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Editorial

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On March 23, 2009 the Oesterreichische Nationalbank organized the workshop *Recent Developments in the Baltic Countries – What Are the Lessons for Southeastern Europe*. The main purpose of the workshop was to review recent economic developments in the Baltic countries and to investigate to what extent the four Southeastern European (SEE-4) countries with comparable monetary policy frameworks, i.e. limited or zero nominal exchange rate flexibility, can draw lessons from the recent boom and bust cycle in the Baltics.[1] The contributions to the workshop thus focused on presenting and discussing country-specific experiences and – notwithstanding the considerable differences between the individual countries – identifying economic policy lessons that can be useful for other countries facing comparable economic challenges.

One or two years ago economic developments in these countries were characterized by different degrees of overheating with financial deepening, increases in real estate prices, EU funding, remittances and expansive fiscal policies being the main drivers of the growth and convergence process. More recently, however, since the 4th quarter of 2008, the situation has changed dramatically and we see now significant recessions or at least severe economic downturns. The countries experience a very strong reduction of capital inflows or in some cases even a reversal of net financial flows. There is a sharp decline of credit growth rates, a sharp decline of wages and an increase in unemployment. Exports are also declining as a result of shrinking external demand. The signs of the previous overheated catching-up processes like double-digit inflation rates and

[1] The four SEE countries with a comparable monetary policy framework are Bosnia and Herzegovina (BH), Bulgaria, Croatia and the Former Yugoslav Republic (FYR) of Macedonia. The euroized economies of Kosovo and Montenegro can also be subsumed under this category but these two countries were not discussed during the workshop.

current account deficits are rapidly vanishing.[2] Instead in particular the Baltic countries are now facing painful adjustment processes with fiscal 'austerity packages' including sizeable reductions in public sector wages and pensions. In the case of Latvia an IMF-EU led financial assistance package became necessary already at the end of 2008 in order to stabilize the Latvian economy. Moreover, there are at times public debates about whether the fixed or tightly managed exchange rate regimes in the Baltics or the SEE-4 countries will survive the current economic and financial crisis.

The presentations and discussions at the workshop showed that a number of macro- and microeconomic lessons can be drawn from the Baltic experience and that these lessons are also relevant for other emerging European countries including the SEE countries. At the same time, however, there are obvious caveats regarding the transferability of such lessons! First and foremost it should be kept in mind that the Baltic countries and – even more so – the SEE-4 countries are a rather heterogeneous group of countries. Country-specific determinants are therefore often of key importance for economic developments. By and large, however, it is fair to say that the Baltics are already further down the *Convergence Road* than most SEE-4 countries in terms of economic developments and institutional integration in the EU. Second, many of the lessons to be drawn from the boom and bust experience of the Baltic countries relate to a world where external capital was readily available and relatively cheap. In the context of the international financial crisis this has changed considerably.

Turning first to fiscal policy, the experience of the Baltic countries shows that fiscal policy should be countercyclical during boom periods and create room for macroeconomic manoeuvre in times of need. The most positive example in this regard is Estonia.[3] Although there was still some pro-cyclicality in fiscal policy in some years, the Estonian government had growing budget surpluses since 2001. The fiscal surplus reached approximately 3% of GDP in 2006 and 2007 and the government sector piled up more than 10% of reserves at the end of 2007 with almost no debt at the central government level. Fiscal policy was considerably less prudent in Latvia and Lithuania as well as – with the exception of Bulgaria – in the SEE-4 countries. As a result, public finances in particular in Latvia and Lithuania are now facing huge adjustment needs resulting in painful and politically difficult austerity packages that aggravate the serious economic downturn in these countries.

[2] For a discussion on the role of the Balassa-Samuelson effect in recent inflation developments see the contribution by Dubravko Mihaljek and Marc Klau, Catching-up and Inflation in the Baltics and Southeastern Europe: The Role of the Balassa-Samuelson Effect, pp. 59–81.

[3] See the contribution by Ülo Kaasik, Reserves Can Help – the Case of Estonia, pp. 82–91.

The workshop illustrated also that the selection of the appropriate exchange rate regime in small open catching-up economies remains a difficult issue. All countries represented at the workshop adopted at an early point of their transition process to monetary policy frameworks which are based on limited or zero nominal exchange rate flexibility and four of the seven countries operate currency boards vis-à-vis the euro. Such fixed ER anchors have obvious advantages and, as emphasized by all country representatives, can be of great help to ensure macroeconomic stability including low inflation. At the same time the Baltic experience shows that fixed exchange rate regimes can lead to very low or negative real interest rates which in turn can accelerate the financial deepening process and GDP growth beyond sustainable levels. In addition, they are likely to increase the share of foreign-currency denominated credits, which increases the foreign-currency risks that individuals and – collectively – the countries are facing.[4] Can exchange-rate regime shifts be a viable policy option? There was consensus among the participants that such a shift would be very difficult and – depending on the country-specific situation – may well be prohibitively expensive. At the same time, however, recent developments in Latvia show that it can also be very difficult and expensive to defend an existing exchange rate regime if the accumulated economic imbalances become excessively large. Looking more systematically at the trade-offs between defending and abandoning existing exchange-rate regimes the flexibility of markets and the extent to which there are unhedged foreign exchange exposures are key variables to assess. [5] This implies a number of concrete lessons. First, once a country decides to adopt a fixed exchange-rate regime it needs to ensure that it's markets are sufficiently flexible to allow an 'internal' adjustment process if needed, i.e. an adjustment process that does not include a change in the nominal exchange rate vis-à-vis the anchor currency. Second, countries with a fixed exchange-rate regime are well advised to try to keep their unhedged foreign exchange exposure limited in order to limit the costs of a change in the exchange-rate regime – should such a change become unavoidable. In this context the experience of Croatia is very interesting. The Hrvatska Narodna Banka used a broad range of measures to slow down the build-up of external vulnerabilities which appears to have had a positive impact on the structure of debt capital inflows as well as the soundness of domestic banks.

The third macroeconomic issue that emerged from the contributions to and discussions at the workshop is the need for a more balanced growth pattern, based on both domestic growth as well as a positive contribution from net exports. Such a *two-pillar* approach to growth can reduce the risk of boom-bust cycles as

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[4] See the contribution by Reiner Martin and Claudia Zauchinger, Recent Developments in the Baltics and Southeastern European Countries with Low Nominal Exchange Rate Flexibility, pp. 10–47.

[5] See the contribution by Max Watson, Financial Stability in a Brave New World: The Challenges for Southeastern Europe, pp. 48–58.

experienced by the Baltic countries. In this context it is important to keep in mind that the Baltic countries initially entered the *bust* period as a result of excessive domestic economic imbalances. This took place already before the effects of the international financial crisis reached emerging European economies, although the latter in turn obviously worsened the situation in the Baltics considerably. The aim to have a more balanced growth strategy in turn raises two questions. First, how can domestic *bubbles* be avoided? Second, how can external competitiveness be maintained respectively increased?

It is obviously a very difficult task to avoid domestic *bubbles* in countries that are experiencing rapid financial deepening driven by readily available foreign capital. Nevertheless, a number of lessons can be drawn from the experience of the Baltic countries. First, governments should prevent over-optimistic expectations regarding future incomes and asset / real estate prices taking hold.[6] This can be done e.g. by appropriate public wage setting, prudent fiscal policy or simply appropriate communication with the general public. Second, governments including the monetary authorities should try to avoid 'excessive' growth rates of credit – both by banks and non-banks. Clearly this is a very difficult task requiring not only to determine whether credit growth is excessive[7] but also – if there is sufficient evidence that this is the case – to implement suitable measures to curb credit growth. Some measures that would appear to be suitable in this case are the establishment of a central credit registry and the abolition of policy measures that fuel real estate – and thus mortgage credit booms. The tax deductibility of interest paid on mortgages which still exists in some countries can for example be abolished and property taxes can be increased respectively introduced.[8]

The second precondition for a balanced growth strategy, the need to maintain or ideally increase external competitiveness, is not any easier to achieve. The recommendations emerging from the contributions to and discussions at the workshop are rather traditional insofar as they were part of most international policy advice given to emerging European economies over the past years. First, the need to maintain respectively promote labor market flexibility and to avoid labor market bottlenecks during periods of rapid growth, e.g. by means of suitable education and training measures, a well-designed migration policy etc. Second, the need to maintain respectively promote product market flexibility and to maintain respectively enhance the attractiveness for inward FDI. Suitable labor and product market measures can also help exporting companies to climb the *quality ladder*,

[6] The contribution by Raimondas Kuodis and Tomas Ramanauskas, From Boom to Bust: Lessons from Lithuania (pp. 102–115), looks at the reasons why the irrational exuberance associated with the large-scale 'import' of foreign capital was often incorrectly assessed.

[7] See the contribution by Ljubinko Jankov, Spillovers of the Crisis: How Different Is Croatia?, pp. 126–134.

[8] Regarding this issue see e.g. the contribution by Santa Berzina, Assessment of Past Developments and Economic Policy Challenges in Latvia, pp. 92–101.

thus making them less vulnerable to negative repercussions of real wage increases for their international competitiveness.[9] Cross-country indicators for economic attractiveness and economic flexibility (e.g. by the World Bank and the Fraser Institute) suggest that the Baltic countries as well as Bulgaria have overall rather flexible economies although there are also areas where improvements would be desirable. For the other SEE-4 countries the indicators suggest even bigger needs for improvement.[10]

Summing up, the findings of the workshop summarized in this volume suggest that a careful review of the Baltic *boom and bust cycle* can provide valuable lessons for the SEE-4 countries as well as other emerging European economies. Obviously it is important to keep in mind that many of the lessons to be drawn from the boom and bust experience of the Baltic countries relate to a world where external capital was readily available and relatively cheap, a situation which has changed considerably due to the international financial crisis. In case foreign capital will soon become readily available again in the SEE region and emerging Europe more generally, many of the lessons from the Baltic experience will be directly applicable, e.g. the need to avoid real estate bubbles as a result of excessively fast financial deepening and the need to strengthen financial sector supervision in case of excessively strong credit growth, in particular if credit are mostly denominated in foreign currency. Even if the current crisis turns out, however, to be a *watershed*, requiring a structural change in the growth pattern of the region (e.g. more reliance on domestic rather than foreign capital and more labor- and productivity- rather than capital-intensive growth) there are important lessons to be learnt from the Baltic boom and bust cycle, e.g. regarding the need for sound fiscal policy and well-targeted structural reforms.

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[9] The contribution by Amir Hadziomeragic, The Current Crisis – a Challenge as Well as a Chance to Implement Needed Reforms, pp. 116–125 presents the current crisis not only as an economic challenge but also as a chance to make progress with structural reforms.

[10] These indicators are reviewed in the contribution by Reiner Martin and Claudia Zauchinger, Recent Developments in the Baltics and Southeastern European Countries with Low Nominal Exchange Rate Flexibility, pp. 10–47.