

Convergence in the Baltics: From Boom to Bust?



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CASE
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EU15:

Population: 332.1 mn

GDP PPP per capita: 27.600

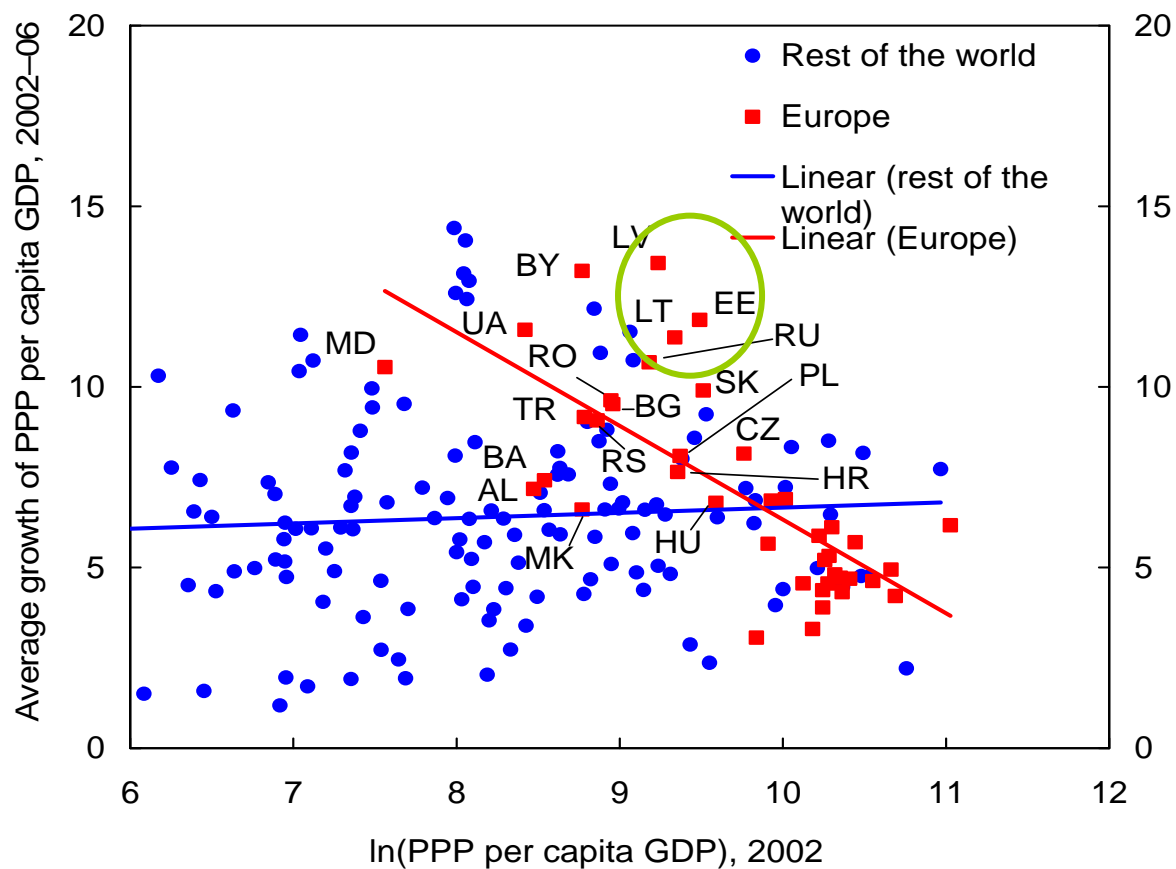


Outline

- What drove the Baltic boom...
- ...and why is it coming to an end now?
- Vulnerabilities: external imbalances and foreign exchange mismatches
- Why the Baltics are different
- How to achieve a soft landing—
avoiding the Portuguese trap

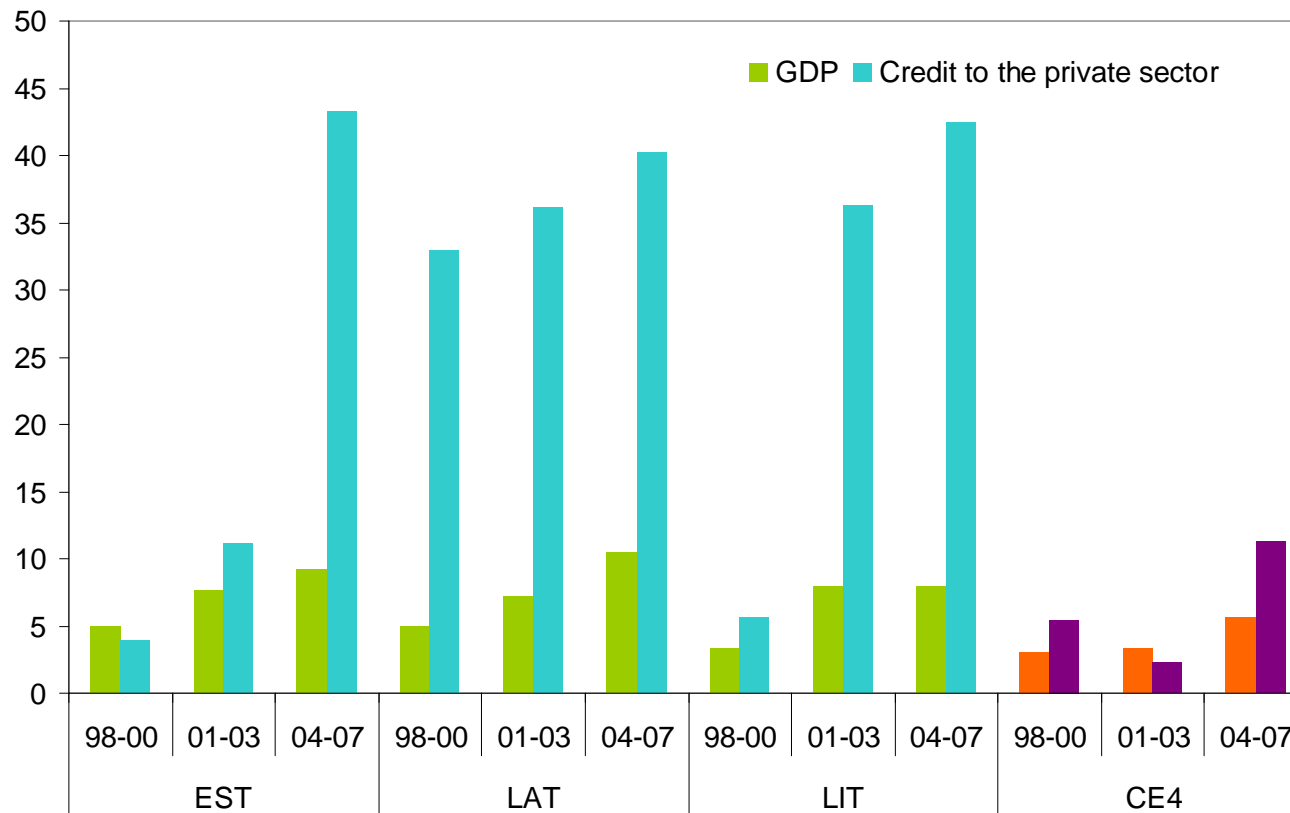
Income convergence has been faster than in other new member states and the rest of the world

Convergence in Emerging Europe and in the Rest of the World, 2002–06



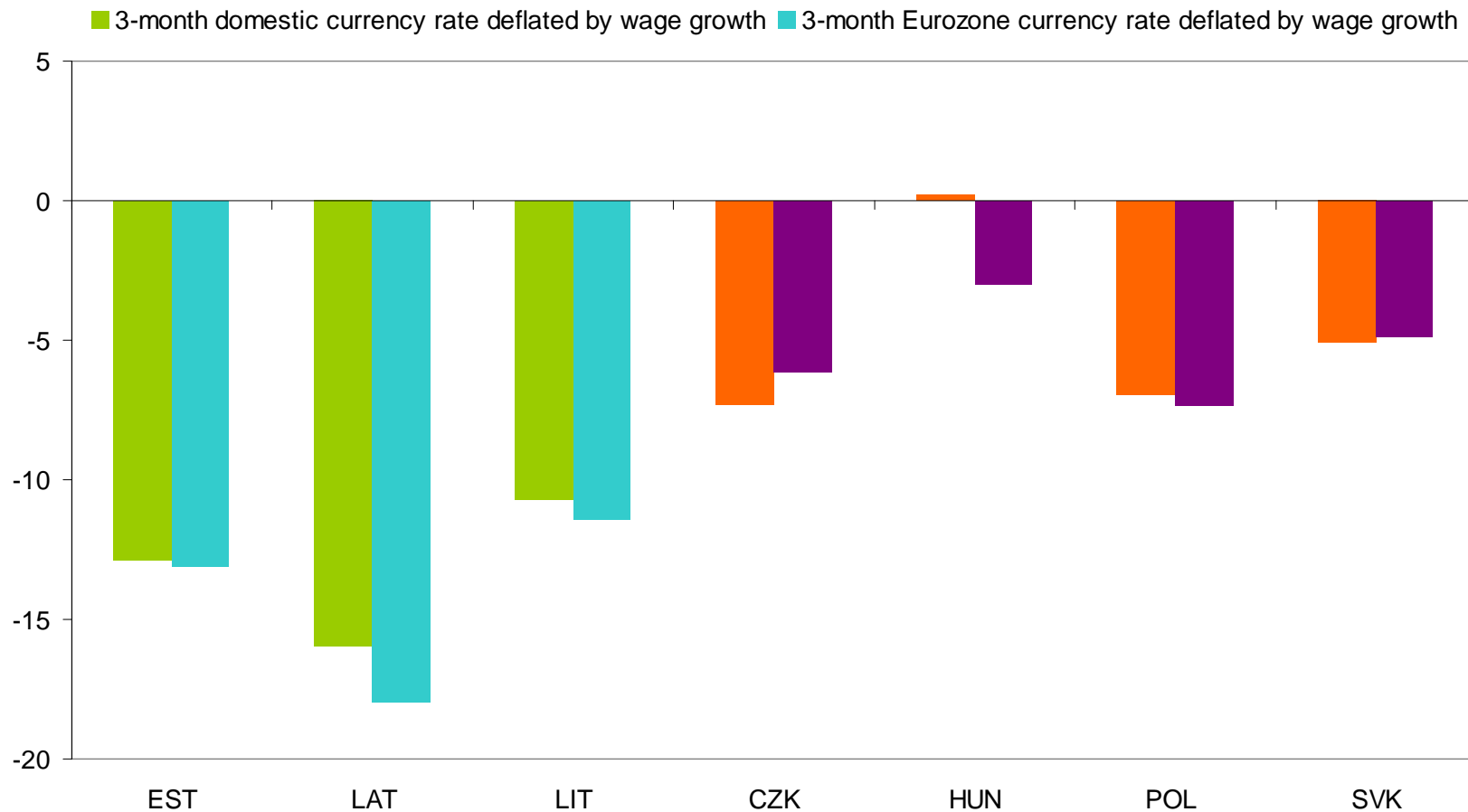
The boom has been fueled by very high credit growth...

Growth in GDP and credit to the private sector
annual average



...which has inter alia been related to negative (perceived) real interest rate

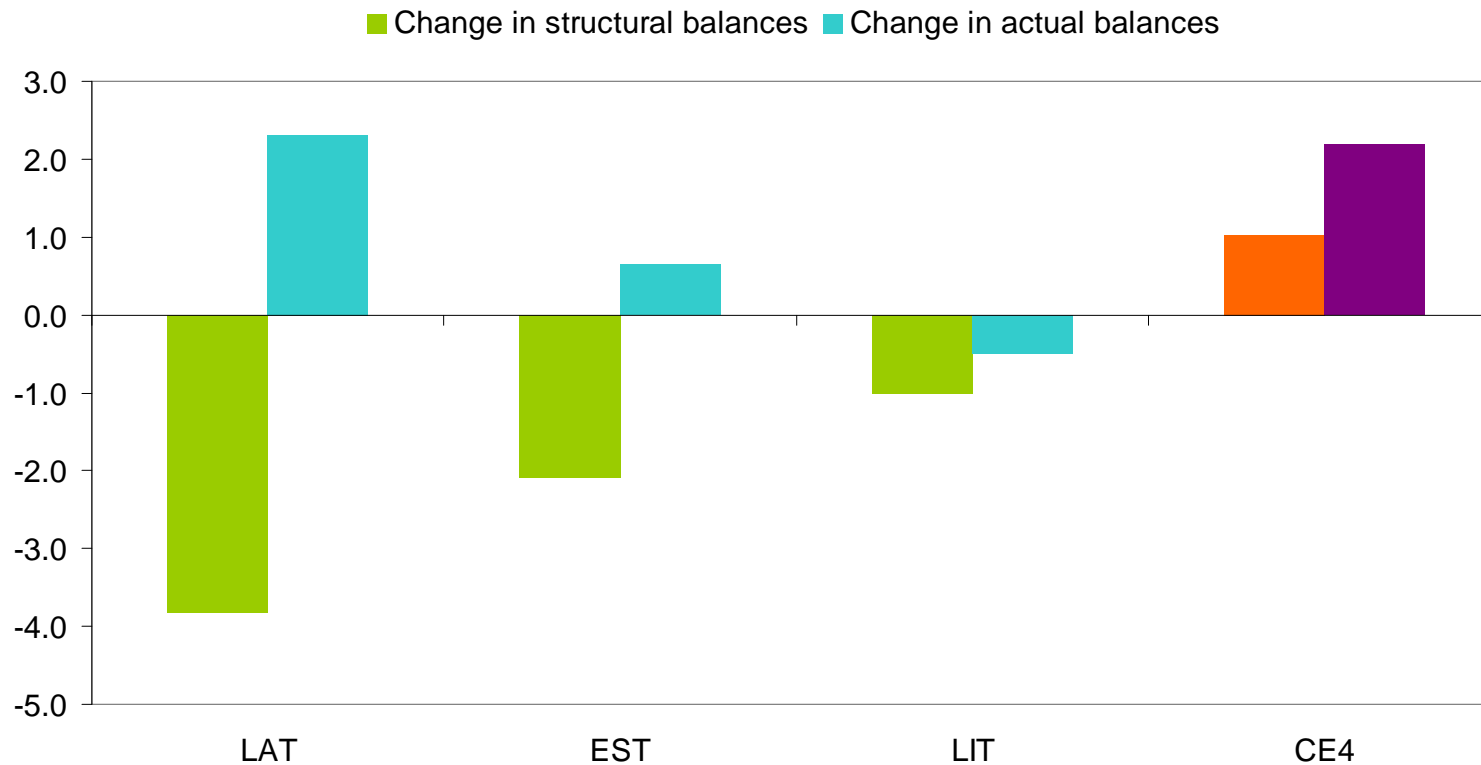
Domestic and foreign currency lending rates, deflated by wage growth, 2007



Source: National authorities, Eurostat and IMF staff calculations.

Procyclical fiscal policies have added oil to the fire

Change in Actual and Structural Fiscal Balances, 2003–07 1/ *Percent of GDP*

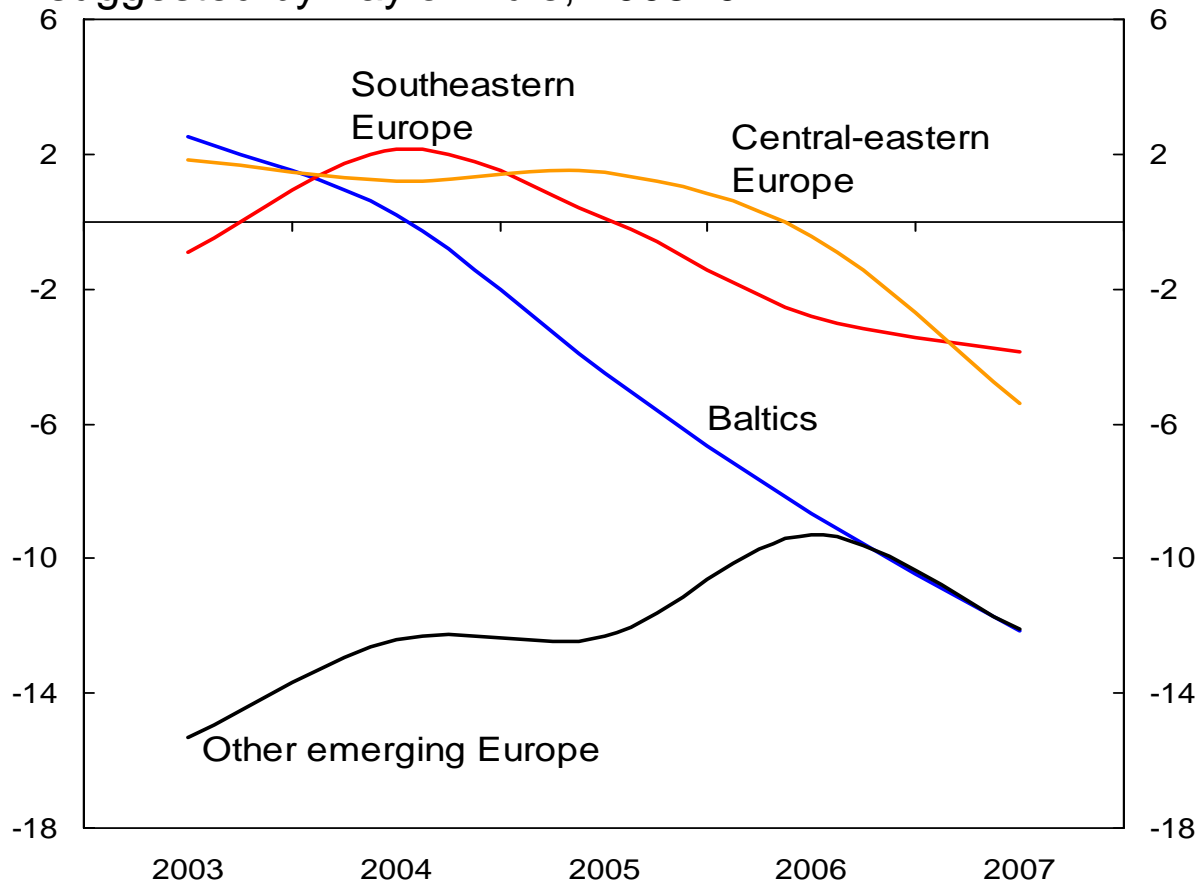


Source: IMF, World Economic Outlook; and IMF staff calculations.

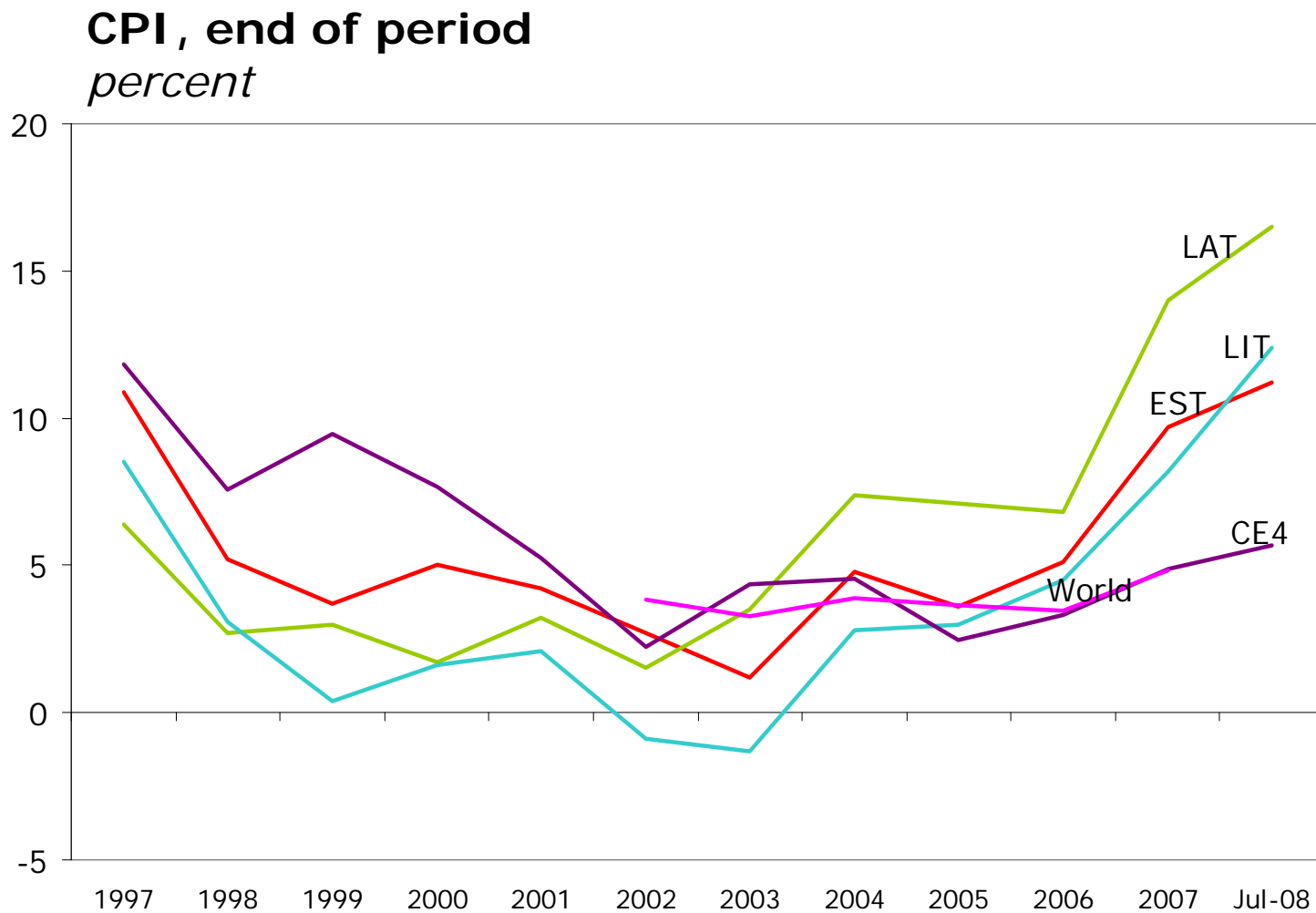
1/ The structural balances do not take into account spending related to pension reform and spending related to EU transfers.

And so have loose monetary policies

Emerging Europe: Lending Interest Rate minus “ideal” suggested by Taylor Rule, 2003–07



The overheating has contributed to consumer price inflation...

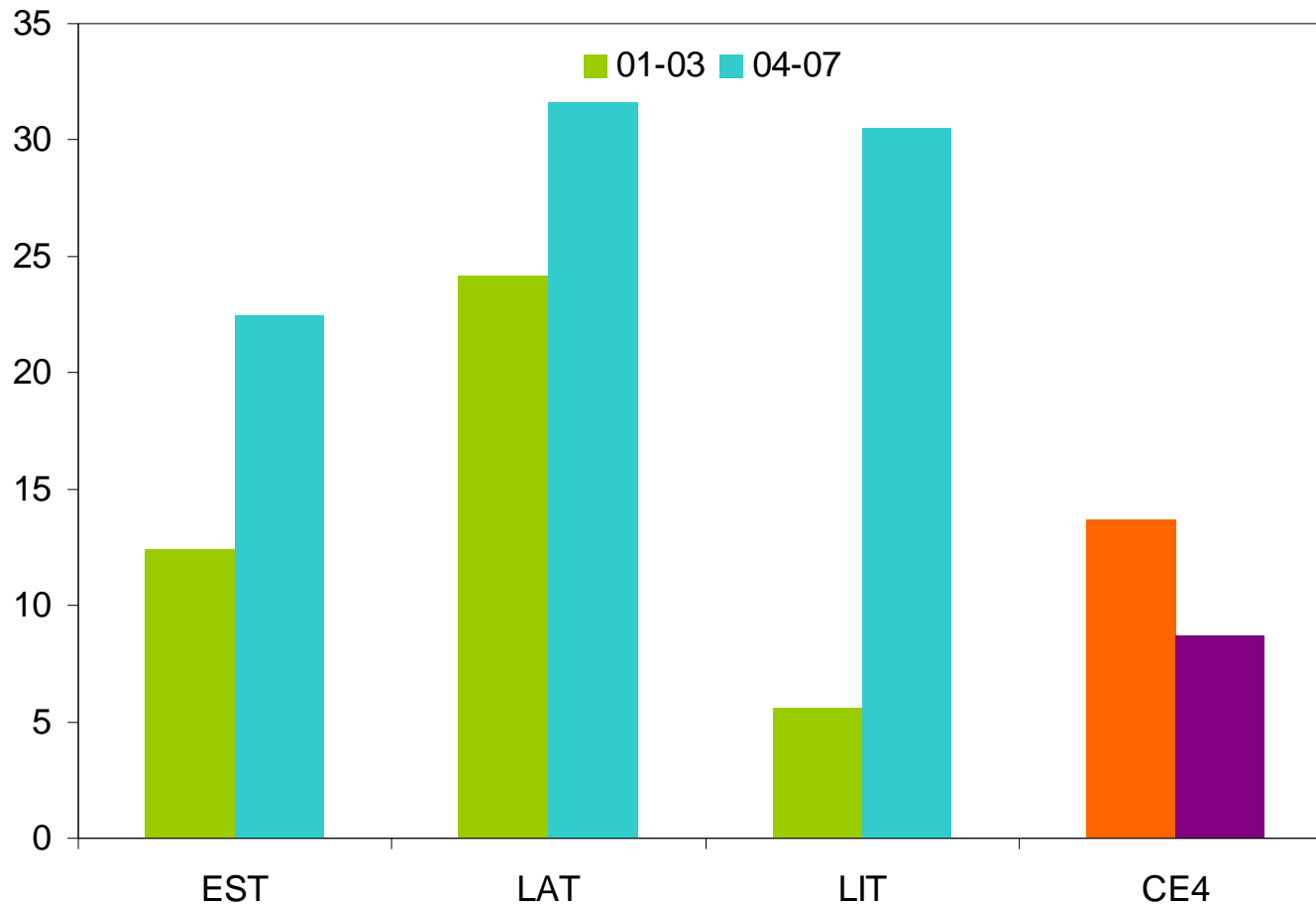


Source: National authorities.

...and soaring real estate prices

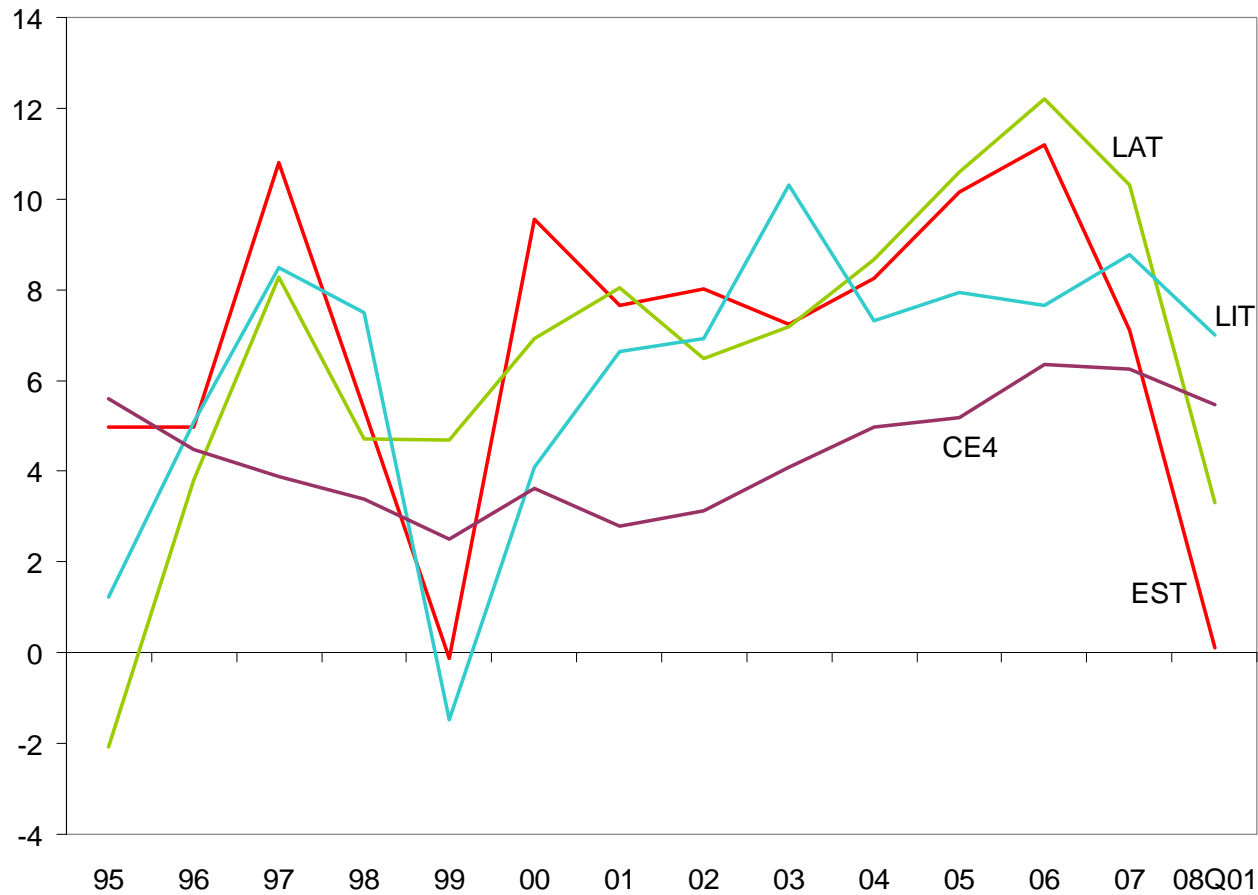
Residential property prices

YoY change in local currency deflated by CPI, period averages



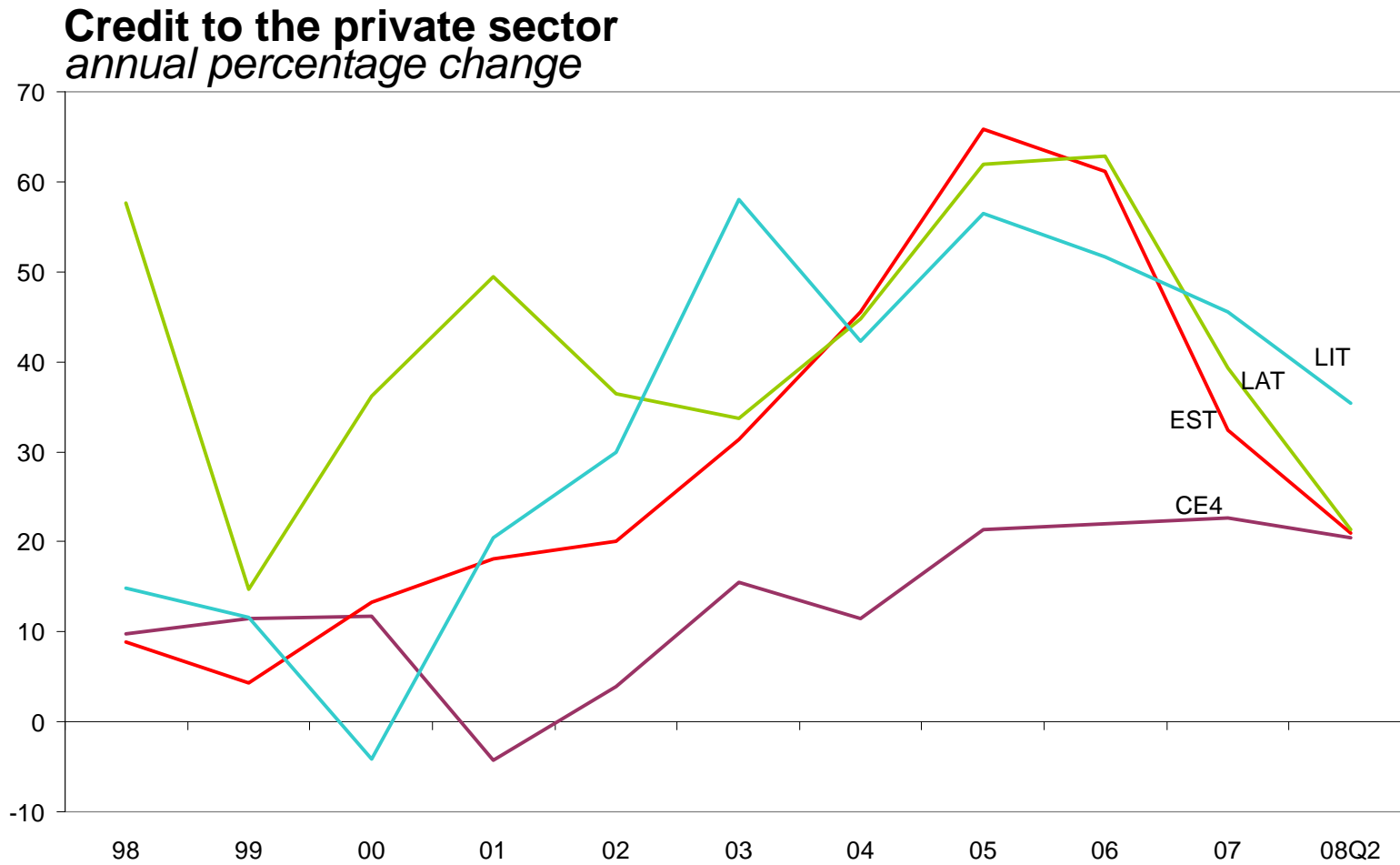
In mid-2007 the growth came to an abrupt halt...

GDP growth
annual percentage change



Source: National authorities.

... mainly driven by a slow-down of credit growth engineered by Swedish parent banks



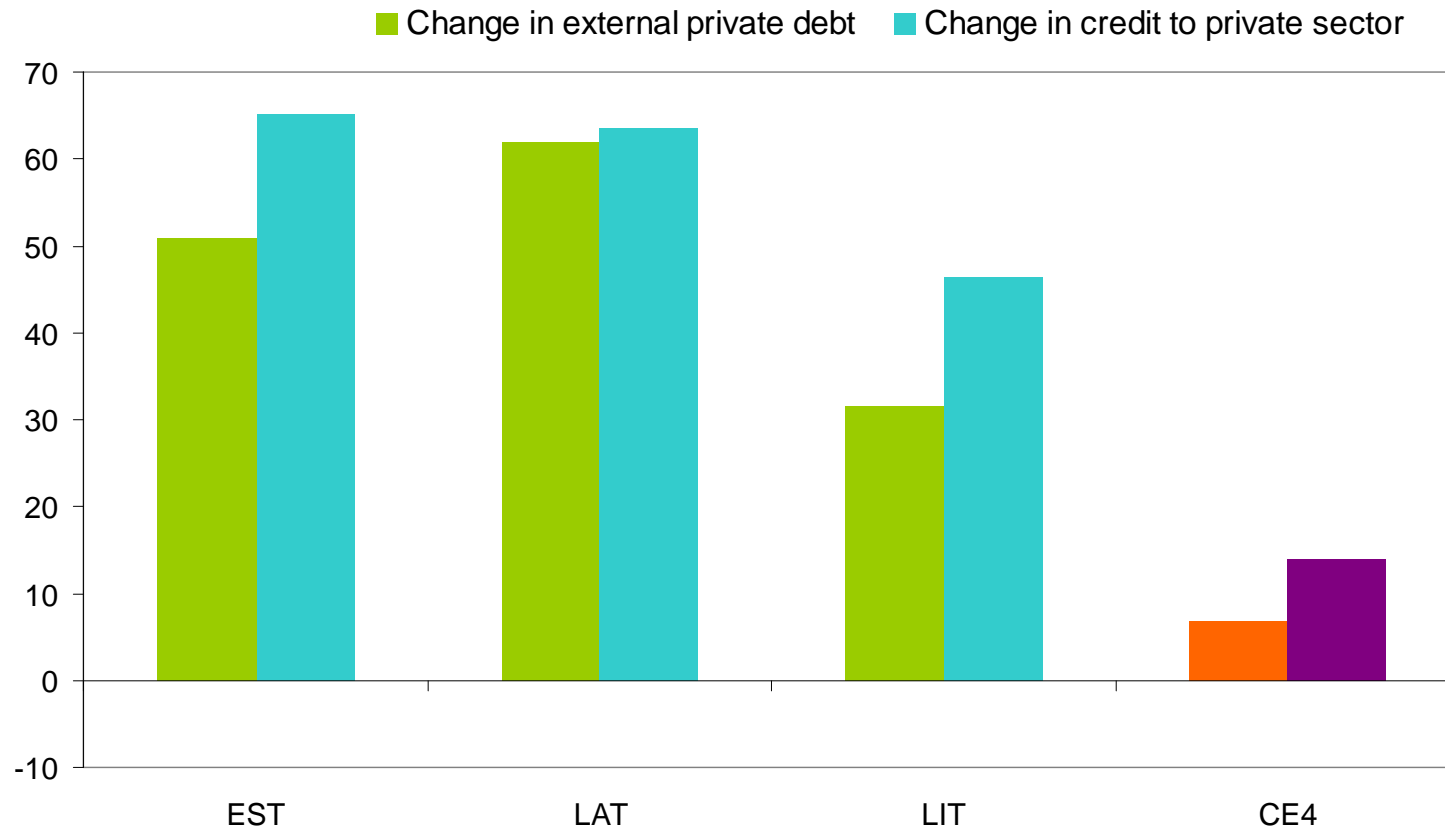
Source: National authorities.

Two key vulnerabilities emerged during the economic boom:

- **Large external imbalances**
(double-digit current account deficits, highly negative international investment position)
- **Large currency mismatches**
(especially in the balance sheets of households and corporates)

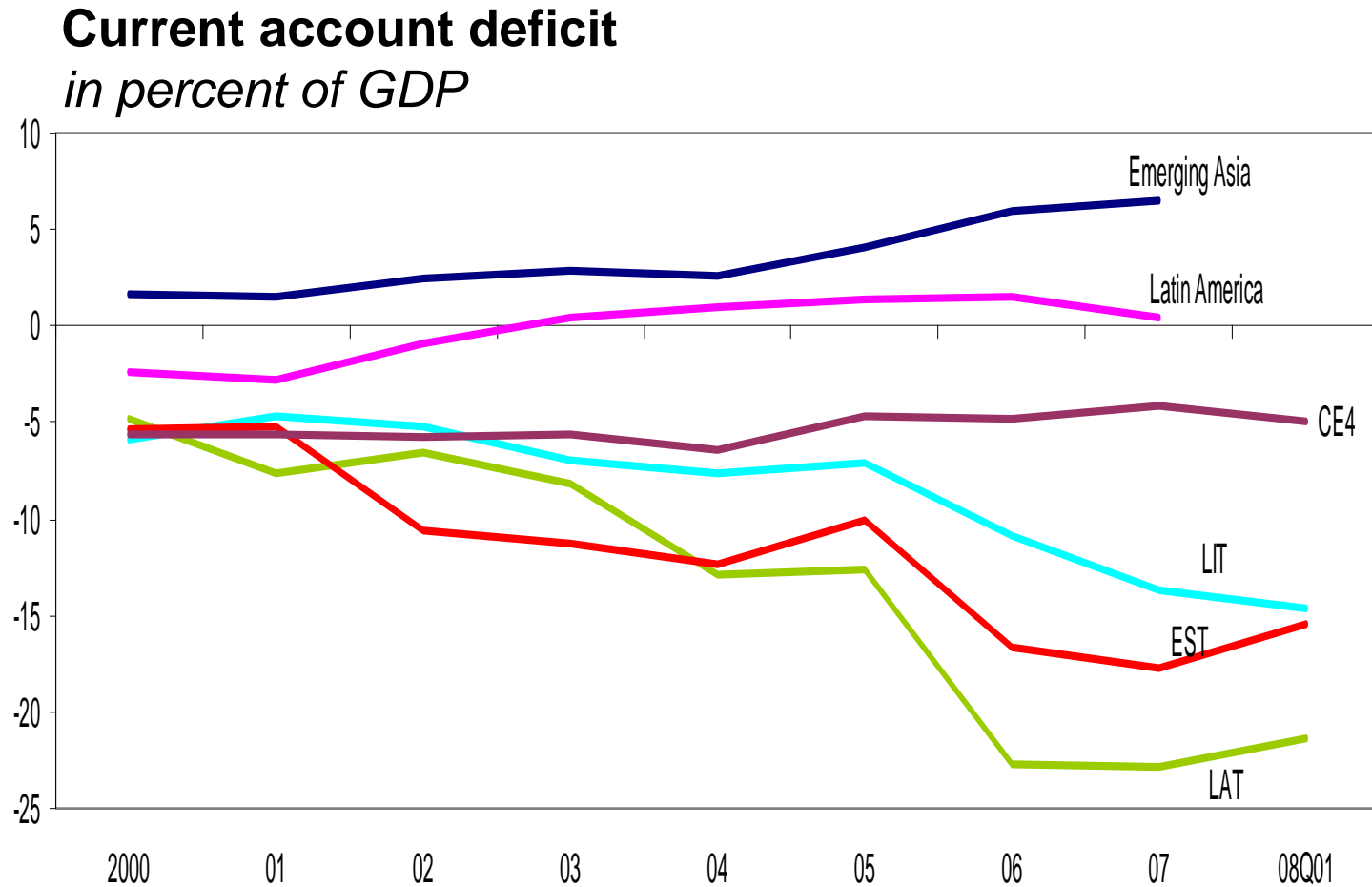
The credit boom was mainly funded by a build-up of external debt

Change in external debt and credit to the private sector, 2002-2007
in GDP percentage points

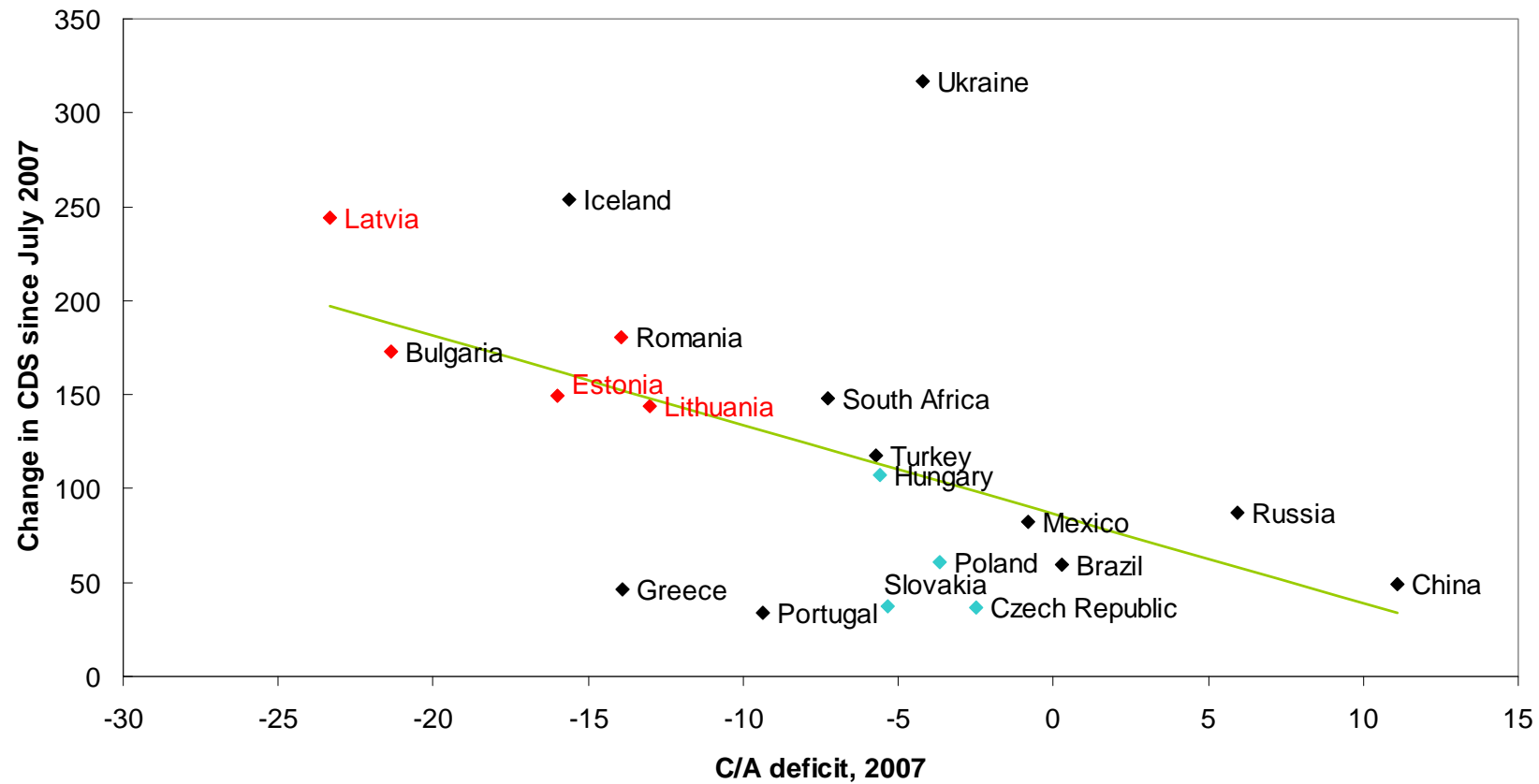


Sources: National authorities; and IMF staff calculations.

The overheating of the economy led to exceptionally high current account deficits.



Since the onset of the global credit crisis, markets have viewed countries with large imbalances as more risky



Determining CA sustainability in the new member states (Rahman, IMF WP 08/92)

Macroeconomic balance approach: estimate current account norms based on macro fundamentals (59 countries, annual data 1971-2007)

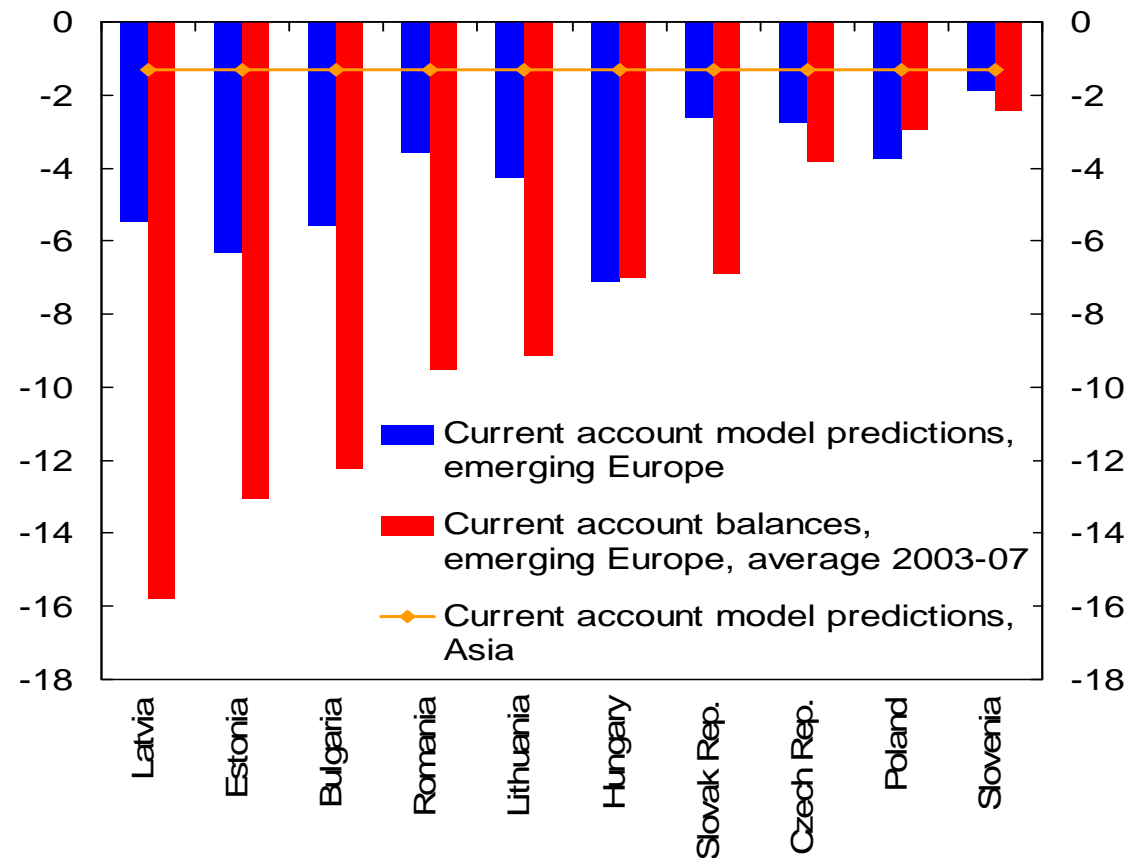
CA norm = f (fiscal balance, demographics, net foreign assets position, relative per capita income, etc.)

⇒ CA norm in the new member states are higher than elsewhere because:

- Large share of dependent population
(=> lower national savings => higher CA)
- Lower net foreign asset position
(greater dependence on foreign capital for growth)

But CA deficits in the Baltics still exceed what would be consistent with macro fundamentals

Current Account Balances and Model Predictions
Percent of GDP

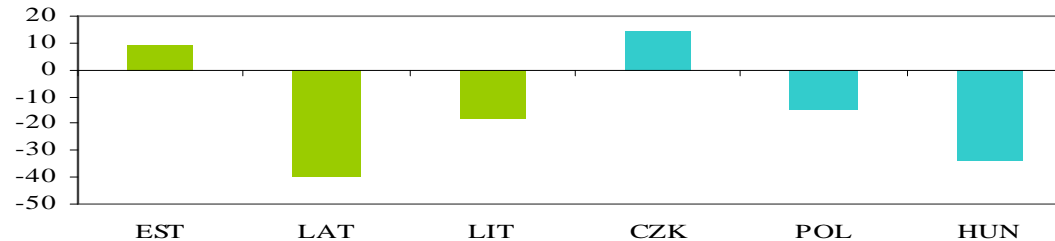


What drives the divergence from CA norms?

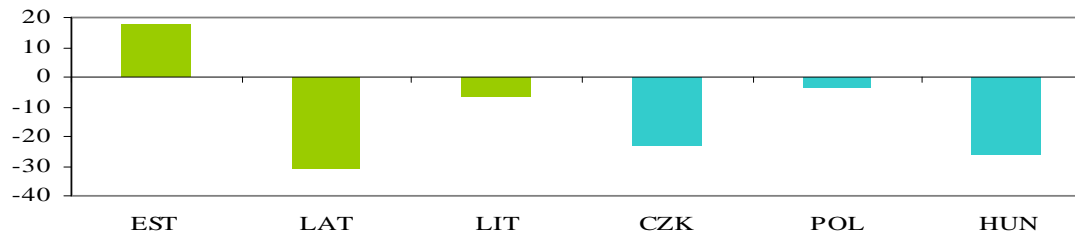
- **Cyclical or temporary factors:** output gap, capital inflows due to EU accession
- **Structural factors:** export composition, cost competitiveness in manufacturing sector
- **Policy-related factors:** exchange rate regime, financial sector policies

The Baltics have built up large currency mismatches...

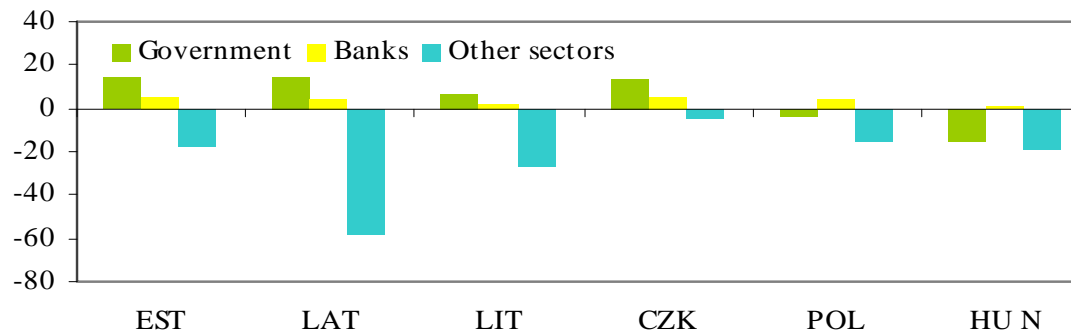
Net FX position, 2007 percent of GDP



Change in net FX position, 2002-2007, percent of GDP



Sectoral net FX position, 2007, percent of GDP

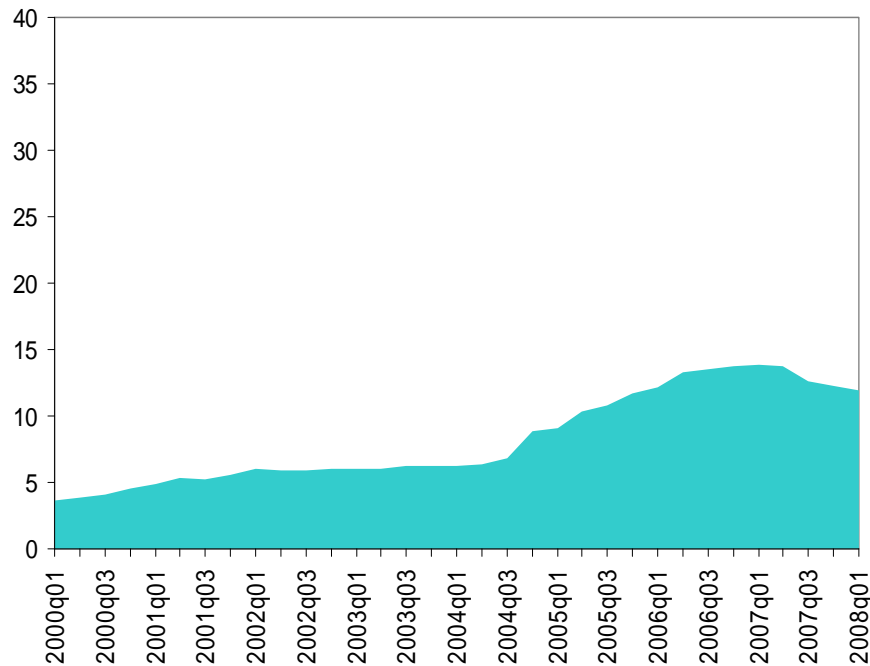


... especially in the household sector

Latvia: Fx liabilities and assets of the household sector

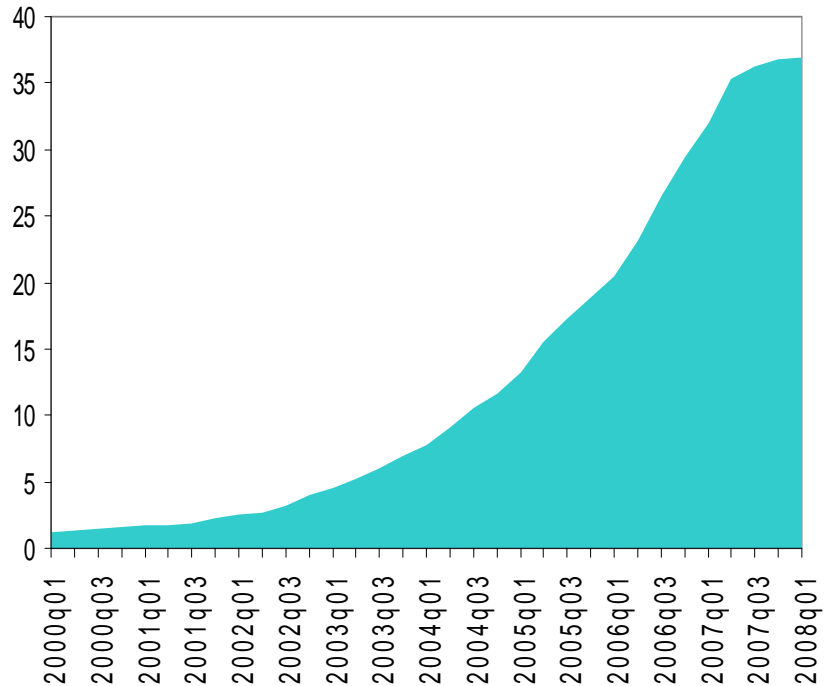
Assets

percent of GDP



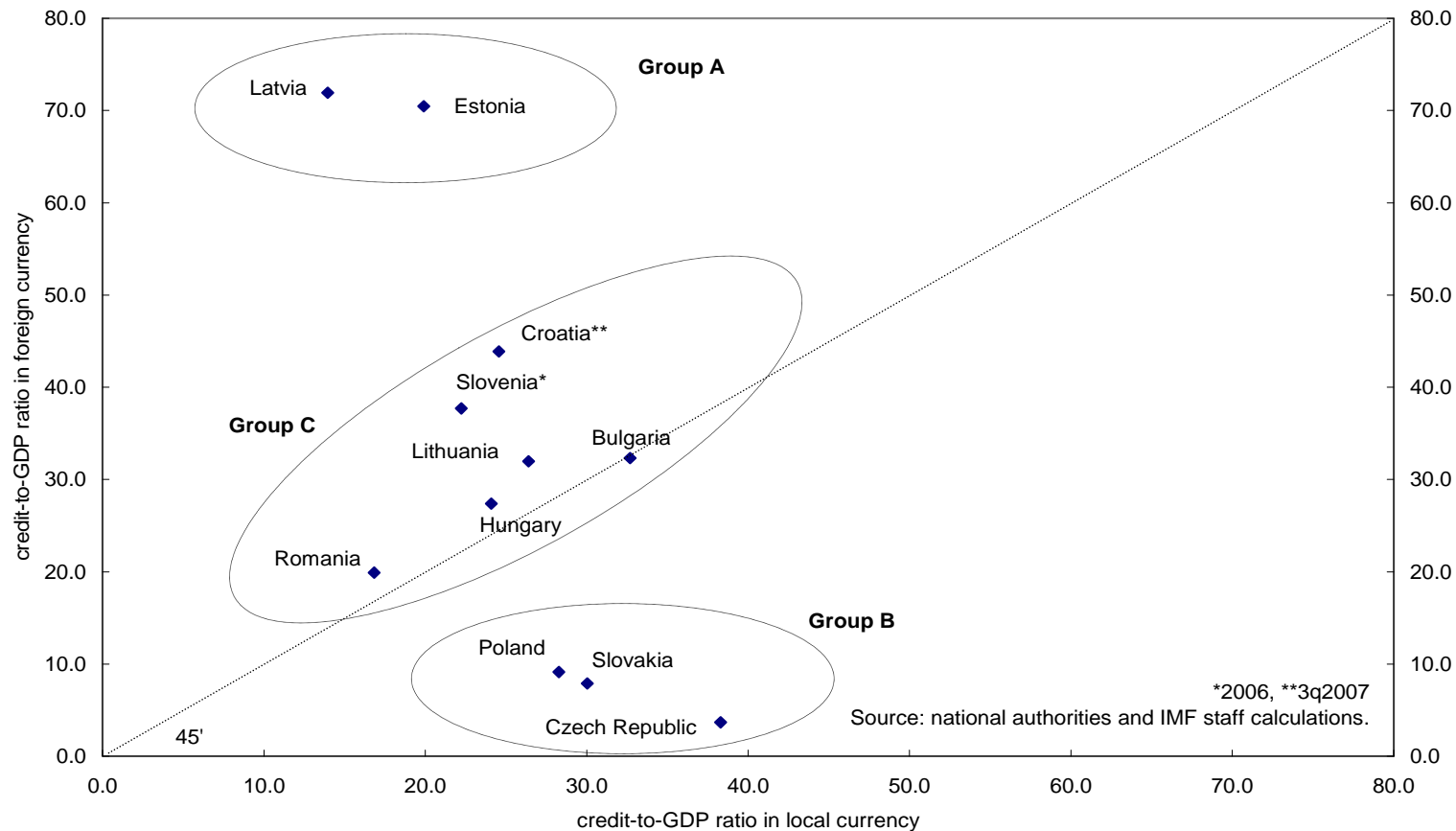
Liabilities

percent of GDP



Euroization is higher than in other new member states

Credit to GDP ratio in local currency vs foreign currency
in %, year 2007



Source: National authorities, IMF staff calculations.

What drives euroization in the new member states?

(Rosenberg and Tirpak, IMF WP 08/173)

Hypothesis: Share of the fx loans depends on:

- interest rate differential
- availability of fx-denominated funding through foreign parent banks
- GDP level
- currency regime
- EU/EMR2 membership
- openness (export/GDP, remittances)
- regulatory measures

Index of regulatory measures:

$$Index_{i,t} = \sum policy_{i,t}$$

| Policies to discourage foreign currency borrowing ($policy_{i,t}$) | Score |
|---|-------|
| Monitoring FX risk | 0.2 |
| Disclosure FX risks to customers | 0.4 |
| Tightening eligibility criteria for FX borrowing | 0.6 |
| Higher risk weights/provisioning/reserve requirements depending on banks' FX exposure | 0.8 |
| Ceilings on banks' FX exposure | 1.0 |

Empirical investigation

$$fxloans_{i,t} = \alpha + \beta_1 irdiff_{i,t} + \beta_2 loantodep_{i,t} + \beta_3 openness_{i,t} + \beta_4 restrict_{i,t} + X_{i,t} + \varepsilon_{i,t}$$

$X_{i,t}$: variable tested, but not included in the preferred model: GDP per capita, asset share of foreign banks, size of the economy, EBRD index of banking sector reform, actual exchange rate volatility, and dummies for ERM2 and EU membership

Estimated coefficients from our preferred model

| | Domestic banks only | Incl. cross-border loans |
|-------------------------------|---------------------|--------------------------|
| | A | B |
| Interest rate differential | 0.00136*** | 0.00194*** |
| Loan-to-deposit ratio | 0.17195*** | 0.07128** |
| Openness | 0.11060* | 0.14416** |
| FX restriction index (lagged) | -0.01317* | -0.00653 |

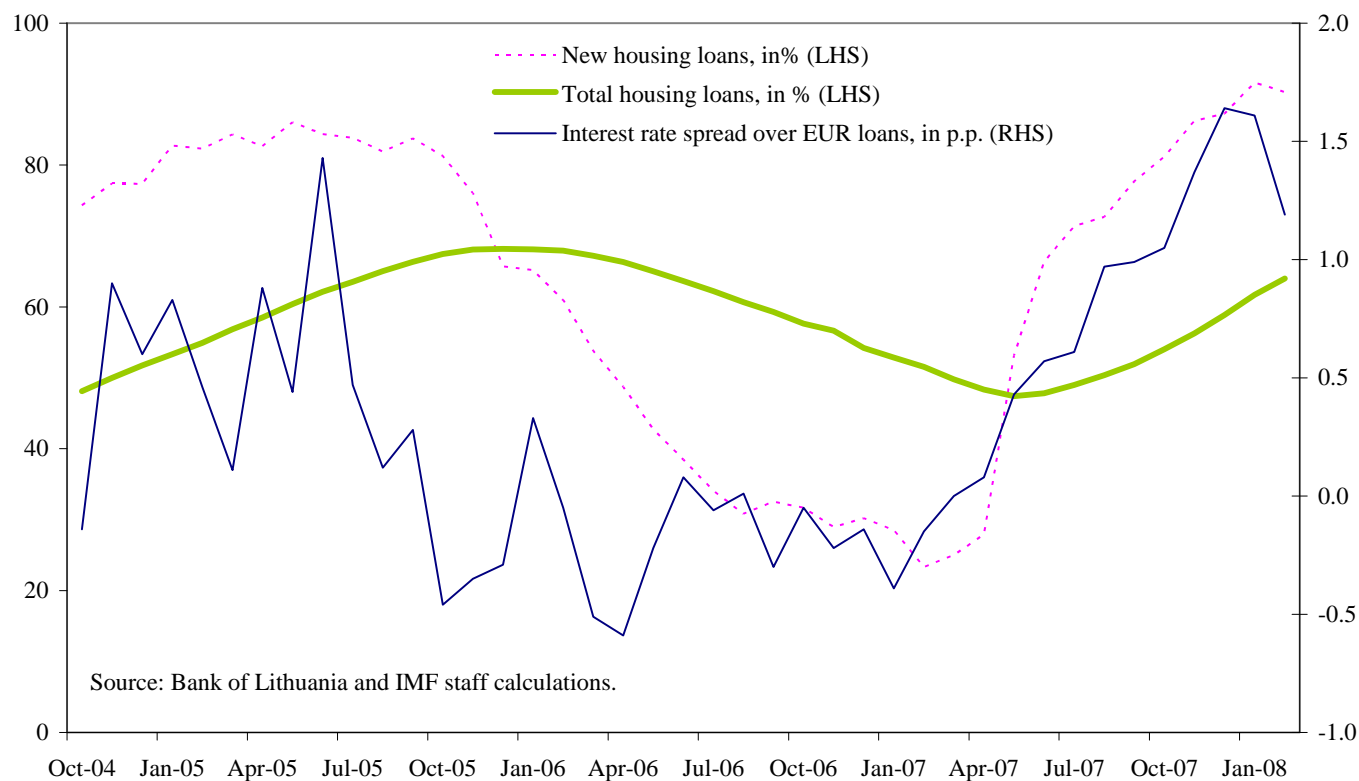
Note: *, **, *** refers to significance at 10%, 5%, and 1% level respectively.

Discussion on the model specification is in the Appendix II. Time dummies are included.

Source: Authors' calculations.

Interest rate differentials matter, especially in the Baltics where exchange rate risk is perceived to be low

Lithuania: Share of foreign currency loans (in EUR) on housing loans and interest rate differential



Preliminary conclusions:

- *Euroization* is a byproduct of convergence.
- EU membership boosts foreign exchange borrowing through multiple channels:
 - it offers better access to foreign funds in a fully liberalized environment of capital flows,
 - it provides natural hedging opportunities, through increasing trade openness,
 - it may boost private sector's confidence in exchange rate stability and imminent euro adoption.
- Regulatory measures have limited effectiveness due to opportunities to borrow directly from abroad (i.e., for corporations).

Will the Baltics follow the Portuguese path?

- Rapid convergence after joining the EU
- Since 2001, sub-par growth and high C/A deficits
- Wage increase exceeded productivity growth and undermined competitiveness

Or relive the Asia experience?

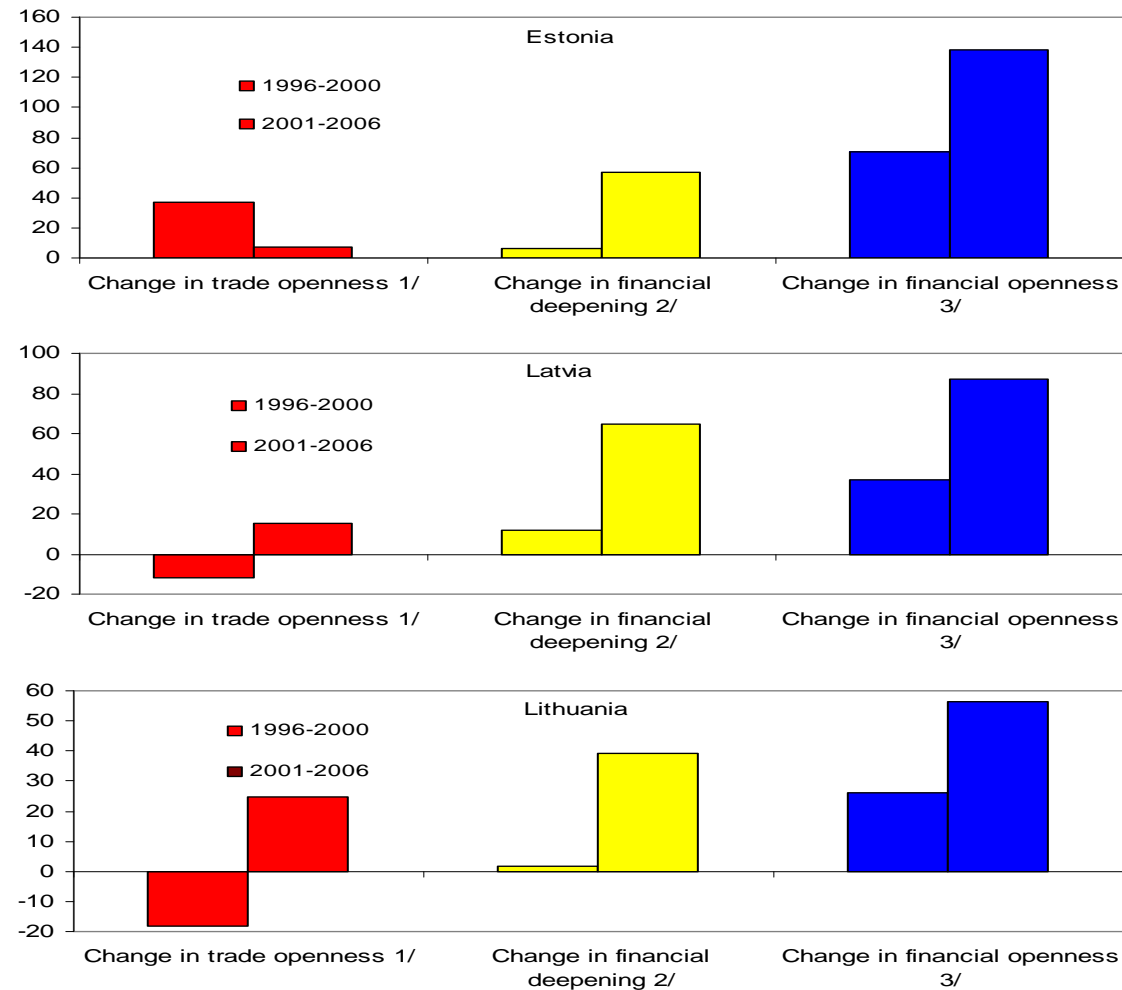
- Strong growth, driven by foreign borrowing
- In 1997, sudden stop of capital inflows, fixed currency regimes collapsed
- Painful recession aggravated by currency mismatches, but relatively fast recovery

What makes the Baltics different?

EU membership has created circumstances that are different from the textbook case:

- Very open capital markets, role of Nordic parent banks
- Labor is highly mobile (emigration)
- Strong commitment to currency pegs, perceived to be backed by EU

Trade and financial integration has accelerated



Sources: World Economic Outlook; International Financial Statistics; country authorities; and Fund staff calculations.

1/ Trade openness is defined as total trade (imports plus exports) in percent of GDP.

2. Financial deepening is defined as credit to private sector in percent of GDP.

3. Financial openness is defined as the sum of total external asset and total external liabilities in percent of GDP.

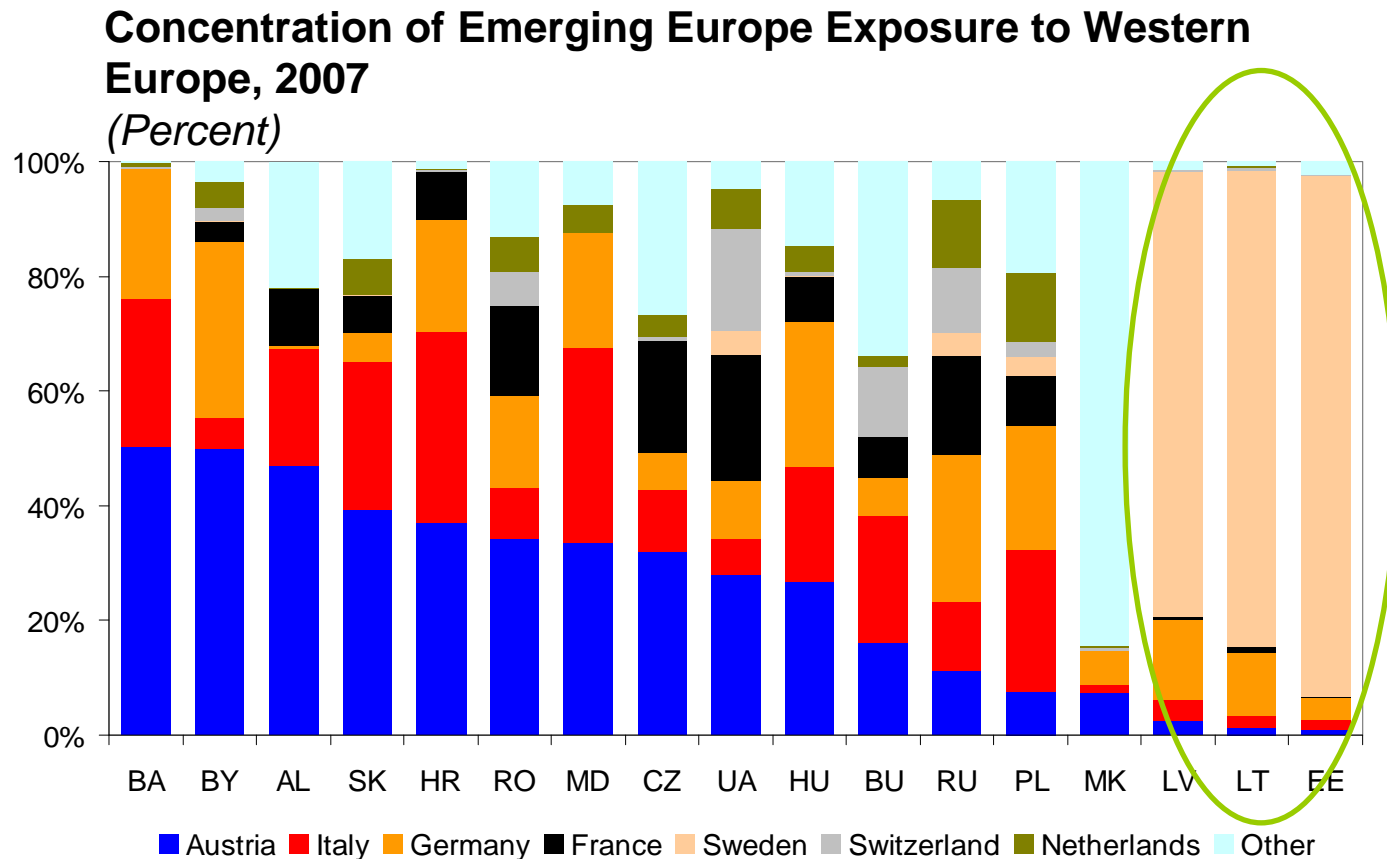
Foreign bank presence offers protection against a sudden Asia-style withdrawal...

Asset share of foreign owned banks
percent

| | 2006 |
|-----|------|
| EST | 99.1 |
| LAT | 62.9 |
| LIT | 91.8 |
| POL | 74.3 |
| CZK | 84.7 |
| HUN | 82.9 |
| SVK | 97.0 |

Source: EBRD.

... but it also exposes the Baltics to common-lender contagion risk

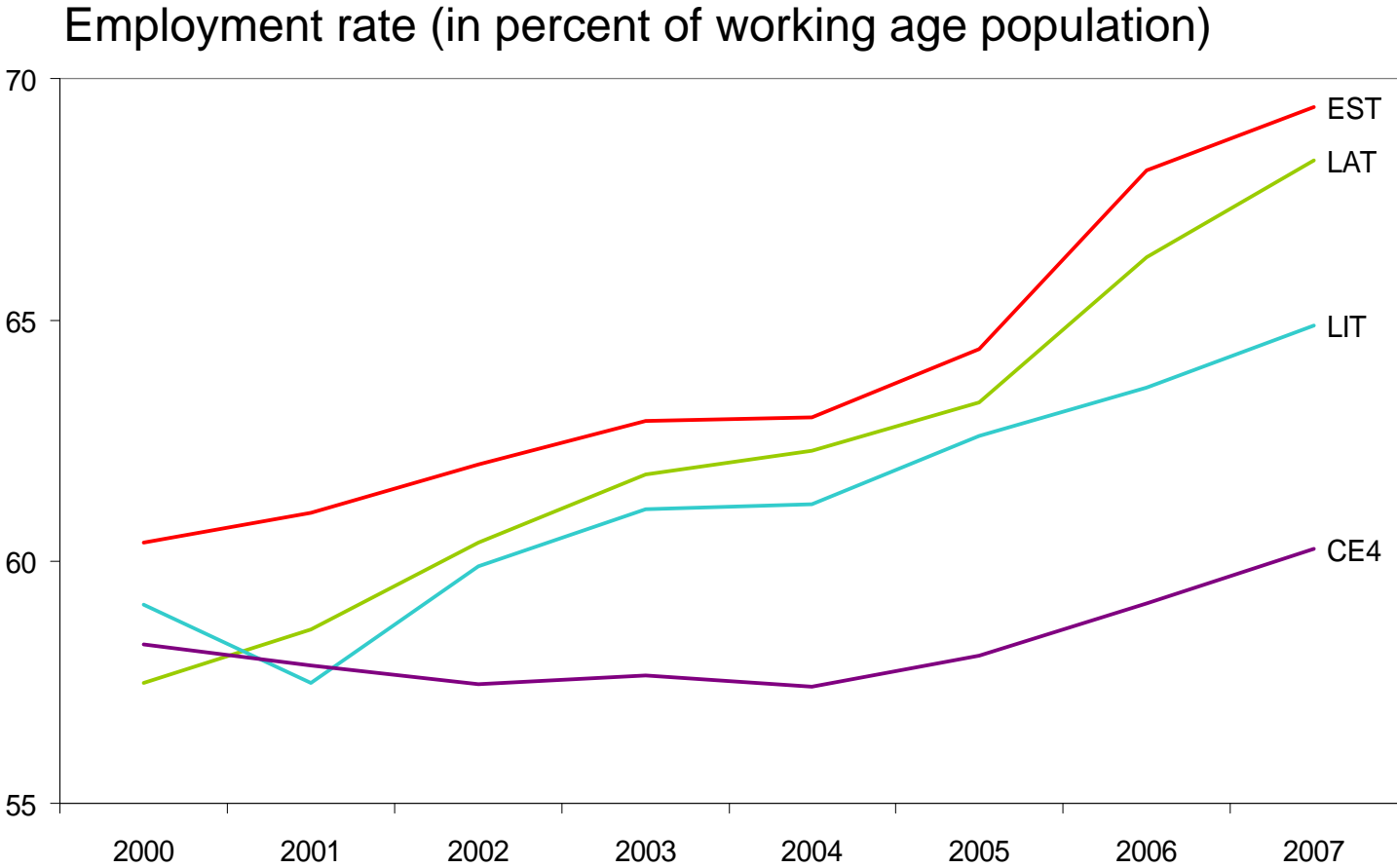


Source: Bank for International Settlements, Quarterly Review, June 2008.

Note: Country names are abbreviated according to the ISO standard codes.

1/ Emerging Europe exposure to western European banks is defined as the share of the reporting banks in each western European country in the total outstanding claims on a given emerging European country (both bank and nonbank sectors). For example, about 42 percent of Croatia's exposures to Western European reporting banks is owed to Austrian banks, 38 percent to Italian banks, 13 percent to French banks, etc. For the Baltic countries, 85 percent or more of exposures to the reporting banks is owed to Swedish banks.

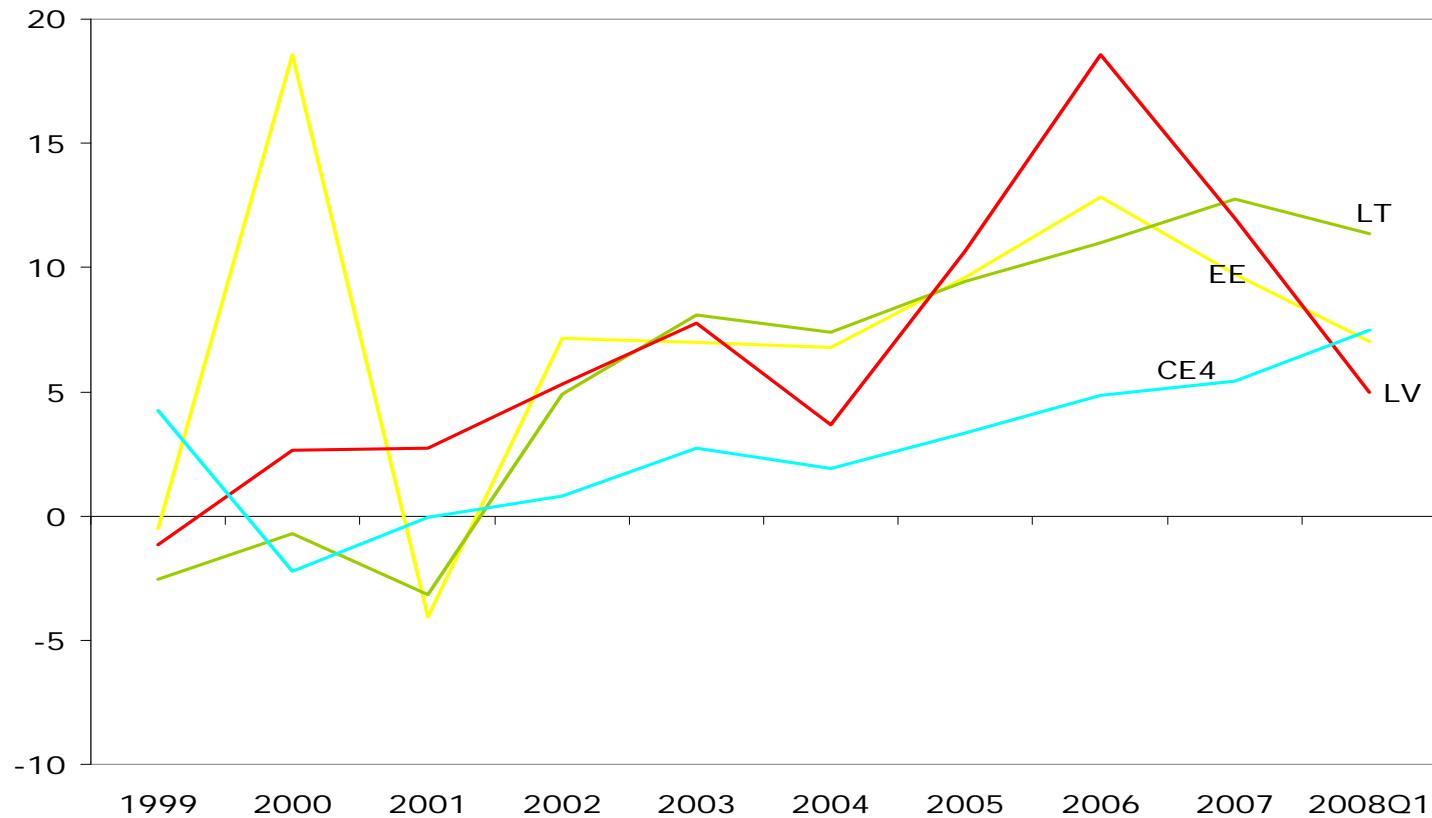
Labor markets are flexible, but emigration has led to tight supply conditions...



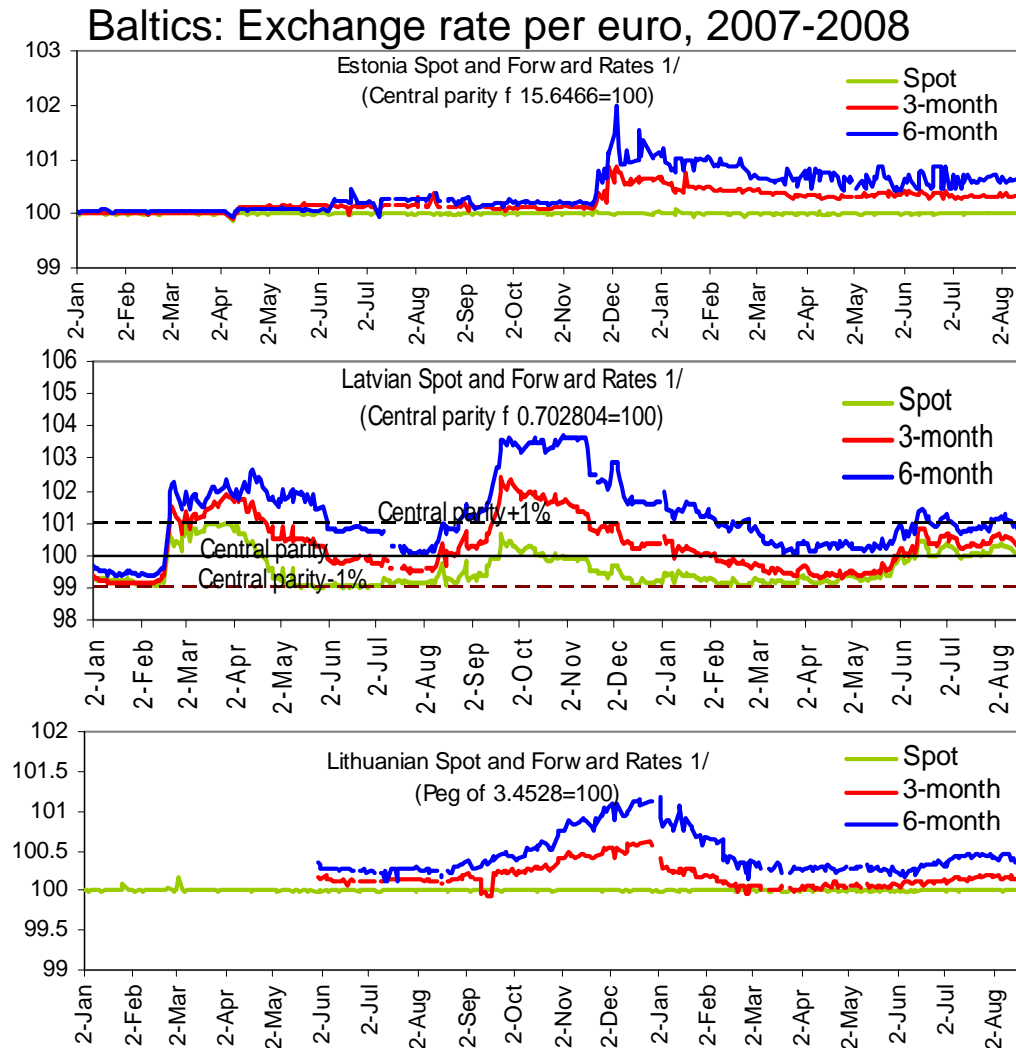
Source: Eurostat

...and, until recently, made it more difficult to contain real wage growth.

Annual real wage growth
percent



The fixed exchange rate regime have weathered the loss in confidence well



Source: Bloomberg.

1/ Calculated cross rate as the product of currency US\$/euro rate, using average of bid and ask prices.

How can a soft landing be achieved?

1. **Fiscal policies** should not seek to offset a contraction in demand by discretionary easing (this was Portugal's mistake).
2. Facilitate the **switch of production and investment** from non-tradables (retail, real estate) to tradables (manufacturing, tourism).
3. **Wages** should be flexible. Inward migration to the Baltics could help.
4. Strengthen **financial supervision**, cross-border cooperation and financial safety nets. Ensure that banks maintain adequate capital and liquidity.

The global twin crisis – a blessing in disguise

The **credit crunch** reduces the access to cheap financing and serves as a reminder that no boom lasts forever

⇒ Dampen expectations with regard to rapid wage growth, employment, large-scale public investment, speedy euro adoption

The **inflation spike** helps to reduce real wages (if nominal wage growth can be contained)

Thank you!

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