Economic Adjustment in the Baltic countries

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Topics

A. Comparison with adjustment in other countries before/during previous recessions

B. Comparison with other small euro-area countries (Ireland, Greece and Portugal)

C. The advantages/disadvantages of sharp versus gradual adjustment
A. Comparison of the adjustment in the Baltic countries with the adjustment in other countries before/during previous recessions
A. The adjustment in the Baltic countries in international comparison: methodology and data

A cyclical peak is defined when the quarterly GDP is higher than in the two preceding quarters and higher than during the next two quarters.

A cyclical trough is defined when the quarterly GDP is lower than in the two preceding quarters and lower than during the next two quarters.

Sample: 23 advanced economies and 18 emerging market economies

Data: 1960 Q1 – 2012 Q2, seasonally adjusted, constant prices.

Source: IMF IFS database

Variables: (1) GDP;
(2) net foreign capital inflows;
(3) real interest rates;
(4) CPI-based REER,

Altogether 188 episodes of recession

We concentrate on developments four years before and three years after the peak in output level.
A. A comparison of the 2007-2009 recession in the Baltic countries with previous cycles in other countries: real GDP

A. GDP dynamics during four years before the cyclical peaks (t-15=100)

B. GDP dynamics during three years after the cyclical peaks (t0=100)
A. A comparison of the 2007-2009 recession in the Baltic countries with previous cycles in other countries: net foreign capital inflows

A. Net foreign capital inflows during four years before the cyclical peaks (% of GDP)

B. Net foreign capital inflows during three years after the cyclical peaks (% of GDP)
A. A comparison of the 2007-2009 recession in the Baltic countries with previous cycles in other countries: real interest rates

A. Real interest rates during four years before the cyclical peaks (%)

B. Real interest rates during three years after the cyclical peaks (%)
A. A comparison of the 2007-2009 recession in the Baltic countries with previous cycles in other countries: price competitiveness

A. Real effective exchange rate dynamics four years before the cyclical peaks (t-15=100)

B. Real effective exchange rate dynamics three years after the cyclical peaks (t0=100)
A. The adjustment in the Baltic countries in international comparison: summary

Recent cyclical developments in the Baltic countries are similar to the general pattern of economic cycles seen in emerging markets.

The business cycles of emerging market economies are characterised by:

1. high volatility of macroeconomic variables;
2. sudden stops in capital inflows;
3. consumption volatility exceeding output volatility;
4. countercyclical trade balance;
5. countercyclical real interest rates.

Similar developments were seen in the Baltic countries.

In comparison with previous recessions, the Baltic countries stand out in terms of:

1. unusually high degree of volatility in most of the economic variables;
2. large changes in domestic demand and high external and financial vulnerabilities.

However, fiscal and competitiveness variables did not exhibit a high degree of volatility.
B. Comparison of the adjustment in the Baltic countries with the adjustment in Greece, Ireland and Portugal
B. Changes in GDP since 2007 among selected EU countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Change in GDP from cyclical peak to trough during 2007-09 crisis</th>
<th>Change in GDP from cyclical peak in 2007/08 to current GDP level (2012 Q2)</th>
<th>GDP level in 2012Q2 (2000=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia</td>
<td>-24.6%</td>
<td>-15.1%</td>
<td>156.9</td>
</tr>
<tr>
<td>Estonia</td>
<td>-19.5%</td>
<td>-6.3%</td>
<td>157.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-15.9%</td>
<td>-6.4%</td>
<td>166.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>-10.7%</td>
<td>-8.4%</td>
<td>132.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>-4.1%</td>
<td>-6.4%</td>
<td>102</td>
</tr>
<tr>
<td>Greece</td>
<td>...</td>
<td>-18.3%</td>
<td>110.9</td>
</tr>
<tr>
<td>Spain</td>
<td>-4.9%</td>
<td>-5.3%</td>
<td>121.6</td>
</tr>
<tr>
<td>Italy</td>
<td>-7.1%</td>
<td>-6.9%</td>
<td>101.9</td>
</tr>
<tr>
<td>Cyprus</td>
<td>-3.0%</td>
<td>-2.3%</td>
<td>130.2</td>
</tr>
<tr>
<td>EU-27 average</td>
<td>-8.4%</td>
<td>-3.6%</td>
<td>130.2</td>
</tr>
</tbody>
</table>

Source: Eurostat.
B. Real GDP: Baltic countries vs Greece, Ireland and Portugal

GDP (quarterly) dynamics and forecast after the cyclical peaks in 2007-08 (t0=100)

Note: E-3 – Ireland, Greece and Portugal

Source: Eurostat, IMF WEO October 2012 database.
B. Private consumption: Baltic countries vs Greece, Ireland and Portugal

Private consumption (quarterly) dynamics after the cyclical peaks in 2007-08 (t0=100)

Source: Eurostat.
B. Unemployment: Baltic countries vs Greece, Ireland and Portugal

Unemployment (quarterly) dynamics and forecast after the cyclical peaks in 2007-08 (%)

Source: Eurostat, IMF WEO October 2012 database.
B. ULC-based REER: Baltic countries vs Greece, Ireland and Portugal

ULC-based REER (quarterly) dynamics after the cyclical peaks in 2007-08 (t0=100)

Source: Eurostat.

Baltic countries vs Greece, Ireland and Portugal
B. Current account balance: Baltic countries vs Greece, Ireland and Portugal

Current account balance dynamics and forecast in 2007-14 (% of GDP)

Source: Eurostat, IMF WEO October 2012 database.
B. Fiscal balance: Baltic countries vs Greece, Ireland and Portugal

Fiscal balance dynamics and forecast in 2007-14 (% of GDP)

Source: Eurostat, IMF WEO October 2012 database.
B. Public and private indebtedness: Baltic countries vs Greece, Ireland and Portugal:

A. Public debt in 2007 and 2011 (% of GDP)

B. Private debt in 2007 and 2011 (% of GDP)

Source: Eurostat.
B. A comparison of the adjustment in the Baltic countries vs Greece, Ireland and Portugal: summary

1. Relatively fast adjustment in the Baltics versus slower adjustment in Greece, Ireland and Portugal.

2. Sudden stop in capital inflows in the Baltics versus gradual adjustment in Greece, Ireland and Portugal (central bank liquidity and official financing replacing private capital inflows).

3. Steep rise in public debt in Greece, Ireland and Portugal versus moderate increase in public debt in the Baltics.

4. Significant increase in private debt in Greece, Ireland and Portugal versus decline in private sector indebtedness in the Baltic countries.

5. Similar developments in cost competitiveness (ULC-based REER).
C. The advantages/disadvantages of sharp versus gradual adjustment

**Disadvantages** of sharp adjustment:
- due to overreaction ‘viable’ firms might be forced out of business leading to losses in physical and human capital;
- politically difficult if electorate not informed/reluctant;
- the high speed of the adjustment might lead to mistakes in economic policy.

**Advantages** of sharp adjustment:
- a shorter period of high uncertainty weighing on economic activity (especially on investment decisions);
- faster closure of ‘non-viable’ firms (elimination of unsustainable businesses/activities)
- avoid reform fatigue;
- avoid excessive accumulation of public and private debt.
C. Why were sharp adjustments possible in the Baltic countries?

Sharp adjustment was to a large extent inevitable:
- A sudden stop and subsequent outflow of private capital on a very large scale;
- Negative trade shock (stronger than in most of the EU countries);
- The absence of effective countercyclical policies or policy space.

The Baltic economies were resilient:
- Banking sectors largely owned by strong foreign banks with good access to central bank’s liquidity assistance (e.g. Swedish banks);
- Strong growth potential;
- Banks in the Baltics were overall well capitalised;
- Labour markets relatively flexible;
- Large tradable sectors.

Relatively high popular acceptance of adjustment:
- An acceptance that a significant part of the growth (especially in real estate sector/construction) was unsustainable;
- “Good times” in years before the crisis;
- Emigration “valve”.

C. Stable growth ahead for the Baltic countries?

Adjustment has provided a more solid foundation:
- External and financial vulnerabilities greatly reduced;
- Significant sectoral reorientation achieved;
- Elimination of unsustainable activities/businesses.

But cyclical shocks still a challenge:
- Need to step in earlier/more aggressively to avoid the creation of vulnerabilities;
- A more active use of fiscal and macro-prudential measures;
- The resilience of the economies has to be maintained.