
The Financial Crisis of 2007-10 in Eastern Europe and the Baltics

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Initial assumptions

Any analysis of certain policy decisions should start with the prevailing assumptions at the moment of decision making. There were several important tenets in the Central and Eastern Europe (CEE) during the early transition years. In the aftermath of hyperinflation, change of currencies, loss of all the lifetime savings for many elderly, fixed exchange rate regimes (particularly, in the Baltics) were chosen to “provide strong nominal anchors” (Purfield and Rosenberg, 2010) and were perceived as the precondition for stability and trust in the financial system. Another strategic goal was to become part of the European Union (EU) to foster greater stability, security, mobility, and increased living standards, and to join the eurozone as soon as possible to increase the easiness of cross-border business transactions and get access to cheaper financing for growth.

The assumptions that 1) fixed exchange rate provides trust in a newly emerging economy, 2) European Union is a great “club” to be part of, and 3) European monetary union (without political and fiscal union) is a good thing, can be strongly debated, but it will not be done in this note. It is, however, important to understand that the policy decisions were made based on these assumptions being true.

Background

After joining the EU, the new member states entered a fast growth period, with the highest growth rates observed in the “Baltic tigers”. As reported by Purfield and Rosenberg (2010), the cumulative changes in GDP from end 2003 to peak averaged over 30 percent in the CEE, and over 50 percent in Latvia. The fast growth in the Baltics was largely fostered by the excessive capital inflow in form of foreign (predominantly, Scandinavian) bank capital that was distributed in private and corporate sector credits. For example, in Latvia the total bank assets grew from LVL 5B in 2003 to LVL 23B in 2008 (increase equivalent to yearly state budget per annum). The credit growth in the Baltics was in the range of 40-60 percent per annum in 2005-07, but far more moderate in the CEE average (see Purfield and Rosenberg, 2010, and Bakker and Gulde, 2010). The two main Swedish banks active in the Baltics – Swedbank and SEB – “sought to engineer a controlled deceleration of credit growth” (Purfield and Rosenberg, 2010), but these attempts were made more difficult by late entry of another Nordic bank (Nordea), that sought...
to gain the market share, often at the expense of the incumbent banks. Eventually a prisoner’s dilemma evolved (see Figure 1), and credit growth caused inflation, real-estate bubble and rapid wage increase.

With the global financial market confidence loss after the Lehman’s bankruptcy in September 2008, the capital inflows in the CEE experienced a sharp drop, particularly so in the Baltics.

As shown in Bakker and Gulde (2010), the Baltics experienced the most extreme boom-bust cycle, while central European countries had a much more moderate recession. Most notably, Poland did not experience a single year of negative GDP growth.

**Alternatives**

Faced with large current account deficits, excessive public spending, no new credit availability, freeze-up of global financial flows, and concerns about the health of parent banks, the Baltic governments faced severe challenges in the fall of 2008. Moreover, the Maastricht criteria (the ticket to joining the eurozone) required, among others, the government budget deficit below 3 percent of the GDP, and the public debt below 60 percent of the GDP.

**Alternative 1: Nominal (external) devaluation**

It was evident that the floating exchange countries (such as Czech Republic, Poland, Romania and Slovak Republic) experienced a much less pronounced boom-bust cycle. It is fair to say that “fixed exchange rate countries face greater challenges when confronted with capital inflows than floaters” (Bakker and Gulde, 2010), nevertheless, we have to remember that the fixed exchange rate regime in the Baltics carried a much heavier “definition” than in many other countries (see the initial assumptions). Given the context with the fixed exchange rate policy, as well as the enormous foreign currency loan exposure, we can only speculate about how severe the devaluation effects would have been in the Baltics. See Figure 2 for the comparison of GDP per capita growth from 1993 to 2011 in Estonia (fixed exchange rate) and Poland (floating exchange rate).
Alternative 2: Borrow more

The borrowing in late 2008 would have been possible (either internally or externally) at excessively high interest rates, clearly breaching the Maastricht requirements on budget deficit and public debt levels for many years to come.

Alternative 3: Printing money or Quantitative easing

Several arguments speak against this alternative. First, direct quantitative easing has not been a tool used by the European Central Bank (ECB). Second, such a tool is practically impossible without floating the currency. Third, “printing money causes hyperinflation” rationale is very strong among the public, and hyperinflation, in turn, would destroy any accumulated trust in the CEE. Finally, the mechanisms for the Central Banks to force (foreign) commercial banks to continue crediting rather than taking new reserves home most probably were limited. The International Monetary Fund (IMF) though managed to secure the confirmation from the Scandinavian banks that they will not repatriate the capital after the EU/IMF support program funding was released in Latvia.¹

Alternative 4: ”Internal devaluation”

The “internal devaluation”, or cutting wages and public expenditures, was motivated by the argument that one should cure the symptoms of the illness, rather than the consequences. The symptoms in this case were excessive wage growth (see Figure 4b) and public expenditures, and the main consequence was low competitiveness.

Internal devaluation: Reasonable alternative?

From the four alternatives mentioned above, the most heated debate continues about the “nominal devaluation” versus “internal devaluation”. The proponents of the currency devaluation, including the Nobel laureate Paul Krugman (e.g., in a conference in Iceland, 26 Oct, 2011), argued that internal devaluation was an unnecessary painful way to overcome the crisis.

The “pain” is typically measured by a single year GDP contraction which was the highest in Latvia (by about 25 percent) and the lost workplaces (by about 20 percent in Latvia, Q2 2008 to Q1 2010). Mark Weisbrot from the CEPR in Washington was even more vocal in a conference in Latvia (2 Nov, 2011), “Save or Borrow for Growth?” His argument was that the “belt-tightening” policy implemented in Europe has been highly counter-cyclical and exacerbated the current sovereign debt crisis around the world. He perceives Argentina as a success story (Weisbrot et al., 2011) where currency devaluation in December 2001 (as a result of severe recession from mid-1998) put Argentina back on the fast growth path, as well as curbed the unemployment. As we see from Figure 3, Argentina indeed has shown a steep growth in GDP per capita terms since 2002 (9 percent per annum) and exceeded Latvia since 2009. However, since 1993, Argentina has grown

¹ Christoph B.Rosenberg, IMF, during a seminar at the Stockholm School of Economics in Riga, 9 Nov 2011.
by 4.8 percent per annum, compared to 6.9 percent per annum in Latvia. The EU and euro accession goals have largely contributed to the structural reforms, generally conservative fiscal policies, and maintenance of financial sector stability. In Argentina, inflation spiked to over 25 percent in 2002, and has been in high single digit or low double digit numbers since then, i.e. a policy not viable for the Baltics given the eurozone accession plans.

Lost workplaces have been another major factor questioning the success story of the internal devaluation. The biggest challenges in the Baltics are related to the labor issues. In Latvia, 200 thousand people, or about 13 percent of working-age population, lost an official workplace (during mid-2008 to mid-2010), see Figure 4a. People “solved” this situation in two ways – unofficial employement and emigration. According to the estimates of a labor economist in Latvia (Hazans, 2011), during 2000-2010 net emigration in Latvia was approximately 200 thousand people (around 10 percent of the population), though only part of this emigration was caused by the recession. As long as there is a considerable income level difference between the new and old member states (see Figure 2b), certain amount of people will move due to open borders and labor markets, irrespective of the current economic conditions in the country.

![Employment (Latvia, '000) vs Average net wages, LVL](image)

The highly praised fiscal adjustment of “close to 10 percent of GDP in 2009 alone” (Åslund, 2011) causes several concerns. Parts of the “cuts” were indeed long awaited, but substantial part resulted in reduced quality of public services. Three major areas for concern, in my view, are education, healthcare, and longer-term health problems due to excessive over-time work. Qualitative education and healthcare in the Baltics has become a paid service. The reduced number of employed people, both in private and public sector typically resulted in all the previous work allocated to the remaining people. I would argue that few changes were really structural, coming from zero-based budgeting and maintaining the quality of public services. Although having its merits in 2009-10, I believe the formal fiscal adjustment during 2011 has been unnecessary, and done at the expense of longer-term growth and public service quality.

**Back to initial assumptions, or How replicable this strategy is?**

The Baltic case is relevant if another country faces similar initial assumptions. If the fixed exchange rate is an important policy anchor (not the case for Greece), if there is a clear policy target to enter a “club” that requires certain monetary and fiscal discipline (not the case for Greece, as they are in already), or if the country wants to maintain high international reputation (e.g., high credit ratings) to finance future growth cheaper (may be the case for Greece), then the Baltic experience shows that internal devaluation, though with rather high social costs, is possible.
As Eichengreen et al., 2011 argue, the countries that rely on undervalued exchange rates to boost economic growth are more susceptible to slowdowns following a fast growth period. They conjecture that currency undervaluation is not a viable mechanism to sustain fast growth when growth becomes more innovation intensive. In addition, there is some indication that policy instability – high and variable inflation rates – are precursors to slowdowns. In the context of these findings, one may argue that the Baltic countries are ready for a continuous convergence towards the EU averages.

References


