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

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# Recent Developments in the Baltics and Southeastern European Countries with Low Nominal Exchange Rate Flexibility<sup>1</sup>

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## **Abstract**

This paper analyses recent developments in and the main similarities and differences between the Baltic countries and those Southeastern European countries with low nominal exchange rate flexibility (Bosnia and Herzegovina, Bulgaria, Croatia and the FYR of Macedonia). In addition to having a similar monetary policy framework all seven countries covered in the paper are very small, open economies. They differ, however, in their level of economic development and the degree of their institutional and economic integration with the EU. This paper reviews the main drivers of the growth and convergence process in these seven countries since 2000, describes the associated build-up of internal and external imbalances and looks at the turning point from boom to bust in the Baltic countries. In addition, the paper looks at the key macro-financial vulnerabilities and the structural challenges that these seven countries are currently facing.

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## 1. Introduction

The Baltic countries (Estonia, Latvia and Lithuania), share some key economic features with the Southeastern European countries Bosnia-Herzegovina (BiH), Bulgaria, Croatia and the FYR of Macedonia (SEE-4).<sup>4</sup> In particular, their exchange rate regimes are either completely fixed (currency boards in BiH, Bulgaria, Estonia and Lithuania) or have a low degree of nominal exchange rate flexibility.<sup>5</sup> In addition, all these seven Baltic and Southeastern European countries (BSEC-7) are very small, open catching-up economies.

There are also significant structural differences between these countries, both within and between the Baltic countries and the SEE-4 sub-groups. In particular their level of economic development (proxied by their level of per capita GDP) is quite different. In addition, whereas the Baltic countries and Bulgaria are EU Member States, the other SEE-4 countries are still candidate or potential candidate countries for EU membership.

Despite these differences, recent economic and financial developments in the BSEC-7 countries have considerable similarities. Since 2000 all these countries experienced strong economic growth, mostly driven by domestic demand and linked with rapid financial deepening. More recently, buoyant GDP growth led to increasing external and internal imbalances and macro-financial vulnerabilities. Following the worsening of the global financial crisis in the autumn of 2008, all BSEC-7 countries became affected by the crisis, although the impact has so far differed significantly.

This paper reviews recent economic and financial developments in the BSEC-7 countries, identifies the similarities and differences between them and flags their main macro-financial and structural challenges. Section 2 reviews the main drivers of the growth and convergence process in the BSEC-7 countries since 2000, describes the associated build-up of internal and external imbalances and looks at the turning point from boom to bust in the Baltic countries. Section 3 looks at the key macro-financial vulnerabilities and the structural challenges that these countries are currently facing and Section 4 summarises the main findings of the paper.

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<sup>4</sup> The two euroised economies Kosovo and Montenegro are not covered in this paper.

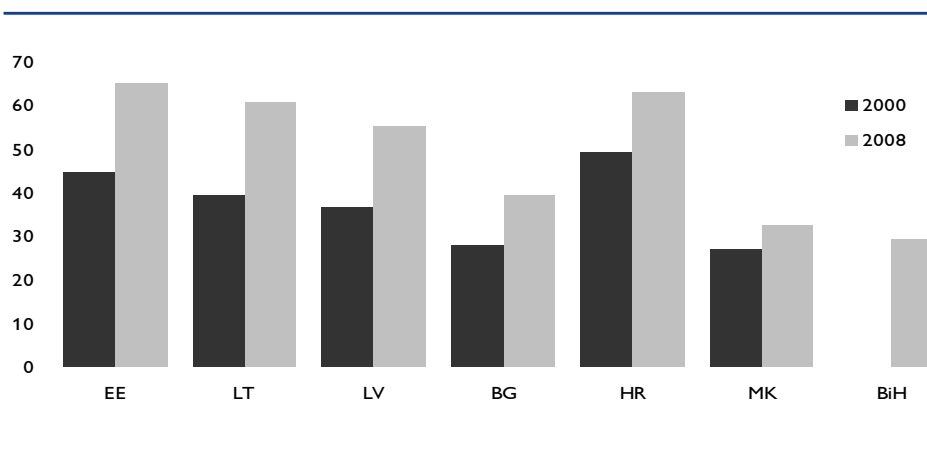
<sup>5</sup> Croatia has a tightly managed float, Latvia is a member of ERM II with a unilateral exchange rate band of +/- 1% and the FYR of Macedonia has a *de facto* peg to the euro.

## 2. Stylised Facts of the Boom and the Bust

### 2.1 Main Drivers of the Growth and Convergence Process

The catching-up process of many BSEC-7 countries since 2000 was impressive (chart 1). In 2000 GDP per capita adjusted for differences in purchasing power and relative to the EU average was between around 27% (FYR of Macedonia and Bulgaria) and 45% (Estonia and Croatia). By 2008, however, the Baltic countries and Croatia reached between 55% and 65% of the EU average and Bulgaria about 39%. Together with BiH, the FYR of Macedonia had the lowest per capita income level in 2008.

Chart 1: GDP per Capita in PPS (EU-27=100)



Source: National central banks, WEO.

Progress with real convergence since 2000 is reflected in strong real GDP growth rates, especially in the Baltic countries (table 1). Estonia grew at more than 7% since 2000 and reached its highest growth rate in 2006 before it started to slow in 2007. In 2008, however, Estonia was the first BSEC-7 country in recession and its economy contracted by -3.6%. Latvia's real GDP growth peaked also in 2006 followed by some deceleration in 2007. In 2008, however, the Latvian economy has contracted by 4.6%. Lithuania's real GDP growth remained around 7%-8% between 2003 and 2007 before slowing down to 3% in 2008.

Growth rates for the SEE-4 countries were on average also strong during the 2000-2007 period but somewhat lower than in the Baltics and only Croatian GDP growth decelerated notably in 2008. In Bulgaria real GDP growth was around 5-6% during the 2000 to 2008 period. Following an average growth rate of 4.7% between 2000-

2007 real GDP growth in Croatia decelerated to 2.4% in 2008. Macedonia's average growth rate was 4.5% between 2004 and 2007 and increased to 5% in 2008. Real average annual GDP growth in BiH was around 5% from 2000 to 2007 and 5.5% in 2008.

*Table 1: GDP at Constant Prices*

% change year on year

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	1Q/09
<b>EE</b>	9.7	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-3.6	-10.0	-1.0	-15.1
<b>LV</b>	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.0	-4.6	-12.0	-2.0	-18.0
<b>LT</b>	4.2	6.7	6.9	10.2	7.4	7.8	7.8	8.9	3.0	-10.0	-3.0	-13.6
<b>BiH</b>	5.2	3.6	5.0	3.5	6.3	3.9	6.9	6.8	5.5	-3.0	0.5	-
<b>BG</b>	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	-2	-1	-3.5
<b>HR</b>	3.0	3.8	5.4	5.0	4.3	4.2	4.7	5.5	2.4	-3.5	0.3	-
<b>MK</b>	4.5	-4.5	0.9	2.8	4.1	4.1	4.0	5.9	5	-2	1	-

Source: National central banks, WEO.

Looking ahead, the Baltic countries are expected to remain in a very deep recession in 2009 and a milder recession in 2010. The SEE-4 countries are also expected to be in recession in 2009, although less than the Baltic countries and GDP growth in 2010 is expected to be around zero.<sup>6</sup>

### 2.1.1 Domestic versus Export-led Growth

In the past years the main drivers of growth changed notably in some BSEC-7 countries. In 2000, net exports still made a considerable positive contribution to real GDP growth in some countries. In 2007, however, GDP growth in all BSEC-7 countries was exclusively driven by domestic demand and the contribution of net exports to real GDP growth turned (or remained) negative.

Domestic demand accelerated in all countries between 2000 and 2007 and reached double digit rates in the Baltic countries in 2006/2007. In 2008, however, the picture changed dramatically, particularly for Estonia and Latvia where the contribution of domestic demand even turned negative. In the SEE-4 countries the domestic demand contributions also accelerated from 2000 to 2007, although less than in the Baltics and 2008 saw some moderation in Bulgaria and Croatia.

<sup>6</sup> At the time of writing growth forecasts for the current and next year are frequently and severely revised.

*Table 2: Contribution to GDP Growth*

<i>in percentage points</i>		<b>2000</b>	<b>2007</b>	<b>2008</b>
<b>EE</b>	Domestic demand	7.9	6.7	-5.0
	Private consumption	4.0	4.4	-2.1
	GFCF	4.1	1.6	-3.4
	Net exports	-0.6	-3.9	6.0
	GDP	9.7	6.3	-3.6
<b>LV</b>	Domestic demand	5.7	13.4	-12.5
	Private consumption	4.3	9.6	-8.0
	GFCF	2.4	3.1	-4.7
	Net exports	2.9	-4.9	8.5
	GDP	6.9	10.3	-4.6
<b>LT</b>	Domestic demand	3.6	13.8	2.1
	Private consumption	3.6	8.0	3.0
	GFCF	-2.0	5.2	-1.7
	Net exports	1.3	-5.5	-0.6
	GDP	4.2	8.9	3.0
<b>BiH</b>	Domestic demand			
	Private consumption			
	GFCF			
	Net exports			
	GDP	5.2	6.8	5.5
<b>BG</b>	Domestic demand	7.4	9.9	9.4
	Private consumption	3.1	3.7	3.3
	GFCF	2.3	5.6	6.1
	Net exports	-2.0	-4.9	-2.3
	GDP	5.4	6.2	6.0
<b>HR</b>	Domestic demand	1.0	6.4	3.0
	Private consumption	2.1	3.7	0.5
	GFCF	-0.8	2.0	2.2
	Net exports	2.8	-0.8	-1.1
	GDP	3.0	5.6	2.4
<b>MK</b>	Domestic demand	7.0	7.5	11.5
	Private consumption	7.8	3.1	6.0
	GFCF	-0.2	3.6	3.8
	Net exports	-5.7	-2.3	-1.6
	GDP	4.5	5.6	5.0

*Source: Ameco, CBBH.*

Turning to net exports, in 2000 Croatia's economic growth was largely driven by net exports and in Latvia and Lithuania net exports contributed a considerable share to real GDP growth. By 2007, however, the contribution of net exports to GDP growth had become negative in all BSEC-7 countries although the dampening effect on GDP growth varied considerably.<sup>7</sup>

### 2.1.2 Financial Deepening, Asset Prices and Domestic Demand

In all BSEC-7 countries credit growth to the private sector was strong in the past years. In the Baltic countries and Bulgaria credit growth accelerated to annual rates between 40 and 60% in 2006/2007. Since then credit growth in all Baltic countries slowed down dramatically although slightly less in Bulgaria. Private sector credit growth in Croatia, BiH and the FYR of Macedonia remained relatively more moderate until 2007 and the deceleration of credit growth in 2008 was also less pronounced.

*Table 3: Private Sector Credit Growth*

*y/y eop (Claims vs. Non Bank Non Government)*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
%									
EE	30.3	22.2	27.8	27.0	31.2	33.4	41.6	33.0	7.2
LV	36.6	50.1	36.6	37.2	46.8	63.6	58.3	34.0	11.8
LT	-1.7	26.9	27.7	54.5	38.9	63.6	40.5	42.8	18.1
BiH	8.7	10.8	27.7	20.3	15.9	27.4	23.3	27.9	20.8
BG	17.0	32.1	44.0	48.3	48.6	32.4	24.6	62.5	31.6
HR	9.0	23.1	30.0	14.6	14.0	17.2	22.9	15.0	10.5
MK	18.7	-0.4	6.2	14.1	25.0	21.0	30.5	39.2	34.2

*Source: OeNB, national central banks.*

As a result of strong credit growth, the stock of domestic credit to the non-financial private sector increased considerably in all BSEC-7 countries. In 2008, the highest stocks of domestic credit to the private sector relative to GDP were recorded in Estonia and Latvia (between 90% and 100%). In Croatia, Bulgaria and Lithuania the stock of private sector credit is between 60% and 75% of GDP. In BiH and the FYR of Macedonia the private sector credit stock relative to GDP is much lower but in particular in the FYR of Macedonia it has rapidly increased over the last few years.

<sup>7</sup> Annual growth rates of private consumption, investment, exports and imports over time show clear differences between the Baltic countries and the SEE-4 countries (see Annex).

*Table 4: Stock of Domestic Credit*

% of GDP; e. o. p.

	2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	35.4	38.8	44.1	50.7	59.0	67.8	81.4	93.8	97.6
LV	23.3	28.5	35.7	45.0	53.9	71.9	89.7	89.5	89.1
LT	13.1	15.7	18.0	23.6	30.5	43.1	48.9	60.2	64.2
BiH	25.8	26.6	31.0	35.3	37.5	44.6	48.7	55.2	58.0
BG	17.8	20.2	23.6	29.6	35.4	42.8	42.7	59.2	66.7
HR	40.8	45.9	54.0	55.7	57.5	63.7	70.0	71.9	74.4
MK				17.2	20.8	20.0	23.5	34.4	42.7

*Source: OeNB, national central banks.*

Nominal and real interest rate developments in the BSEC-7 countries since 2000 suggest a link between strong credit growth and decreasing interest rates. During the 2000–2008 period *nominal* interest rates reached their lowest point in 2005 with nominal short-term rates for the Baltic countries and Bulgaria between 2.4% and 3.6% and nominal long-term rates between 3.7% and 4.2%. The corresponding rates for the other SEE-4 countries at that time were considerably higher, especially for households although the fixed or almost fixed exchange rate regimes had a downward impact on nominal interest rates in all BSEC-7 countries. In line with interest rate developments in the euro area nominal interest rates in the Baltic countries and Bulgaria started to increase in 2006, whereas nominal rates in the other SEE-4 countries mostly remained stable or even decreased. This suggests that the upward impact of euro area rate increases was counterbalanced by other determinants of market interest rates such as increasing competition in the banking sector and lower country-specific risk premia.



*Table 5: Short-term Interest Rates*

%									
<b>Nominal</b>									
	2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	5.7	5.3	3.9	2.9	2.5	2.4	3.2	4.9	6.7
LV	5.4	6.9	4.4	3.8	4.2	3.1	4.4	8.7	8.0
LT	8.6	5.9	3.7	2.8	2.7	2.4	3.1	5.1	6.0
BiH*									
corporate			12.07	10.54	9.9	9.0	7.7	7.0	7.4
household					9.8	9.3	9.6	10.5	9.1
BG	4.6	5.1	4.9	3.7	3.7	3.6	3.7	4.9	7.1
HR**									
corporate	8.3	6.0	8.6	7.8	8.2	8.1	7.1	7.0	7.7
household	20.6	19.5	17.2	15.0	14.4	13.1	12.1	12.1	12.2
MK**									
corporate						10.8	9.8	9.1	8.7
household						19.5	17.6	15.7	12.7
<b>Real</b>									
	2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	1.8	-0.3	0.3	1.5	-0.5	-1.7	-1.2	-1.8	-3.9
LV	2.8	4.4	2.4	0.9	-2.0	-3.8	-2.2	-1.4	-7.3
LT	7.5	4.3	3.4	3.9	1.5	-0.3	-0.7	-0.7	-5.1
BiH*									
corporate					9.5	5.3	0.2	5.4	7.4
household					9.4	5.6	2.1	8.9	9.1
BG	-5.7	-2.3	-0.9	1.4	-2.4	-2.4	-3.7	-2.7	-4.9
HR**									
corporate	1.8	1.0	6.9	6.1	6.1	4.6	4.0	4.1	1.5
household	14.2	14.5	15.5	13.2	12.3	9.6	8.9	9.2	6.0
MK**									
corporate						10.3	6.5	6.3	1.5
household						19.0	14.3	12.9	5.5

Source: EC Economic Forecast spring 2009, NCB's.

\* interest rates on loans in local currency.

\*\* interest rates on loans without currency clause.

*Table 6: Long-term Interest Rates*

%									
<b>Nominal</b>									
	2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	10.5	10.2	8.4	5.3	4.4	4.2	5.0	6.1	8.2
LV		7.6	5.4	4.9	4.9	3.9	4.1	5.3	6.4
LT		8.2	6.1	5.3	4.5	3.7	4.1	4.6	5.6
BiH*									
corporate			10.59	9.18	8.2	7.7	7.4	7.1	7.4
household					10.8	9.9	9.3	10.0	10.9
BG			8.3	6.5	5.4	3.9	4.2	4.5	5.4
HR*									
corporate	10.46	8.21	6.79	6.31	6.01	5.38	5.77	6.15	6.78
household	11.62	11.16	9.79	8.70	8.13	7.37	6.63	6.49	7.73
MK**									
corporate						10.9	10.7	9.7	8.9
household						12.1	11.3	10.3	9.4
<b>Real</b>									
	2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	6.6	4.6	4.8	3.9	1.4	0.1	0.6	-0.6	-2.4
LV		5.1	3.4	2.0	-1.3	-3.0	-2.5	-4.8	-8.9
LT		6.6	5.8	6.4	3.3	1.0	0.3	-1.2	-5.5
BiH*									
corporate			10.2	8.6	7.8	4.0	-0.1	5.5	7.4
household					10.4	6.2	1.9	8.4	10.9
BG			2.5	4.2	-0.7	-2.1	-3.2	-3.1	-6.6
HR*									
corporate	4.0	3.2	5.1	4.5	3.9	1.9	2.6	3.2	0.6
household	5.2	6.2	8.1	6.9	6.0	3.9	3.5	3.6	1.5
MK**									
corporate						10.4	7.4	6.9	1.7
household						11.6	8.0	7.5	2.2

Source: Ameco, EC Forecast spring 2009, national central banks.

\* interest rates on loans in local currency.

\*\* interest rates on loans without currency clause.

Real ex post short-term interest rates (deflated by headline inflation) became negative in Estonia, Latvia and Bulgaria in 2004, followed by Lithuania in 2005. In Latvia and Bulgaria real ex post long-term interest rates were also negative as of 2004. In 2008, short- and long-term real ex post rates in the Baltic countries and Bulgaria were strongly negative due to the considerable increase in inflation (see below). In Croatia and in the FYR of Macedonia also corporate short-term interest rates and long-term corporate and household rates were close to zero or slightly negative.

*Table 7: Share of Foreign Currency*

% of total		2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	Loans to domestic non-banks	77.9	78.7	82.6	81.5	80.0	79.3	77.5	78.5	84.8
	Loans to households	63.1	67.0	72.8	66.6	64.9	75.0	77.8	77.3	82.2
	Loans to enterprises	81.8	81.9	86.0	87.3	87.5	82.3	77.4	79.8	87.3
LV	Loans to domestic non-banks				56.0	60.9	69.9	76.9	86.3	88.4
	Loans to households	49.2	48.6	54.2	58.3	65.1	69.7	77.1	85.8	87.4
	Loans to enterprises	52.3	58.8	54.4	53.5	58.1	69.8	76.6	86.8	89.0
LT	Loans to domestic non-banks	61.3	57.3	47.9	53.5	57.9	65.3	52.1	54.8	64.0
	Loans to households	48.5	44.5	26.6	29.2	42.8	54.7	43.9	49.8	61.6
	Loans to enterprises	71.6	62.8	54.1	59.8	62.9	69.8	57.4	58.7	66.3
BiH*	FX share of total loans	67.1	51.7	35.2	64.9	65.4	68.7	71.0	74.0	73.0
BG	Loans to domestic non-banks	35.9	36.0	42.2	43.4	48.1	47.2	45.0	49.9	56.7
	Loans to households	3.2	4.9	7.2	8.9	11.0	15.4	19.0	20.0	29.2
	Loans to enterprises	43.5	44.4	52.2	56.3	65.3	66.9	62.5	67.7	72.8
HR*	Loans to domestic non-banks	86.2	85.2	80.4	74.9	76.7	78.3	71.8	62.5	66.2
	Loans to households	89.5	89.8	88.3	81.2	79.4	80.0	77.7	67.6	67.9
	Loans to enterprises	85.6	80.5	74.6	71.4	74.1	75.1	64.4	53.7	59.7
MK*	FX share of total loans				37.6	42.3	47.8	54.4	57.1	55.8

Source: National central banks, OeNB.

\* including FX indexed loans, for BH indexed loans included since 2003.

The strong decrease of real ex post rates in 2007 and 2008 coincided with a deceleration of credit growth in the Baltic countries, suggesting that more recently other factors played an important role in determining credit growth. This could be, inter alia, more restrictive lending practices by commercial banks or the deceleration or decline of property prices. In some BSEC-7 countries the latter may have had an even stronger impact on the behaviour of economic agents than headline inflation.

An important aspect of the rapid financial deepening process in the BSEC-7 countries is the importance of loans denominated in foreign currency. The cross-country picture is somewhat heterogeneous although foreign currency-denominated credit to the domestic non-financial sector played an important role in all BSEC-7 countries. In 2008 the highest stock of FX-loans was registered in Latvia with almost 90%, followed by Estonia, Lithuania and Croatia. Bulgaria and Macedonia have the lowest share of FX-denominated credit stock among the BSEC-7 countries. Looking separately at credits to households and enterprises, the foreign currency shares of credits for households tended in the past to be lower in most countries (but higher in Latvia) and the shares are ‘converging’ more recently.

### *Box 1: Determinants of Foreign Currency Lending*

The significant share of foreign currency borrowing in per cent of total borrowing in most CESEE countries is well known and well documented. By contrast, there are not many analyses of the determinants of foreign currency borrowing in these countries.

Based on a panel regression analysis for the 10 CESEE EU Member States plus Croatia covering the period 1999-2007, Rosenberg and Tirpak (2008) identify a number of important drivers for foreign currency borrowing, notably the interest rate differential between loans in domestic and foreign currency and the extent to which lending is based on funding from abroad rather than domestic deposits. They also find that some other variables such as country size, per capita income level, trade openness and regulatory policies have some impact on the share of foreign currency lending. Their findings are less clear when it comes to the impact on exchange rate volatility, membership in the EU or ERM II or remittances. The paper by Basso, Calvo-Gonzales and Jurgilas (2007), looking at 24 transition economies arrives at similar conclusions. In particular they emphasise banks’ access to foreign funds, interest rate differentials and trade openness (for the corporate sector only) as determinants of foreign currency borrowing.

The 2008 spring wave of the OeNB Euro survey contained a set of questions on the motives for holding foreign currency-denominated loans. Particularly in CESEE countries, many respondents agreed with the notion that ‘foreign currency loans are cheaper than local currency loans’. However, this statement received considerably less support from the interviewees in SEE countries. Both, in CEE and SEE, a considerable share of respondents agreed with the statement that they had taken out a foreign currency-denominated loan ‘because their bank had advised them to do so’ and in both regions some people agreed with the statement ‘the interest rate in foreign currency is more stable than that of the local currency’.

Whereas these analyses mostly focus on the demand side of foreign currency borrowing, the role of banks is given less prominence. On the one hand banks face a number of regulatory rules such as limits to their open currency positions. Especially at a time of rapid credit expansion and intense competition for market shares such rules may be a strong incentive for the promotion of credit in foreign currency. It is not clear, however, whether such constraints were the key determinant for the promotion of foreign currency credits. An alternative motive could have been the desire to pass on currency risks from the use of foreign funding to customers. With the benefit of hindsight, however, this may have increased banks' credit risk.

The rapid financial deepening process was closely interlinked with changes in real estate prices.<sup>8</sup> Available data on residential property price developments show that house prices in Bulgaria and the Baltic countries have grown very rapidly compared with the euro area average as well as other CESEE countries and 'old' EU Member States experiencing a sharp increase in property prices such as Ireland and Spain (Égert and Martin, 2009).<sup>9</sup>

*Table 8: House Price Growth*

% change year on year									
	2001	2002	2003	2004	2005	2006	2007	2008	last observation y/y
EE	34.2	29.5	12.9	27.8	30.9	51.8	10.1	-12.3	-20.7 (Q42008)
LV						159.3	45.2	-20.6	-19.6 (Q32008)
LT	23.8	9.5	18.0	9.9	51.8	39.2	33.5	5.2	-5.0 (Q42008)
BG	0.3	1.8	12.2	47.6	36.6	14.7	28.9	24.9	11.7 (Q42008)
HR			2.4	4.8	-0.7	0.3	25.9	7.5	

Source: Datastream, CROSTAT (HR).

Looking at the period from 2005 to 2008, the Baltic countries and Bulgaria recorded very high average annual house price increases. House price increases peaked in the Baltic countries around 2005/2006, followed first by a deceleration

<sup>8</sup> Looking at other asset prices, stock markets peaked around 2007 or early 2008, followed by strong declines, bringing the stock market indices at the end of 2008 back to where they were in 2003 or 2004. However, share ownership in the BSEC-7 countries tends to be restricted to a rather small part of the population which is likely to limit the repercussions for disposable income.

<sup>9</sup> The price level in the late 1990s was, however, significantly lower in the CESEE countries and, in particular, in the Baltic countries and Bulgaria than in the euro area including Ireland and Spain.

of growth and in 2008 by a fall in nominal house prices in Estonia and Latvia. By contrast, annual house price increases remained relatively high in Bulgaria in 2008 and increased strongly in Croatia in 2007.

*Box 2: Credit and House Price Growth – Equilibrium Phenomena?*

High private sector credit growth in recent years in many CESEE countries and in particular in the Baltic countries and Bulgaria led to the question whether credit developments in these countries were still an equilibrium phenomenon? Estimating equilibrium credit levels in catching-up countries obviously entails considerable uncertainty, especially in a period of rapid financial deepening. Nevertheless the OeNB has produced a number of empirical analyses on this issue, based on a dynamic panel co-integration framework (see e.g. Backé et al. 2006).<sup>10</sup>

The latest available analysis based on this framework (using data until 2008Q1) suggests that credit stock levels in Latvia and Bulgaria were within the estimated equilibrium range, but more tilted towards a deviation at the overshooting side. Credit stock levels in Estonia, Lithuania and Croatia were very close to the mid-point of the equilibrium range or more tilted towards a deviation at the undershooting side, especially Estonia (Backé et al., 2008).<sup>11</sup>

Given the methodological and data-related caveats of this approach the authors urge for caution in the interpretation of their results. Moreover, the ranges for the equilibrium credit levels derived with this model tend to be relatively large. Notwithstanding these shortcomings the empirical analysis suggests that *past* credit growth was largely connected to economic fundamentals.

Credit booms are often associated with asset price booms and the recent rapid credit growth in CESEE countries was indeed associated with a rapid rise in house prices. This in turn led to the question whether real estate price levels in these countries are still in equilibrium or misaligned. Unfortunately, however, analyses on real estate price levels are almost impossible due to the lack of reliable and comparable data.

Égert and Mihaljek (2007), using data up to 2006, argue that their estimates indicate either an equilibrium correction from initial undervaluation of house prices or overshooting. They stress that house price developments in the CESEE countries can in any case not be “completely disconnected from fundamentals”. UniCredit Group (2008) argues that residential property prices are in most countries still below their ‘equilibrium’ level – although moving towards them – and that the rapid increase in residential property prices up until 2007 could still be compatible with the convergence story.

<sup>10</sup> Earlier papers such as Cottarelli et al. (2003) and Coricelli et al. (2006) arrive overall at a rather benign assessment of fast credit growth in CESEE countries but stress already the associated macroeconomic and financial stability risks.

<sup>11</sup> No such estimates are available for Bosnia-Herzegovina and the FYR of Macedonia.

Chart B1: Residential Real Estate Price Levels

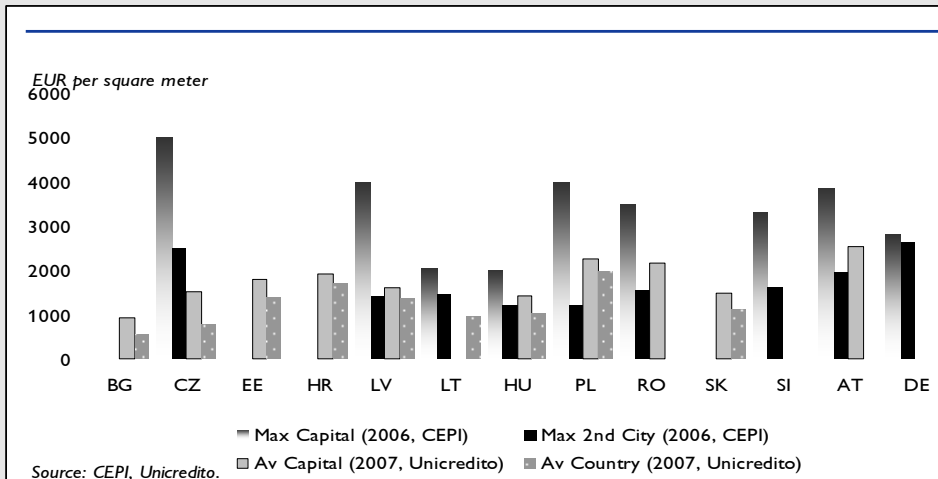


Chart B1 provides an overview of residential real estate price levels in a number of CESEE countries, Austria and Germany. The chart contains average prices in capitals, average prices in the country, maximum prices in capitals and maximum prices in the ‘second city’.<sup>12</sup>

These data allow some tentative qualitative conclusions. First, there are major price level differences between CESEE capitals and CESEE ‘2<sup>nd</sup> cities’ or country averages. Second, there are large differences between maximum and average prices in capitals. Third, average capital price levels in CESEE countries are still below the level of Vienna although average prices for Warsaw and Bucharest come close. Fourth, maximum price levels in a number of CESEE capitals (in particular Prague, Riga and Warsaw) exceed comparable price levels in Berlin and Vienna.

A simple correlation analysis with GDP per capita data tends to confirm that on the basis of the available data only the top end of real estate prices in some CESEE capitals is likely to have moved away from equilibrium levels in 2006 (and possibly even more so in 2007/8).<sup>13</sup> Overall, the limited available information does not suggest a widespread misalignment of house price levels.

<sup>12</sup> (1) and (2) are 2006 data collected by CEPI (the European Council of Real Estate Professions) ([www.cepi.eu](http://www.cepi.eu)). (3) and (4) are 2007 data used in UniCredit Group (2008). All data refer to the square meter price of apartments, expressed in EUR.

<sup>13</sup> Correlating the different price level series with national or regional GDP per capita levels (relative to the EU average) yields correlation coefficients of around 0.5 suggesting a reasonably strong link between real estate prices and relative income levels. Only for the maximum price level in capitals, the correlation coefficient with relative regional GDP is significantly lower (around 0.26), indicating that other factors including speculative purchases or the presence of large groups of international buyers may have had a stronger impact on house price levels.

Besides the financial deepening process there are a number of other factors that have played a role in stoking domestic demand in some BSEC-7 countries, namely the remittances they received from an increasingly large number of emigrants and – for EU Member States – the inflow of funds in the context of EU Cohesion Policy.

World Bank data<sup>14</sup> suggest that remittances play a considerable role for the BSEC-7. In 2007, such inflows ranged between 2.1% and 3.8% of GDP for the Baltic countries, Croatia and Macedonia. Inflows to Bulgaria were somewhat higher (5.7% of GDP) and in the case of BiH remittances are a key source of funding at around 15% of GDP. Figures on migration (see below) suggest that the flow of remittances to most BSEC-7 countries has increased over time. Against the background of recent global economic developments, however, the flow of remittances to the BSEC-7 countries is likely to decline.<sup>15</sup>

For BSEC-7 countries that are in the EU, funding from the EU Cohesion Policy is another important provider of capital, in particular for investments in infrastructure. The figures envisaged in the 2007-2013 EU budget framework suggest that the Baltic countries as well as Bulgaria receive on average around 2.5% of GDP per year during this seven-year period.<sup>16</sup> For the period 2004 to 2006 the budget was somewhat lower. Past experience shows, however, that actual Cohesion Policy payments tend to be lower than envisaged at the beginning of the budget period and higher at the end. This is due to initial administrative absorption problems and suggests that the EU BSEC-7 countries will benefit more from these funds in the future.

### 2.1.3 The Role of Fiscal Policy

Budget balances in the BSEC-7 countries suggest significant differences in fiscal policy. Between 2001 and 2007 Estonia and Bulgaria had almost always budget surpluses which tended to increase over time. Latvia and Lithuania continued to have budget deficits (except for Latvia in 2007) which, however, declined over time.<sup>17</sup> BiH's budget deficit initially improved but worsened again since 2007, Macedonia's budget balance oscillated around a broadly balanced budget and Croatia had sizeable budget deficits which only improved since 2006. In 2008

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<sup>14</sup> Downloadable at [econ.worldbank.org](http://econ.worldbank.org)

<sup>15</sup> Official data are likely to underestimate both actual migration as well as remittances.

<sup>16</sup> On this issue see e.g. Kamps, Leiner-Killinger and Martin (2009). Candidate and potential candidate countries also benefit from some EU support programmes but their financial magnitude is smaller than that of EU Cohesion Policy.

<sup>17</sup> According to European Commission estimates the cyclically adjusted budget balances in all three Baltic countries in 2007 and 2008 were close to zero (Estonia in 2007) or negative (up to -3.9% in Lithuania in 2008). Such estimates should, however, be interpreted with great caution given in particular the difficulty to quantify potential output in catching-up economies.



budget balances deteriorated significantly in the Baltic countries, in BiH and the FYR of Macedonia. Looking forward, budget balances in all BSEC-7 countries are expected to deteriorate (further) in 2009 and 2010, in the case of Latvia the forecast even points to double-digit deficits.<sup>18</sup>

*Table 9: Government Net Lending/Borrowing*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<i>as % of GDP</i>											
EE	-0.2	-0.1	0.3	1.7	1.7	1.5	2.9	2.7	-3.0	-3.0	-3.9
LV	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.5	-0.4	-4.0	-11.1	-13.6
LT	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.2	-5.4	-8.0
BiH <sup>1</sup>					-0.5	0.8	2.2	-0.1	-1.9	-2.5	
BG	-0.5	0.2	-0.8	-0.3	1.6	1.9	3.0	0.1	1.5	-0.5	-0.3
HR					-4.3	-4.2	-3.0	-2.5	-2.0	-3.3	-2.7
MK <sup>2</sup>					0.0	0.2	-0.5	0.6	-1.0	-3.5	-3.7

*1 IMF Art IV 10/2008.*

*2 EC spring forecast 2009.*

*Source: Ameco, IMF (for BiH).*

Overall fiscal policy in the BSEC-7 countries tended to be either insufficiently restrictive or even pro-cyclical. Sizeable improvements in (headline) budget balances in almost all BSEC-7 countries appear to have been largely the result of strong or very strong GDP growth, in particular since 2004. In addition, current public expenditure in per cent of GDP increased in recent years in some BSEC-7 countries, notably the Baltic countries and BiH and low tax levels are likely to have further stoked the boom.

Looking forward, the economic and financial crisis is expected to have a considerable impact on fiscal variables, which is likely to affect the monetary integration plans of some BSEC-7 countries with the euro area, notably the Baltic countries which are already members of ERM II for more than two years. The above-mentioned forecasts for the Baltic countries cast some doubts on the prospects of these countries to fulfil the Maastricht criterion on public finances in the near future.

## **2.2 The Build-up of Internal and External Imbalances**

### **2.2.1 Internal Imbalances – Changes in Prices and Costs**

Inflation in the Baltic countries and Bulgaria increased strongly from quite low levels in 2003/2004 to double-digit figures in 2008. Inflation increased in particular

<sup>18</sup> Developments in debt levels reflect largely the above-mentioned trends in budget balances (see Annex).

since early 2007, peaked around mid-2008 in all four countries and declined since then. Also Croatia and the FYR of Macedonia experienced a large increase in inflation in 2008 but remained at lower levels than the Baltic countries and Bulgaria. Looking forward inflation will decrease sharply in all BSEC-7 countries until 2010 due to favourable base effects and the very strong economic slowdown. The IMF expects inflation to become even negative in Estonia and Latvia in 2010.

*Table 10: Inflation, Average Consumer Prices*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
% year on year change											
EE	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	0.8	-1.3
LV	2.6	2.5	1.6	3.3	6.2	6.9	6.6	10.1	15.3	3.3	-3.5
LT	1.1	1.6	0.3	-1.1	1.2	2.7	3.8	5.8	11.1	5.1	0.6
BiH	5.0	4.5	0.3	0.5	0.3	3.6	6.1	1.5	7.4	2.1	2.3
BG	10.3	7.4	5.8	2.3	6.1	6.0	7.4	7.6	12.0	3.7	1.3
HR	4.6	3.8	1.7	1.8	2.0	3.3	3.2	2.9	6.1	2.5	2.8
MK	6.4	5.5	2.2	1.2	-0.4	0.5	3.2	2.3	8.3	1.0	3.0

*Source: WEO, IMF.*

Inflationary pressures in the BSEC-7 countries in recent years were mostly broad-based, with large contributions to inflation coming from external factors such as increases in food and energy prices as well as adjustments in taxes and excise duties. There were, however, also large increases in services prices which mainly reflected the tightening labour market situation in most BSEC-7 countries.

On the back of the fast economic growth in recent years, the unemployment rate in most BSCE-7 countries declined considerably since 2000, except for the FYR of Macedonia and BiH, and fell to rather low levels in the Baltic countries and Bulgaria (5%–6% in 2008). Looking forward, the downward trend in unemployment will reverse and unemployment rates are projected to double in the Baltic countries in 2009. In the SEE-4 countries a slight increase is also expected.

*Table 11: Unemployment Rate*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
%											
EE	12.8	12.4	10.3	10	9.7	7.9	5.9	4.7	5.5	11.3	14.1
LV	13.7	12.9	12.2	10.5	10.4	8.9	6.8	6	7.5	15.7	16
LT	16.4	16.5	13.5	12.5	11.4	8.3	5.6	4.3	5.8	13.8	15.9
BiH*			41	42.1	42.9	42	44.8	43.2			
BG	16.4	19.5	18.2	13.7	12.1	10.1	9	6.9	5.6	7.3	7.8
HR	16.1	15.9	14.8	14.2	13.7	12.7	11.2	9.6	8.4	9.6	9.4
MK	32.2	30.5	31.9	36.7	37.2	36.7	36	34.6	33.7	35	36

\*EBRD

Source: Ameco – definition EUROSTAT.

In some BSEC-7 countries migration had a notable impact on labour supply during the years of rapid economic growth.<sup>19</sup> Latvia, Lithuania and the FYR of Macedonia were on average net emigration countries during the period 2001-05. By contrast BiH and Croatia were on average net immigration countries. Data for 2005 suggest that emigration increased notably in Lithuania and Bulgaria compared to the first half of the decade. The situation remained broadly unchanged in the other BSEC-7 countries. In addition to official migration flows it is likely that various forms of unrecorded migration have had a negative impact on labour supply in some BSEC-7 countries. Together with strong GDP growth and mostly unfavourable demographic developments, migration<sup>20</sup> is thus likely to have contributed to labour market tightening in many BSEC-7 countries.

*Table 12: Net Migration Rates*

	EE	LV	LT	BiH	BG	HR	MK
<i>per 1,000 population</i>							
2001-2005	0.1	-0.8	-1.6	1.6	0	2.6	-2.9
2005	-0.3	-0.5	-3	na	-1.8	2.6	na

Source: Münz (2007).

In line with tight labour markets and high inflation expectations, the growth rate of nominal compensation per employee in the Baltic countries and Bulgaria increased significantly in recent years. Growth in compensation per employee peaked in the Baltic countries in 2007 and the SEE-4 countries in 2008. Looking forward, negative growth rates are expected in the Baltic countries, especially in Latvia and

<sup>19</sup> See e.g. IMF 2008b and Münz 2007.

<sup>20</sup> Especially in a tight labour market the option to migrate may be sufficient for ‘stayers’ to obtain higher wages.

Lithuania. In the SEE-4 countries the deceleration is expected to be milder than in the Baltics, but still considerable.

*Table 13: Nominal Compensation per Employee (Wage+Social Contribution from Employer)*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<i>% growth</i>											
EE	15.7	9.5	9.1	12.2	11.2	11.0	14.0	26.5	14.7	0.7	-3.5
LV	6.9	3.4	4.0	11.3	14.3	25.3	23.6	34.8	16.7	-9.0	-3.0
LT	-0.7	7.1	5.0	8.9	10.9	11.5	16.7	16.9	14.5	-10.3	-8.8
BiH <sup>1</sup>					3.7	5.6	9.1	10.3	17.2	7.3	
BG	-9.9	14.9	5.9	5.1	4.9	5.9	7.4	17.9	19.3	6.5	4.2
HR	0.1	1.5	10.3	-2.9	14.6	5.5	3.9	5.3	9.3	3.7	5.0
MK	2.6	-0.2	4.5	8.0	-2.9	-3.3	11.7	-4.8	10.1	1.7	1.7

<sup>1</sup> IMF Art. IV 10/2008.

Source: Ameco.

The strong recent growth rates in compensation per employee exceeded productivity gains in some BSEC-7 countries, resulting in considerable increases in real unit labour costs particularly in Latvia and Estonia. This trend is now expected to reverse. In the SEE-4 countries real ULC remained mostly flat or declined since 2000.

*Table 14: Real Unit Labour Costs: Total Economy<sup>1</sup>*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<i>2000=100</i>											
EE	100	97.4	96.2	97.1	97.3	95.7	97.5	106.3	117.6	122.5	116.2
LV	100	96.1	92.1	93.9	93.4	97.6	102.4	108.1	115.6	112.9	113.4
LT	100	96.8	98.4	100.1	100.9	100.3	103.7	105.2	105.4	95.8	90.6
BiH											
BG	100	102.7	99.9	101.2	97.1	95.8	92.3	97.7	101.9	102.9	103.1
HR	100	94.5	96.2	89.0	95.7	94.5	94.1	93.4	94.8	96.1	96.3
MK	100	99.2	98.8	101.5	91.4	83.5	88.7	77.3	78.0	75.2	73.0

Source: Ameco.

<sup>1</sup> Ratio of compensation per employee to nominal GDP per person employed.

Changes in the real effective exchange rate partly confirm this picture. In particular the Baltic countries' REER increased notably over time, in particular since 2006. In addition, however, also the REER in Croatia and in particular in Bulgaria appreciated over time. Only a small appreciation respectively depreciation took place in BiH and Macedonia.

Table 15: Real Effective Exchange Rate Index

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<i>2000=100</i>										
EE	100	102.1	102.6	104.9	102.8	101.0	101.4	105.0	107.4	102.1
LV	100	97.9	96.7	94.0	100.2	98.4	102.9	106.8	111.4	0.0
LT	100	99.1	103.5	102.7	100.3	98.5	99.7	103.8	107.4	107.5
BiH	100	105.0	96.3	98.9	98.4	101.4	104.8	98.1	102.3	0.0
BG	100	104.8	104.5	104.0	104.9	100.6	104.3	106.7	109.0	0.0
HR	100	103.8	101.0	100.6	102.1	102.0	102.0	100.9	103.9	0.0
MK	100	101.0	106.3	98.5	96.8	96.7	99.9	99.2	103.1	101.0

Source: EIU.

### 2.2.2 External Imbalances

The strong economic growth in recent years was also linked with external imbalances in nearly all BSEC-7 countries. Particularly in those countries where GDP growth was early on exclusively driven by domestic demand, import growth outpaced export growth, thereby putting pressure on the trade and current account balances.<sup>21</sup>

In the Baltic countries and Bulgaria the current account deficit continuously increased in the past years. In 2007 the current account deficit reached its peak in the Baltic countries and since then is on a clear downward path as the deceleration of domestic demand dampens import growth. In Bulgaria the current account deficit peaked in 2008 and is projected to ease only gradually over the forecast period. Bosnia's current account deficit has been consistently high since 2001 whereas Croatia's current account deficit increased only recently to around 10% of GDP. In the FYR of Macedonia the current account deficit was mostly more moderate but increased sharply to -7.2% of GDP in 2007. Current account balances in the Baltic countries are expected to fall significantly this year<sup>22</sup> whereas relatively few changes are expected for the SEE-4 countries. The limited or non-existent room for nominal exchange rate corrections for the BSEC-7 countries may, however, make it somewhat more difficult for them to retain or increase their export shares.

<sup>21</sup> See the Annex for the trade balance.

<sup>22</sup> According to data for 2009Q1 the current account balance has already turned slightly positive or was balanced in the Baltic countries.

*Table 16: Current Account*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
% of GDP											
EE	-5.3	-5.0	-10.4	-11.4	-12.4	-10.1	-16.7	-18.3	-9.1	-1.1	-3.1
LV	-4.8	-7.6	-6.6	-8.2	-12.8	-12.5	-22.5	-22.5	-13.6	-1.5	-1.9
LT	-5.9	-4.7	-5.1	-6.8	-7.5	-7.1	-10.4	-15.1	-12.2	-1.9	0.7
BiH	-8.7	-15.5	-21.3	-19.4	-16.3	-17.3	-7.9	-10.4	-14.6	-14.0	
BG	-5.6	-6.1	-2.7	-5.9	-6.5	-11.5	-18.6	-22.5	-22.9	-18.8	-17.2
HR	-1.1	-1.6	-6.0	-7.2	-4.5	-5.6	-7.0	-7.6	-9.5	-7.4	-8.2
MK	-2.0	-7.1	-9.5	-3.1	-8.4	-2.7	-0.9	-7.2	-13.1	-10.7	-13.5

*Source: Ameco, CBBH (until 2008) 2009 (IMF).*

In recent years there was considerable discussion about the sustainability of large external imbalances such as those in a number of BSEC-7 countries. On the one hand it was argued that “The large current account deficits [...] have plausibly facilitated a more rapid convergence rate in output and living standards” (Lane and Milesi-Ferretti 2006) although it was acknowledged that the sustainability of the rapid convergence process in these countries would depend also on the use of the incoming capital. In addition, large external imbalances raised the question about their financing. In this context it was pointed out that much of the capital inflows have taken the form of Foreign Direct Investment (FDI), which is generally assumed to be a more ‘secure’ form of external financing than e.g. short-term portfolio investments.

*Table 17: Coverage of Current Account by Net FDI*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
%									
EE	107.9	104.6	20.3	69.5	50.6	156.9	24.6	26.1	39.9
LV	105.4	18.1	41.0	28.3	29.7	28.9	33.3	29.8	26.5
LT	55.4	76.9	97.7	11.3	29.5	37.0	47.7	25.0	26.6
BiH <sup>1</sup>	33.1	14.5	20.2	23.5	43.0	30.5	69.0	104.6	33.8
BG	144.4	104.4	235.9	187.8	172.4	119.3	130.4	100.1	65.8
HR	199.9	153.2	25.3	87.7	46.8	64.6	95.1	107.3	63.1
MK <sup>1</sup>	36.9	15.9	22.5	23.5	71.4	61.5	755.5	143.0	58

<sup>1</sup> IMF Art IV.

*Note: Net FDI (inflow-outflow) includes intercompany loans.*

*Source: National central banks, IMF.*

Table 17 looks at the coverage of the current account deficit in BSEC-7 countries by net FDI. This is a rather volatile series, strongly impacted by large-scale privatisations or individual FDI inflows. Overall, however, the data shows that for the Baltic countries the coverage ratio in the later stage of the boom period tended to be lower than in the early stage. In 2007 the share of the current account deficit covered by net FDI was around one third in all Baltic countries. The situation is different for the SEE-4 countries. In Bulgaria net FDI consistently exceeded the current account deficit until 2007. In Croatia the pattern was very volatile but on average higher than in the Baltic countries and in Bosnia and the FYR of Macedonia the initially relatively low coverage ratio tended to increase over time. In 2008 the situation changed completely in the SEE-4 countries as net FDI fell sharply. Only about two thirds of the current account deficit was covered in Bulgaria, Croatia and Macedonia and only one third in BiH.

### **2.3 From Boom to Bust in the Baltic Countries**

As discussed in section 2.1 the recent growth performance of the BSEC-7 countries had similarities but also clear differences. Annual real GDP growth in the Baltic countries peaked in 2006/2007 and decelerated afterwards. By contrast, growth in the SEE-4 countries only started to decelerate in the course of 2008.

These timelines suggest that the triggers for the turning point in the growth cycle of the Baltic countries were country-specific and related to the internal and external imbalances described in section 2.2 rather than the current international financial crisis, which hit most emerging markets only in the second half of 2008. The impact of the crisis, however, severely aggravated the situation in the Baltic countries – as well as all other BSEC-7 countries.

Looking in more detail at the sequencing of events in the Baltic countries, the interaction between financial and ‘real’ sector played a key role in the process.<sup>23</sup> Exceptionally favourable external financing conditions in recent years facilitated a strong increase in domestic credit in particular for mortgages and the fixed exchange rate regimes helped to keep interest rates low. Affordable credit in turn led to an increase in domestic demand and increasing integration in the EU helped to increase exports. Strong real GDP growth resulted in rapid increases in disposable income and employment which over time fuelled inflation and increased ULC.

Higher inflation resulted in a further decline of already low real interest rates, which further stoked credit growth, domestic demand and external debt. Moreover, strong competition for market shares in the fast-growing Baltic banking markets may have had a negative impact on lending standards. At the same time, buoyant

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<sup>23</sup> For a more general description of these interactions see e.g. Martin, Schuknecht and Vansteenkiste (2007) and chapter 3 in IMF (2008b).

demand for imports resulted in large external imbalances which in turn resulted in a further increase in external debt.

In the later stage of the boom strong asset price growth in particular for housing further increased the scope for credit via increased collateral values and asset price increases resulted in exuberant expectations by economic agents as regards future asset price growth. Together these factors resulted in a self-reinforcing cycle and it became increasingly clear that the Baltic countries were overheating.<sup>24</sup>

What was the role of economic policy in the Baltic countries during the boom years? Given the fixed or almost fixed nominal exchange rate regimes in the Baltic countries, monetary policy could influence domestic liquidity conditions and thus credit growth only to a very limited extent. Latvijas Banka, the only Baltic central bank setting national policy rates, raised its key interest rate by a total of three percentage points to 6.0% between September 2002 and May 2007.<sup>25</sup> In addition, increases in the rate and base of reserve requirements were used in Latvia and Estonia. Central banks and supervisors also took measures to strengthen banks' capital bases, encourage better risk management, increase disclosure requirements, broaden the collection of information in the credit registry and made public statements on risks related to developments in the housing market.

The Baltic countries have also undertaken a number of other policy actions during the boom period. Some of these measures had the explicit aim to contribute to a cooling of the economy whereas others rather stoked the boom.<sup>26</sup>

In Latvia a so called 'anti-inflation package' was implemented in March 2007. This package consisted of a number of prudential, structural and fiscal measures. As part of this package only income declared to the tax authorities could e.g. be used to determine loan eligibility, a minimum 10% down-payment was required for all large loans to households and taxation of real estate was tightened.

As argued above it is not straightforward to assess whether fiscal policies had a counter-cyclical effect on the Baltic economies during the boom period. On balance, however, it seems that fiscal policies tended to be either insufficiently restrictive or even pro-cyclical and did not provide an important contribution to reducing macroeconomic imbalances although Estonia had consistently a stronger fiscal position than the other two Baltic countries.

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<sup>24</sup> See for example Luengnaruenmitchai and Schadler (2007), IMF (2007 and 2008a), Vamavakidis (2008) and Szekely and Watson (2009).

<sup>25</sup> The de facto impact of changes in the policy rate on monetary conditions in Latvia is, however, limited due to the large degree of euroisation.

<sup>26</sup> The measures designed to dampen economic growth sometimes reversed earlier policy measures that fuelled the boom during its early years. Latvia reduced e.g. the minimum required capital adequacy ratio from 10% to 8% in late-2004. In addition, limits on banks' open positions in euros were eliminated in early 2005, before being reinstalled in April 2007.



Labour and product markets in the Baltic countries are overall assessed as flexible and well-functioning although there is scope for further improvement (see Section 3.2). However, significant increases in minimum and public sector wages during the boom period further fuelled wage increases and thus domestic demand and external imbalances. In addition, the countries were reluctant to foster immigration, which could have helped to ease increasing labour market bottlenecks. Finally, for a long time the countries were reluctant to take measures to dampen housing market developments such as changes in the tax treatment of real estate.

What were the domestic factors triggering the economic turnaround in the Baltic countries? Again there appears to have been a close interaction between the financial sector and the real economy. Growing awareness of the risks associated with increasingly unsustainable internal and external imbalances appears to have resulted in more restrictive lending practices by commercial banks. At the same time there was some cooling of the housing markets, possibly due to the strong increase in housing supply and / or a growing realisation that prices in at least some segments of the real estate market had become out of line with economic fundamentals (see Box 2). These two mutually reinforcing effects resulted in a reversal of investment and consumption growth as well as income and profit expectations. In Latvia, the above-mentioned anti-inflation package most likely accelerated this chain of events.

To conclude, the triggers for the turning point in the growth cycle of the Baltic countries were country-specific and initially unrelated to the international financial crisis. The impact of the crisis, however, severely aggravated the situation in the Baltic countries and – as of the second half of 2008 – impacted all other BSEC-7 countries as well. The interaction between financial and ‘real’ sector played a key role in the boom-bust cycle and the ability of the Baltic authorities to influence demand conditions during these years was significantly curtailed by the rigid nominal exchange rate regimes. In addition, the policy measures used during the boom years were mostly either not effective and / or came too late. The Latvian anti-inflation package shows that an encompassing set of policy measures could have had a significant effect on credit growth and domestic demand. The package was, however, only introduced when serious internal and external economic imbalances had already been built up, making Latvia highly vulnerable to the impact of the international financial crisis.

### **3 Macro-financial and Structural Challenges**

The current international financial crisis impacts the BSEE7 countries in different ways. First, it creates difficulties to obtain financing abroad to service existing debt and to ensure further credit growth. The magnitude of these difficulties depends critically on factors such as the overall indebtedness of the economy, the share of

short-term external debt and the extent to which this is covered by reserve assets. Second, it weakens foreign demand and reduces exports, which has a negative impact on output and employment. This in turn aggravates problems in the banking sector such as an increase in non-performing loans.

The magnitude of existing economic imbalances and macro-financial vulnerabilities are important to assess how well the BSEC-7 countries are likely to cope with the current economic and financial crisis. In addition the structural features of the economies including the relative quality of the functioning of markets will be important for the speed with which they are likely to return to a growth and convergence trajectory once the current global economic crisis has come to an end.

### 3.1 Macro-financial Vulnerabilities

A key challenge for BSEE-7 countries at the current juncture is to obtain financing from abroad. The extent of this challenge is associated with the ratio between credits and deposits. In all BSEC-7 countries the credit/deposit ratio was around one in 2000. By 2008, however, it had increased to around 2 in Lithuania and Estonia and 2.5 in Latvia. By contrast there was relatively little change over time in the credit/deposit ratios in the SEE-4 countries.

*Table 18: Credit/Deposit Ratio*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
EE	1.2	1.2	1.4	1.6	1.8	1.6	1.8	2.1	2.1
LV	1.2	1.4	1.5	1.7	1.8	2.0	2.2	2.3	2.5
LT	1.0	0.9	1.0	1.2	1.2	1.4	1.5	1.8	2.1
BG	0.7	0.7	0.8	0.9	1.0	1.0	1.0	1.1	1.3
HR	1.1	0.9	1.0	1.1	1.1	1.2	1.2	1.1	1.2
MK	1.2	0.7	0.9	0.8	0.8	0.8	0.9	0.9	1.0

*Source: National central banks, OeNB.*

Looking at gross foreign debt developments the differences between the two country groups are much less developed. In the Baltic countries gross foreign debt (in % of GDP) roughly doubled between 2000 and 2008 to around 71% in Lithuania, 120% in Estonia and 128% in Latvia. Gross external debt in Bulgaria started from a much higher level than in the Baltic countries and declined initially before reaching around 108% of GDP in 2008. In Croatia one can see an almost steady increase to 83% in 2008 and in BiH and in the FYR of Macedonia there is

no clear trend with gross foreign debt oscillating around 40% and 54% of GDP respectively in 2008.<sup>27</sup>

*Table 19: Gross Foreign Debt*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
<i>in % of GDP</i>									
EE	53.0	53.6	57.9	64.5	76.0	86.1	97.7	112.4	120.2
LV	60.1	67.9	69.3	75.7	88.4	98.4	113.0	127.0	128.1
LT	42.0	43.9	39.5	40.4	42.3	50.7	60.2	72.3	71.4
BiH					47.5	52.6	48.0	48.5	40.5*
BG	86.7	78.3	64.8	59.9	63.7	70.9	81.9	100.2	107.7
HR	53.0	53.3	53.9	66.3	70.0	72.1	74.9	76.9	83.0
MK	43.2	43.5	43.5	39.7	47.9	53.9	49.1	48.4	54.2

\* 2008 projection, IMF Art. IV.

Source: National central banks, OeNB.

Short term debt levels in the BSEC-7 countries show a clear upward tendency. By 2007 this ratio exceeded 50% in Estonia and Latvia and 30% in Bulgaria. In 2008 short-term debt to GDP started to decrease in Estonia and Latvia but further increased in Bulgaria.

*Table 20: Short-term Gross Foreign Debt*

		2000	2001	2002	2003	2004	2005	2006	2007	2008
%										
EE	STD/GDP	25.0	24.1	26.2	30.9	30.5	42.9	52.5	54.2	46.6
	Reserves/STD	97.3	77.4	68.4	58.1	62.2	49.3	46.3	45.2	38.1
LV	STD/GDP			30.2	35.5	36.9	41.0	45.8	50.6	42.9
	Reserves/STD			58.1	38.0	41.0	46.8	73.8	66.1	28.4
LT	STD/GDP	9.6	13.0	13.5	15.9	15.2	19.7	18.0	18.6	20.8
	Reserves/STD	117.7	103.9	110.7	102.9	93.3	76.4	99.7	91.9	76.9
BG	STD/GDP	9.6	7.1	9.1	8.6	12.3	18.0	24.8	33.7	38.9
	Reserves/STD	257.3	343.3	280.2	326.7	263.8	173.3	132.6	115.2	89.8
HR	STD/GDP	4.5	2.4	2.0	5.7	8.7	10.3	11.9	10.3	11.1
	Reserves/STD	424.7	994.3	1134.1	441.2	256.5	231.2	214.5	241.9	191.4
MK	STD/GDP					13.4	14.8	14.1	18.1	22.5
	Reserves/STD					163.9	201.5	257.2	168.3	150.2

Source: National central banks, OeNB.

<sup>27</sup> Net foreign debt levels are much lower (between 35% and 56% of GDP) but show a clear and sometimes rapid upward trend in all countries for which data are available.

In situations where short-term external debt can not be rolled over quickly enough, foreign currency reserves can for some time be used as buffers. The extent to which BSEC-7 countries can use such buffers is, however, rather uneven across countries. The ratio of reserves to short-term debt in 2008 was between 30% and 40% in Estonia and Latvia, between 76% and 90% in Lithuania and Bulgaria and far above 100% in Croatia and the FYR of Macedonia. Compared to 2007 the ratio declined in all BSEC-7 countries, sometimes significantly.

Structural banking sector indicators show similarities as well as differences between the BSEC-7 countries. The share of foreign ownership is rather similar with between around 85 and almost 100% of the banking sector being owned by foreign parent banks.<sup>28</sup> State ownership is either low or non-existent.

Performance indicators for the banking sector show high and rising profitability for the years from 2005 to 2007 although country differences are considerable. Data for 2008 show a sharp decline in profitability for the Baltic countries and BiH whereas the figures for the other SEE-4 are almost unchanged.

Table 21: Structural Banking Indicators

	Ownership 2007			Return on assets				Return on equity			
	Foreign	Domestic	State	2005	2006	2007	2008	2005	2006	2007	2008
%											
EE	97.5	2.5	0.0	2	1.7	2.6	2	21	19.8	30.2	21.4
LV	78.2	16.3	5.5	2.1	2.1	2	0.3	27.1	25.6	24.2	4.6
LT	95.6	4.4	0.0	1.1	1.5	2	1.2	13.8	21.4	27.3	16.1
BiH	91.0	4.2	4.9	0.7	0.9	0.9	0.5	6.2	8.5	8.9	4.8
BG	84.2	15.7	0.0	2	2.2	2.4	2.1	21.4	25	24.8	23.1
HR	90.4	4.9	4.7	1.7	1.5	1.6	1.8	15.1	12.7	10.9	10.9
MK	85.9	n.a	a.a	1.2	1.8	1.8	1.9	7.5	12.3	15	16.5

Source: IMF, Global Financial Stability Report 04/2009, national central banks.

These figures are consistent with changes in the *share of non-performing loans over total loans*. Between 2002 and 2007 the share of non-performing loans dropped or remained constant in all BSEC-7 countries – hardly surprising given the very strong macroeconomic performance of the countries during these years.<sup>29</sup> The 2008 figures for Latvia, Bulgaria and in particular Estonia show an increase in the ratio of non-performing loans although in absolute terms the share of non-

<sup>28</sup> The banking sector in the Baltic countries is predominantly owned by Swedish banks, the banking sector in Bulgaria and Croatia is dominated by Austrian and Italian banks and the banking sector in BiH and FYR of Macedonia by Austrian, German and Italian banks.

<sup>29</sup> On a more cautious note Maechler et al. (2007) argue that caution regarding credit quality is justified if credit growth accelerates, which was for some years the case in some BSEC-7 countries. Stable rates of credit growth are seen as less problematic.

performing loans is still low.<sup>30</sup> The figure for Croatia has actually declined compared to 2007.

*Table 22: Non Performing Loans /Total Loans*

	2002	2003	2004	2005	2006	2007	2008
%							
EE	0.8	0.4	0.3	0.2	0.2	0.4	1.6
LV	2	1.4	1.1	0.7	0.4	0.4	2.2
LT	5.3	2.4	2.2	0.6	1.0	1.0	1.1
BiH		8.4	6.1	5.3	4	3	3.1
BG	2.6	3.2	2	2.2	2.2	2.1	2.4
HR	10.2	8.9	7.5	6.2	5.2	4.8	4.8
MK	23.1	22.1	17	15	11.2	7.5	6.6

*Source: Global Financial Stability Report 04/2009.*

As soon as the international financial crisis spread to the CESEE countries and other emerging markets (in the case of the Baltic countries even before) speculations about the risk of sovereign default in the BSEC-7 countries became topical. In this context sovereign ratings by Fitch, S&P's and Moody's have – except for Estonia and Lithuania in the case of Moody's – all been recently downgraded to 'B' levels. Furthermore the outlook is mostly seen as negative. The Fitch banking system indicator suggests a rather low overall quality of the banking system although this rating is not atypical for emerging market banking systems<sup>31</sup> and the macro-prudential indicator by Fitch suggests – by international standards – an intermediate level of vulnerability.

Another widely used indicator for market perceptions regarding the risk of sovereign default are credit default swaps (CDS) although for many BSEC-7 countries the liquidity in the markets for government bonds is low, which reduces the information contents of long-term interest yields and decreases the share of 'fundamental' information contained by CDS spreads. CDS spreads for the BSEC-7 countries have peaked in March 2009 and since then are on a decreasing trend as markets appear to have calmed down in response to IMF and EU financial assistance packages for some countries in the region. However, they are still far away from pre-crisis levels.

<sup>30</sup> Data until March 2009 show a further increase in Latvia to 7%.

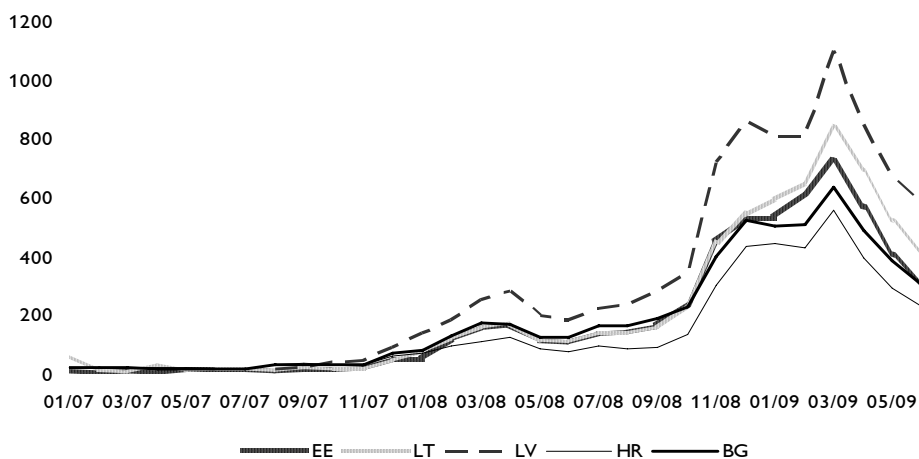
<sup>31</sup> In September 2006 half of all emerging market banking systems was placed in category 'D'.

*Table 23: Country Ratings*

	Country Rating			Moody's	Banking System Indicator (BSI)	Macro-Prudential indicator (MPI)		
	Fitch	S&P's						
		outlook		outlook				
EE	BBB+	–	A	–	A1	–	D (B)*	2
LV	BB+	–	BB+	–	Baa3	–	D (C)*	2
LT	BBB	–	BBB	–	A3	–	D	2
BiH	n.a.		B+	=	B2	=	n.a.	n.a.
BG	BBB-	–	BBB	–	Baa3	=	D	2
HR	BBB-	–	BBB	–	Baa3	=	D	2
MK	BB+	–	BB	–	n.a.		n.a.	n.a.

*Note: Figures in brackets are from April 2008.*

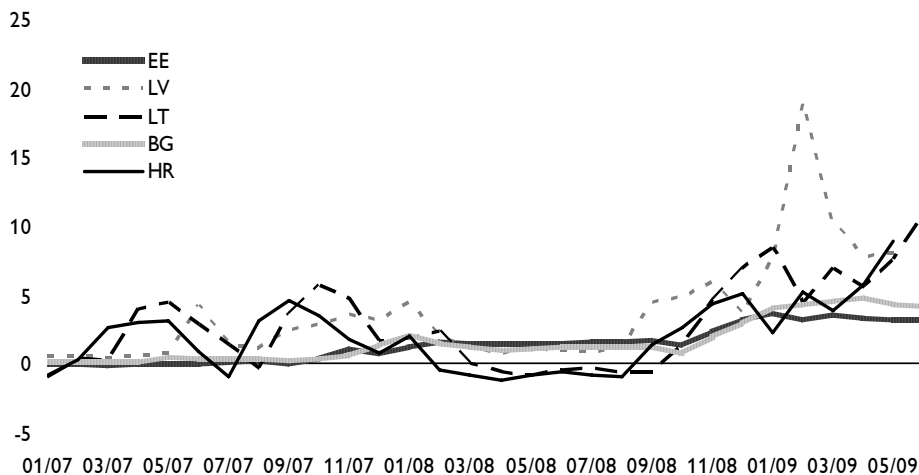
*Chart 2: Spreads for Five-Year Credit Default Swaps*



*Source: Datastream.*

Turning to exchange rate developments, the three BSEC-7 currencies with (some) nominal exchange rate flexibility (Croatian Kuna, Latvian lats and Macedonian denar) have recently experienced an increase in volatility compared to the pre-financial crisis period (see Annex).

Chart 3: Spread 1-Month Interbank/Euribor



Source: Datastream, Bloomberg.

Recent money market spread developments vis-à-vis the Euribor suggest that market confidence in the ability of some BSEE-7 countries to retain exchange rate anchors was at times weakened although the explicit aims of the IMF-led support program for Latvia to maintain the exchange rate anchor may have helped to enhance market confidence.<sup>32</sup> The spread peaked in Latvia at 19% in February 2009.

### 3.2 Structural Challenges

As argued in Section 2.1 the growth and convergence process in the BSEC-7 countries since 2000 became over time increasingly driven by domestic demand, which in turn was closely interlinked with the rapid financial deepening process and resulted in significant external imbalances. These findings are in line with Bems and Schellekens (2007) who argue that the recent rapid financial deepening process in most emerging economies in Europe benefitted disproportionately the non-tradable sector including real estate and construction.<sup>33</sup> At the current juncture, however, the BSEC-7 countries face a rather different situation characterised by a

<sup>32</sup> At times such concerns are also publicly voiced, with regard to Latvia there were a number of public comments suggesting the need for a devaluation of the currency.

<sup>33</sup> The share of GVA in construction in per cent of total GVA in the Baltic countries, Bulgaria and Croatia was between 7 and 8% in 2007 compared to around 5% in the euro area (Égert and Martin, 2009).

deep downturn of domestic growth as well as a considerable reduction in foreign demand. The impact of the latter will inter alia depend on nominal exchange rate developments in competitor countries with flexible exchange rate regimes.

This leads to a set of questions regarding the structural flexibility of the BSEC-7 economies. First, how fast can the allocation of resources between the tradable and non-tradable sector be changed? How long will it take for example for ‘inflated’ construction sectors to shrink to ‘normal’ levels?<sup>34</sup> Second, will markets be flexible enough to preserve or regain external competitiveness?

These questions require an assessment of the flexibility of capital, product and labour markets in the BSEC-7 countries, which is difficult given the lack of clarity how to define these types of flexibility and the difficulties of cross-country comparisons. One way to approach this task is to look at available indicators compiled by the EBRD, the Fraser Institute and the World Bank comparing different aspects of flexibility across large groups of countries.

The EBRD and the Fraser Institute provide various indicators with values ranging between 1 and 4+ (EBRD) respectively 1 and 10 (Fraser Institute). The World Bank summary indicators show country ranks out of a total of 181 countries.

*Table 24: European Bank for Reconstruction and Development*

	<b>Banking sector reform</b>	<b>Enterprise Reform</b>	<b>Competition Policy</b>	<b>Infrastructure reform</b>
<b>EE</b>	4.0	3.7	3.7	3.3
<b>LV</b>	4.0	3.0	3.0	3.0
<b>LT</b>	3.7	3.0	3.3	3.0
<b>BiH</b>	3.0	2.0	2.0	2.3
<b>BG</b>	3.7	2.7	3.0	3.0
<b>HR</b>	4.0	3.0	2.7	3.0
<b>MK</b>	3.0	2.7	2.3	2.3

*Source: EBRD Transition Report 2008; data refer to 2008.*

*Note: 4,3 is the maximum value (standards and performance typical of advanced industrial economies).*

<sup>34</sup> Public expenditure programs with a strong focus on construction may cushion the short-term impact of the current financial crisis on growth but may also extend the structural adjustment period.



Table 25: Fraser Institute

	Credit Market Regulations	Business Regulations	Labour Market Regulations	Summary Indicator (Rank)
<b>EE</b>	10.0	7.7	5.2	7,9 (11)
<b>LV</b>	9.7	6.7	5.7	7,3 (40)
<b>LT</b>	9.6	6.8	4.9	7,4 (31)
<b>BiH</b>	9.5	4.5	5.9	6,0 (105)
<b>BG</b>	9.2	5.1	7.0	6,8 (68)
<b>HR</b>	8.8	5.6	5.6	6,4 (90)
<b>MK</b>	8.9	6.3	6.1	6,4 (85)

Source: Fraser Institute: *Economic Freedom of the World 2008*; data refer to 2006.

Note: Summary indicator values are between 1 and 10; ranks are out of a sample of 141 countries.

Table 26: World Bank

	Getting Credit	Starting a Business	Closing a Business	Dealing with Construction Permits	Registering Property	Employing Workers	Ease of Doing Business Rank (Summary)
<b>EE</b>	43	23	58	19	24	163	22
<b>LV</b>	12	35	86	78	77	103	29
<b>LT</b>	43	74	34	63	4	131	28
<b>BiH</b>	59	161	60	137	144	117	119
<b>BG</b>	5	81	75	117	59	60	45
<b>HR</b>	68	117	79	163	109	146	106
<b>MK</b>	43	12	129	152	88	125	71

Source: World Bank – *Doing Business 2009*; data refer to 2008.

Note: Ranks are out of a sample of 181 countries.

Starting with capital markets indicators, all BSEC-7 countries and in particular the Baltic countries seem to do rather well by international standards. Some weaknesses are, however, shown by the EBRD indicator for banking sector reform in BiH and Macedonia. Moreover, credit markets in Croatia get a relatively weaker assessment by the Fraser Institute and the World Bank although the EBRD's banking sector reform indicator has a very high value.<sup>35</sup>

Turning to product markets and 'business' indicators the picture is more mixed. According to the EBRD, enterprise reforms are less advanced in the SEE-4

<sup>35</sup> As mentioned above the Fitch banking system indicator suggests by contrast a rather low overall quality of the banking system in the BSEC-7 countries although the rating is in line with the assessment for many other emerging markets.

countries (except Croatia) than in the Baltic countries and the same picture emerges from the Fraser Institute's business regulation index. Selected World Bank indicators in this field suggest, however, that it is relatively burdensome by international standards to start a business in Lithuania (as well as in BiH and Macedonia). In addition, in most BSEC-7 countries it appears to be relatively burdensome to close a business. It is also interesting to note that Estonia, Lithuania and Bulgaria do rather well on real estate related indicators whereas the other SEE-4 countries do rather badly. All BSEC-7 countries still have room for improvements when it comes to infrastructure reform, in particular BiH and Macedonia.

As far as labour market indicators are concerned, the relative international position of the Baltic countries, in particular Estonia and Lithuania, is somewhat poorer than for capital and product markets.<sup>36</sup> The SEE-4 countries are also not doing too well except for Bulgaria which has the best score out of these seven countries both for the Fraser Institute labour market regulations indicator and the World Bank's employing workers indicator.<sup>37</sup>

The overall summary ranks provided by the Fraser Institute and the World Bank suggest that the Baltic countries - and in particular Estonia - have by international standards very flexible economies Bulgaria is also doing rather well by international standards. Macedonia, Croatia and BiH (in this order) have the lowest summary indicator ranks.

## 4. Conclusions

The catching-up process of many BSEC-7 countries in particular the Baltic countries but also Bulgaria and Croatia during the period 2000 to 2007 was impressive. The main drivers of this process changed notably over time. In 2000, net exports still made a considerable positive contribution to real GDP growth in some BSEC-7 countries. In 2007, however, GDP growth in all BSEC-7 countries was exclusively driven by domestic demand which in turn was fuelled by rapid financial deepening made possible by easy access to international capital and low global interest rates.

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<sup>36</sup> Data compiled by the World Economic Forum suggests, however, that the wage determination is very flexible in all three Baltic countries (World Economic Forum 2008).

<sup>37</sup> The relatively weak position with regard to structural labour market indicators could be partly related to tight labour markets in some BSEC-7 countries and the associated increase in the bargaining power of labour, not only with regard to wages but also with regard to structural labour market features such as employment protection and minimum wages. The relatively good performance of Bulgaria, however, casts some doubts on this argument.

Credit growth to the private sector – often denominated in foreign currency – was strong in all BSEC-7 countries, in particular in the Baltic countries and Bulgaria and the stock of domestic credit to the private sector increased considerably. The rapid financial deepening process was fostered by decreasing nominal and real interest rates – not least due to the fixed exchange-rate regimes in the BSEC-7 countries – and rapidly growing asset prices, in particular real estate prices. A number of other factors are also likely to have played a role in stoking domestic demand in some BSEC-7 countries and fiscal policy tended to be either insufficiently restrictive or even pro-cyclical.

Fast growth and real convergence resulted in substantial internal and external macroeconomic imbalances. HICP inflation in the Baltic countries and Bulgaria increased to double-digit figures in 2008 and also Croatia and the FYR of Macedonia experienced a large increase in inflation in 2008. Inflationary pressures were mostly broad-based, with large contributions coming from external factors as well as adjustments in taxes and excise duties. There were, however, also large increases in services prices mainly reflecting the tightening labour market situation in most BSEC-7 countries. Strong economic growth created also significant current account deficits in some BSEC-7 countries. Additional production was concentrated on meeting domestic demand, rather than on the tradable sector and real appreciation may have had a negative impact on competitiveness. The coverage of the current account deficits by net FDI inflows for the Baltic countries tended to decrease over time to around one third in 2007 but exceeded 100% in all SEE-4 countries until 2007.

The triggers for the turning point in the growth cycle of the Baltic countries were country-specific and initially unrelated to the current international financial crisis. The impact of the crisis, however, severely aggravated the situation in the Baltic countries and since the second half of 2008 impacts all BSEC-7 countries in a number of ways. First, it increases the price of foreign capital and may create difficulties to obtain financing abroad. Second, it weakens foreign demand and reduces exports, which has a negative impact on output and employment. This in turn aggravates problems in the banking sector such as an increase in non-performing loans.

The challenge to obtain financing from abroad is associated with the credit/deposit ratio, which has strongly increased in the Baltic countries in particular. Developments in foreign debt are more similar across countries with foreign debt exceeding by mid-2008 100% of GDP in Estonia, Latvia and Bulgaria. Short term debt levels also show a clear and sometimes rapid upward trend across the BSEE7 countries, implying a considerably higher need to obtain short-term external financing than a few years ago. Foreign currency reserves as a share of short-term debt are rather uneven across countries and well below 100% in the Baltic countries and Bulgaria.

Key banking sector indicators show that the share of foreign ownership is rather similar across the BSEC-7 countries and Performance indicators for the banking sector show high and rising *return on equity rates* for the years 2003 to 2007. For some countries data for 2008 show a sharp decline in profitability and a strong increase in the ratio of non-performing loans. Sovereign ratings for the BSEC-7 countries have almost all been downgraded recently and CDS spreads for the BSEC-7 countries have soared. BSEC-7 currencies with (some) nominal exchange rate flexibility have recently experienced increased volatility and recent money market spreads vis-à-vis the Euribor suggest that market confidence in the ability of some BSEC-7 countries to retain exchange rate anchors was at times weakened.

The current deep downturn of domestic demand in conjunction with a considerable reduction in foreign demand and the need in some countries to re-allocate resources between the tradable and non-tradable sector requires considerable flexibility of capital, product and labour markets in the BSEC-7 countries. Looking at available flexibility indicators all BSEC-7 countries and in particular the Baltic countries seem to do rather well as regards capital market indicators although some weaknesses are shown in BiH, the FYR of Macedonia and Croatia. For product markets and 'business' indicators the picture is more mixed. Enterprise reforms appear less advanced in the SEE-4 countries except Croatia than in the Baltic countries but there are some weak aspects in all BSEC-7 countries. As regards labour market indicators, the position of the Baltic countries is somewhat poorer than for capital and product markets and the SEE-4 countries are also not doing too well except for Bulgaria. Overall summary ranks suggest, however, that the Baltic countries and Bulgaria have by international standards very flexible economies.

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## Annex: Tables

Annex Table 1

Private Final Consumption Expenditure Growth, Constant Prices											
%	2000]	2001]	2002]	2003]	2004]	2005]	2006]	2007]	2008]	2009]	2010]
EE	7.2	7.4	11.0	10.0	9.5	9.9	12.7	7.9	-3.8	-9.0	-1.3
LV	6.8	7.5	7.1	8.4	9.7	11.2	21.2	14.8	-11.0	-22.0	-6.5
LT	5.5	4.2	6.0	10.4	11.9	12.2	10.6	12.4	4.7	-17.5	-7.2
BH											
BG	4.4	5.2	7.2	5.5	5.9	6.1	9.5	5.3	4.8	-0.3	0.1
HR	4.2	4.3	8.1	4.8	4.1	4.2	2.6	6.2	0.8	-2.5	2.0
MK	11.2	-11.6	12.5	-1.5	8.0	5.7	6.0	9.8	7.8	2.0	3.0

Source: Ameco.

Annex Table 2

Gross Fixed Capital Formation Growth, Constant Prices											
%	2000]	2001]	2002]	2003]	2004]	2005]	2006]	2007]	2008]	2009]	2010]
EE	16.9	9.6	24.0	19.0	4.8	8.3	20.1	7.6	-10.4	-20.7	-1.2
LV	10.2	11.4	13.0	12.3	23.8	23.6	16.4	7.5	-13.2	-24.0	-8.0
LT	-9.0	13.3	10.6	13.7	15.7	11.2	19.4	20.8	-6.1	-22.1	-7.3
BH											
BG	15.4	23.3	8.5	13.9	13.5	23.3	14.7	21.7	20.4	-12.7	-2.0
HR	-3.9	7.1	14.0	24.8	5.0	4.9	10.9	6.6	8.2	-7.5	5.0
MK	-1.5	-8.6	17.6	1.1	10.9	-5.4	11.6	13.1	18.8	-11.6	2.0

Source: Ameco.

Annex Table 3

Export Growth											
%	2000]	2001]	2002]	2003]	2004]	2005]	2006]	2007]	2008]	2009]	2010]
EE	38.0	6.8	-0.9	9.4	16.8	26.0	19.5	7.1	6.5	-17.0	-0.4
LV	14.9	9.7	8.5	14.3	21.5	32.6	15.7	24.5	8.8	-19.8	0.0
LT	20.6	18.3	13.3	6.2	12.0	27.0	18.0	9.1	24.9	-19.6	3.1
BH											
BG	40.6	10.8	1.2	10.5	19.9	16.5	23.7	12.5	12.6	-15.5	7.7
HR	23.9	12.5	2.3	14.0	9.0	6.1	10.3	8.2	6.7	-2.6	3.9
MK	30.4	-13.2	-7.1	2.7	14.5	19.5	14.8	26.5	10.7	-12.9	4.4

Source: Ameco.

Annex Table 4

Import Growth											
%	2000]	2001]	2002]	2003]	2004]	2005]	2006]	2007]	2008]	2009]	2010]
EE	34.6	5.6	6.1	9.8	17.3	22.2	26.5	7.5	-1.7	-20.6	1.5
LV	9.3	15.4	9.3	19.8	26.8	27.3	31.5	24.4	-3.2	-32.3	4.2
LT	9.1	15.3	13.1	6.7	14.2	25.7	23.1	16.0	18.9	-30.4	0.6
BH											
BG	36.4	14.9	3.5	14.2	20.0	22.9	25.8	17.5	15.0	-16.9	5.0
HR	14.0	13.6	13.1	12.2	5.7	6.5	11.2	9.6	8.7	-5.7	6.0
MK	37.7	-11.8	7.2	-2.8	19.0	9.8	15.2	23.4	22.3	-12.0	8.5

Source: Ameco.

Annex Table 5

Employment Rate											
%	2000]	2001]	2002]	2003]	2004]	2005]	2006]	2007]	2008]	2009]	2010]
EE	41.9	42.4	43.2	44.0	44.1	45.3	48.2	48.9	48.5	47.6	47.1
LV	39.8	41.0	41.9	42.9	43.6	44.6	46.9	48.8	49.6	47.9	47.1
LT	40.0	38.7	40.2	41.3	41.5	42.8	43.8	44.9	44.5	43.4	42.9
BH*		40.6			44.9						
BG	39.7	40.7	41.1	42.5	43.9	45.3	46.9	48.2	50.0	51.0	51.9
HR	34.9	33.0	34.3	34.6	35.1	35.4	35.7	36.3	36.7	37.0	37.3
MK	24.2	23.7	23.8	23.2	22.7	23.1	23.8	24.6	25.3	26.1	27.0

\*EBRD

Quelle: Ameco.

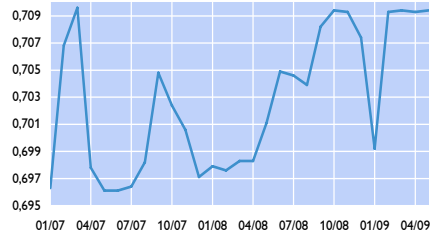
Annex Table 6

Trade Balance as % of GDP, Current Prices, LC											
%	2000]	2001]	2002]	2003]	2004]	2005]	2006]	2007]	2008]	2009]	2010]
EE	-3.6	-2.5	-7.4	-7.5	-8.2	-6.3	-11.5	-10.9	-4.4	-0.9	-2.2
LV	-7.0	-9.5	-9.7	-12.6	-15.6	-14.4	-21.5	-20.2	-13.1	-4.3	-2.7
LT	-6.3	-5.5	-5.7	-5.8	-7.1	-7.1	-10.2	-13.4	-11.2	-1.5	0.5
BH					-45.6	-45.8	-34.9	-38.4	-40.2	-37.9	-38.7
BG	-5.4	-7.6	-8.4	-10.8	-11.5	-16.2	-18.8	-22.1	-22.8	-17.5	-16.5
HR	-3.2	-3.9	-8.3	-7.9	-6.4	-6.5	-7.0	-7.6	-8.4	-7.0	-7.8
MK	-14.9	-13.9	-20.1	-17.0	-20.7	-17.4	-18.6	-18.8	-26.0	-22.3	-25.0

Quelle: Ameco, IMF (BH Art IMF IV).

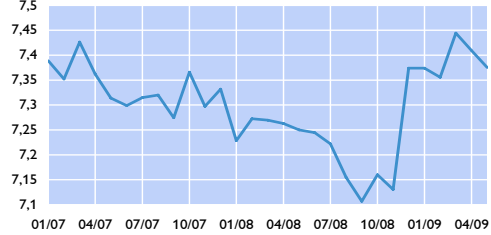
## Annex Charts: Exchange Rates

**Latvian Lat EUR/LVL**



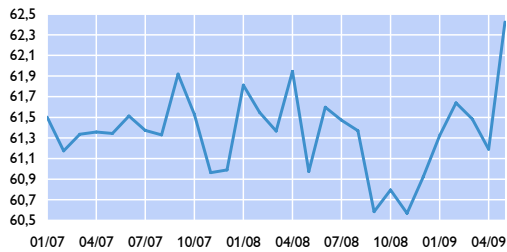
Source: Bloomberg

**Croatian Kuna HRK/EUR**



Source: Bloomberg

**Macedonian Denar MKD/EUR**



Source: Bloomberg