

# THE EFFECTIVENESS OF INTERNAL DEVALUATION IN LITHUANIA AND LATVIA

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**Abstract.** *In the face of economic crisis, Baltic governments had to choose between internal and actual devaluation. Eventually, the first path was chosen to tackle the external and domestic macroeconomic instability. The aim of this study was to evaluate the effectiveness of the internal devaluation policy in the Baltic economies. Using qualitative research methods and graphical analysis, we have evaluated whether the choice of internal devaluation or deflation was appropriate in the exceptional recession period and whether it helped to eliminate the imbalances of the boom period. Obviously, fiscal consolidation helped to ease the tensions and restore confidence in the markets. However, we believe that the internal devaluation policy was efficient only temporarily in Latvia and Lithuania. This policy was hampered by the sectorial mismatches between labour demand and supply, which resulted from a strong surge in unemployment. A detailed cost–benefit analysis of the internal devaluation policy option requires a more formal econometric analysis which will be implemented in the future research.*

**Key words:** *deficit, internal devaluation, unit labour cost, productivity, cyclically adjusted budget*

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## Introduction

Since joining the European Union in 2004, the Baltic economies have switched to a higher gear of growth. The underlying vast economic potential has encouraged Nordic lenders to pursue very proactive lending processes. This has fed domestic demand, housing market and fostered growth; unfortunately, it led to significant economic imbalances, e.g., the collapse of “Lehman brothers” in 2008, which kick-started the global recession and resulted in a severe risk aversion undermining the shaky fundamentals of the Baltic economies. The halt in the export markets and internal devaluation led to the largest GDP fall in the Baltic States and on the global scale in 2009.

Given the circumstances of 2009, the Lithuanian and Latvian governments had only two options to tackle the external repercussion. As borrowing from financial markets was virtually impossible, one choice was to cut spending, the other being to abandon the currency pegs and thereby to meet nominal obligations with less valuable banknotes.

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The possible adverse effects of the latter option are still very hard to measure given the significant amount of foreign liabilities that could have destabilised the whole banking system. The first one was socially unpopular and hard to implement politically, but it was eventually adopted by all three Baltic governments. Latvia did not avoid the IMF bailout, but, as the developments in 2010 show, all three Baltic governments managed to restore credibility in the financial markets. Since then, competitiveness has improved significantly in spite of a fixed exchange rate, and the economic growth has resumed, Lithuania and later Latvia could tap the international markets while Estonia joined the EU.

Consequently, Part 2 of this article describes the pre-crisis characteristics of the Baltic economies, which led to the deepest GDP downfalls in 2009 and required a painful internal devaluation adjustment process. In Part 3, the internal devaluation process is discussed within the frames of fiscal policies, labour market. Part 4 evaluates the outcome and the success of the choice of this policy. The struggle to maintain currency pegs in Lithuania and Latvia today leaves us with an open question whether the EMU is still an attractive option for these economies. A set of arguments for and against joining the EMU is being discussed in Part 5 of this study.

## 2. Pre-crisis (crisis) economic conditions

The pre-crisis Baltic economies can be characterised in several ways.

**Fast economic growth.** Since the European Union accession up to the beginning of the crisis, the Lithuanian GDP expanded at an average annual rate of 8.2%, Latvian 10.4%, Estonian 8.5%. The key driver of such a fast growth was domestic demand, which was fuelled by the buoyant credit market. The favourable economic conditions abroad supported the reliability of the financial sector which was eager to lend money and facilitate the catch-up process between the Baltics and the EU.

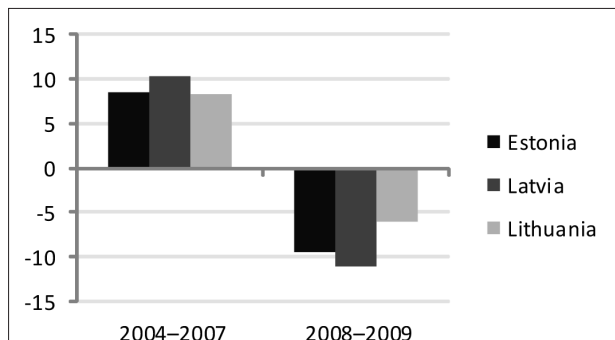


FIG. 1. Pre-crisis Baltic GDP growth rates (averages during the period, %)

Source: national statistics.

**Unemployment at the natural level.** Another idiosyncrasy of the pre-crisis Baltic economies was the situation in the labour market. The intensive emigration fostered by the EU entry and economic growth above its long-term potential led to unemployment rates being close to the “natural” level.

Pre-crisis labor market

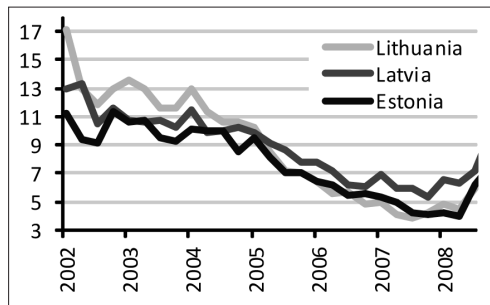


FIG. 2. Unemployment rate (%)  
Source: national statistics.

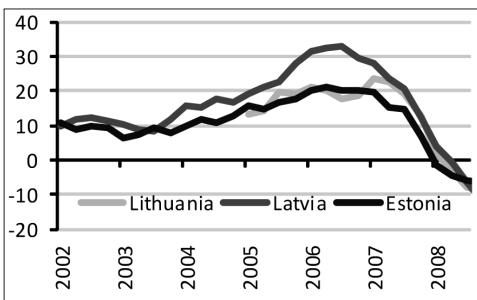


FIG. 3. Gross wage growth (%)

**Significance of the credit market.** The EU accession attracted the attention of foreign players in the Baltic economies who were eager to exploit the underlying potential. Here, the indisputable role was played by the Nordic banks, which nourished their subsidiaries with a relatively cheap funding and drove domestic demand. There were active discussions as to whether this surge in the credit market was adequate or not; however, only the economic downturn revealed all the imbalances in different economic segments.

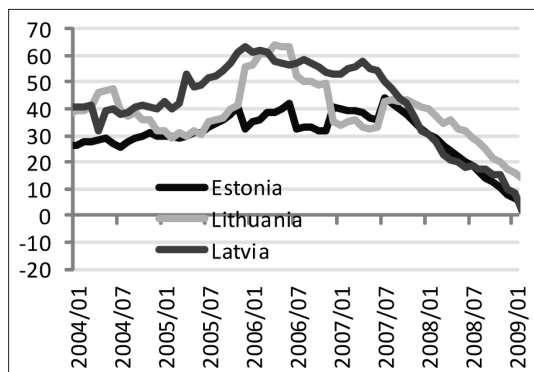


FIG. 4. Pre-crisis credit market (domestic credit, y/y %)  
Source: Reuters EcoWin.

The banking sector in the Baltic States has gone through a major boost compared to most economies in the CEE region. The asset growth was outstanding and loans were accumulated at a much higher speed. No wonder the significance of the credit market emerged so quickly, thereby leading to the situation that any kind of misalignment in the

global credit markets imposed a systemic economic risk on the Baltic economies. In the meantime, the initial assumptions for the economic downturn in other CEE economies were less severe – next to the fact that in general the credit expansion was not so fast, the other CEE countries still had independent monetary policies as their currencies were not pegged to euro as in the case of Lithuania, Latvia and Estonia.

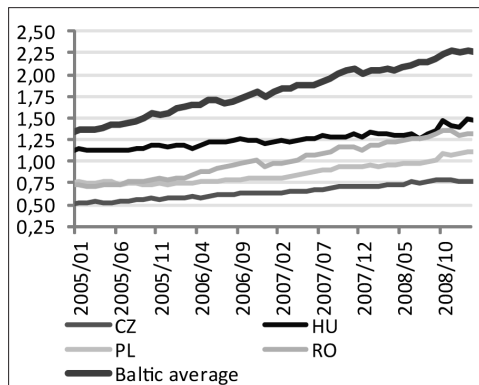


FIG. 5. Loan-to-deposit ratio\*

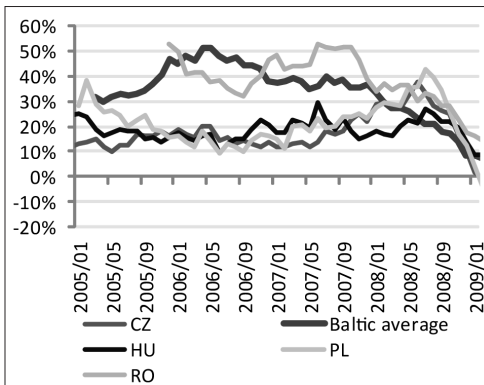


FIG. 6. Banking asset growth (y/y, %)

\*Non-MFI's excluding government

Source: ECB and author's calculations.

**Accumulation of foreign liabilities.** As the credit market was financed by the fund inflows from abroad, this quickly translated into the accumulation of foreign gross debt. Naturally, it was concentrated in the hands of monetary financial institutions. One reason for the depth of the GDP downfall in the Baltics was the size of the debt relative to the total size of the economies. In 2009, the Latvian foreign gross debt stood at 155% of GDP, which could partially explain why this economy experienced the most severe contraction and the slowest recovery among its Baltic peers.

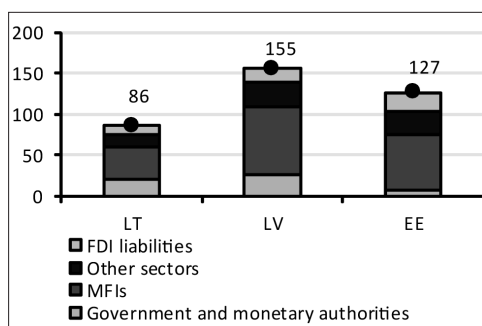


FIG. 7. Gross foreign debt in 2009 (% of GDP)

Source: national central banks and Reuters EcoWin.

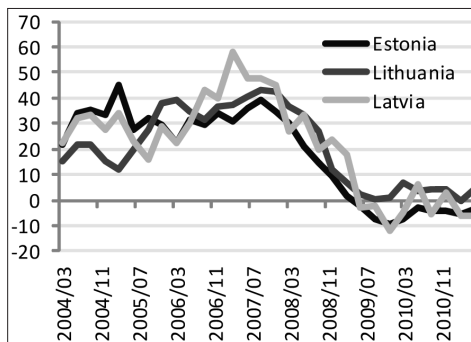


FIG. 8. Gross external debt growth (%)

**Pegged currency exchange rates and declining risk premiums.** The strong official policy position to maintain domestic currencies pegged to the euro and the intention to enter the euro area “as soon as possible” were also major sources of stability for all economic agents. Foreign trade conditions were less uncertain, given that the pegged local currency interest rates in local currencies converged to those of the euro area.

**Twin deficits.** During the period of expansion the, Baltic economies accumulated external and internal imbalances. The debt accumulation and fast economic growth led to swollen current account deficits, which peaked given the strong imports and external debt inflows. In the meantime, the Lithuanian and Latvian governments were reluctant to follow more austere fiscal policies, which became a big disadvantage in 2009 when access to the international fund markets was close to impossible.

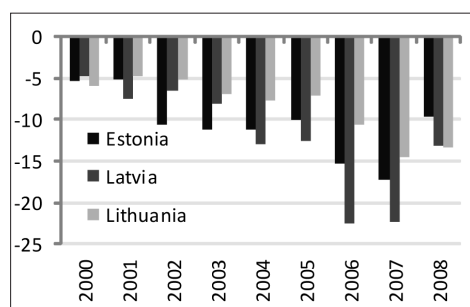


FIG. 9. Current account balance (% of GDP)

Source: IMF database.

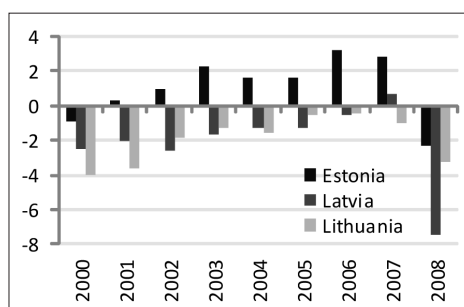


FIG. 10. Budget balance (% of GDP)

**Housing price bubble.** The credit market expansion and fast economic growth caused massive investment inflows in the housing market. At their peak, housing prices grew by more than 60% y/y and led to a bubble formation in this market. The housing market started its reversal in 2007, and if the global economic crisis had not occurred, this probably would have ended in a ‘soft landing’ for the Baltic economies. However, the enormous rise in global risks resulted in more widespread effects including a halt in all areas of credit, leading to a sharp contraction of the domestic demand.

TABLE 1. Housing price growth, 2004–2008

	2004	2005	2006	2007	2008
Lithuania	31.0%	64.0%	27.1%	30.9%	-8.8%
Latvia	24.3%	61.5%	69.0%	-1.7%	-35.0%
Estonia	33.2%	49.4%	24.7%	1.3%	-24.5%

Sources: Lithuanian Registry Center, Estonian National Statistics, Bank of Lithuania, European Central bank, and author’s calculations.

To some extent, the prosperity of the post-EU-accession period in 2004–2008 was unjustified by the underlying economic fundamentals. Instead, the demand driven by the borrowed funds translated into economic imbalances and vulnerabilities, which made the Baltic economies very sensitive to changes in the global environment. The reluctance to pursue fiscal austerity in Lithuania and Latvia only strengthened the assumptions for the upcoming economic downturn.

### **Crisis in the Baltic economies: 2008–2010**

In pre-crisis years, economists agreed that the Baltic economies had been growing too fast and that economy would turn from boom to bust (Kuodis, Ramanauskas, 2009). Initially, discussions focused on the soft landing scenario, and expectations were related only to a correction of local economic imbalances, i.e. the housing price bubble burst and the overly extensive credit growth. However, the possibility of the most severe global economic crisis since WWII was not taken into account. Thus, expectations of a correction in imbalances of a local nature ended in the total wipeout of domestic and external demand in these economies. The global economic recession revealed poor resilience, which became evident in the areas numbered below.

**Frozen domestic and external demand:** the fall was evident in both domestic and external demand areas. But the drop in the local economic sectors was more pronounced and unlike the decline in exports, which started asynchronously in all three Baltic countries. Estonia and Latvia were the ones with economies expanding more rapidly, and thus the effects of overheating and deceleration became apparent a couple of quarters before they did in Lithuania. Despite the different timing, the contraction in domestic demand was severe in all three countries. During the period of economic crisis, Lithuanian demand lost up to 31%, Latvian demand 36% and Estonian demand 33% from their peak. The fact that domestic demand was so severely hit only reaffirmed how much the Baltic economies are dependent on the external sector, foreign funding in particular. At its high, unemployment stood at 18.3–20.5%; however, the Baltic governments had no policy instruments to foster the economy as the debt market was closed and the monetary policy was non-applicable given the currency pegs. The only way was to rely on external demand (which actually later saved the Baltic economies from recession in 2010), but the greatest global economic downturn wiped the demand from the foreign markets. The fall in exports was not as severe as the domestic demand, but still substantial – 19–22% from its pre-crisis peak.

**The reversal of bank funding and deleveraging.** The economic downturn reversed the flow of funds in the banking sector. The parent banks started withdrawing money from their subsidiaries. The banking system focused on managing the outstanding loans instead of building up new loan portfolios. Along with the declining external liabilities

of the banking sector, domestic credit portfolios shrank as well. The quality of the banks' loan portfolios deteriorated rapidly: in Lithuania, the share of non-performing loans in the total portfolio rose from 1.1% to 19.6% in the period from early 2008 to mid-2011; in Latvia, it rose from 1.3% to 19.4% and in Estonia from 0.7% to 7.14%. The credit portfolio quality was deteriorating all the way through 2008 and 2009 and stabilised only in mid-2010. The banking system faced massive writedowns which led to significant losses.

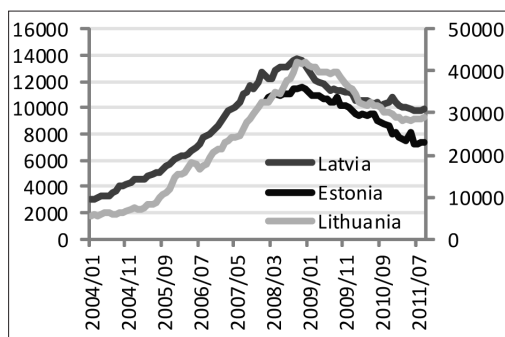


FIG. 11. External liabilities of banking sector (millions of local currency)

Sources: national central banks.

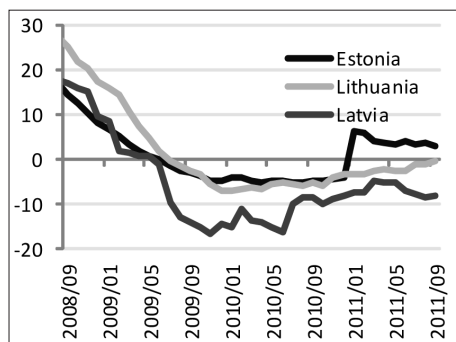


FIG. 12. Deleveraging (domestic credit, y/y %)

**Rise in risk premiums and limited access to global credit markets.** In the very early days of the downturn, there were hopes that the crisis would be contained in the financial markets, but eventually it penetrated into the real economy. In fact, the strains in the financial markets became a severe obstacle for the Baltic economies: namely, Lithuanian and Latvian governments faced a need to raise funds to finance their budget deficits. However, the risk premiums were so high that outstanding government bonds yielded about 12% to maturity. In early 2009, there was either almost no possibility of

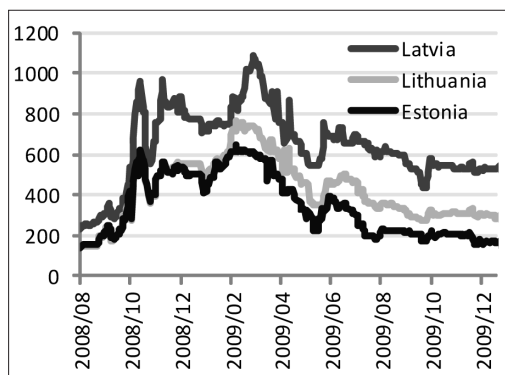


FIG. 13. CDS spreads from Germany (basis points)

Source: Bloomberg.

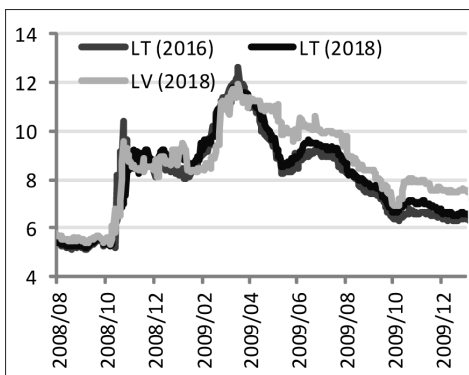


FIG. 14. Government bond yields (to maturity, %)

securing funding from the financial markets or the cost of that funding would have been extremely high. The tensions in the financial markets left only alternative options to solve the liability problems: currency devaluation, tough austerity measures (i.e. internal devaluation) and/or seeking bailout from international institutions.

**Currency devaluation threat.** A strong perception of risk undermined the stability of the Baltic currency pegs. The falling budget revenues and limited possibilities to get the necessary funding to fill in the gaps created a serious pressure to devalue the litas and latas. Latvia faced the most severe tensions given its greater imbalances. Eventually, the country turned to the international institutions, the IMF, European Commission, etc. for a bailout. Lithuania chose a different path and decided to rely on its own competence to pursue fiscal austerity measures. The incentives not to devalue the currency were fairly strong, as most of the outstanding loans were issued in euros (or in other foreign currencies). Exchange rate depreciation would have undermined the ability to service the FX-denominated debt and probably would have resulted in more pronounced adverse economic changes than in the case of internal devaluation.

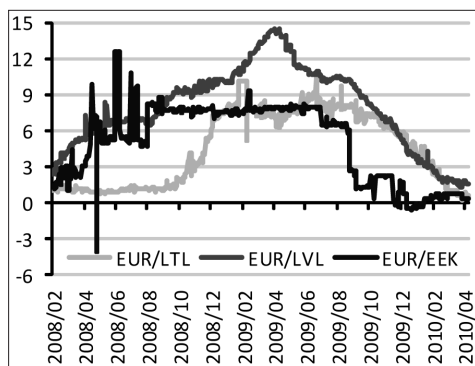


FIG. 15. Implied currency devaluation risk spot and 12 month forward rate differences (%)

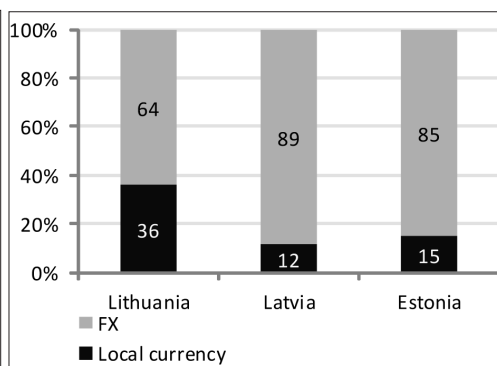


FIG. 16. Loan structure by currencies in 2008 (%)

Source: Bloomberg, national central banks and author's calculations.

**Motivation to introduce fiscal austerity.** Given the circumstances of 2009, the Lithuanian and Latvian governments had only two options to tackle the external repercussions. As borrowing from financial markets was virtually impossible, one choice was to cut spending, the other being to abandon the currency pegs and thereby meet nominal obligations with less valuable banknotes. The possible adverse effects of the latter option are still very hard to measure given the significant amount of foreign liabilities that could have destabilised the whole banking system. The first one was socially unpopular and hard to implement politically, but was eventually adopted by all three Baltic governments. Latvia did not avoid an IMF bailout, but, as the developments in 2010 show, all three Baltic governments managed to restore credibility in the financial markets.



**Banking system remained resilient.** Despite the notable losses in the banking system, which occurred given the massive writedowns, financial stability was maintained. The participation of the Nordic capital in the Baltic banking sector provided support. The credit market went through a notable squeeze –lending activities came to a halt and remain tentative to this day. But the economic recession was contained within the frames of the real economy and was not amplified by the fall of any of the major banks<sup>1</sup>.

### **3. Ways out of the crisis – internal devaluation option**

The response to the crisis aimed to counter the drop in domestic demand depends upon a country's ability to implement counter-cyclical fiscal and/or monetary policies. Turning to monetary policy, if a country's economic policy is based on a currency peg option, the burden of adjustment to shocks falls mostly on fiscal policy (Klyvienė, Rasmussen, 2010).

Lithuania and Latvia have no sufficient leeway for expansionary policies. First of all, the countries have been running budget deficits for the past 10 years. Judging from the fiscal stance, which assesses the discretionary fiscal measure (change in cyclically-adjusted primary balance) in relation to the development of the output gap, the Lithuanian fiscal policy has been pro-cyclical in the current decade. In the high-growth years of 2006–2007, fiscal consolidation was put on the backburner, and in 2009 the fiscal stance was a pro-cyclical fiscal easing. Despite the consolidation programme adopted at the end of 2008, public expenditure dynamics were affected by the earlier approved public sector wage growth programme (mainly for the education sector). Thus, the consolidated public wage disinflation effect was not felt until Q3 2009. It should be mentioned that the 2009 change in the cyclically adjusted budget was not the best indicator of assessing the fiscal stance. A closer look at the consolidation policy in 2009 shows that part of the measures were related to the refusal to act on pre-election promises. At the beginning of 2009, the budget draft assumed a deficit of around 12% of GDP (Convergence Programme of the Republic of Lithuania, 2009–2012). After the implementation of consolidation measures, the public deficit reached “only” 9.5% of GDP in 2009. A more evident fiscal consolidation policy was implemented in 2010.

Latvia's budgetary strategy during the boom period 2005–2007 implied a significant fiscal loosening despite the very favourable macroeconomic environment. The cyclically-adjusted budget deficit rose significantly, suggesting that a tighter fiscal stance would have been more appropriate during the boom period characterised by strong demand pressures and large external imbalances.

Thus, even though both countries have very low public debt levels, there is significant concern in the global financial markets. The Latvian and Lithuanian CDS (credit default

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<sup>1</sup> Except the Latvian bank “Parex” which might have caused some additional instability in the economy.

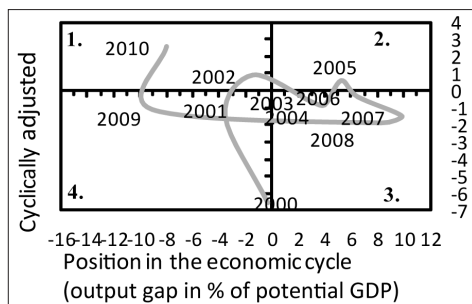


FIG. 17. Lithuanian fiscal stance

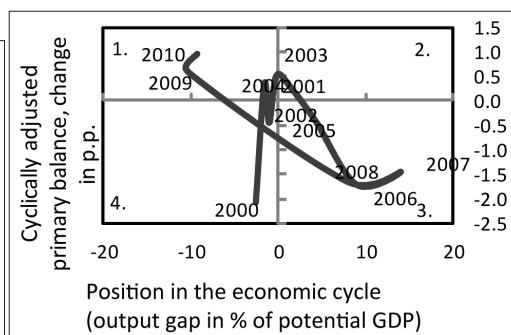


FIG. 18. Latvian fiscal stance

Notes: 1. Pro-cyclical fiscal tightening (consolidation). 2. Anti-cyclical fiscal tightening (consolidation). 3. Pro-cyclical fiscal easing. 4. Anti-cyclical fiscal easing.

Sources: European Commission data, authors' calculations.

swap) spread for five-year debt skyrocketed in the beginning of 2009, clearly indicating a collapse of confidence due to the huge private external debt. The Latvian situation was even more complicated. Due to external funding constraints the second largest bank, Parex (locally controlled), suffered a crippling bank-run at the end of 2008 and was finally nationalised. This deepened the economic crisis in Latvia and forced the Latvian government to ask international financial institutions for help. Therefore, the two economies, despite the fact that they were exposed to different forces (financial markets vs. international donors) went through a pro-cyclical fiscal tightening.

The structural characteristics of the Baltic economies allow us to raise the hypothesis that neo-classical effects of fiscal policy on the output gap are more likely than the Keynesian effects (Rzońca, Ciżkowicz 2005). The presence of sizeable macroeconomic imbalances (including strong tensions in the labour market, rises in unit labour costs, large current account deficits, rising inflationary pressure, excessive borrowing and potential domestic currencies overvaluation) indicates that any attempt to raise domestic demand by running fiscal deficits will only widen trade deficits and current account imbalances and further stimulate imbalances in the economy. Thus, despite internal criticism, the pro-cyclical fiscal tightening renewed confidence in the economy, eased interest rate pressure and finally positively contributed to domestic demand recovery.

Fiscal consolidation has contributed to internal devaluation but, based on the success of its implementation, it was a necessary and appropriate private sector response. In both economies, the labour market is described as very flexible, especially in terms of downward wage flexibility (Goretti, 2008). Lithuanian companies tend to use performance-related bonuses as a form of labour compensation, and around 74% of companies use flexible wage components that account for 17.1% of the total wage bill (Virbickas, 2010). The data show that the Latvian labor market was also characterized by similar features (see Fig. 20).

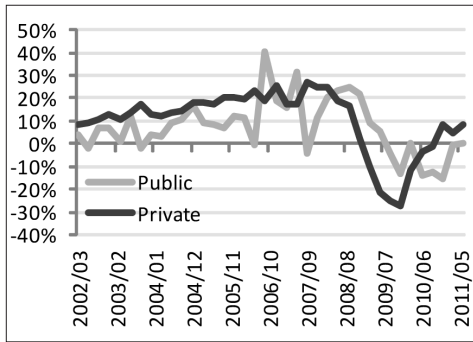


FIG. 19. Lithuania: compensation of employees (nominal, annual growth)

Sources: Reuters EcoWin, authors' calculations.

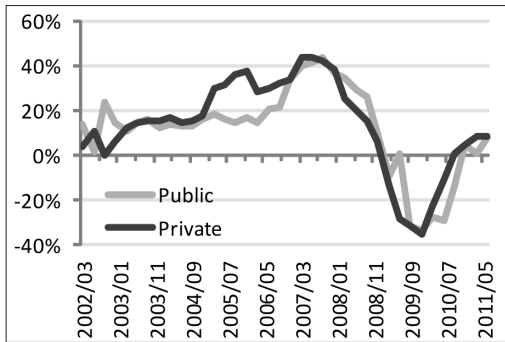


FIG. 20. Latvia: compensation of employees (nominal, annual growth)

Besides, institutional fundamentals have also helped to support wage flexibility in Latvia and Lithuania. In both countries, the labour market has the following features: low unionisation, private labour law contract in public administration, easy dismissal rules (Eamets, Masso, 2004).

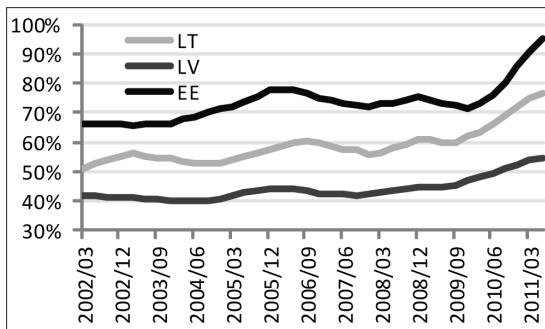


Fig. 21. Export (% of GDP)

Source: Reuters EcoWin.

The success of internal devaluation policy also depends on a country's level of openness. The recovery in the Baltics was led by a strong export growth which benefited from competitiveness gains and improving economic conditions in the main trading partners. Although Lithuania's and Latvia's economic structures are similar, in Latvia it seems less favourable in terms of exposure to the foreign demand. Thus, despite the inordinate amount of internal devaluation, which helped to improve external competitiveness, and the strong impetus from global demand, Latvia's recovery in 2010–2011 remained weaker than in Lithuania or Estonia and is the reason why Latvia's economy is less dependent on export performance.

It is clear that the success of internal devaluation highly depends on several factors, but mainly on domestic market flexibility and openness of the economy, which reduce

the adverse effects of this policy on domestic demand (Pfannkuche, 2010). Essentially, those features are common to both Latvia and Lithuania. However, further analysis showed that the internal devaluation policy in these economies have been successful only partially. The higher external competitiveness means not only reduction of unit-labour costs, but also a focus on policies reinforcing structural changes in the economy.

### ***Recommendations on removing the causes that contributed to crisis in the Baltic countries***

The circumstances that resulted in a deep recession in 2009 can be a good lesson for the future policy makers. Several areas can be addressed, which should be prudently managed in the future, namely, adequate lending, currency stability, prudent fiscal policy and more diversified foreign trade. Of course, the political risks remain that, despite understanding what needs to be done, the measures may not be applied as some of them restrict growth and are socially unattractive.

First of all, the major source of vulnerability is an excessive credit growth. It resulted in accumulation of foreign debt and vast external imbalances. Thereby, the Baltic economies became very vulnerable to the fluctuations in the global environment and created an asset price bubble in the housing market. Going forward, lending standards should be considered more thoroughly to prevent from new discrepancies in the demand and the risk of severe adjustments in the case of another economic downturn.

Given the structure of the Lithuanian debt, currency devaluation is hardly a reasonable option under any circumstances. For another potential internal devaluation process to be less severe, the euro area entry is a must. Any risk premiums which emerge in the market when the conditions are weak, regarding potential currency instability would be eliminated from the market thereby reducing the cost of capital.

As the Estonian example clearly shows, prudent fiscal policies have helped the country to absorb external shocks. The Estonian government has accumulated necessary reserves and managed to finance its deficit without entering global credit markets which were very reluctant to lend at that time. Even though public debt levels were decently low, Lithuania and Latvia found themselves in an extremely difficult situation to tap the international debt markets. In the meantime, constant budget deficits did not allow accommodative stabilizing fiscal policies. In general, such small open economies, which are still considered as emerging, should be strongly motivated to avoid twin deficits.

The fourth solution might be more diversified exports in terms of geographic areas. It is common that the greatest share of the foreign trade is happening with the neighbouring partners. However, this implies a lack of diversification and no immunity as the neighbour economies are subject to the same external economic shocks. The search for alternative export markets should be considered systemically by facilitating innovation processes, improving competitiveness and finding niches in the global trade pattern.

#### 4. The effectiveness of internal devaluation policy in Lithuania and Latvia

In the absence of exchange rate flexibility, the response to external shocks will have to be mitigated by a tight fiscal policy as well as by policies enhancing external competitiveness and structural flexibility, also known as ‘internal devaluation policy’. The fiscal consolidation policy renewed confidence in the Lithuanian and Latvian economies and eased the pressures in the financial markets significantly.

In 2009–2010, quite significant and wide-ranging measures in the areas of taxation and expenditure were implemented in both countries with the aim to restore stability in the public finances. Budgetary adjustments in Latvia amounted to around EUR 2.9 bn in 2009–2011, of which EUR 1.6 bn was spending cuts and EUR 1.3 bn tax increases. Consolidation measures included up to a 25% cut in public sector wages, major layoffs, lower transfers and subsidies, introduction of the property tax, tax on capital income, rise in the personal income tax, VAT and excise duties (Convergence Programme, 2009–2012). According to our calculations and the information contained in the convergence programme, Lithuanian consolidation measures amounted to around EUR 1bn in 2009–2010. The tax reform which aimed to broaden the tax base, to eliminate tax exemptions, to raise indirect tax rates and a wide range of expenditure saving measures, including reduction in public wages, was implemented. Despite the extent of the measures introduced, a relatively wide gap between revenues and expenditure still remains. Thus, the economies will have to continue pursuing a restrictive fiscal policy.

One of the major sources of imbalance has been the labour market. Over previous years wages grew much faster than labour productivity. The widening of the gap between wages and productivity was mostly associated with non-tradable sectors like construction, retail trade and transportation, but export-oriented manufacturing also started to feel the pressure. The consequence of this imbalance was pressure on external competitiveness.

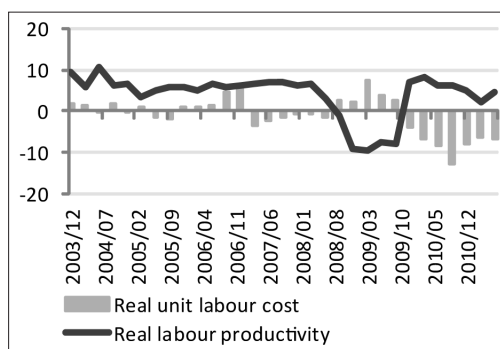


FIG. 22. Lithuania: wage/productivity gap (annual growth, %)

Source: Reuters EcoWin.

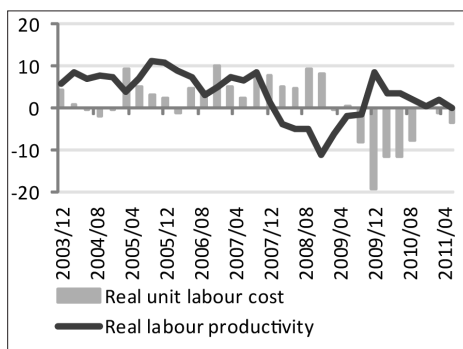


FIG. 23. Latvia: wage/productivity gap (annual growth, %)

Labour cost reductions in both countries were mainly achieved through significant wage cuts and employment reduction. Cost optimisation and enhancing productivity helped to narrow the wage-productivity gap significantly in both countries. However, Latvia's achievements are less sustainable. The Latvian labour productivity is still rising, but not as fast as during 2010, and more measures are needed to improve competitiveness in the medium term.

The appreciation of real effective exchange rates (REER) based on export price deflator and unit labour costs (ULC) indicate that export competitiveness has been deteriorating in foreign markets, especially in 2007–2008. Internal devaluation resulted in lower prices and has made local products more attractive to export markets. However, a stronger adjustment is observed in REER deflated by CPI than by ULC, which might suggest that wage disinflation does not eliminate the potential problem of the overvalued currency, especially in Latvia.

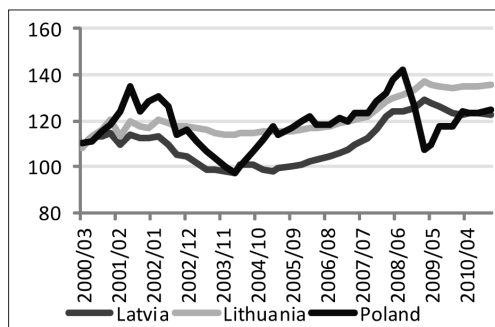


FIG. 24. REER (based on CPI)

Source: Reuters EcoWin.

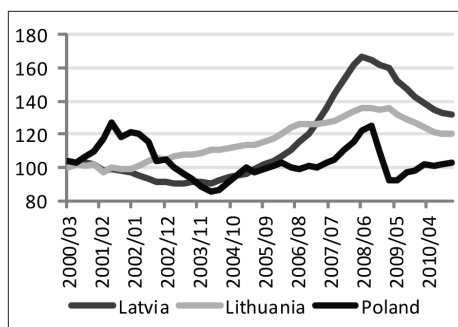


FIG. 25. REER (based on ULC)

Source: Eurostat.

It is obvious that internal devaluation has led to competitiveness gains which are reflected in the significantly improved external position and broadly balance the current account positions. It should be mentioned that a correction in external imbalances occurred due a sudden halt in domestic demand which reversed the external flow funds.

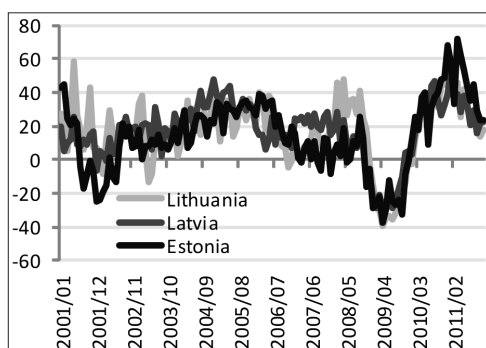


FIG. 26. Exports (% y/y)

Source: Reuters EcoWin.

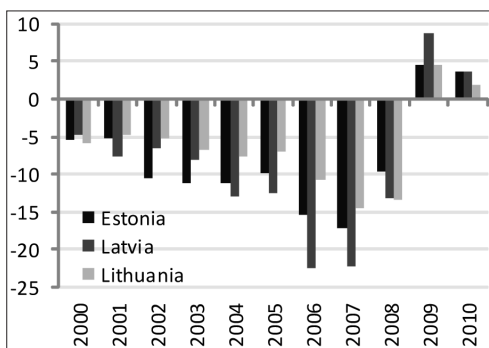


FIG. 27. CAB (% of GDP)

Besides, fiscal consolidation amplifies the negative demand effect as well (through the lowering public sector demand). The contraction was so deep that the notable current account deficits in 2006–2008 have turned into surpluses in 2009, while, already in 2010, a greater role in the improvement of current account arose from the recovering external demand and export performance.

However, risks from surging imports, accelerating inflation and wages should not be underestimated. While the weak domestic demand growth performance should prevent the external deficit from reaching an unsustainably high level, we anticipate structural challenges in the Baltic economies if a higher growth path is achieved in the state of already wide external imbalances.

In this context, we would highlight the external imbalances as one of the key risk areas in the economies. The sustainable external rebalancing process requires not only an improvement in competitiveness, but also a shift of resources from the non-tradable to the tradable sector. Excess supply during the boom period was particularly large for the non-tradable sector in both economies. In the absence of appropriate sectorial shifts in labour and capital, the current account improvements might be a temporary process (European Commission, 2011).

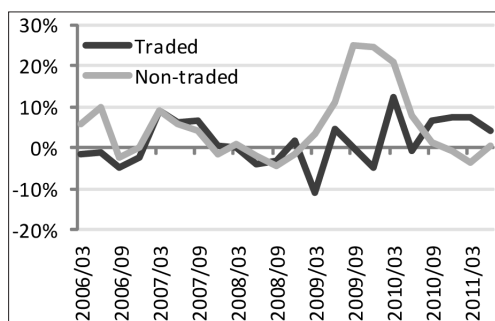


FIG. 28. Real productivity development in Latvia (2005 = 100)

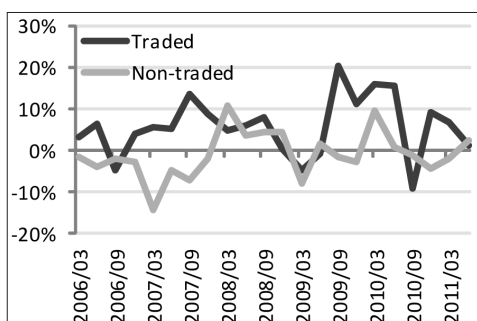


FIG. 29. Real productivity development in Lithuania (2005 = 100)

Sources: Reuters EcoWin, authors' calculations

Previous two graphs show how the productivity developed in the tradable and non-tradable sectors of Latvia and Lithuania. Due to notable adjustments, mainly observed in the non-tradable sector, its productivity improved significantly<sup>2</sup> in Latvia. The excess supply in the non-tradable sector was corrected mainly through prices and employment. Although in Lithuania the correction in the non-tradable sector has been observed as well, a higher productivity gain appeared in the tradable sector. The reason may be the obvious

<sup>2</sup> Into the traded sector we included manufacturing, agriculture, mining, transportation and communications, and hotels while the non-traded sector includes energy, construction, wholesale and retail trade, real estate and business services, education, health and personal services.



supply-side channel of internal devaluation, i.e. lower production costs and tradable prices and, as a consequence, a higher productivity growth. On the other hand, it can also indicate that adjustments in the Lithuanian non-tradable sector were insufficient.

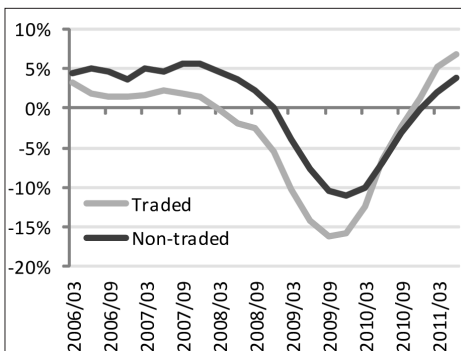
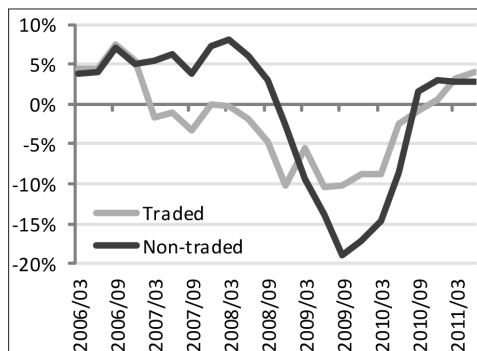


FIG. 30. Employment in Latvia (annual growth)      FIG. 31. Employment in Lithuania (annual growth)

Sources: Reuters EcoWin, authors' calculations.

In order to achieve a sustainable current account adjustments, the economies will need to reallocate the employment from the non-tradable to tradable sectors (European Commission 2011). A shift in the structure in favour of the tradable sector is apparent in both economies. However, high unemployment rates do not support the idea of efficient resource re-allocation. It was mainly determined by the objective factor as a significantly different labour demand across sectors, especially in terms of qualification.

Overall, the internal devaluation policy was efficient only temporarily in Latvia and Lithuania. This policy helped to restore competitiveness and at least some imbalances in the economies. However, the internal devaluation policy has been hampered by the sectorial mismatches between labour demand and supply, which resulted from a strong surge in unemployment. It is clear that in order to restore a sustainable economic growth path, more complex policy options have to be implemented.

### 5. How attractive is the EMU for the Baltic economies?

The turmoil in the euro area regarding the debt problems that have already lasted for two years has awakened the euro sceptics. The theory raises certain questions regarding the usefulness of the single currency: first, whether or not the Baltic economies are structurally similar; second, whether there are significant trading ties; thirdly, whether it is possible to punish the undisciplined governments. These are general items, but more elaborate studies (Mongelli, 2002) define a broader list of optimal currency area properties: price and wage flexibility, labour market intergration, factor market integration, financial market integration, the degree of economic openness, diversification of production and



consumption, similarity of inflation rates, fiscal integration, political integration and, finally, similarity of shocks. Given the latest and hottest economic topic – the high debt burden among the old euro area members, – the argument of fiscal discipline is the key focus today. It raises doubts as to whether a euro bloc can function properly with a unified monetary policy but independent fiscal policies. In the euro area economic policy, the decision-making process appears to be ineffective and prolonged, thus raising scepticism as to whether or not the remaining Baltic countries will follow Estonia and strive to adopt the single European currency. However, there are still many more arguments in favour of adopting the euro versus the possible negative effects.

### ***Pros and cons: why the EMU is still useful for Lithuania and Latvia***

#### *Pros*

**Lower risk premiums and cost of capital.** In periods of economic soundness and growth, the Baltic interbank has converged to the ones in the euro zone. Despite the fixed currency exchange rate, the money market has remained subject to upside risks causing the unstable environment for the financial market participants and a volatile cost of capital. Any loss of confidence is quickly reflected in the interbank market; the 2007 example in Latvia is very illustrative – the money market premia rose up to 5.6 percentage points when academic speculations regarding the latas devaluation occurred. The presence of the euro would reduce these fluctuations and provide a more determined environment in which to pursue financial decisions for firms and households.

**Better protection from external shocks and stability of capital flows.** This directly relates to the first argument, and the case of the 2008-09 economic crisis is a clear example. The economic crisis would probably not have been this severe had the Baltic countries already been in the EMU. The perception of the risk was clearly overstated: Lithuania and Latvia found themselves on the brink of currency devaluation as they could not raise the funds in the international markets. However, the actual fiscal situation was not this bad: the government debt level was relatively decent and stood at 16% and 18% of GDP in Lithuania and Latvia respectively in 2008. The private sector would also have gone through a correction to a lesser extent if the money market rates had not surged this high.

**External trade links with euro area.** Now, countries are subject only to euro fluctuations which, despite the recent turmoil, are less sensitive to risk aversion compared with the possibly free floating Lithuanian litas and Latvian latas. Roughly 30% of total Baltic exports are directed to the euro area countries, thereby suggesting that the trade links are significant and that the presence of the euro can facilitate the transactions and remove the currency exchange cost.

**Significant share of domestic liabilities in euro.** The lion's share of total debt liabilities of the private sector in the Baltic countries were and still are in foreign

currencies (see Fig.14), of which the dominant one is the euro. In earlier years, Baltic economic agents accumulated FC liabilities as the interest rates in euros were lower and the official determination to maintain currency was convincing. In the meantime, there is a currency mismatch with regard to income, which is generated in local currencies. Thus, given this aspect, it is very unlikely that any time soon the option to shift away from the current pegs will be considered. On the contrary, the need for a better protection against external and domestic shocks suggests the euro adoption to be a reasonable choice.

**Financial stability.** A huge share of the domestic liabilities is mainly concentrated in the banking sector. In times of economic growth, parent banks excessively fed their Baltic subsidiaries with a cheap FC funding. Therefore, any currency depreciation would have a significant negative effect on the banking system: given the above mentioned mismatches between the liabilities and income of the domestic economic agents, there is a substantial risk that the banking system could experience another dip.

**Motivation to achieve fiscal soundness and control of undisciplined politicians.** The goal to enter the euro area provides motivation for local governments to put efforts into achieving fiscal stability. Although it is widely upheld that euro area membership should not be the key reason for prudent fiscal policies, this has set guidance for governments in the earlier years. In fact, all Baltic governments managed to maintain their key fiscal ratios to meet the Maastricht criteria. The EMU mechanisms to ensure that governments are responsible for their finance may put into doubt today. However, the general idea and the lessons of the post-crisis period may induce the necessary changes in the supervisory mechanisms.

#### Cons

**No independent monetary policy.** Being in the EMU would mean that the Baltic governments would have give up their autonomy and therefore could not pursue independent monetary policies. Bearing in mind the recent example of the economic downturn, an independent monetary policy might have been useful to some extent. The Baltic governments have been unable to pursue an expansionary fiscal policy, and the monetary policy was unavailable given the currency pegs. Thereby, the economies had no adequate policy instrument to tackle the scale of the economic downturn.

**Money for euro area bailout:** EMU membership would mean that the Lithuanian and Latvian governments would have to participate in the EU bailout projects. For the economies struggling to maintain sound fiscal finances and to avoid another Hungary scenario, this possibly would not be a good direction for expenditures. However, worth remembering is the fact that, despite the contribution to the bailout mechanisms, the Baltic countries would remain the net receivers of the EU money through the structural funds.

**Failure of fiscal stability control mechanism.** The fiscal stability control mechanisms have clearly not been working over the last decade. Throughout the period 1991–2005,

the interest rate-growth differential has been contributing to the build-up of the debt ratio (Coenen et al., 2008); later, fiscal policies contributed only marginally to curbing the public debt. A clear example today is Greece struggling with a huge and probably contagious debt problem. It can lead to a significant euro scepticism and disapproval from the fiscally sound EMU members, which eventually have to pay for the others' lack of responsibility.

## **Conclusions**

The severity of the Baltic economic downturn resulted from a combination of two circumstances: currency pegs and a strong dependence on foreign funding. Economic prosperity turned out to be an illusion as soon as the global economic picture turned shaky.

On the positive side, the economic downturn helped reduce some of the imbalances in the booming economy environment. The huge current account deficits shrank to much more consistent levels, and the market situation prompted the introduction of fiscal consolidation measures.

Fiscal consolidation helped to ease tension in the currency market and gave additional support to maintain a stable currency. No access to the capital markets was one of the main factors that have put Lithuania and Latvia face to face with the option of internal devaluation.

On the other hand, abandoning the currency pegs would have hurt the banking system, and in the case of this scenario the crisis would probably have distorted the economic picture more severely.

To conclude, the internal devaluation policy was efficient only temporarily in Latvia and Lithuania. The internal devaluation policy has been hampered by the sectorial mismatches between labour demand and supply, which resulted from a strong surge in unemployment.

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