons can be drawn from the Baltic crash? Realistically, there is very little that Baltic policy makers could have done differently—certainly not in light of what was known when these countries' policy frameworks were constructed. In fact, even with the benefit of hindsight, it is not clear that fundamentally different policy regimes would have served their economies better. Instead, if overarching strategies of maximising the net gains of being small, open economies by emphasising institutional and income convergence towards European Union (EU) standards are accepted, then the policy regimes that were in place at the time of the crisis may need to be assessed as broadly correct—perhaps even in *ex post* terms. The Baltic economies' great misfortune—and the conundrum facing Baltic policy makers—lies in the fact that, however large or small the risks facing these policy regimes may have been, their consequences have turned out to be extremely costly.

Chart 1: GDP trends in Baltic, other economies (2007-2009)



Source: IMF World Economic Outlook, April 2009.

The "Baltic tiger" model: Characteristics and performance

The Baltic economies are not identical, either in economic structure, extent of accumulated fiscal and external imbalances, composition of trade, or internal political dynamics. Latvia stands out most unfavourably vis-à-vis most macroeconomic and socio-economic vulnerability indicators; it is the only Baltic country at present to have an active IMF programme. But differences aside, the Baltic economies' similarities are clearly important in understanding how and why the crisis developed, and why significantly different, qualitatively better economic policy choices are difficult to identify.

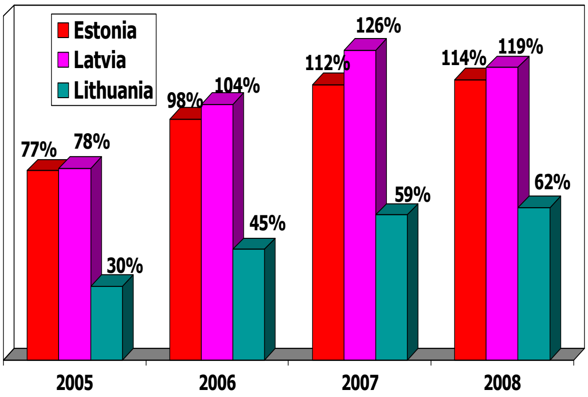
The Baltic economies share a number of structural, institutional, policy and performance characteristics. All three reported the EU's most rapid pre-crisis GDP growth rates. This growth was accompanied (or made possible) by relatively small state sectors, reflecting a modest role for state redistribution and relatively tight fiscal policies. National economies were not seen as optimal currency areas and euroisation was embraced rather than feared. Euro- (or SDR-) pegged currency boards were the foundations of all three Baltics' macro policies. Commercial banks and most strategic enterprises were privatised to European investors. Reputations for relatively favourable business and investment climates were consolidated by ambitious privatisation schemes, early introduction of flat personal and corporate income taxes and by reforms to labour market regulation and social protection (including pension) systems.

Many observers regarded these policies as quite appropriate for small, open, middle-income economies with limited state capacity (for tax collection, financial sector regulation, and social protection), small domestic savings pools and aspirations for rapid convergence towards Western European living standards.

What went wrong? What could have been done differently?

The Baltic model was undone by the rapid growth of private sector foreign debt, reflecting large current account deficits financed by Western parent banks of Baltic subsidiaries. Rapid growth in foreign inter-bank credits was facilitated by the currency boards (neutralising exchange-rate risk) and EU accession. It was also a reflection of these countries' deep need for capital and *de facto* euroisation. The currency boards precluded the use of discretionary monetary and exchange rate policies, and left domestic financial systems open to the potentially destabilising effects of hot money in search of attractive "emerging market returns".

Chart 2: Private debt-to-GDP ratios in Baltic economies (2005-2008)



Ratio of gross foreign debt to GDP. EIU data, UNDP calculations.

These policy regimes are often accused of harming the Baltic States' external competitiveness. While unit labour cost data would seem to strongly support this charge for Latvia, they do not support it so clearly for Estonia or Lithuania. A recent study of competitiveness trends among the EU-10 countries found that, while euro unit labour cost growth in the Baltic economies was above EU-27 averages between 2004 and 2008; this was primarily a result of labour-market, rather than exchange-rate trends. In contrast to the Baltic economies, other new EU member states experienced strong nominal exchange rate appreciation during the same period. This rapid wage growth should be seen as a consequence not only of booming domestic demand, but also of increasing Baltic integration into European labour markets—especially after EU accession in 2004.

Competitiveness issues aside, a review of the available macroeconomic policy options prior to and after the onset of the crisis underscores the limits of discretion for Baltic policy makers.

Competitive devaluation?

A number of arguments strongly suggest that, for the Baltic economies, the "devaluation cure" would be worse than the "external imbalance disease". While these arguments don't prove that devaluations are impossible, they do explain why Baltic governments and central banks have gone to great lengths to avoid them.

Discretionary fiscal policy?

Many observers have argued that the rapid pre-crisis growth in domestic demand indicated that fiscal policy was too loose. But while greater pre-crisis fiscal probity is indeed the textbook answer, such arguments must be reconciled with the facts that: (i) the Baltic states had the EU's tightest pre-crisis fiscal policies, and smallest state sectors; (ii) rapid public-sector wage growth was in part a reflection of Baltic integration into European labour markets; (iii) further pre-crisis fiscal tightening would have limited the Baltic states' abilities to absorb post-accession structural and cohesion funding, which have helped finance these countries' trade imbalances and (iv) despite the above, fiscal adjustments were nonetheless pursued in all three Baltic countries during 2007 and 2008.

Capital controls? Or better prudential regulation?

Ex post calls for administrative restrictions on the large capital inflows that precipitated the Baltic crash are at first blush difficult to reconcile with the liberalised capital movements that are implied by the EU's "four freedoms". A related question is whether tighter prudential regulation of the local subsidiaries of the (mostly Scandinavian) banks that dominate Baltic financial systems might have significantly moderated the crisis's impact. Here, policy makers may have erred in believing that the "outsourcing" of prudential responsibilities to financial regulators in the parent banks' home countries had effectively resolved key bank supervision issues. On the other hand, as problems of financial regulation in EU-15 countries and the US have been among the crisis's most unpleasant surprises, Baltic financial regulators may be in good company on this point.

Unilateral euro adoption?

Had the Baltic States been members of the euro zone, they could have avoided destabilising exchange-rate speculation, and minimised the scale of the capital outflows that have accompanied the crisis. For these (and other) reasons, the crisis has renewed calls—supported by the IMF and some EU member states—for modifying the Maastricht convergence criteria for euro adoption in light of transition economy realities. However, as long as the Baltic States wish to eventually

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become *bona fide* members of the euro zone, and until the European Central Bank and other EU member states decide to relax the Maastricht criteria, unilateral euro adoption seems likely to remain off the table. Moreover, to the extent that Baltic economic problems reflect exchange rate misalignments, euro adoption *per se* would not address these problems.

De-euroisation?

In light of strong household and enterprise attachment to the euro, and the Baltic States' obligations (as EU member states) to ultimately adopt the euro, this is not a relevant option.

Thus, as unfortunate as the macro policy regimes that facilitated the Baltic crash may have been, it is far from obvious that superior alternatives were present—even with the benefit of hindsight. This is the essence of the Baltic conundrum.

What can be done now?

In principle, a number of steps can be identified to reduce the Hobbsian policy trade-offs implied by the Baltic conundrum. Some of these, which would need to be taken by the European Commission, European Central Bank (ECB), and EU member states include:

Facilitating more rapid Euro adoption, to address exchange-rate risk and the spectre of ruinous devaluation. As was pointed out above, this does not seem to be in the cards. More plausible policy issues could be posed by the Baltic States' prospective entry into the ERM II "waiting room" that precedes euro adoption. Since ERM II features a plus/minus 15 percent band around the central parity exchange rate, ERM II entry could combine progress toward official euro adoption with the introduction of greater nominal (downward) exchange rate flexibility. Of course, the ECB could view such depreciation as inconsistent with the exchange rate stability goal that should precede euro adoption.

Significant expansion of the scope of intra-EU fiscal transfers (e.g., via structural and cohesion funds) to finance persistent shortfalls on merchandise and income accounts in Baltic States' balance of payments. However, in the absence of rapid progress towards a "federal European economy" (including larger transfers from national budgets to Brussels), such an outcome does not seem politically realistic.

Steps which Baltic policy makers could undertake include:

Better prudential regulation, to ensure that national subsidiaries of international banks have stronger incentives to avoid the accumulation of excessive foreign-exchange or term-structure risk.

Accelerated structural reforms, to increase labour productivity and competitiveness, and to increase the downward flexibility of wages and prices. The absence of the devaluation option means that the price competitiveness of merchandise and service exports can only improve via falling costs and prices. On the other hand, the relatively liberal approaches taken to labour market regulation and social protection systems in the Baltic States, combined with the need to avoid tax cuts and maintain fiscal revenues, suggest that the benefits of such measures could be relatively small. Moreover, deep socio-economic crises combined with access to the broader EU labour market suggest that the Baltic States could experience an accelerating brain drain of the financial, managerial and social policy specialists needed to turn the situation around.

Encourage domestic savings, in order to reduce the need for capital inflows to finance modernisation. Unfortunately, the absence of discretionary monetary (interest rate) and fiscal policy constraints that limit the use of tax breaks to promote saving, imply that such measures would not have a significant short-run impact.

Greater emphasis on trade facilitation in those sectors (e.g., food processing, wood and paper products, tourism, finance, transport) in which comparative advantages have already been demonstrated, or in which they could realistically be expected to develop. This could reduce the Baltic States' trade deficits, which make up the largest components of their current account imbalances. On the other hand, Baltic companies' extensive integration into global supply chains suggests that such measures would not have large immediate impact.

Conclusion

Economic reformers in the Balkans, Western Commonwealth of Independent States (CIS) and the Caucasus have often ascribed multiple virtues to the rapid adoption of European standards. In addition to strengthening prospects for eventual EU accession, the adoption of such standards allows for the "outsourcing" of various governance functions—such as monetary policy (via euro pegs) or financial regulation to European institutions. In addition to burnishing one's European credentials, such outsourcing can seem a practical way to minimise the burdens on under-capacitated national

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institutions. Such arguments can be discerned, for example, in the "European direction" proclaimed by policy makers in Ukraine, Moldova, and the Western Balkans; and in the "right-sizing the state" paradigms proposed by the World Bank and other international development agencies.

The countries that joined the EU in 2004 and 2007 derived significant important benefits from accession. However, the Baltic crash shows that rapid European integration—when characterised by deep euroisation, extensive capital- and labour-market liberalisation, and the effective outsourcing of prudential regulation of (and corporate governance within) the banking system—is not a silver bullet for the problems of economic transition and development. Recent devaluations in Turkey, Serbia, and Armenia (not to mention the Czech Republic, Hungary, and Poland) would not have been successful had these countries' integration into European financial institutions reached Baltic dimensions. This realisation is unlikely to reinforce the imperative of EU integration and accession within the "wider neighbourhood". It also suggests that, irrespective of European orientation, many transition economies in Europe and the CIS—even those that are already in the EU—share important commonalities with other middle-income, emerging-market countries.

Recent articles suggest that the crisis has posed serious new challenges for economic theory, particularly in the areas of macroeconomics and finance. Alleged failures to appropriately model (and regulate) financial market risks and imperfections, and arguments about the desirability of discretionary fiscal policies in current crisis circumstances, have attracted particular attention. The Baltic economic crash points to additional theoretical lacunae. Here, we have a group countries that have suffered disproportionately from the effects of the global economic crisis, despite having done "most things right". Even with the benefit of hindsight, it is not clear that qualitatively different policy approaches could have been pursued. If international finance and macroeconomics are now to be redesigned, the "Baltic conundrum" should be kept in mind.

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