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

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GDP: Boom and Bust

– High growth 2000-7,
– 2009: Big fall in Baltics, growth in Poland, average declines elsewhere
– Almost all back to growth in 2010
– Baltics back on top, Hungary remains the laggard
Indicators of Overheating

• Large current account deficits
• Excessive credit expansion
• High and rising inflation
Current Account Balances Swung around, 2007 vs 2010

Percent of GDP

Source: IMF
High Inflation Fell to Normal Level, 2003-2011

Average Consumer Prices, Percent Change

Source: IMF
Fiscal Consequences of Crisis

• Sharply rising budget deficits: checked
• Surging public expenditures: major lingering concern
Budget Deficits: Minimal in 2007, 6% of GDP in 2009

Source: Eurostat
Public Expenditure as Share of GDP: Rose by 10 percentage points in Baltics

Source: IMF
Public debt remains limited, end 2010

(percent of GDP)
1. Substantial Fiscal Adjustments

- Balts: Public adjustment of 9% of GDP in 2009
- Latvia reduced public salaries by 28% in one year
- Closed half state agencies
- Sacked 30% of public employees
Major Public Sector Reforms

• Public administration trimmed
• Education reforms
• Health care reforms
• But pension reforms reversed to save the poor
Maastricht Criteria More Respected in CEE

• Average public debt in 10 CEE 39% of GDP in 2010, but 85% of GDP in eurozone

• Only Hungary has exceeded the Maastricht debt ceiling, but 12 of 14 Western EMU members
Will CEE BE Competitive?

• Public expenditures must be brought down

• Business environment?
  – Ease of doing business
  – Corruption

• Real unit labor cost

• Real effective exchange rate

• Investment ratio
Ease of Doing Business, 2012: Decent, Baltics Lead

Lower score indicates greater ease of doing business

Source: World Bank
Corruption Perception Index, 2010: Est and Slo lead

Highly Clean = 10, Highly Corrupt = 0

Source: Transparency International
REER, 2008 – 2010: Balts & Pol Improved Greatly

Index, 2008=100, ULC

- Estonia, Latvia, Lithuania
- Slovakia, Slovenia
- Bulgaria, Romania
- Greece, Italy, Spain, Portugal

Source: Eurostat
Investment Was Sound, But Must Recover

Percent of GDP

Source: IMF
Total Exports, Percent Increase 2010 – 2011 (First Half, yoy): Increased Most Where Exchange Rate Fixed!

Source: Eurostat
Paradox: Currency Board Countries Increased Exports Most

• Nominal depreciation: Not necessary to kickstart exports
• Internal devaluation causes greater structural reforms than nominal devaluation
• The ultimate reason for greater reforms: undesired liquidity squeeze.
• Thus, currency board countries stay committed to euro adoption to avoid future liquidity squeeze.
European Convergence, GDP in PPP as a % of EU: Substantial, and Likely to Continue

Source: World Bank
Conclusions

• Baltic countries have carried out most structural reforms – likely to enjoy most growth
• Hungary, Romania and Bulgaria: More austerity than structural reform – likely to see less growth
• Poland suffered no crisis & Czech Republic, Slovenia & Slovakia little – no major changes.
• But the whole region save Hungary looks good.