

Box 2

THE EXPERIENCE OF MACROECONOMIC ADJUSTMENT IN THE BALTIC STATES

Driven by strong growth in exports, the economies of the Baltic States (i.e. Estonia, Latvia and Lithuania) are currently recovering from a deep economic downturn. Although the severity of the macroeconomic imbalances accumulated during the boom years differed across the three countries, there have been important similarities in economic developments over the past few years and the policy strategies addressing these imbalances.¹ This box describes some key elements of the adjustment strategies undertaken in the region. Although this process is still incomplete, the Baltic experience thus far may provide useful lessons for macroeconomic adjustments in other countries lacking nominal exchange rate flexibility as an adjustment mechanism.

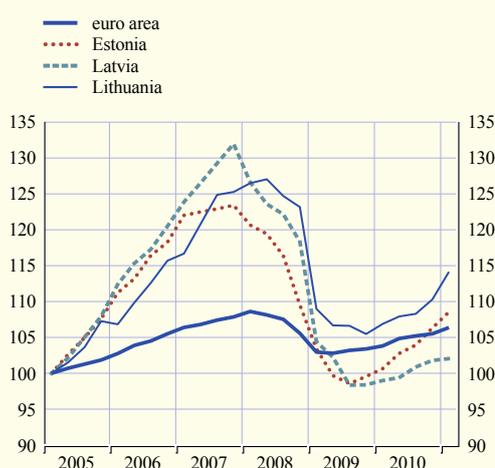
In the years directly preceding the global financial and economic crisis, the Baltic economies grew extremely rapidly, in a period characterised by strong capital inflows and accommodative macroeconomic policies.² Although the rapid pace of economic growth partly also reflected the catching-up process, over-optimistic expectations and excessive credit growth resulted in a strong boom in domestic demand, which ultimately proved to be unsustainable. This boom led to high inflation, wage increases substantially above gains in labour productivity, very high increases in real estate prices and large current account deficits.

Signs of a correction were becoming visible just before the global financial crisis. Then, when the crisis hit the three countries in late 2008, their imbalances made the Baltic region vulnerable to higher risk aversion and an abrupt decline in capital inflows. At the same time, the collapse in global trade weighed on Baltic exports. As a result of these financial and trade shocks, the Baltic economies recorded severe losses in output, setting their real GDP back by mid-2009 to approximately the same levels as in 2005 (see Chart A). The banking systems in all three countries experienced varying degrees of funding difficulties. In Latvia these tensions led to a run on a large domestically-owned bank, which prompted the authorities to seek international financial assistance in the form of an adjustment programme led by the EU and the IMF.

Although there were differences in the severity of the macroeconomic, fiscal and financial imbalances, all three countries embarked on similar adjustment strategies. A key element of these was the maintenance of the strict exchange

Chart A Real GDP

(seasonally and working day adjusted; index: Q1 2005 = 100)



Source: Eurostat.

1 Estonia adopted the euro on 1 January 2011. It was outside the euro area during most of the adjustment process described in this box.

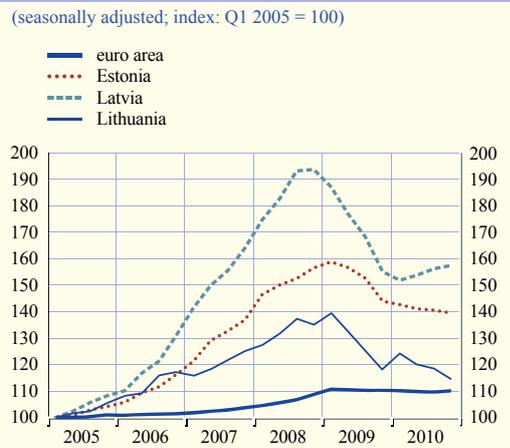
2 See the box entitled "The impact of the global financial and economic crisis on public finances in central and eastern Europe" in this issue of the Monthly Bulletin for more details on the role of fiscal policies before, during and after the crisis.

rate peg vis-à-vis the euro.³ Furthermore, all economies benefited from the fact that the degree of flexibility in labour and product markets was rather high before the onset of the crisis, thus facilitating the adjustment. The adjustment was achieved by a mix of policies and market mechanisms that hinged, to varying degrees, on the following four elements.

- First, in the absence of nominal exchange rate flexibility, any real exchange rate adjustment had to be delivered via cuts in wage costs and prices combined with enhancements in labour productivity. The adjustment in wages was both market driven, owing to a sharp decline in the demand for labour, and supported by policies aimed at reducing public sector wage costs. The labour market adjustment was not only achieved through wage cuts, but also through employment cuts, reductions in hours worked and a restructuring of production processes. As a result, unit labour costs declined significantly, partly offsetting their previous excessive gains (see Chart B).
- Second, sizeable fiscal consolidations were targeted at bringing fiscal positions back to a sustainable path, lowering sovereign funding needs and regaining market confidence. The fiscal adjustment relied mainly on expenditure cuts, although the authorities also implemented tax increases. Further efforts focused on strengthening budgetary frameworks and procedures. Following a sharp increase in fiscal deficits, fiscal positions have started to improve, but remain at very high levels in Latvia and Lithuania, while Estonia recorded a small fiscal surplus in 2010 (see Chart C). During the economic downturn, Estonia's fiscal position deteriorated less than that of the other Baltic countries, as its fiscal policy was prudent, involving deficit-reducing measures of around 9% of GDP in a single year, and benefiting from a strong medium-term-oriented fiscal framework comprising, for example, a balanced-budget rule and an efficient tax collection system.

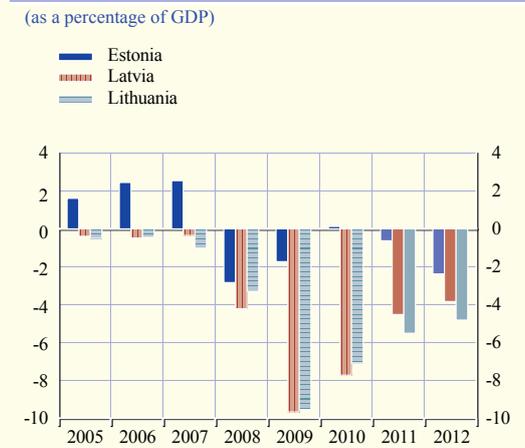
3 The currencies of all three countries were participating in ERM II when the adjustment process started, while maintaining stricter unilateral commitments. Estonia had a currency board until it adopted the euro on 1 January 2011, Latvia maintains a fluctuation band of $\pm 1\%$ around the central rate and Lithuania has a currency board.

Chart B Unit labour costs



Source: Eurostat.

Chart C General government balance



Sources: Eurostat and European Commission Spring Forecasts for 2011 and 2012.

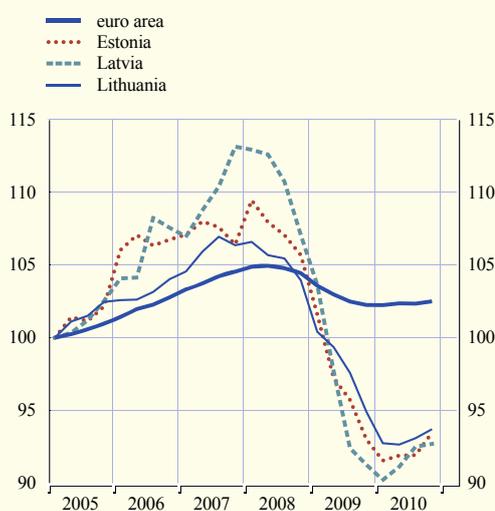
- While the Baltic economies were already regarded as rather flexible before the crisis, a third element of the adjustment strategy comprised structural reforms to enhance market flexibility further and medium-term growth. Measures focused on both labour and product markets, such as amending labour market legislation to strengthen labour market flexibility, improving the business climate by streamlining start-up procedures and tax administration, supporting exporting firms and combating the informal economy.
- Fourth, the strategy comprised measures to strengthen financial stability and reduce private sector debt burdens. The authorities initially focused on securing liquidity in banks and on (temporarily) relaxing supervisory requirements in order to relieve the immediate strain on the banks. Subsequently, adequate capitalisation became increasingly important, given the deterioration in the quality of banks' loan portfolios in the wake of the economic downturn. As a result, financial stability was maintained, although more time is still needed to repair private sector balance sheets.

To sum up, the macroeconomic adjustment process in the Baltic States thus far shows that large macroeconomic imbalances can be reduced without adjusting the nominal exchange rate, a message which is also important for other countries inside the euro area. Such an adjustment benefits from a high degree of flexibility of the economy and needs to rely on a determined and strong policy response to rebalance the economy, regain competitiveness and lay the foundations for sustainable output growth. A sizeable fiscal adjustment was essential for strengthening fiscal sustainability and critical in regaining market confidence. Cuts in wage costs and prices were necessary to create the conditions for the subsequent export-led recovery in economic activity. Two and a half years after the crisis hit the Baltic region, Latvia now seems close to concluding its EU/IMF programme.

The adjustment process is not over, however, and important challenges remain. In the near term, although economic activity is picking up again, employment levels remain substantially lower than before the downturn despite recent signs of recovery (see Chart D). Employment levels are unlikely to return to pre-crisis levels owing to structural changes reducing the supply of labour, such as emigration. It is a key challenge for the countries concerned to bring down high structural unemployment. However, in the medium term, it will be important for these economies to avoid the re-emergence of large macroeconomic imbalances such as those seen in the middle of the past decade, in the absence of an independent monetary policy. To this end, it is imperative that other policy areas are geared to supporting a path for the economy that does not lead to a new phase of overheating but rather is sustainable in the long run.

Chart D Employment

(in persons; seasonally and working day adjusted; index: Q1 2005 = 100)



Source: Eurostat.