OeNB Seminar "Recent Developments in the Baltic Countries – What Are the Lessons for Southeastern Europe?"

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The OeNB seminar "Recent Developments in the Baltic Countries – What Are the Lessons for Southeastern Europe" took place in Vienna on March 23, 2009. The idea behind this seminar was to create a platform for discussion for the central banks of the three Baltic countries and of four Southeastern European (SEE) countries with comparable monetary policy frameworks (SEE-4: Bosnia and Herzegovina, Bulgaria, Croatia and FYR Macedonia[1]). All seven countries have exchange rate regimes with low or zero nominal flexibility and are small, open economies. Considerable economic differences notwithstanding, they face a number of similar challenges. The main purpose of the seminar was thus to present and discuss country-specific experiences and to identify policy measures and approaches that could be particularly useful in the current difficult international environment.

The seminar started with the presentation of the background paper prepared by *Reiner Martin* (ECB; currently OeNB) and *Claudia Zauchinger* (OeNB). The paper states that the recent catching-up process in particular in the Baltic countries, Bulgaria and Croatia was predominantly driven by domestic demand, which in turn was fueled by strong credit growth – often in foreign currency. Financial deepening was fostered by decreasing nominal and real interest rates – not least due to the fixed exchange rate regimes – and rapidly growing asset prices. Fiscal policy tended to be insufficiently restrictive or even procyclical. Fast growth resulted in substantial internal and external macroeconomic imbalances. HICP inflation in the Baltic countries and Bulgaria increased to above 10% in 2008, and current account deficits widened to more than 20% in some countries, with real appreciation likely to have reduced competitiveness.

The paper argues that the reasons for the end of the boom in the Baltic countries were country-specific and unrelated to the current financial crisis. The impact of the crisis, however, severely aggravated the situation and is now being felt in all seven countries, making it difficult to obtain financing abroad and weakening foreign demand. When looking at the macrofinancial challenges, recent gross foreign debt figures exceed 100% of GDP in Estonia, Latvia and Bulgaria, and short-term debt levels also show a clear upward trend across the seven countries. Foreign currency reserves as a share of short-term debt are rather uneven across countries and well below 100% in the Baltic countries. Almost all sovereign ratings were recently downgraded or the outlook was revised to negative, and CDS spreads soared.

Available indicators suggest that all seven countries – and in particular the Baltic countries – have rather flexible capital markets. For product markets, the picture is more mixed, especially in the SEE-4 countries except Croatia. Labor market indicators for the Baltic countries are less favorable than capital and product market indicators. Except for Bulgaria, the SEE-4 countries are not doing too well in this respect either. Overall summary rankings suggest that the Baltic countries and Bulgaria have very flexible economies by international standards, whereas FYR Macedonia, Croatia and Bosnia and Herzegovina are lagging further behind.

[1] *"FYR Macedonia" refers to the former Yugoslav Republic of Macedonia.*

The seven countries now face the key question of how to return to a sustainable growth path.

Next, *Dubravko Mihaljek* (BIS) presented a paper called "Catching-Up and Inflation in Transition Economies: The Balassa-Samuelson Effect Revisited." According to Mihaljek, the peaks of inflation in many CEE countries in 2008 were mainly triggered by high oil prices, a poor crop and high wage growth rather than the BS effect. He also argued that BS effect estimates vary a lot across countries and over time and that most of the estimates suggest that BS effects are rather small. Nevertheless, he argued that the BS effect cannot be entirely disregarded and that its analysis can help understand competitiveness issues. More specifically, his BS estimates suggest that Latvia, Bulgaria and Croatia lost competitiveness in recent years, whereas Estonia and Lithuania appear to have maintained it. This contrasts with real exchange rate developments suggesting that Croatia, Latvia and Lithuania maintained their competitiveness over time (or at least until 2007). Such differences indicate a need to evaluate in more detail alternative measures of competitiveness, not least given the important role external imbalances have played in the Baltic and fixed exchange rate SEE countries in recent years.

Max Watson (University of Oxford) presented a paper on "Financial Stability in a Brave New World" focusing on adjustment needs and adjustment options in the Baltic and SEE countries. He argued that Eastern Europe must change its current growth model based on large-scale capital inflows because a period of "cheap and readily available" money is unlikely to return anytime soon. Eastern Europe is thus more structurally affected by the current financial crisis than other emerging market regions. He also elaborated on adjustment "tradeoffs" for different currency regimes. Whereas countries with flexible markets and high balance-sheet risks have a clear case to hold on to a peg, a country with rigid markets and low balance-sheet risks has a clear case to devalue nominally. In a "grey area" are countries with flexible markets and low balance-sheet risks or rigid markets and high balance-sheet risks. These cases require a careful country-by-country assessment and are likely to face tough choices. Watson argued that the scale of the problem in Eastern Europe requires an EU approach, that countries operating in the region should be "convinced" to maintain their exposure and that it needs to be a key policy goal to pull non-leveraged funds into the region.

In the *Baltic Session*, representatives of the Baltic central banks presented the economic situation in and an outlook for their countries.

Ülo Kaasik (Eesti Pank) argued that over-optimistic expectations were behind the exuberant credit and wage growth in Estonia. The authorities had failed to manage those expectations properly. At the same time he argued that Estonia did not suffer from a loss of competitiveness and that the government budget reserves of 10% of GDP are now a useful buffer although more could have been done as regards fiscal policy. Although Estonia is now in a deep recession, the economy is, according to Kaasik, in a better shape than the other Baltic countries. The labor market responds in a flexible manner and wage growth is decelerating rapidly. Lending to companies has not stopped yet, intra-banking group financial flows are still stable and, in his view, short-term liabilities are not a problem for Estonia. The nonperforming loan ratio, though increasing very fast, is still quite low and the banks can cover a significant writedown of their loan portfolio with their reserves. Kaasik regards the fixed exchange rate regime as a good anchor for both inflation expectations and wage flexibility and expects that Estonia will meet the inflation criterion in late 2009, which would pave the way for a successful convergence assessment in 2010.

Karlis Bauze (Latvijas Banka) argued that the Latvian government's anti-inflation plan contained a range of effective measures (e.g. the establishment of a central credit register, incentives to increase savings, the need to provide tax certificates for income as a precondition for bank credits) but that it was implemented too late. Regulators could have done more, too (e.g. raise the capital adequacy ratio for banks and move more swiftly to impose limits on banks' open foreign exchange positions). Bauze also mentioned that earlier attempts by banks to reduce credit growth had been counteracted by nonbanks providing more credit – although at higher rates. Since the start of the crisis wage growth has decelerated rapidly and is expected to be negative in the first quarter of 2009. At the same time, social expenditures increase rapidly and more strongly than expected. CDS spreads for Latvia were at times larger than those for Iceland, which Bauze saw as clearly not realistic. A tight income policy, implemented primarily through cuts in public sector wages and employment, is considered to be the most effective instrument for restoring competitiveness. In the medium run, Bauze sees a need for structural reforms, mostly in education and health care, which are inefficient sectors. Such reforms can now be more easily justified by politicians than in the past.

Raimondas Kuodis (Lietuvos bankas) explained that in Lithuania imbalances are less pronounced than in the other Baltic countries because the financial deepening process had started later. Nevertheless, Lietuvos bankas had warned about a real estate bubble in Lithuania already in 2004. The country for instance did not levy a general property tax, and tax subsidies for mortgages should have been eliminated much earlier. In addition, Lithuania traditionally has small but persistent budget deficits resulting in a situation where there are no buffers in the budget. On the positive side, wage bargaining is completely decentralized in the country, and wage growth fell already strongly in 2008. Hence, Kuodis argued, there is no need for Lithuania to have a flexible nominal exchange rate. ULC growth in recent years was observed mostly in the nontradable sector, which did not affect competitiveness. In fact, trade imbalances were almost zero in January 2009. Kuodis concluded that a fixed exchange rate regime makes economic management easier and should therefore be preserved.

The afternoon session was dedicated to the SEE countries with low or zero nominal exchange rate flexibility.[2] The situation within this group of countries is even more heterogeneous than within the Baltic states.

Amir Hadziomeragic (Centralna banka Bosne i Hercegovine) presented the current situation in Bosnia and Herzegovina. Owing to the war, the transition process and the period of strong growth and productivity gains started only lately. During the recent strong growth period, high unemployment mitigated possible wage pressure. Fiscal policy was expansionary before the global crisis started. The banking sector in Bosnia and Herzegovina is still rather traditional. The credit to deposit ratio and the ratio of short-term debt to foreign exchange reserves are both low although the country also relied on capital inflows in recent years. On a

[2] *The National Bank of the Republic of Macedonia was not represented at the seminar.*

more skeptical note, Hadziomeragic argued that cross-border banking supervision had not been adequate in the past. Moreover, the resilience and flexibility of the country's economy in a serious downturn are largely untested and there are still quite a few obstacles to private sector growth. Finally, given the importance of remittances for the economy of Bosnia and Herzegovina, Hadziomeragic worried about the impact of a significant decline in remittances if migrants need to return to their country.

Kalin Hristov (Bulgarian National Bank) explained that Bulgaria's macroeconomic policy is strongly based on the currency board. Bulgaria has invariably registered fiscal surpluses since 2003. This is largely due to the rule that once the budget hits 0%, expenditures are cut. He also emphasized that in Bulgaria wage bargaining is decentralized. Banks started to "import" capital to Bulgaria in 2007, and 2008 banking sector profits are being reinvested, which further strengthens the banking sector. He stressed that foreign banks in Bulgaria cannot in any case withdraw quickly given the assets they have in the country. In the worst case, only gradual "bleeding" would be possible. Since late 2008 the large current account deficit has been adjusted via the trade channel (imports, which are mostly investment goods, are declining more rapidly than exports). FDI inflows are still strong and Hristov argued that they are in fact the reason for Bulgaria's large current account deficit. They should thus not only be seen as a means to cover this deficit.

Ljubinko Jankov (Hrvatska narodna banka) gave a detailed account of the measures with which Croatia's central bank had tried to slow down credit growth in the past, e.g. the high reserve requirements for foreign currency loans. In his view, these measures had some impact on household borrowing but practically none on loans to enterprises. He emphasized that there are no plans to change the managed float. Croatia entered the crisis with a high level of foreign currency reserves, which reduces vulnerabilities, although it is still possible to envisage a shock where people withdraw large amounts of euro cash from banks. Croatia recently observed a significant change in the structure of lending, with lending to private nonfinancial enterprises having contracted and lending to banks (from parent banks) having increased.

Both sessions were followed by general discussions about the growth and convergence processes of these countries and of how they should react to the current crisis. Among others, the following issues were raised: the role of the government, the effectiveness of fiscal measures, adequate regulatory frameworks as well as euro area entry as an exit strategy. These points were summarized in the concluding remarks by *Doris Ritzberger-Grünwald* (OeNB). Representatives of the Greek and Swedish central banks, who chaired the sessions, emphasized that the banks in their countries have no plans to leave the countries in the region.