The Baltics Experiment

The broader implications for the European Central Bank.

By Barry D. Wood

At first glance, it is laughable to view the three small Baltic states in northeast Europe as systemically important. The combined €68 billion GDP of Estonia, Latvia, and Lithuania is not even 1 percent of the eurozone total. Statistically, the entire Baltic region is equivalent to two or three medium-sized cities in western Europe.

And yet the financial and economic tsunami that has swept over the region and the seven million inhabitants of these former Soviet republics is likely to have effects reaching far beyond Baltic shores.

With astonishing speed, the Baltic states lurched from being the European Union's fastest growers to its biggest decliners. The reversal was sudden and dramatic. In the three years after joining the European Union in 2004, Estonia, Latvia, and Lithuania registered Europe's highest growth rates, 8 percent to 12 percent advances annually. Per capita incomes rose by 50 percent, an achievement unmatched anywhere in transforming Europe. But in the late 2007, in the wake of America's subprime debacle, the region's housing bubble burst. The boom was fueled by what is now seen as reckless lending by Swedish banks, which accounted for much of the 40 percent to 50 percent annual increases in private sector credit flows.

In just months, growth stalled and went into reverse. In early 2008, Estonia was the first EU nation to slip into recession. The 8.7 percent growth the Baltics recorded in 2007 became a 0.7 percent decline in 2008. This year, according to the International Monetary Fund's July update of its *World Economic Outlook,* the shrinkage in the Baltics will exceed 10 percent. With the downturn still deepening in the third quarter, the Latvian economy is now expected to decline by a stunning 18 percent in 2009, while Lithuania falls 15 percent, and Estonia over 10 percent. Even with a mild upturn forecast for next year, growth is still expected to be negative in 2010. In all three economies, unemployment has quadrupled in

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the past year to levels ranging from 13 percent to 18 percent.

How did things get so much worse in the Baltics than elsewhere in the European Union?

Latvian Example

Stung by street protests, Latvia's free-spending government collapsed in February 2009 and was succeeded by a new coalition that forced through unprecedented austerity measures. The point man is finance minister **Einars Repse,** a dour, bulldog-like forty-seven-year-old physicist turned politician who is credited with taming runaway inflation by successfully introducing Latvia's currency when he ran the central bank in the 1990s. The combative Repse dismisses complaints that the 30 percent spending and wage cuts approved by parliament in June are excessive. "We have chosen deflation.

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UNHEEDED WARNINGS

Some experts saw the approaching crisis. Among them was Lars Christensen, Baltics specialist at Danske Bank in Copenhagen. In February 2007, he prepared a paper entitled "A Warning Not to Be Ignored." In it, he says, "We screamed about the imbalances," and argued that Latvia's current account deficit, in excess of 22 percent of GDP, was unsustainable. Heavy foreign indebtedness, he said, had put all three Baltic states in the danger zone. In Tallinn, Hardo Pajula of SEB Eesti Uhispank wrote in mid-2007 that, "The prosperity of Estonia and the other Baltic States was largely based on the credit lines of the Swedish banks." He continued, "I believe that the main threat to our economy lies in a global economic crisis that would inevitably influence Scandinavian banks." Pajula pointed to rampant property speculation, noting that Tallinn land prices had soared 500 percent in recent years. The Estonian economy, he said, needed to slow down from its 8–10 percent growth rate to facilitate better business decisions and to restrain rising inflation that had reached 6.5 percent.

The IMF's then-top official for the Baltics, Christoph Rosenberg, also sounded the alarm. In various 2007 presentations he warned that the boom was fueled by very high credit growth, which had contributed to consumer price inflation and soaring real estate prices. In Latvia, real wages had doubled in six years. Riga apartment prices were rising 40 percent a year and Latvia's inflation rate exceeded10 percent. In April 2008, Rosenberg told a regional seminar that the global credit crunch was "a blessing in disguise" because it reduced the Baltics' access to cheap financing and dampened expectations of continuing rapid wage growth, large public investments, and speedy euro adoption.

A new crisis could cause the European Central Bank to turn inward to protect its vulnerable members on the periphery—Greece, Ireland, and Portugal—and temporarily suspend further expansion.

It was the near-collapse and nationalization of the biggest home-grown Baltic bank, Parex, in November 2008 that triggered the crisis that sent Latvia running to the IMF for help. Deeply involved with Russia, Riga-based Parex had 271,000 customers, a 15 percent market share, and was the only local challenger to the Swedish banks that dominated the Latvian market. With assets approximating 20 percent of Latvian GDP, Parex handed itself over to the government when it appeared it might default on $1 billion of syndicated credits due in 2009.

In the initial loan discussions, IMF staff questioned whether in the midst of a downturn the country was well-served by maintaining its fixed currency peg to the euro, which during the boom had been the emblem of successful post-communist transition. But the Swedish banks that were so heavily exposed to Latvia, as well as the Latvians themselves and top European Union officials, argued that devaluation would trigger massive defaults on the majority of Latvian mortgages denominated in euros and held by Swedish banks. Mark Allen, head of the IMF's office for Central Europe and the Baltic States, acknowledged "that there would be a chain reaction in the region" if the Latvians devalued. Devaluation, other analysts warned, would have

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contagion effects not just in Estonia and Lithuania but in Bulgaria, which also pegs its currency to the euro.

In the end, the European view prevailed. In announcing the December 23, 2008, loan agreement, Rosenberg said the program was centered on maintaining the exchange rate peg, "while recognizing that this calls for exceptionally strong domestic policies and substantial international financial assistance." He concluded, "The current global financial crisis has brought Latvia's vulnerabilities to a head. Years of unjustifiably high growth and large current account deficits have coalesced into a financial and balance of payments crisis." Significantly, the IMF arrangement covers only 20 percent of Latvia's financing gap. The bulk of the €7.5 billion ($10 billion) package comes from the European Union, the European Bank for Reconstruction and Development, Sweden, and other Nordic countries.

"WE CHOSE DEFLATION"

Policymakers in all three Baltic States argued persuasively that long-term stability would come only from membership in the now sixteen-nation eurozone, which they aspire to join. As the membership criteria require low interest rates, low inflation, a budget deficit under 3 percent of GDP, and two years of exchange rate stability, they recognize that devaluation upends their accession plans. Estonian officials say they will meet the criteria next year and join in 2011. Latvia had hoped for 2012 and Lithuania 2013, but that timetable is slipping. Policymakers acknowledge that absent currency depreciation, restoration of competitiveness requires compression of prices and wages, a savage "internal devaluation." Accordingly, the three Baltic states have been willing to endure deflation as the only alternative to devaluation.

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Most outside analysts are unconvinced. Economist Nouriel Roubini believes the IMF was mistaken in allowing Latvia to keep the peg. Paul Krugman says devaluation appears inevitable. Christensen says holding the peg is "mission impossible." The Latvians, he says, "are trying to do something that has never been done before…cutting wages and prices during a contraction to restore competitiveness." Former IMF economist Desmond Lachman, now at the American Enterprise Institute, says the Latvians have put themselves into a straightjacket and gone into depression for what will ultimately be a failed effort to hold the peg. Lachman doesn't foresee either the Latvians or the Estonians entering the eurozone. But Anders Aslund of the Peterson Institute for International Economics supports the peg, saying that with enough outside support it can be defended. He points to the progress already made as the current account deficit that was 25 percent of GDP in 2007 has already shifted to surplus.

The December 2008 IMF program required Latvia to hold its budget deficit to 5 percent of GDP. But since December, the economic and revenue outlook has worsened so much that even with draconian spending cuts, the 2009 deficit is likely to be 10 percent and the 2010 deficit 8.5 percent. Believing that despite exceeding the program's limits, the Latvians will get their money, Christensen suspects there is an implicit guarantee that the European Union will bail out any member country that gets into financial trouble. For him, the bigger question is the institutional arrangements evolving between the European Central Bank, its constituent central banks, and the IMF. "Suppose," Christensen asks, "that an even bigger bailout for Latvia is agreed and then one of the other Baltic states decides to devalue. What then?" Returning to the theme that Europe pressed for the Latvian bailout to prevent contagion and Swedish banks having to take a hit from a rush of loan defaults, Christensen believes a new crisis could cause the European Central Bank to turn inward to protect its vulnerable members on the periphery—Greece, Ireland, and Portugal—and temporarily suspend further expansion. Should that happen, say experts, there would be an immediate adverse market reaction as well as political turmoil in the Baltics. The contagion that was to be avoided would almost certainly be unleashed.

Time will tell. ◆