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

Presented by Anders Åslund

Discussion by:
Anete Pajuste, PhD
Associate Professor of Finance
RTU Riga Business School, Latvia

Atlanta, 29 November 2011
Initial Assumptions

- Fixed exchange regime – strong policy anchor (in the Baltics)
- European Union is our “club”
- Eurozone is good, and the ultimate goal is to enter it
### Background

- **Prisoner’s dilemma in the banking sector**

<table>
<thead>
<tr>
<th>BANK A</th>
<th>BANK B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conservative lending</strong></td>
<td><strong>Aggressive lending (&quot;Grab the market&quot;)</strong></td>
</tr>
<tr>
<td>Conservative lending</td>
<td>A</td>
</tr>
<tr>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>B</td>
<td>A</td>
</tr>
</tbody>
</table>

**Strategic partners**

- UB
- uOttawa
- RBS
- Riga Technical University
Alternatives

- Currency (external) devaluation
- Less pronounced boom-bust cycle for floating exchange countries
- But... special conditions in the Baltics

GDP per capita, PPP, current Intl.$
(IMF World Economic Outlook database)
Alternatives (2)

- Borrow more
  - Maastricht criteria...
- Print money or Quantitative easing
  - Policy not favored in the EU
  - Fear from inflation
  - Commercial banks’ actions
“Internal devaluation”?

- Cut wages and public spending
  - Argument: cure the symptoms

- Severe budget consolidation
  (expenses cut from LVL 6.3 bn in 2008 to LVL 4.8 bn in 2011)

---

**Average net wages, LVL**

- Average -11% p.a.
- Average +19% p.a.

**Budget deficit, % of GDP**

- 2003 H1 to 2011 H1
“Internal devaluation” - concerns

- Lost workplaces (13 percent of working-age population)
  - “Solutions”: unofficial work; emigration

- Fiscal adjustment implications
  - Qualitative education and health care has become a paid service
  - Quality of public service has deteriorated
  - Over-time work
According to Eichengreen et al. (2011) study:

- Undervalued exchange rates not viable for long-term (innovation intensive) growth
- Policy instability are precursors to slowdowns

Convergence is likely to continue
Thank you!
Extra slides (for reference)
Latvia vs. Argentina

GDP per capita, PPP, current Intl.$

- Argentina
- Latvia

Strategic partners
Employment (Latvia)

Employment (Latvia, '000)

13% of work-age population

Strategic partners

uOttawa

Riga Technical University

RBS
Current situation: loan portfolio quality

- Loan loss provision to net loans
- The share of loans 90+ days past due in total non-banking loans

Source: Financial and Capital Market Commission in Latvia
Tools to overcome the financial sector crisis: The Case of Latvia (1)

- Strong financial support from the state (total of 1.03 bn LVL injected)
  - To avoid the systemic risk (bank runs)
- Restructuring of the problem bank
  - Citadele bank (“good assets”) and Parex bank (“bad assets”)
- Close monitoring by the financial market regulator (www.fktk.lv)
  - Since the beginning of 2009, 19 banks have increased their share capital in total by 1.3 bn LVL