OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

Boom and Bust in the Baltics – What lessons for South-Eastern Europe?

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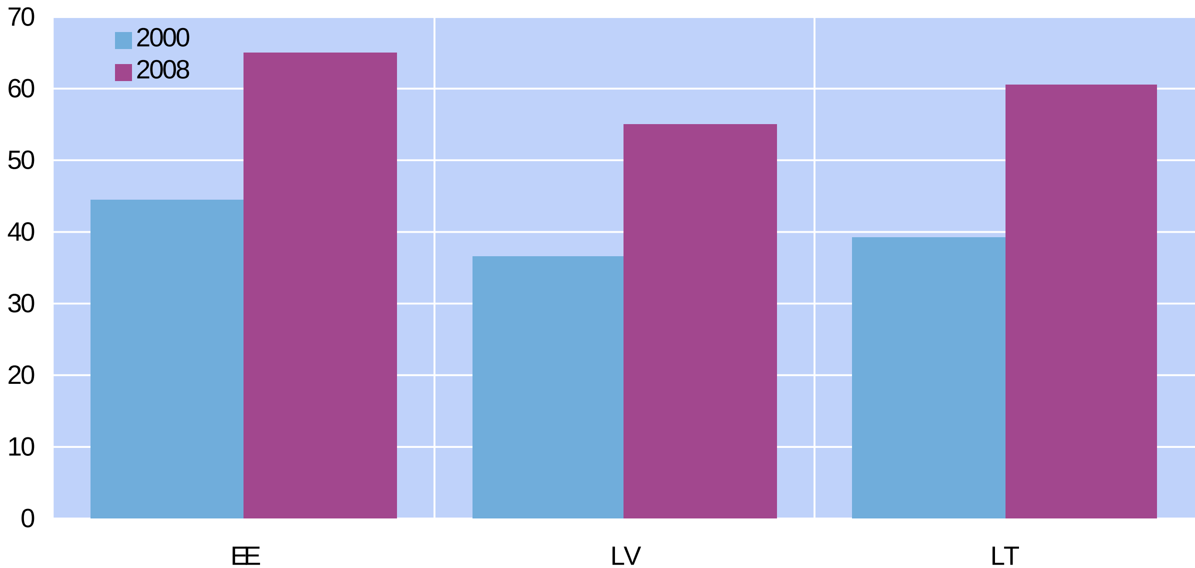
Outline

- The Boom and Bust in the Baltic Countries
  - Key Features of the Boom Period
  - From Boom to Bust
- Current Macro-financial and Structural Challenges in the Baltics and in South-Eastern Europe
- What are the Lessons from the Baltic Experience?
  - Macroeconomic Lessons
  - Microeconomic Lessons

Main Drivers of the Growth and Convergence Process

Impressive catching-up process in the Baltic countries since 2000 …

GDP per capita in PPS (EU-27=100)

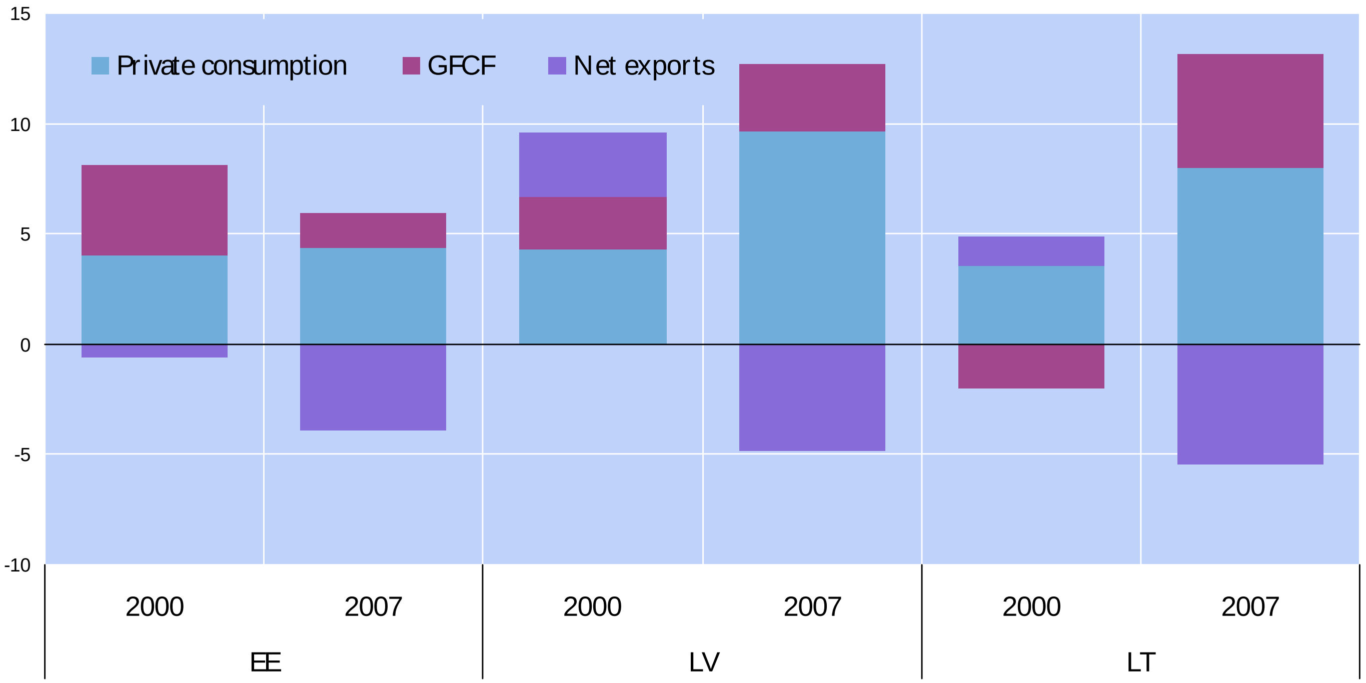


Source: Eurostat

Main Drivers of the Growth and Convergence Process

…mostly (and increasingly) driven by domestic demand.

Contribution to the increase of GDP

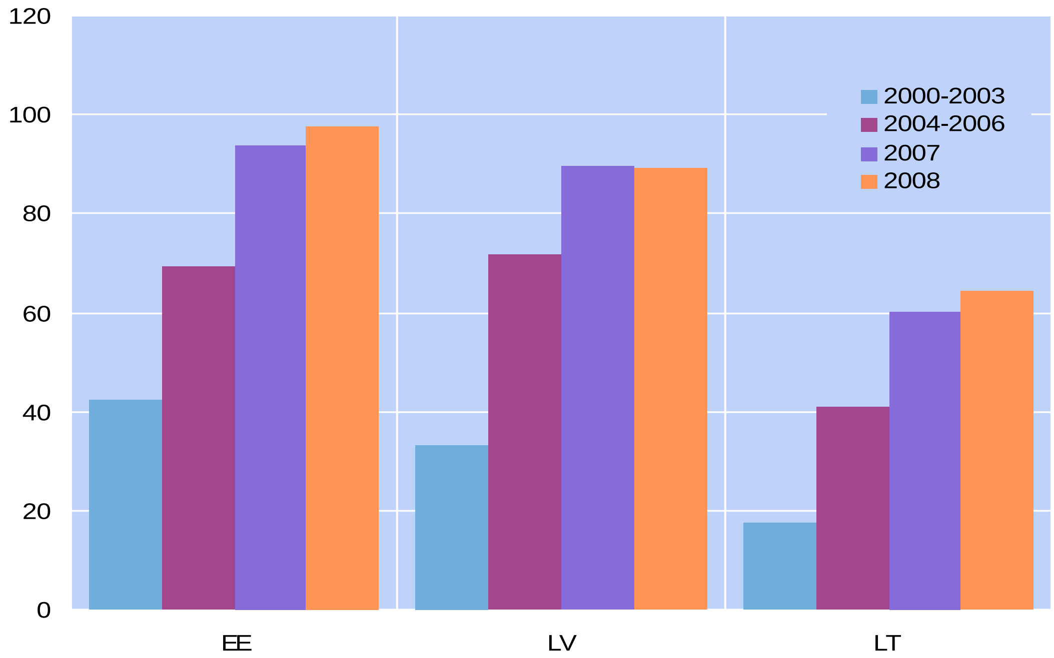


Source: Ameco, NB's

Main Drivers of the Growth and Convergence Process

Domestic demand was fuelled by rapid financial deepening...

Domestic claims, eop, as % of GDP

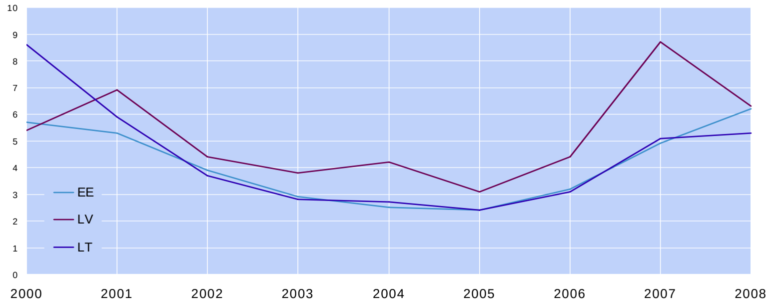


source: NCB's, OeNB

Main Drivers of the Growth and Convergence Process

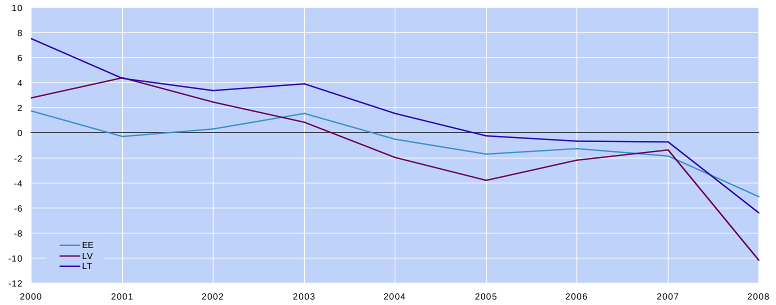
...in times of low nominal and (often) negative real interest rates.

Short-term interest rates, nominal



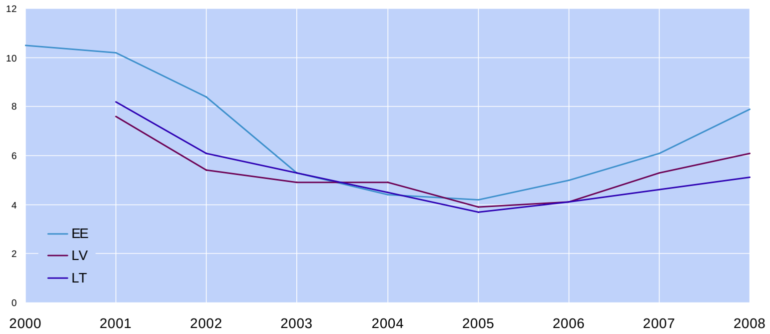
Source: EC Economic Forecast Autumn 2008, Bloomberg, NB's

Short-term interest rates, real



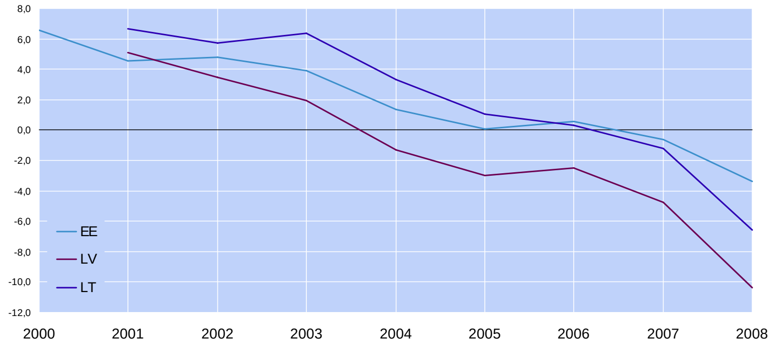
Source: EC Economic Forecast Autumn 2008, Bloomberg, NB's

Long-term interest rates, nominal



Source: EC Economic Forecast Autumn 2008, Bloomberg, NB's

Long-term interest rates, real

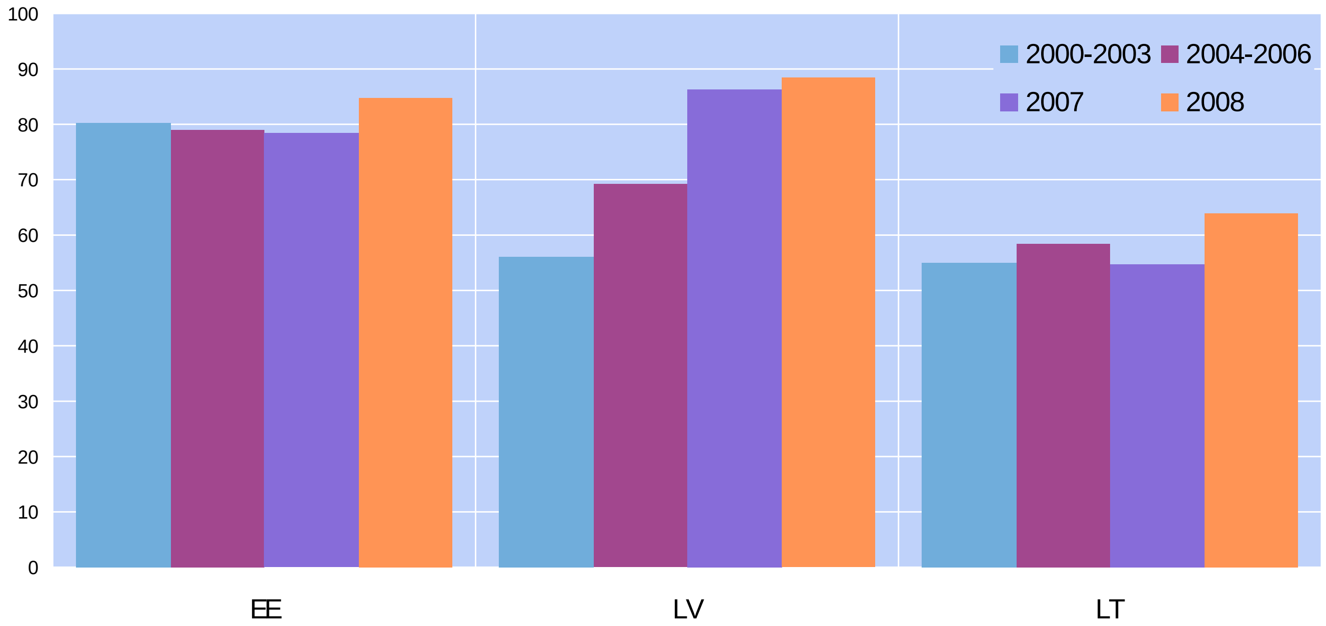


Source: EC Economic Forecast Autumn 2008, Bloomberg, NB's

Main Drivers of the Growth and Convergence Process

Foreign-currency denominated loans played a major role.

Share of foreign currency loans to domestic non-banks as % of total



*incl FX indexed loans, for BH indexed loans included since 2003

Source: NB's, OeNB, FX Loans to Domestic comprises: gen.gov, NFC, Non-m FC, HH, NPISH

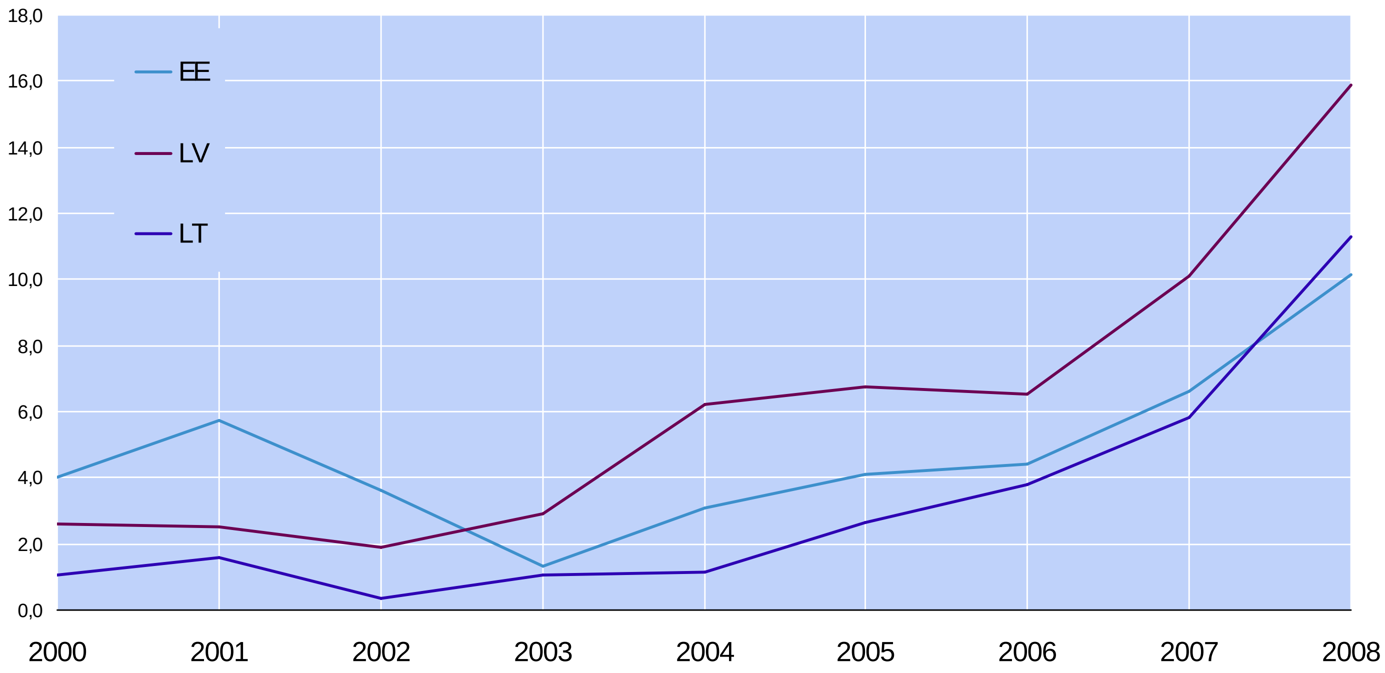
Main Drivers of the Growth and Convergence Process

- Rapid growth in real estate prices – also compared e. g. with Ireland and Spain. Linked with financial deepening.
- Other factors stoking domestic demand:
  - Remittances from an increasingly large number of emigrants.
  - Funding from EU Cohesion Policy.
- Fiscal policy tended to be either insufficiently restrictive or even pro-cyclical.
- Current public expenditure (in % of GDP) increased in some countries and low tax levels stoked the boom.

The Build-up of Internal and External Imbalances

Inflation increased strongly in the Baltic countries in recent years.

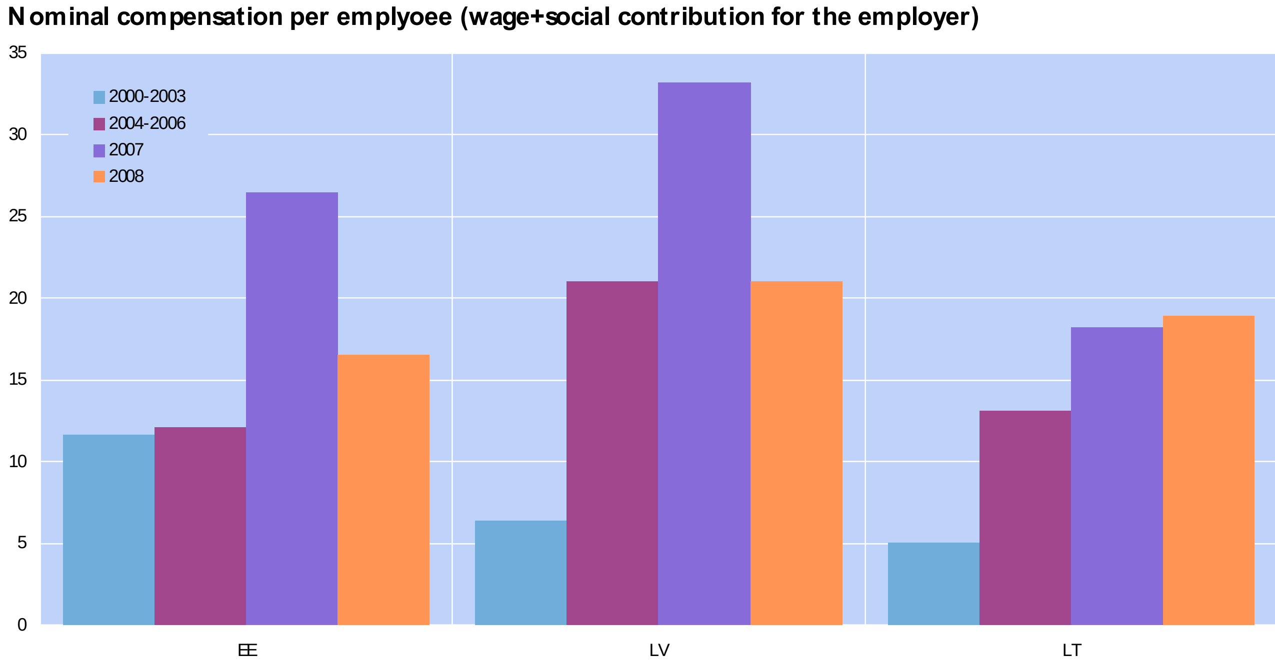
Inflation, average consumer prices yoy change



Source: WEO IMF, EIU

The Build-up of Internal and External Imbalances

Inflationary pressures were broad-based. Besides external factors labour cost increases were an important factor.

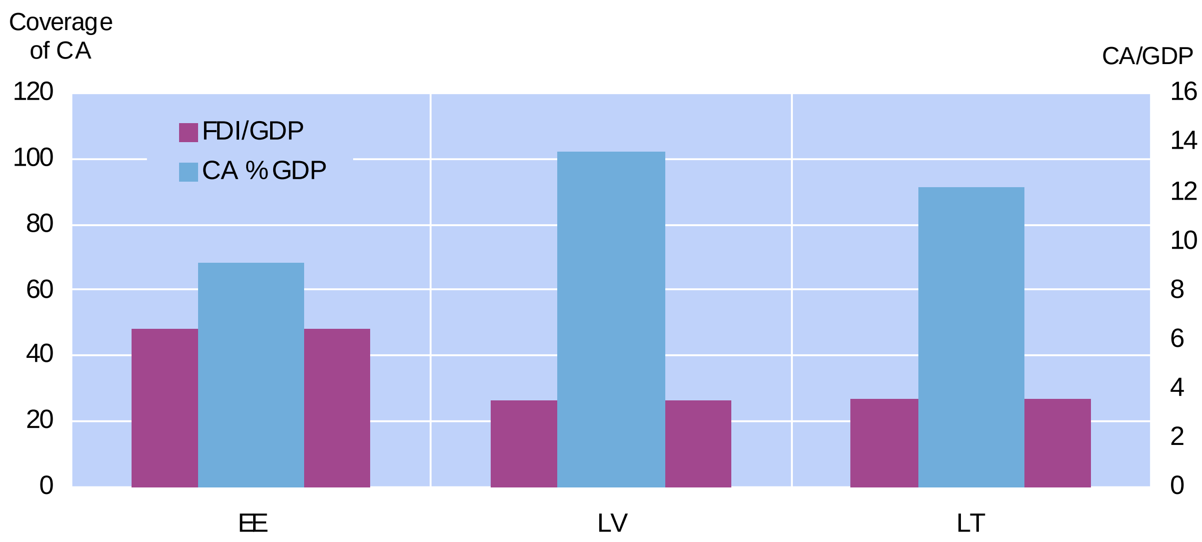


Source: Ameco

The Build-up of Internal and External Imbalances

Strong growth in recent years was linked with considerable CA deficits in the Baltic countries - only partly covered by FDI.

Current account deficit as % of GDP, Coverage of Current account by net FDI, 2008



Source: Ameco,

From Boom to Bust in the Baltic Countries

Was real convergence at this speed sustainable? A few years ago the views among policy makers and observers differed widely!!

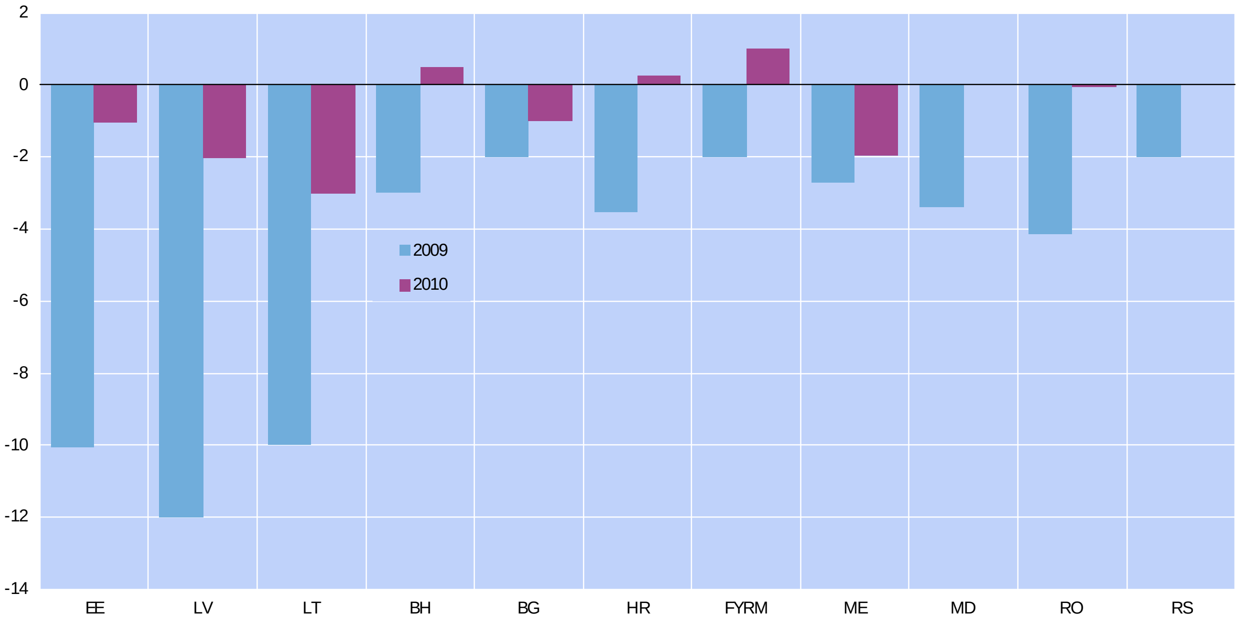
From Boom to Bust in the Baltic Countries

- GDP growth in the Baltic countries peaked in 2006/07 → triggers for turning in growth cycle domestic.
- Interaction between financial and real sector played a key role in the process
- Exchange-rate regimes limited scope for policy action and available instruments were mostly used too late / too timidly.
- Growing risk-awareness by banks led to more restrictive lending and real estate bubble became apparent.
- International financial crisis severely aggravated the 'domestic' downturn since 2008.

Current Challenges in the Baltics and in SEE

GDP forecasts are negative for most countries and forecast revisions still tend to be downward.

GDP, constant prices, y/y growth

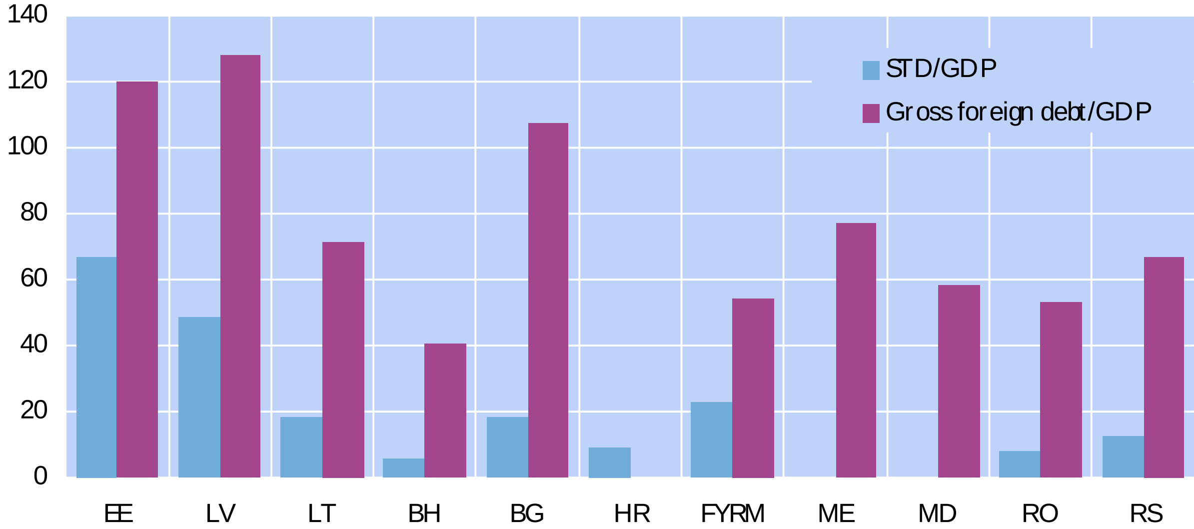


Source: IMF WEO 04/2009

Current Challenges in the Baltics and in SEE

The need to obtain financing has become a key challenge for Baltic and SEE countries as external financing and foreign demand dried up.

Debt and reserves 2008



Source:NB's, Art IV IMF, OeNB

Current Challenges in the Baltics and in SEE

As a result of the difficult macroeconomic situation ratings were downgraded…

Foreign currency long-term debt

	Moody's	outlook	S&P's	outlook	Fitch	outlook
EE	A1*	-	A	-	BBB+	-
LV	Baa3	-	BB+	-	BB+	-
LT	A3	-	BBB	-	BBB	-
CEE-ET						
BH	B2	=	B+	=		
BG	Baa3	=	BBB-	-	BBB-	-
FYRM			BB-	-	BB+	=
HR	Baa3	=	BBB-	-	BBB-	=
ME	Ba3*	-	BB+	-		
CEE-IT						
MD	Caa1	=			B-	=
RO			BB+	-	BB+	-
RS			BB-	-	BB-	-

* FC Issuer Rating
Source: Bloomberg as of 05/15/2009

Current Challenges in the Baltics and in SEE

…and some countries needed to take recourse to IMF / (EU) programs.

	Total Credit (in bn. USD)	of which IMF (in bn. USD)	in percentage of quota	other payments (in bn. USD)
Bosnia and H.[1]	1.52	1.52	600%	none
Latvia	10.42	2.4	1.223 %	EU: 4.29 MTFA World Bank: 0.552, EBRD: 0.14 SW, DK, NO, FI: 2.48 CZ: 0.28, PL: 0.14, EE: 0.14
Romania	26.3	17.1	1.111 %	EU: 6.6 World Bank: 1.3 EBRD, EIB and IFC: 1.3
Serbia	4	4	560 %	none
Ukraine	16.4	16.4	802 %	none

[1] This Staff Level Agreement on a USD 1.52 Stand-By Arrangement is subject to approval by IMF Management and the Executive Board.

What are the Lessons from the Baltic Experience?

A number of macro- and microeconomic lessons can be drawn from the Baltic experience – but there are obvious caveats!

- **The Baltic and – even more – the SEE countries are a rather heterogeneous group!**
- **By and large, however, the Baltics are already further down the 'Convergence Road' than the SEE countries, both in terms of economic developments and institutional integration in the EU.**
- **Many of the Baltic Boom and Bust lessons relate to a world where external financing is readily available.**
- **This seems like a distant world at the moment – but will hopefully be less distant again in the future!**

What are the Lessons from the Baltic Experience?

1) Fiscal policy should be countercyclical and create room for macroeconomic manoeuvre in times of need.

Net lending/ borrowing general government % of GDP

	2005	2006	2007	2008	2009	2010
EE	1,5	2,9	2,7	-3,0	-3,0	-3,9
LV	-0,4	-0,5	-0,4	-4,0	-11,1	-13,6
LT	-0,5	-0,4	-1,0	-3,2	-5,4	-8,0
BH[2]	0,8	2,2	-0,1	-1,9	-2,5	
BG	1,9	3,0	0,1	1,5	-0,5	-0,3
HR	-4,2	-3,0	-2,5	-2,0	-3,3	-2,7
FYRM		-0,5	0,6	-1,0	-3,5	-3,7
ME[1]		2,1	6,4	1,5	-6,2	-7,9
MD[1]	1,3	0,2	-0,2	0,0	-0,5	-0,5
RO	-1,2	-2,2	-2,5	-5,4	-5,1	-5,6
RS[1]	0,8	-1,6	-1,9	-2,3	-1,8	-1,0

1 Art IV IMF, PRGF

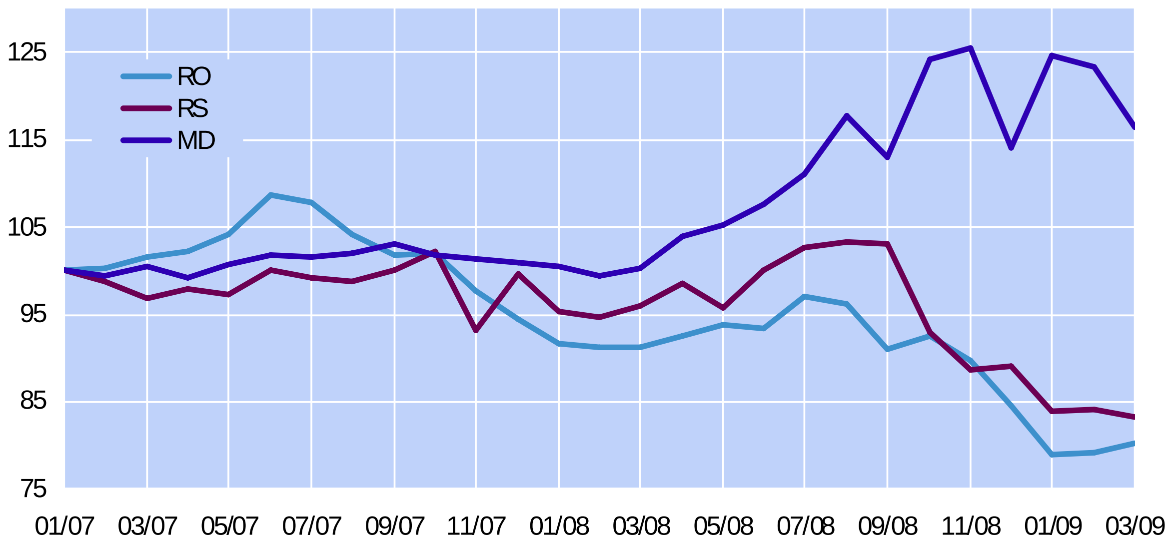
[2] until 2003 CBBH (Overall balance of General Government), since 2004 Art IV IMF(general govt budget)

Source: AMECO

What are the Lessons from the Baltic Experience?

2) Choosing the appropriate Exchange Rate regime is difficult and implies trade-offs. Fixed ER anchors have obvious advantages but increase the risk of 'speeding' and may impede competitiveness.

CEE-IT exchange rates



Source: NCB's

What are the Lessons from the Baltic Experience?

Are ER regime shifts an option? Involve high costs with balance sheet risks and the flexibility of the economy as important considerations.

	Low Balance Sheet Risk	High Balance Sheet Risk
Flexible Costs	?	Clear case to hold the peg
Rigid Costs	Clear case to depreciate	?

Source: Watson (2009)

Share of foreign currency (loans to domestic non-banks) as % of total

	2000-2003	2004-2006	2007	2008
EE	80	79	79	85
LV	56	69	86	88
LT	55	58	55	64
BH*	55	68	74	73
BG	39	47	50	57
HR*	82	76	63	66
FYRM*	38	48	57	56
RO			53	56
RS**		75	74	68

*incl FX indexed loans, for BH indexed loans included since 2003

** Share of net (excl.provisions) fx-indexed and fx-denominated loans

Source: NB's, OeNB, FX Loans to Domestic comprises: gen.gov, NFC, Non-m FC, HH, NPISH

What are the Lessons from the Baltic Experience?

3) A balanced growth pattern reduces the risk of boom-bust cycles (the Baltic bust was worsened but not caused by the International Financial Crisis!).

This raises two questions:

- How can domestic ‘bubbles’ be avoided?
- How can external competitiveness be maintained / increased?

What are the Lessons from the Baltic Experience?

How can domestic ‘bubbles’ be avoided?

- Manage expectations (e.g. by appropriate public wage setting and prudent fiscal policy)!
- Counteract ‘excessive’ credit growth (by banks and non-banks).
- Establish a central credit registry.
- Beware of policies that fuel real estate bubbles (e.g. tax deductibility of mortgages, absence of property taxes…).
- FX-denominated credit growth adds to balance sheet risks

What are the Lessons from the Baltic Experience?

How can external competitiveness be maintained / increased?

- Promote / maintain labour market flexibility and avoid labour market bottlenecks (e.g. by means of education and training, migration policy…)
- Promote / maintain product market flexibility and the attractiveness for FDI.
- Help exporting companies to climb the ‘quality ladder’.

What are the Lessons from the Baltic Experience?

Cross-country indicators (e.g. by World Bank and Fraser Institute) provide information about various aspects of relative economic attractiveness – as well as regulatory deficits.

- **Regarding 'business' indicators, the Baltic countries are clearly ahead of the SEE countries with the SEE EU countries following suit. Some weak aspects in all countries.**
- **As regards labour market indicators, the position of the Baltic countries is poorer than for product markets but most SEE countries are also not doing too well either except for BG.**
- **Overall summary ranks suggest that the Baltic countries have very flexible economies. BG, ME and RO are also doing reasonably well. Other SEE countries have lower summary indicator ranks.**

What are the Lessons from the Baltic Experience?

Summing up:

- A careful review of the Baltic ‘boom and bust cycle’ can provide valuable lessons for the catching-up process in SEE countries.
- If the current crisis is just a ‘hiccup’ for the catching-up process in the SEE region and foreign capital will become readily available again soon the lessons are very obvious.
- But even if the current crisis is a ‘watershed’ requiring a structural change in the growth pattern of the region (e.g. more reliance on domestic capital and more labour- / TFP-intensive growth) there are important lessons to be learnt.

Thank you for your attention!