

Lindner, Axel

Article — Published Version

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Intereconomics

Suggested Citation: Lindner, Axel (2011) : Macroeconomic adjustment: The Baltic states versus euro area crisis countries, Intereconomics, ISSN 1613-964X, Springer, Heidelberg, Vol. 46, Iss. 6, pp. 340-345,
<https://doi.org/10.1007/s10272-011-0398-z>

This Version is available at:

<https://hdl.handle.net/10419/88896>

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Axel Lindner*

Macroeconomic Adjustment: the Baltic States versus Euro Area Crisis Countries

Estonia, Latvia and Lithuania have succeeded in rapidly reducing their current account deficits despite fixed exchange rates. Which factors have played a major role in this? What similarities, and what differences, do the Baltic states show compared to Greece and Portugal? What insights can be gained for the political debate on the euro area debt crisis?

The European debt crisis is, at first sight, of a fiscal nature: public debt levels in Greece, Ireland and Portugal are so high that it is doubtful whether these states will be able to raise the funds needed to fulfil their obligations. The confidence of financial markets in debtor countries depends, however, to a large extent on indicators that relate to the economy as a whole, including firms and private households. This is because the present value of all future tax receipts and thus of the state's ability to pay must be lower than the present value of all future incomes earned by all domestic agents. The external position of the economy has an important role in this inequality: adverse international investment positions such as a lot of external debts, as in the case of Ireland, put income prospects as well as the rating of the sovereign at risk.¹ Current account balances are also regarded as informative indicators²: if current expenditures in an economy are substantially higher than current incomes, so that the international investment position is steadily deteriorating, it might be difficult for the public authorities to markedly increase the share of income that is distracted from private use in order to meet the obligations of the state. This reasoning is behind the fact that Greece and Portugal, with current account deficits of about 10% of GDP, lost access to capital markets in 2010, while the UK, with a relatively modest current account deficit of about 2.5% in 2010, is still regarded as a trustworthy debtor, although the British structural public deficit, at 8.3% in 2010, was larger than that of Greece (6.5%) or Portugal (7.6%).³ Thus, an important prerequisite for Greece and Portugal's regaining access to capital markets appears to be a significant decrease in the current account deficits of these countries.

The Baltic Economies: Dramatic Turnaround Despite Fixed Exchange Rates

It has frequently been argued recently that a fundamental decrease in current account deficits is only possible if wages and prices significantly devalue relative to foreign cost and price levels. In the case of the euro area member countries in

crisis, nominal wages and prices are regarded as quite sticky (with the notable exception of Ireland). Thus, it is frequently argued, the only way of rebalancing the macroeconomic fundamentals in a timely way is to leave the monetary union; a new national currency would surely drastically devalue.⁴ The example of the Baltic states shows, however, that high current account imbalances can vanish very quickly in member states of the European Union, even if exchange rates are kept constant. In 2007, the year before the crisis broke out, the current account deficits of Estonia (17.2% of GDP), Latvia (22.3%) and Lithuania (14.5%) exceeded those of Greece (14.3%) and Portugal (10%). All three Baltic states have kept their fixed exchange rate relative to the euro; Estonia even waived its own currency, the kroon, and joined the euro area at the beginning of 2011. Nevertheless, the huge deficits turned into sizable surpluses within two years, while the deficits of the two Southern European economies were still close to 10% in the first quarter of 2011 (Figure 1). The dramatic turnaround in the Baltic economies was, however, accompanied by recessions that were much more drastic than those in Portugal or even Greece: production was, at the trough of the recession, between 17% (Lithuania) and 25% (Latvia) lower than at the peak before the crisis hit. Since the end of 2009, production has been expanding again, quite vigorously in Estonia and Lithuania but more slowly in Latvia (Figure 2).

1 As this paper discusses the reactions of current account imbalances, Ireland, which has a largely balanced current account, will not be in our focus.

2 For example, Attinasi, Checherita and Nickel find in a dynamic panel approach that higher expected current account deficits are associated with higher sovereign bond yield spreads. See M. Attinasi, C. Checherita and C. Nickel: What explains the surge in euro area sovereign spreads during the financial crisis?, ECB working paper No. 1131, 2009, p. 34. Klepsch and Wolmershäuser in their otherwise insightful study do not control for current account balances. See C. Klepsch, T. Wolmershäuser: Yield spreads on EMU government bonds – how the financial crisis has helped investors to rediscover risk, in: *Intereconomics*, Vol. 46, No. 3, 2011, pp. 169-176.

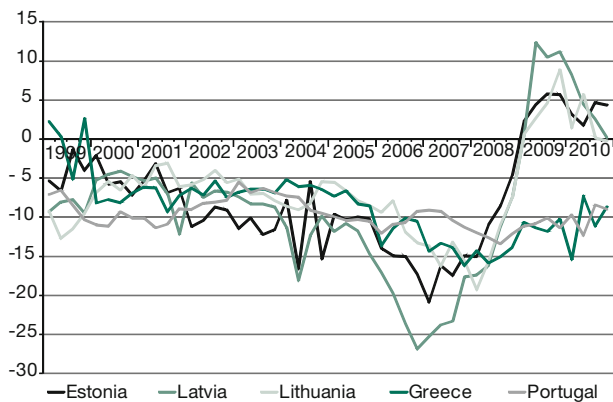
3 OECD: *Economic Outlook*, No. 89, 2011.

4 See, for example, N. Rubini: The Eurozone Heads for Break Up, in: *Financial Times*, 13 June 2011; D. Lachman: Portugal should quit the euro to restore competitiveness, in: *Financial Times*, 9 May 2011.

* Halle Institute for Economic Research (IWH), Halle, Germany.

Figure 1
Current Account Deficits as a Percentage of GDP

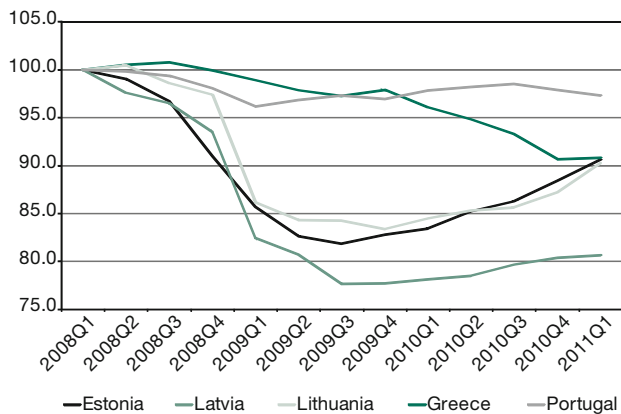
(seasonally adjusted, quarterly data)



Source: Eurostat.

Figure 2
Real GDP

(seasonally adjusted, quarterly data; 1. quarter 2008 = 100)



Source: Eurostat.

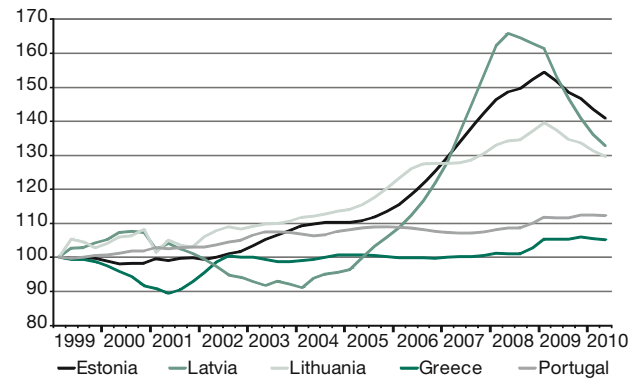
Different Reactions to the Crisis

Why did the current accounts of the Baltic countries behave so differently from what we see in the euro area crisis countries? Did Estonia, Latvia and Lithuania regain international competitiveness via a swift real devaluation during their deep recessions?⁵ Wages indeed fell quite dramatically in 2009 and 2010. This adjustment, however, allowed the economies to achieve a competitive position that was (measured by nominal unit labour costs) only as strong as in 2007, when current account deficits were at record levels (Figure 3). Indeed, ex-

5 According to the ECB, the flexibility of wages was – in addition to sizeable fiscal consolidation, structural reforms and measures to stabilise the banking system – pivotal for the swift macroeconomic adjustment of the Baltic economies (see ECB Monthly Bulletin, June 2011, pp. 17-19). This paper will argue below that such a view is in danger of overrating the short-run effects of adjustments in the real economy and of economic policy.

Figure 3
Real Effective Exchange Rate

(deflator: unit labour costs, whole economy – 27 trading partner; 1. quarter 1999 = 100)



Source: Eurostat.

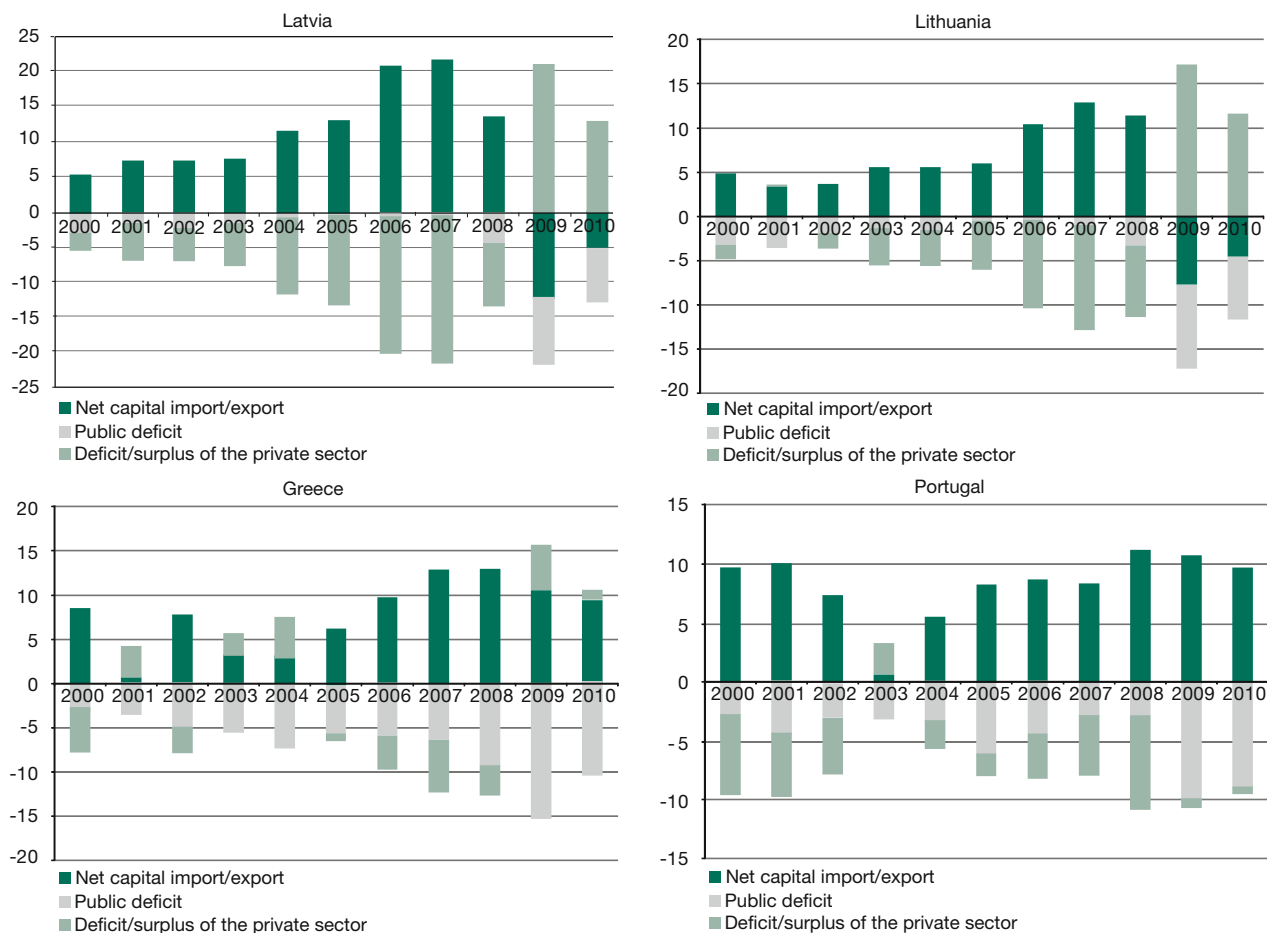
ports collapsed about as strongly as those of the Southern European crisis countries.⁶ Even so, the current account balances turned around in 2009 because expenditure on imports collapsed: in Latvia and Lithuania by 36%, in Estonia by 32%. Meanwhile, in Portugal imports decreased by 18% and in Greece by 25% – huge numbers in normal times, but not unusual ones during the Great Recession, and indeed moderate ones compared to what happened in the Baltic economies. The swift improvement in competitiveness was obviously not decisive for turning the current account balances in these countries. Instead, the collapse of domestic demand that was more dramatic than in any other EU country played the key role.

The question now to be answered is: why was the collapse of domestic demand in the Baltic economies so deep? In particular, it was much deeper than in Greece and Portugal in any phase since the Great Recession hit (see again Figure 2), although since 2009 the macroeconomic situation in these southern economies appears to be as precarious as it was at any time in the Baltic states. One might think that the international rescue funds make the difference: they enable a continuous financing of the high public deficits. The programmes prescribe that the deficits are to be reduced speedily in the coming years, but not in an abrupt way. Estonia and Lithuania did not need international help, as capital markets kept confidence in the soundness of public finances during the crisis. Matters stood differently in Latvia: here, the state took over the business and liabilities of the second largest commercial bank in the country, Parex, at the peak of the financial crisis in November 2008 in order to prevent the institute's

6 Comparing the figures for 2009 with those for 2008, income from exports of goods and services was down by 20% in Estonia, 17% in Latvia and 25% in Lithuania (balance of payments data). In Greece the collapse was 21%, in Portugal 15%.

Figure 4
Net Capital Imports (+) or Exports (-), Public Deficit, and Deficit (-) or Surplus (+) of the Private Sector for Selected Member States of the European Union

(seasonally adjusted, quarterly data; 1. quarter 2008 = 100)



Sources: Eurostat, IMF International Financial Statistics.

imminent collapse. As a consequence, however, capital markets lost confidence in the state of Latvia itself. International institutions, mainly the IMF, the European Union and Nordic neighbour countries had to put up about € 7.5bn for the years 2009 to 2011 in order to prevent a Latvian default. The money amounts to more than 10% of Latvian GDP and enabled the state to run sizable deficits (9.7% of GDP in 2009 and 7.7% in 2010). Even so, the Latvian current account deficit quickly turned into a surplus. Thus, international rescue packages do not explain the difference between the macroeconomic adjustments in the Baltic states on the one hand and Greece and Portugal on the other.

Financial Constraints on Private Agents in the Baltic States ...

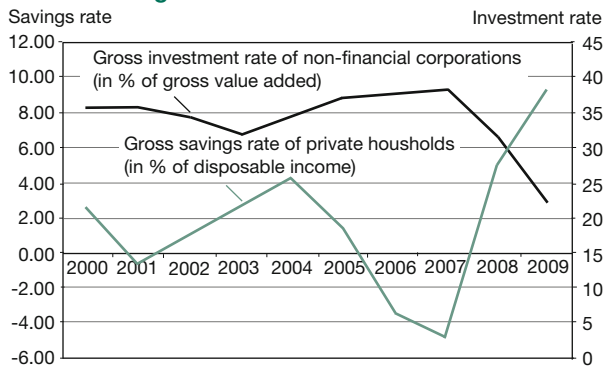
It was the reaction of the private sector to the financial crisis that caused the turn of the current account in the Baltic states. This can be seen by looking at the movement of the

financial accounts of the private and the public sectors (Figure 4). The sum of the two gives the financial balances of the respective economies (green columns) that roughly mirror the current account balances.⁷ Net capital inflows from abroad divide into capital demand of the public sector (grey columns) and of private households and firms (light green columns). If the private sector is a net financial saver (if the light grey column is above the base line), and if the amount of private savings exceeds the public deficit, net capital is flowing out of the country (the green column is below the base line); the international investment position of the economy improves.

Figures 4 reveals that public deficits increased by around 6 percentage points of GDP in all four countries (in Portugal by a bit more). Net capital flows developed so differently because

⁷ This is exactly the case if the remaining items of the balance of payments, the capital account and net errors and omissions are equal to zero. These items are usually of minor importance.

Figure 5
Private Saving and Investment in Latvia



Source: Eurostat.

of the private sectors: in Latvia and Lithuania (as in Estonia) private households and firms had run sizable deficits that collapsed in 2008 and turned into equally sizable surpluses in 2009. The financial accounts changed between 2007 and 2009 by about 30 percentage points of GDP in Lithuania, 25 in Estonia, and by no less than 40 in Latvia! In the Southern European countries, private agents reacted much more slowly to the crisis: in Portugal by about 7½ percentage points of GDP and in Greece by about 10 percentage points (same time span).

The drastic reduction in private spending that was behind the turnaround in the Baltic economies corresponds to a jump in the savings rate of private households and to a collapse of investment by firms (see Figure 5 for the example of Latvia). The financial sector played a decisive role in initiating this adjustment. In the Baltic economies, finance is dominated by branches and subsidiaries of foreign, in particular Scandinavian, banks. They hold a market share of between 68% in Latvia and 97% in Estonia.⁸ Already in 2007, banks came increasingly to the conclusion that the economic boom in the Baltic countries was excessive and unsustainable. The deterioration of the global financial environment was an additional reason why international banks now drastically slowed the expansion of their credit exposure in the Baltic countries. This change of strategy is reflected in the balance of payments: in the years up to 2007, the liabilities of Baltic commercial banks to agents abroad (including their parent companies) in the form of deposits or loans had grown rapidly; in the two succeeding years, they decreased.⁹ The change in this sub-item of the financial account covers more than 80% of the change

8 ECB: EU Banking Structures, Sept. 2010, p. 20. The rescued Parex bank was the largest commercial bank that was domestically owned in the Baltic countries.

9 Changing credit liabilities enter the balance of payments in the financial account under the item "other investment (i.e. not direct investment, portfolio investment or reserves), liabilities"; see Table 1.

Table 1
Latvian Balance of Payments

(in € million)

	2006	2007	2008	2009	2010
Current + capital account	-3411	-4297	-2673	2047	995
Financial account	3311	4468	3083	-2191	-959
Financial account, direct investment	1201	1434	702	113	248
Financial account, portfolio investment	25	-496	255	123	-139
Financial account, derivatives	47	165	-71	301	-167
Financial account, other investment	3620	4084	1752	-1802	-182
Financial account, other investment, assets	-1550	-4374	-313	-740	-736
Financial account, other investment, liabilities	5171	8458	2061	-1063	554
of which: liabilities of commercial banks	4026	6120	363	-3085	-732
Financial account, reserves	-1584	-717	448	-927	-718
Errors and omissions	102	-168	-414	141	-35

Note: Sum of items can diverge from 0 due to rounding errors.

Sources: Eurostat, IMF International Financial Statistics.

in the overall financial account in the case of Lithuania; for Estonia and Latvia (see Table 1) the former is even larger than the latter. The turnaround in capital flows, mainly through the banking sector, was associated with a dramatic increase in real interest rates for credit (Figure 6) and a rapid contraction of bank credit to private households and non-financial corporations (Figure 7). While credit volumes in Latvia and Lithuania had grown by about 15% relative to GDP in the second half of 2006 and by about 30% in Estonia, they have been shrinking since 2009 by about 5% of GDP in all three Baltic countries.

All in all it seems fair to say that the Baltic current account balances were turned around mainly because the financial sector stopped the (relative to the size of the countries) massive inflow of capital from abroad. However, international banks stayed committed to their long-run engagement in the Baltic markets¹⁰: support for their domestic subsidiaries was enough to keep the financial sector stable – which is true for all of Central and Eastern Europe.

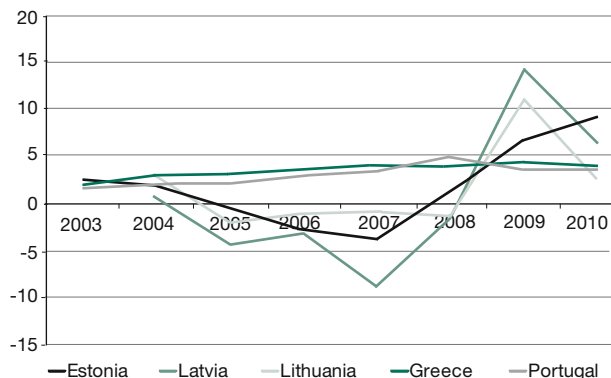
... and in the Southern European Crisis Countries

The Baltic economies were forced to adjust their macroeconomic imbalances in a very short space of time. Why were

10 For those economies in Central and Eastern Europe that were the targets of rescue programmes organised by the IMF, e.g. Latvia, the "Vienna initiative" made a valuable contribution: under mediation by the EBRD and the IMF, major international banking groups agreed on supporting their respective subsidiaries in the region.

Figure 6
Real Interest Rates in the Baltic States, Greece and Portugal

(Average Interest Rate on Credit to Non-financial Corporations (Outstanding Amounts) with a Maturity of Less than One Year less Annual Relative Change of the GDP Deflator)



Source: Eurostat.

Greece and Portugal not forced to do the same when, as the debt crisis intensified increasingly in the course of 2009 and 2010, the macroeconomic risks seemed equally as high as, for example, in Latvia in 2009? The main reasons can be found by looking at the different conditions for commercial banks.

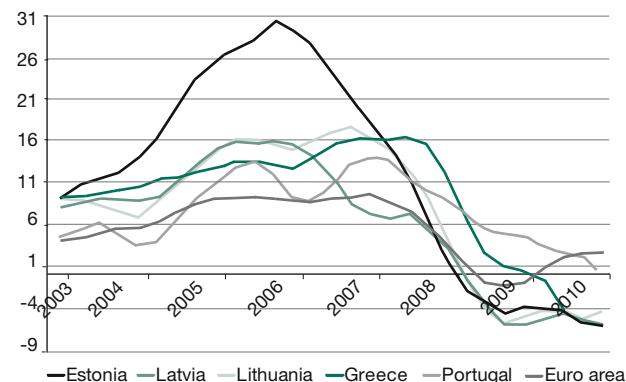
What the financial sectors in Greece and Portugal have in common with those in the Baltic countries is a strong expansion of credit for private households and firms in the years before the financial crisis. In 2008 and 2009, however, this expansion bottomed out at a markedly slower pace in the Southern European countries, and only after 2010 were the dynamics lower than in the euro area as a whole (Figure 7). The – up to the middle of 2010 – quite stable credit supply helps explain why the private sectors, other than those in the Baltic economies, had more or less balanced financial accounts (Figure 4).

However, with the intensification of the fiscal debt crisis, and as the liabilities of the respective fiscal authorities make for a significant share of total bank assets, the prospects of Greek and Portuguese banks deteriorated.¹¹ The loss of confidence has led customers to withdraw bank deposits to a significant extent: total deposits have been declining in Greece; the trend in Portugal appears to be down as well – though at a more moderate pace. In order to comply with their customer’s wishes, the institutes need a lot of liquidity. The interbank money market is, for lack of confidence, to a large extent closed for banks of the two southern countries. Unlike their Baltic peers, most banks do not have parent companies that might serve as

11 Banks in Ireland and savings banks in Spain have come under similar pressure.

Figure 7
Credit Expansion Relative to GDP in Per Cent

(Change of the Seasonally Adjusted Volume of Bank Credit to Private Households and Non-financial Corporations, Divided by the Seasonally Adjusted GDP; moving 3-quarter average)



Source: Eurostat.

lenders of last resort.¹² This position, however, has been filled by the Eurosystem: the national monetary authorities in the crisis countries provide the liquidity commercial banks need, frequently accepting as collateral sovereign bonds that can no longer fulfil this function on financial markets. When deposits change from, say, a Greek commercial bank to a French one, the position of the French bank vis-à-vis the Eurosystem, represented by the Bank of France, expands, and the position of the Greek bank vis-à-vis the Bank of Greece contracts. The change of positions of the national central banks is mirrored by changing balances in the TARGET2 system that takes account of the settlement of central bank operations.¹³ The large-scale refinancing of Greek and Portuguese banks (as well as Irish and Spanish ones) by the Eurosystem leaves its mark on the balance of payments as liabilities of the (national) monetary authorities (to the Eurosystem). In the case of Greece (see Table 2) and Portugal, these liabilities increased in 2010 by more than the “other liabilities” (consisting of currency, deposits and loans) of commercial banks decreased.

The ballooning liabilities of the national central banks of Greece, Portugal, Ireland, and for a brief time also of Spain, are primarily the symptom of a latent bank run. The relation to macroeconomic imbalances is far from one-to-one. For example, the increase in Irish liabilities in 2010, at €93bn, was larger than that of Greece, Portugal and Spain combined (€83bn), but the Irish current account (at 0.7% of GDP) was

12 Independent domestic banks have a market share of close to 80% in Portugal and more than 60% in Greece. See ECB, op. cit., p. 20.

13 For a detailed discussion of the role of TARGET2 balances see H.-W. Sinn, T. Wollmershäuser: Target Loans, Current Account Balances and the ECB’s Rescue Facility, CESifo Working Paper No. 3500, 2011.

Table 2
Greek Balance of Payments

(in € million)

	2006	2007	2008	2009	2010
Current + capital account	-20706	-28244	-30706	-23798	-21986
Financial account	20453	27570	29914	24396	22068
Financial account, direct investment	1043	-2284	1423	273	691
Financial account, portfolio investment	7391	17934	16894	28665	-21230
Financial account, derivatives	724	-492	-466	-802	376
Financial account, other investment	11519	12742	12094	-3636	42133
Financial account, other investment, assets	-5852	-16266	-27824	-23875	7639
Financial account, other investment, liabilities	17371	29006	39918	20238	34494
of which: liabilities of commercial banks	16080	29508	17692	2086	-31788
of which: liabilities of the monetary authorities	850	2715	23011	14652	36973
Financial account, reserves	-224	-322	-29	-106	97
Errors and omissions	262	699	793	-594	-80

Note: Sum of items can diverge from 0 due to rounding errors.

Sources: Eurostat, IMF International Financial Statistics.

close to equilibrium. In Ireland, the latent bank run just produced a shift in the composition of the financial account: the increase in the liabilities of the monetary authority offset the increase in deposits at foreign financial institutions (money that had been withdrawn from the Irish banks).

In all of the crisis countries, the financial sectors have stayed stable, thanks to the supply of liquidity from the Eurosystem. Thus, the Eurosystem prevented an imminent banking crisis in the euro area crisis countries in 2010 in a similar way as the internal capital markets of international banking groups did in 2009 in the case of the Baltic economies. The system, however, did even more: the liquidity flow into the Greek and Portuguese economies¹⁴ covered, in the three years between 2008 and 2010, more than 90% of the requirements for financing the current account deficits of these countries. What if this channel had not existed? Even if the financial sector had been kept stable by some mechanism, it appears doubtful whether a similarly cheap alternative of financing the current account deficits could have been found. In all probability, markedly higher financing costs would have induced private agents to reduce their spending drastically, like in the Baltic economies in 2009.

¹⁴ For Greece see again Table 2, “liabilities of the monetary authorities”.

Baltic Lessons for Southern Europe

Macroeconomic readjustment in the Baltic states gives us several insights that are useful for the present political debate on the euro area debt crisis. Firstly, a rapid reduction of current account deficits is possible, even if the exchange rate cannot be used as an instrument of adjustment. An improvement in the competitive position of domestic industry via deflation is not the decisive factor here, although it might, of course, be important for the medium to long-run growth prospects of the respective economies. Instead, a rebalancing of the current account can be achieved by an adjustment of the financial accounts of private agents. Such an adjustment can be enforced within a very short time if the financial sector is no longer willing to finance deficits at costs that are acceptable to private households and firms. The deep recession that accompanies such an adjustment process can be overcome relatively quickly if the financial sector stays stable, as was the case for the Baltic economies, where banks were backed up by their international parent institutions. The reduction of fiscal deficits, however, needs much more time, as the recession is a heavy burden on public households. The recession causes falling wages and an improvement in the competitive position of producers at home – at least if prices and wages are as flexible as in the Baltic economies.

The international rescue programmes for Greece and Portugal are not the main reason why macroeconomic adjustment, up to 2010, did not make much progress in these countries. What makes the difference is the financial sector: the ample flow of liquidity from the Eurosystem to Greece and Portugal has kept financing costs much lower than they would otherwise have been. Thus, it appears that a more rapid macroeconomic adjustment could be reached by slowing this flow of liquidity. For example, refinancing would become less attractive for commercial banks if the haircut on collateral demanded by the Eurosystem increased. A complete stop of liquidity support, however, would precipitate a disastrous banking crisis that was avoided in the case of the Baltic economies.

The price of macroeconomic adjustment in the Baltic states, with a collapse in production of about 20%, at first sight does not look very attractive. In summer 2011, the economies were still struggling with the debt overhang in the private sector.¹⁵ Still, societies in all three countries have opted against alternatives such as ending the fixed exchange-rate regime. Growth prospects, 2½ years after the Great Recession hit, are much better than in the euro area crisis countries. This might partly be due to the flexibility of the Baltic economies; but equally important is that macroeconomic imbalances have largely disappeared.

¹⁵ See V. Herzberg: Assessing the risk of Private Sector Debt overhang in the Baltic Countries, IMF working paper 10/250, 2010.