



# Challenges for Baltics as for the Eurozone countries having Advanced Economy status



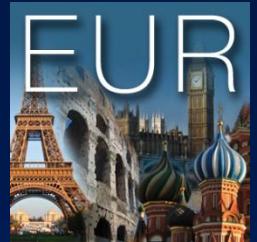
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Vilnius, February 4, 2016

Bas B. Bakker  
Senior Regional Resident Representative  
for Central and Eastern Europe

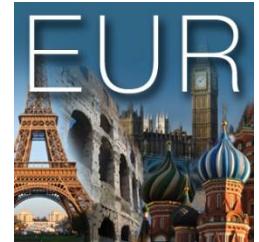
# Outline



- Advanced vs. emerging country status, 2006-15
- Current advantages of advanced country status
- Current advantages of euro area membership
- Future challenges for Lithuania within the euro area



# 1. Advanced vs. emerging country status, 2006-15



# Advanced country vs. emerging market

## Wikipedia

- An **emerging market** is a country that has some characteristics of a developed market, but does not meet standards to be a developed market
- An **advanced country** is a sovereign state that has a highly developed economy and advanced technological infrastructure relative to other less industrialized nations.

# View before 2008: advanced countries more stable

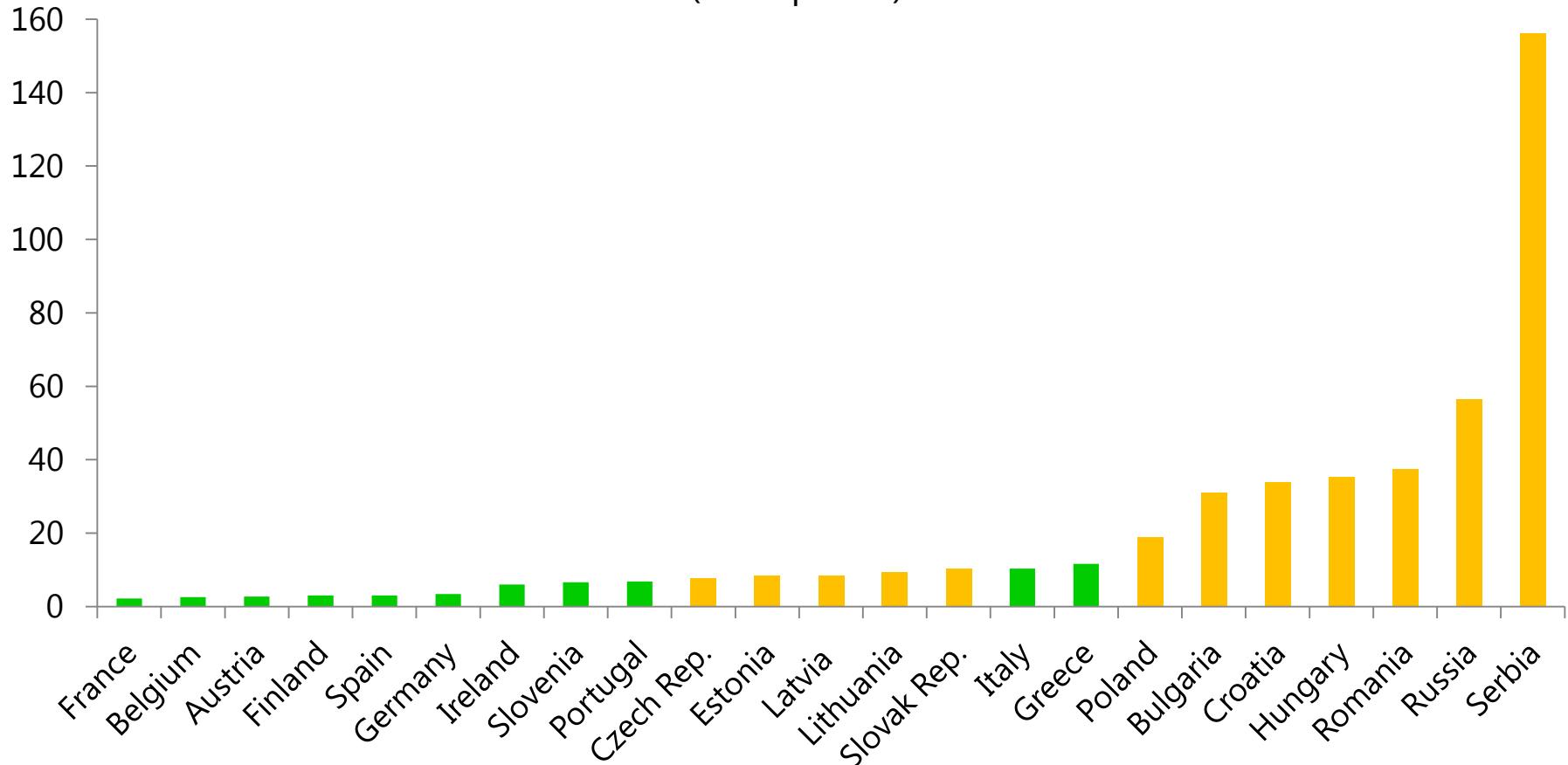


- Emerging market country:
  - volatile capital flows;
  - prone to boom-busts and crises
  - Policies not as good
- Advanced country:
  - More stable
  - Better policies

# Therefore, advanced countries had lower borrowing costs



5-year CDS spreads in 2006  
(basis points)

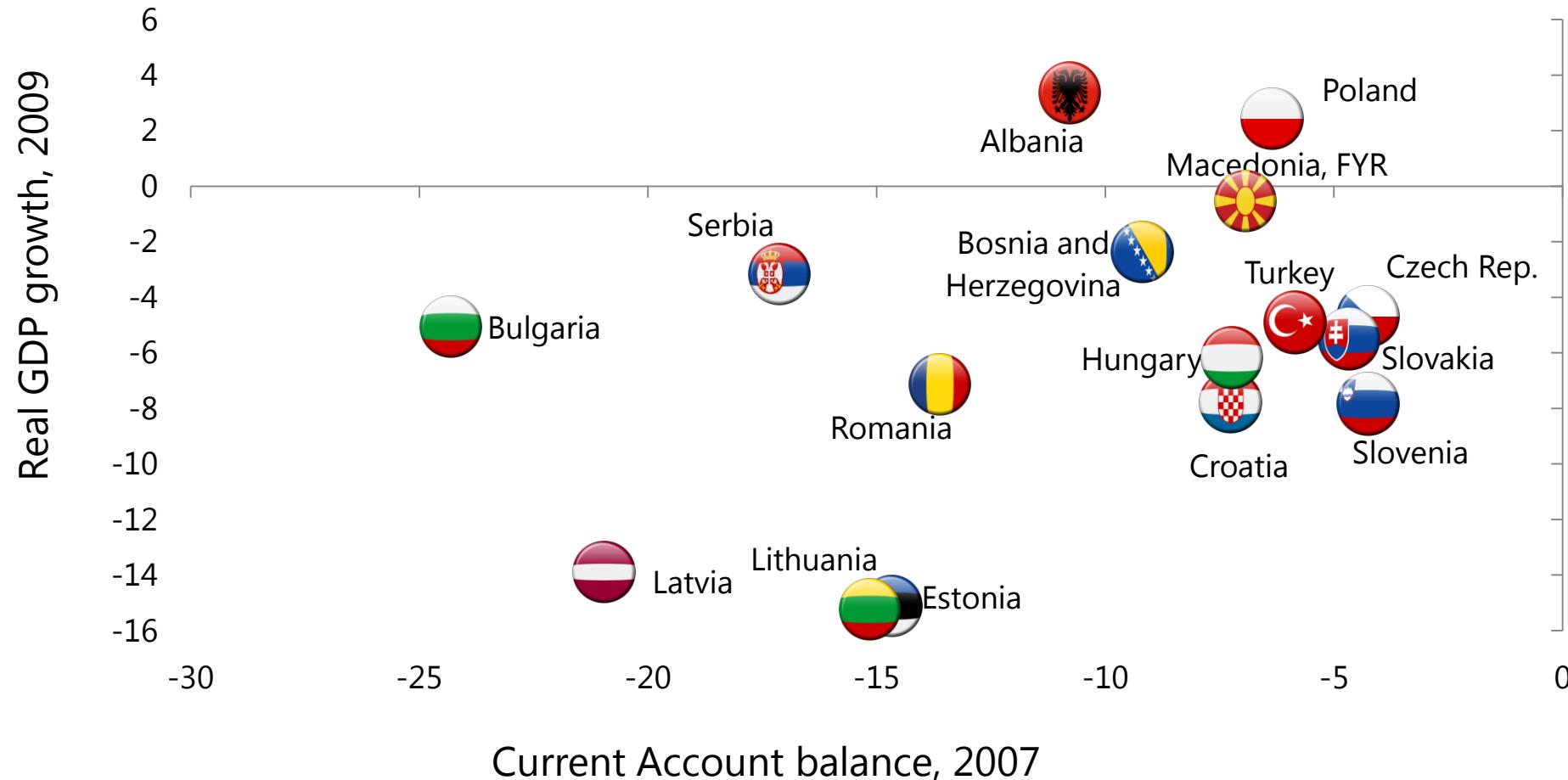


Note: Emerging markets as of 2006 in orange.

This idea seemed to be confirmed in 2009, when emerging Europe had a capital account crisis...



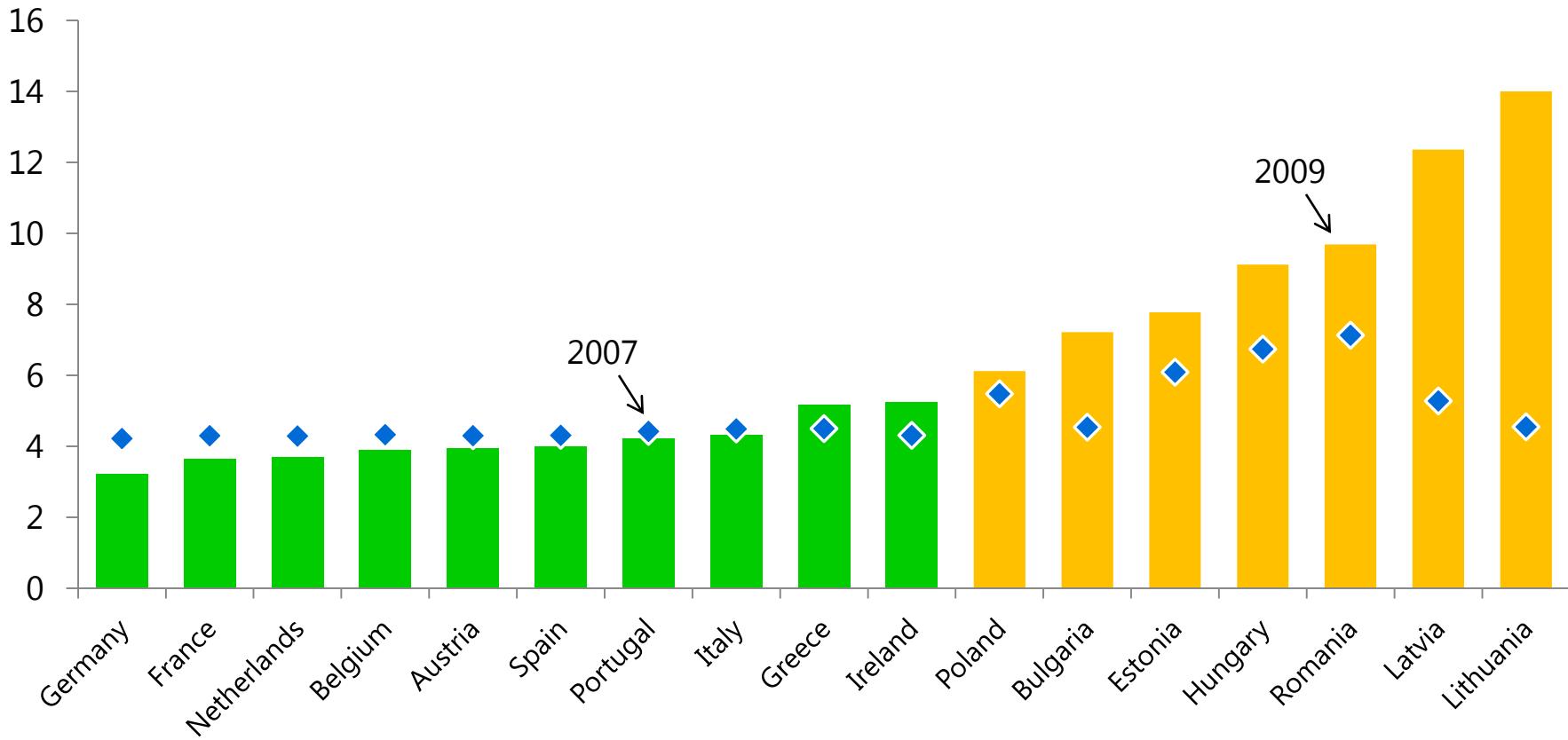
Real Domestic Demand Growth and Real GDP Growth  
(Percent)



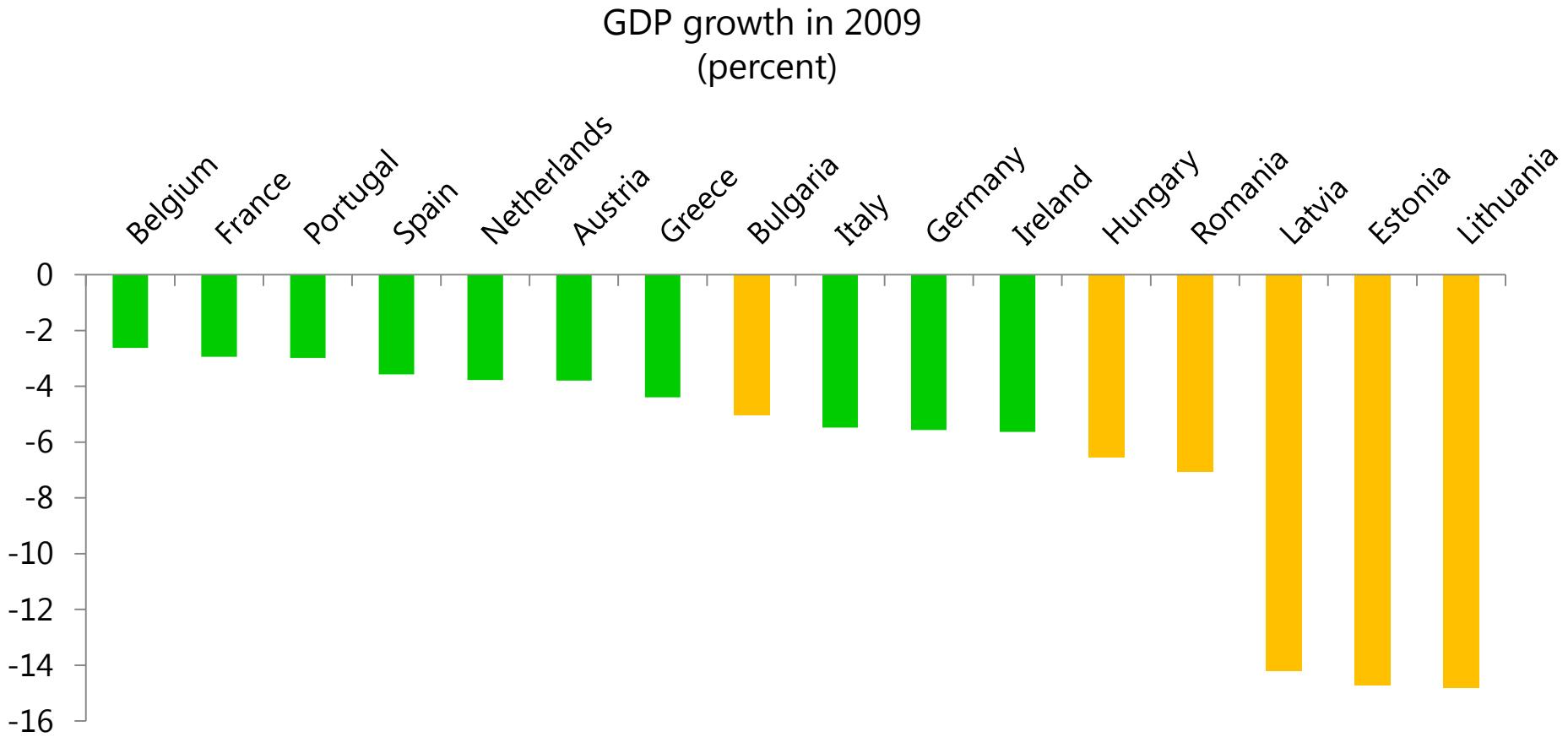
# Interest rates rose...



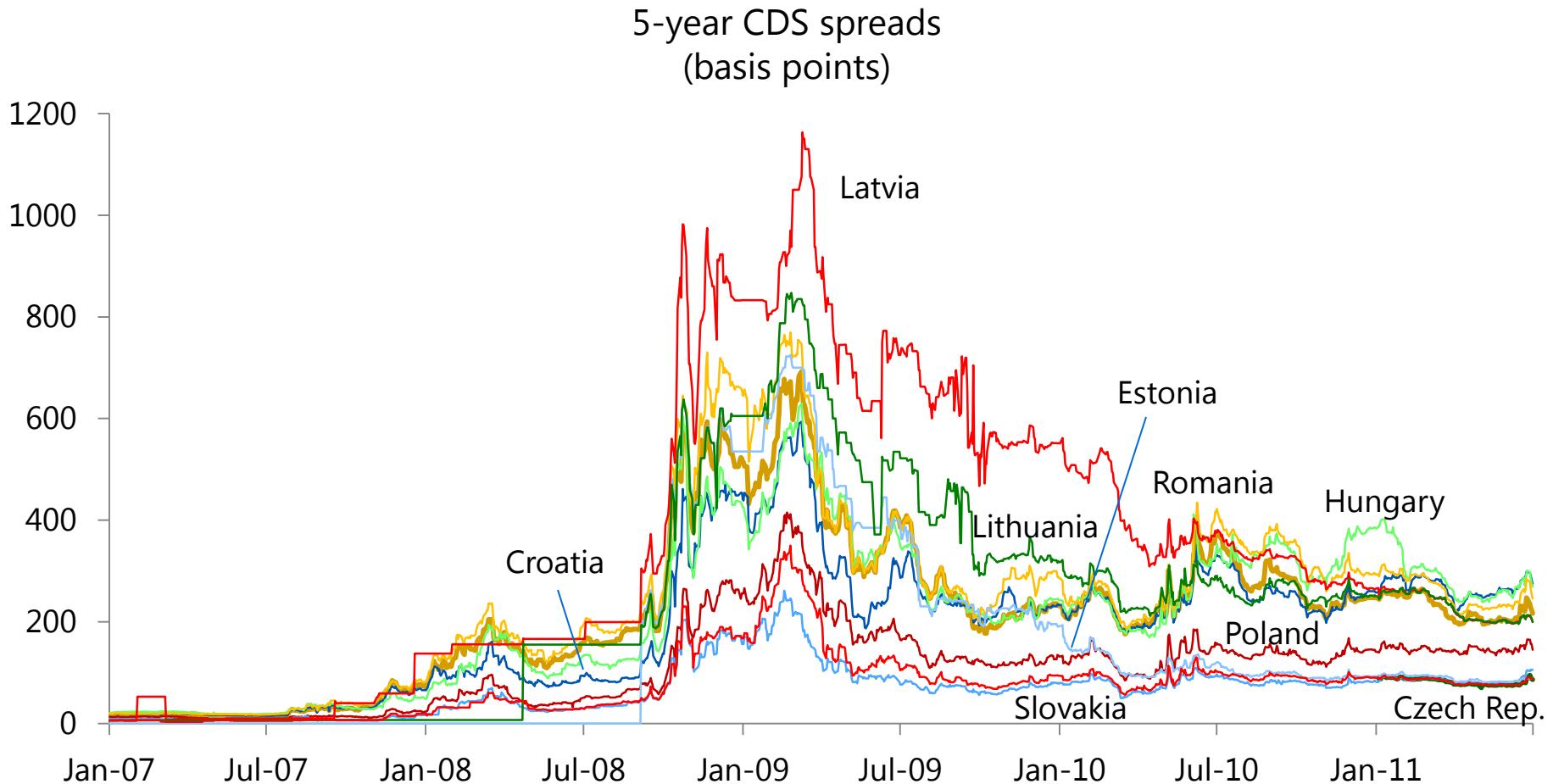
Long term interest rates  
(percent)



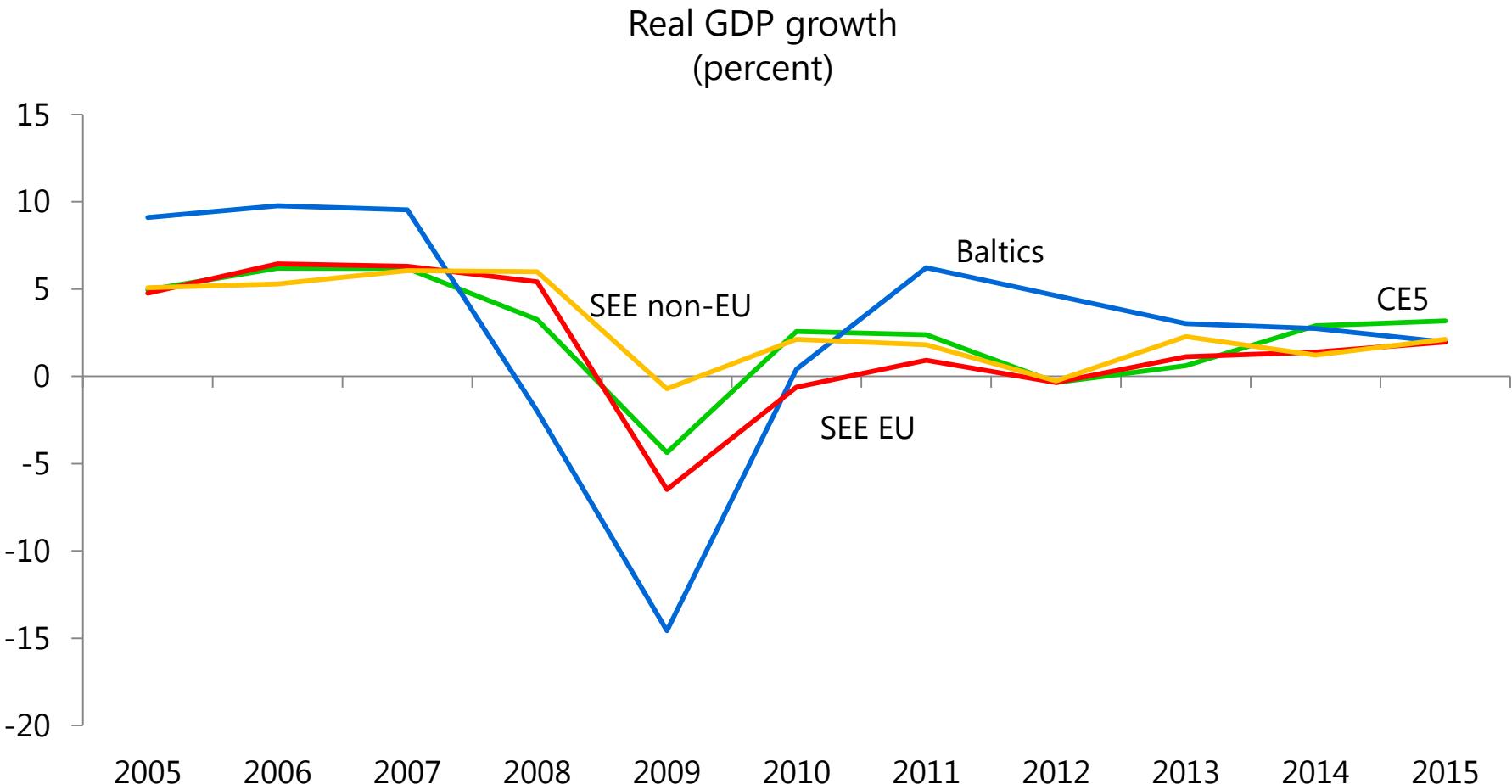
# ...and GDP declined sharply



Crisis was deep, but by late 2009, CDS spreads in Eastern Europe had come down sharply

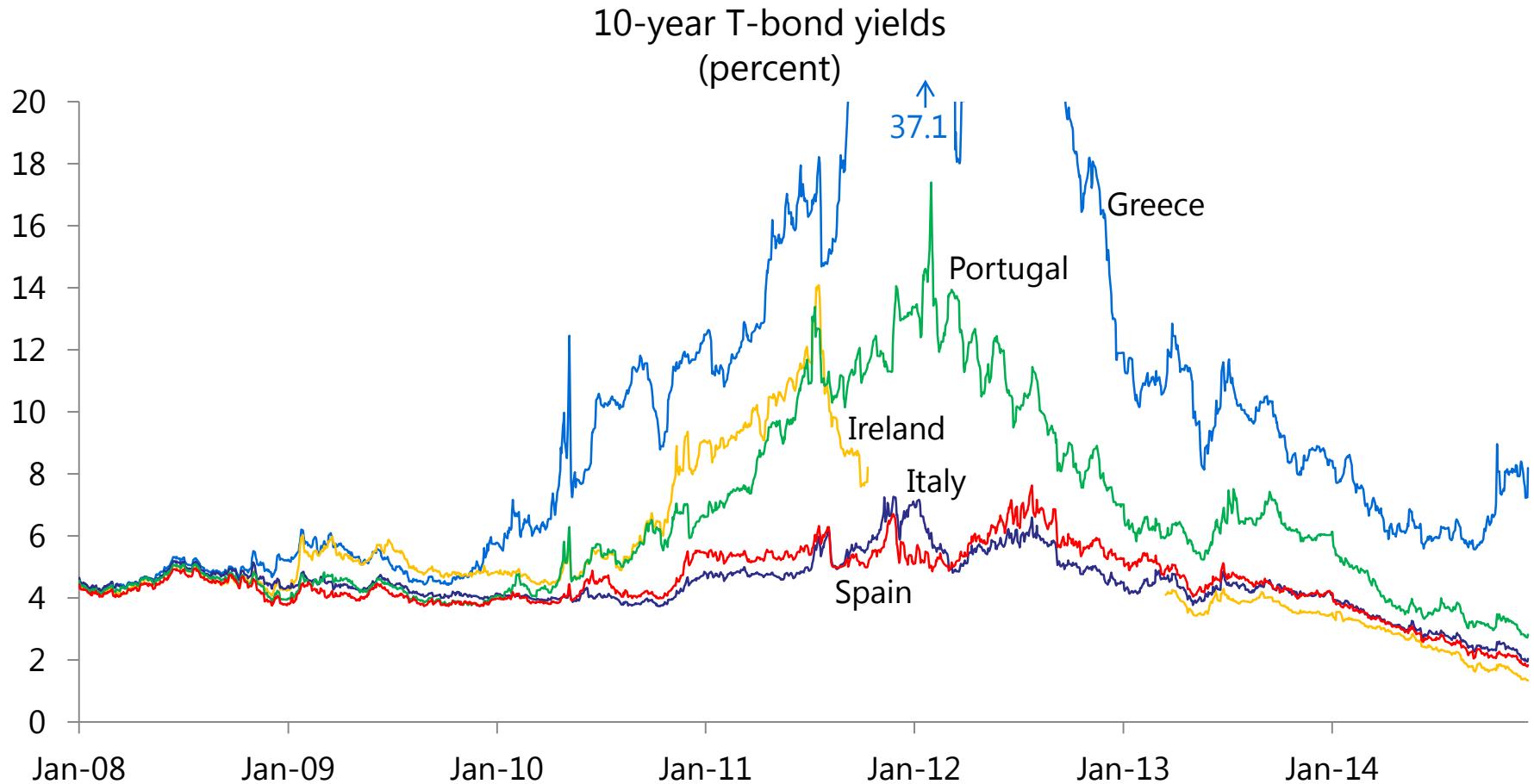


# Growth turned positive in 2010



Note: Unweighted averages.

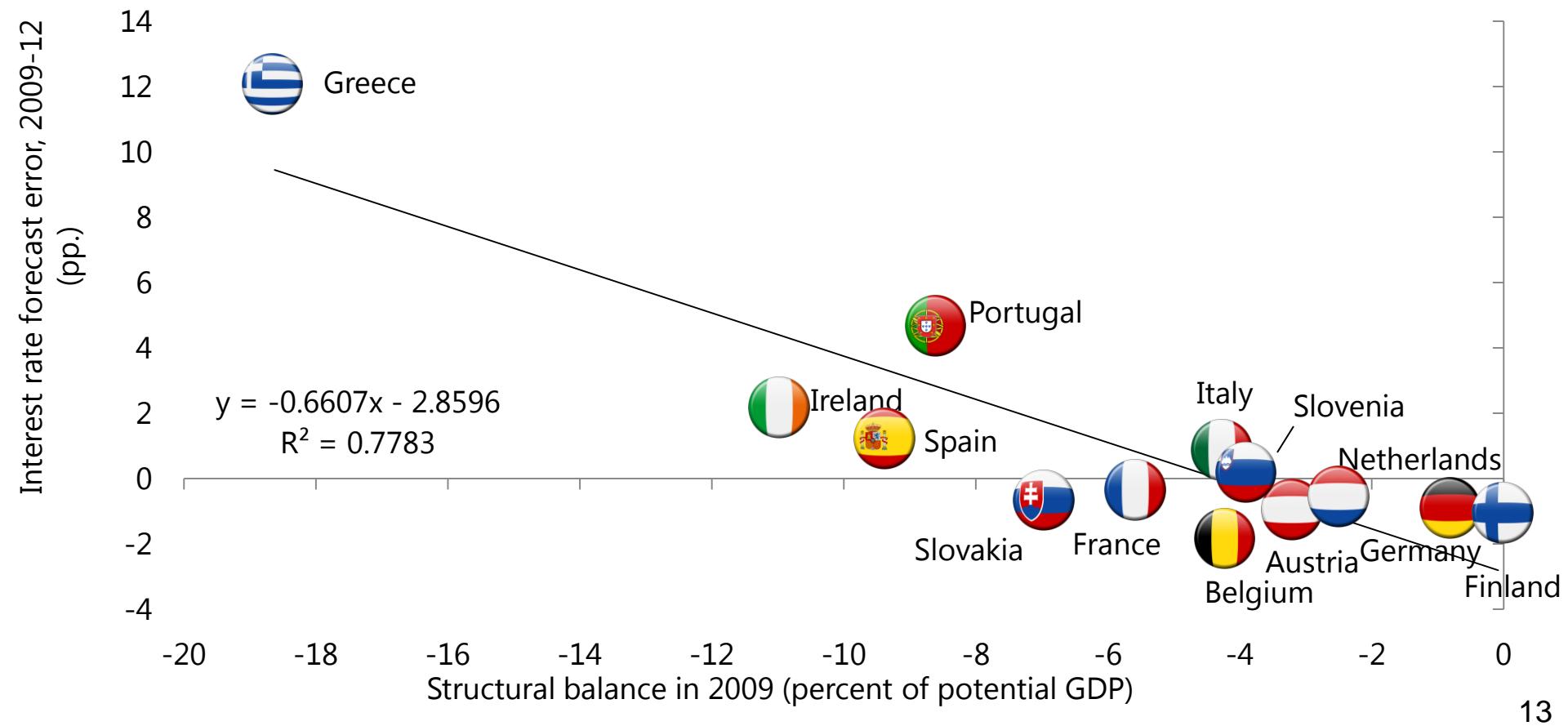
Idea that advanced countries were more stable was short-lived, as euro area crisis hit



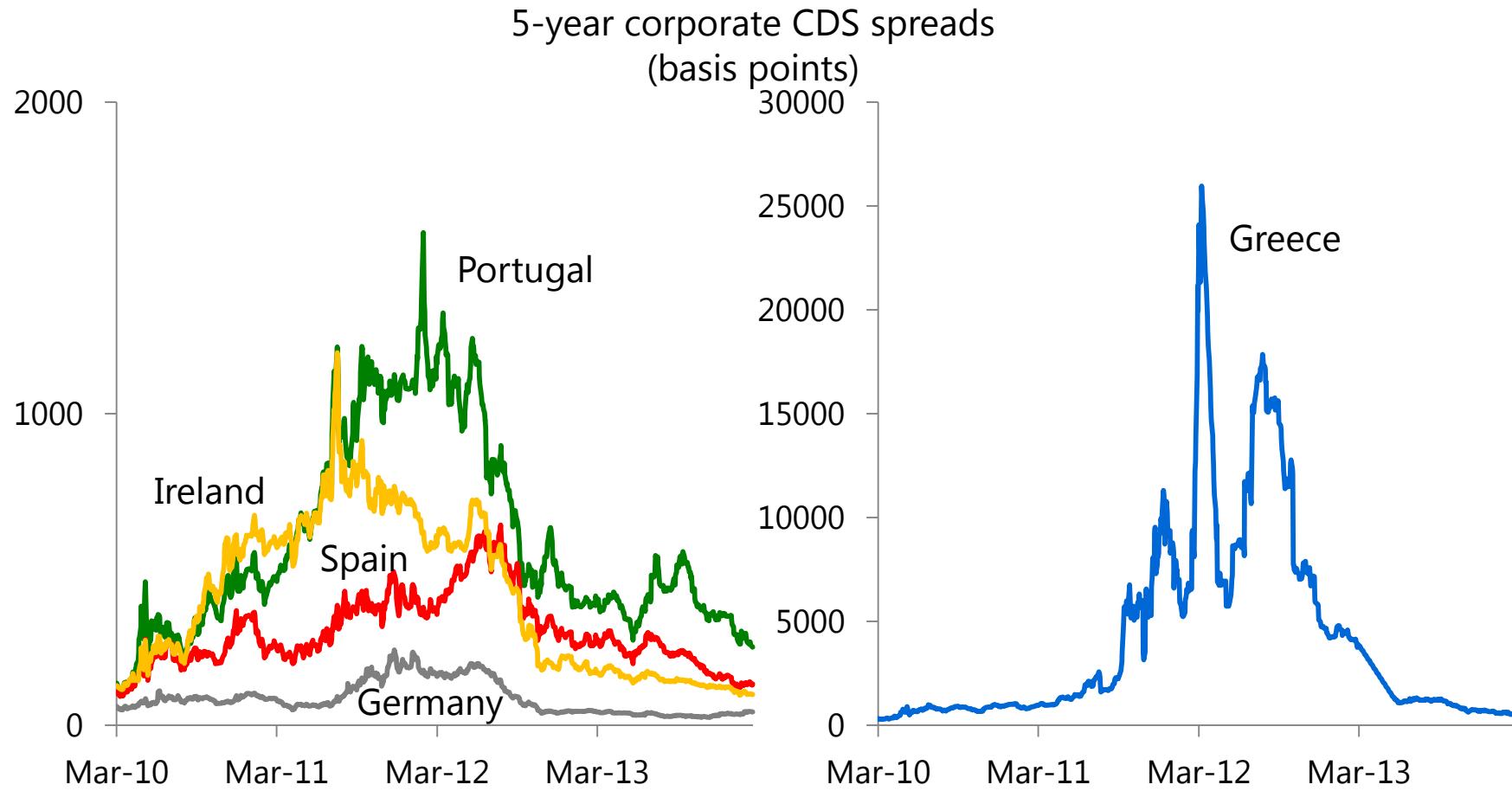
# And countries with weak fiscal positions saw large and unexpected interest rate increases



Structural balance in 2009 and WEO interest rate forecast errors



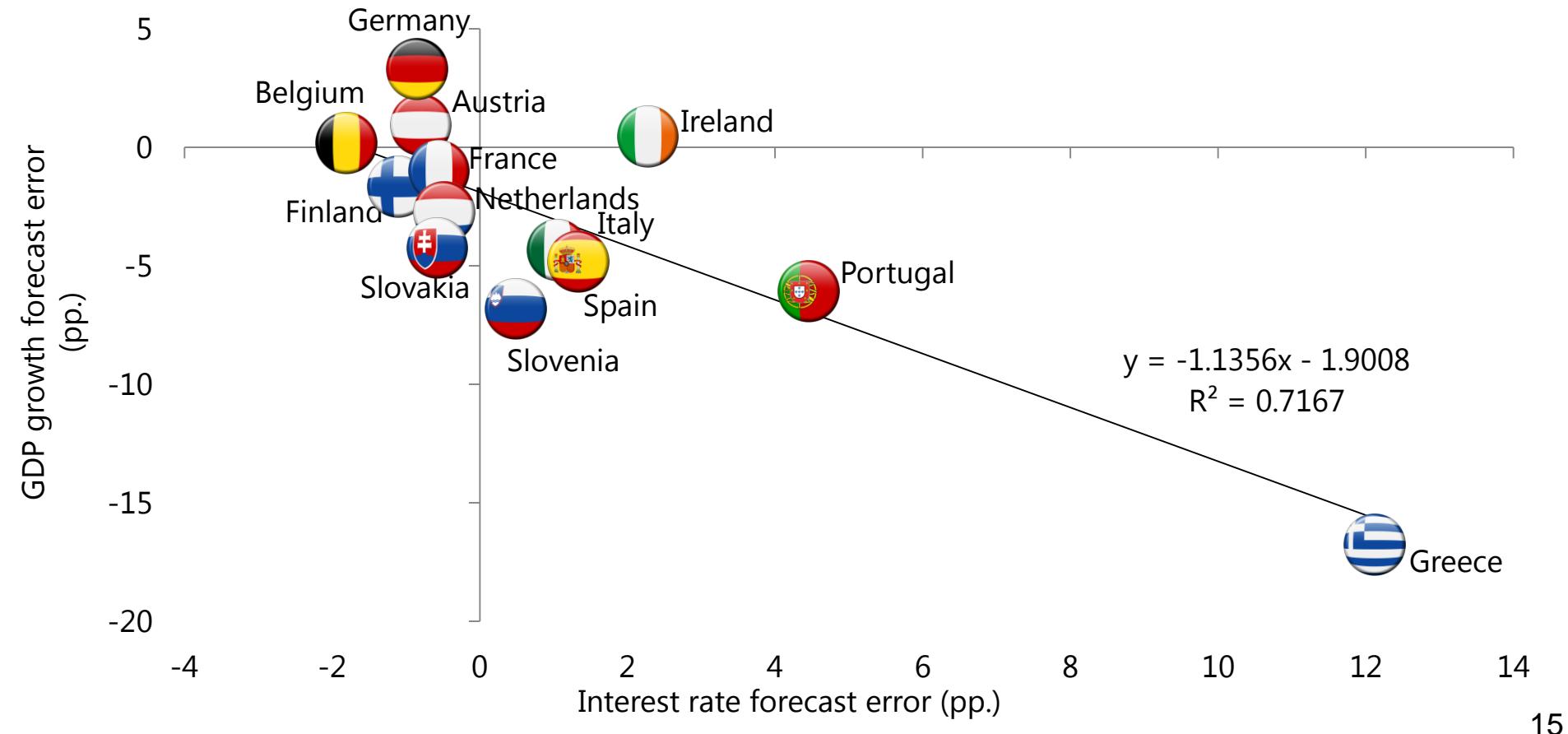
# Rise in borrowing costs spilled over to private sector



# The more interest rates exceeded projections, the more growth disappointed



Spring 2010 WEO Interest and growth forecast errors

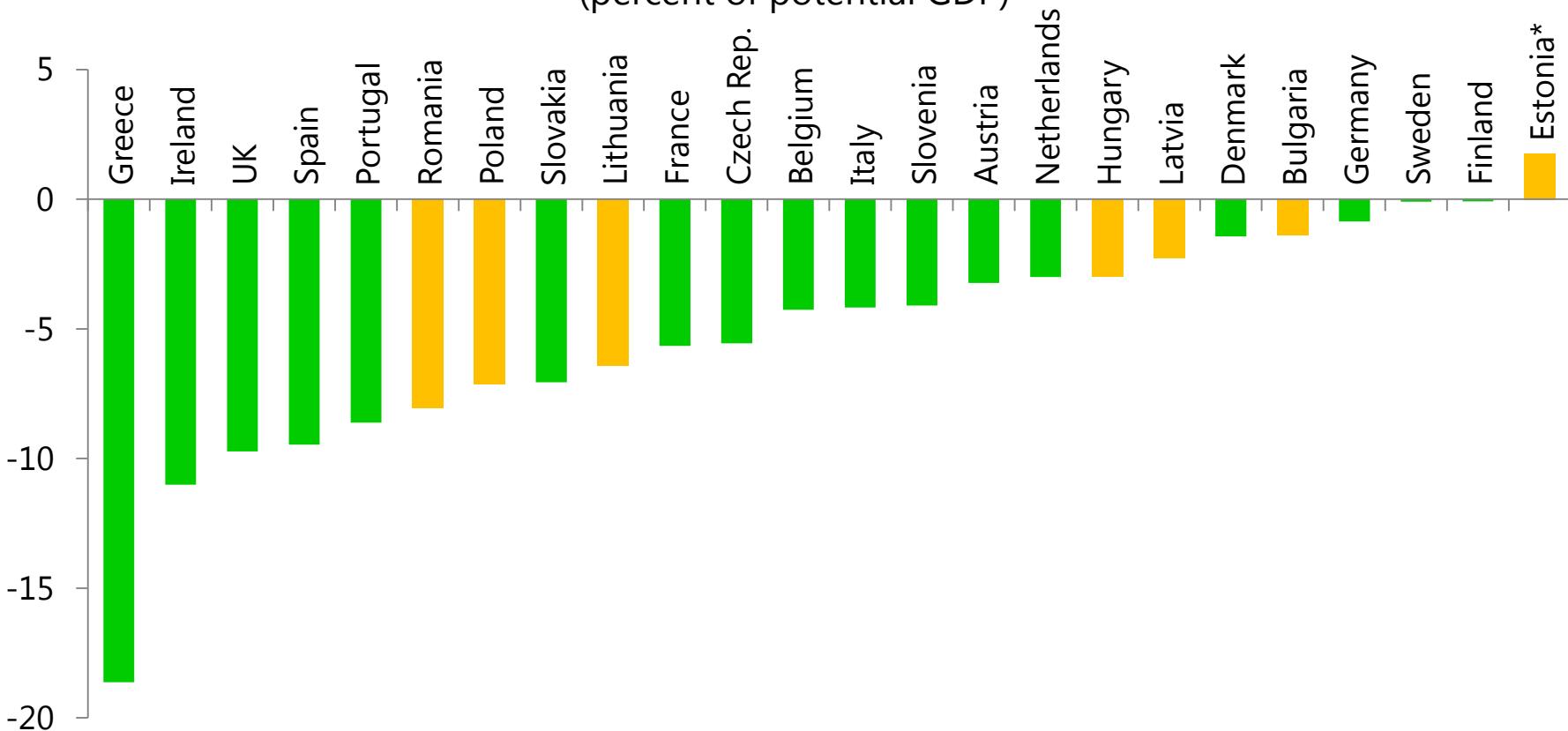


Note: Forecast errors are differences between 2012 and 2009 WEO vintages estimates.

# Fiscal positions in emerging Europe were better than in the euro area periphery...

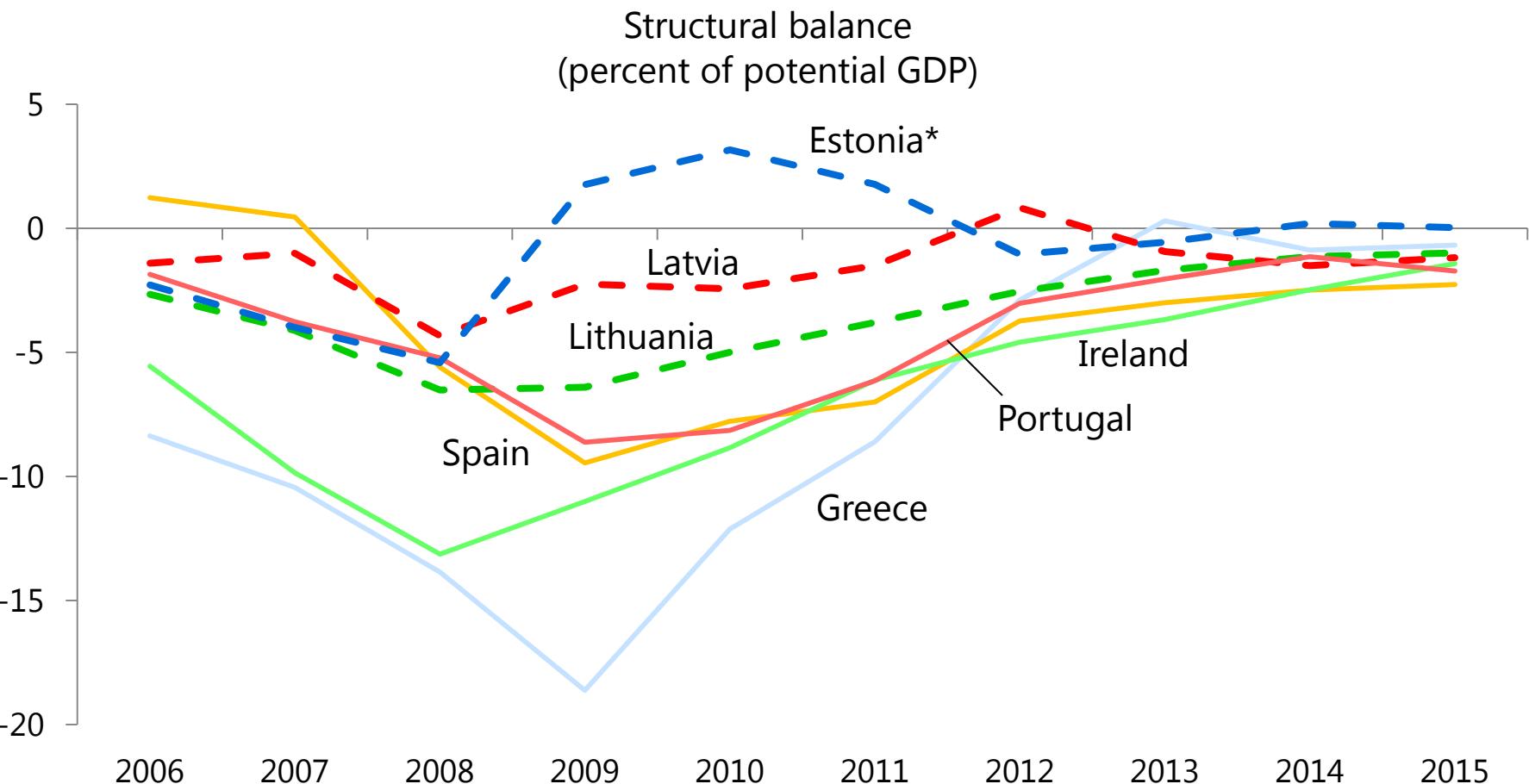


Structural balance, 2009  
(percent of potential GDP)



\* Cyclically adjusted balance (AMECO database)

# And had also not deteriorated as much

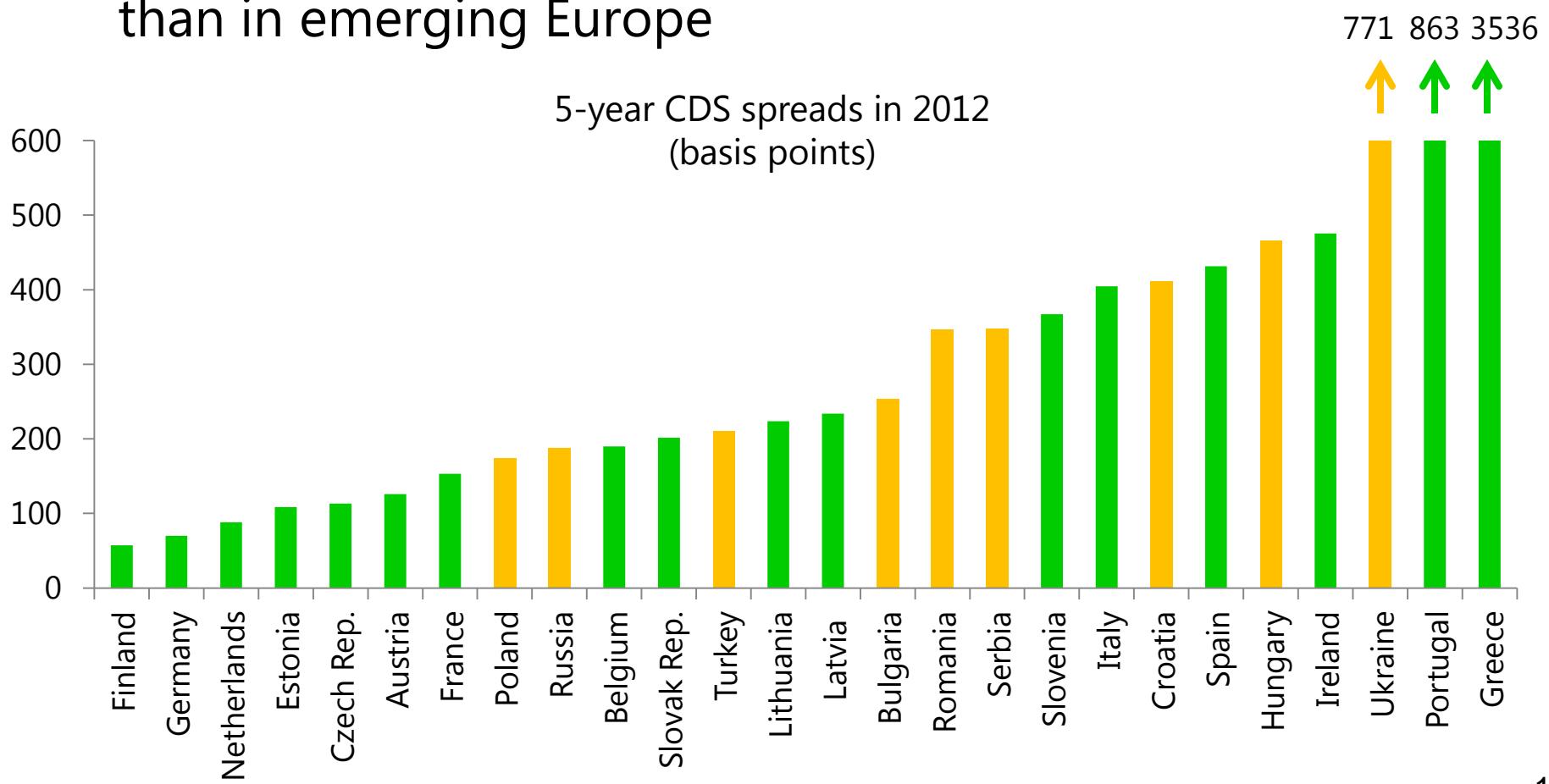


\* Cyclically adjusted balance (AMECO database)

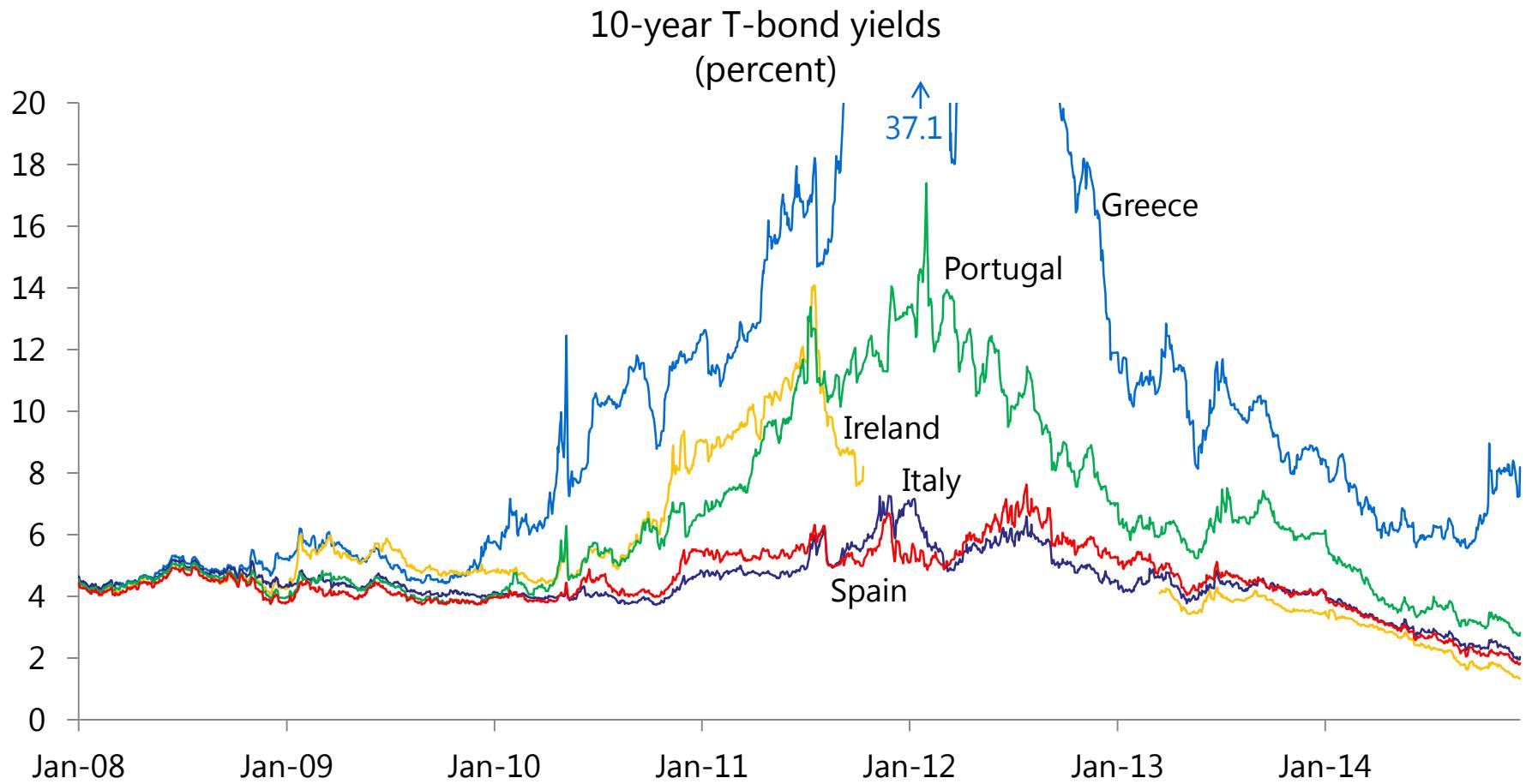
# As a result, emerging Europe was less affected by the euro area crisis



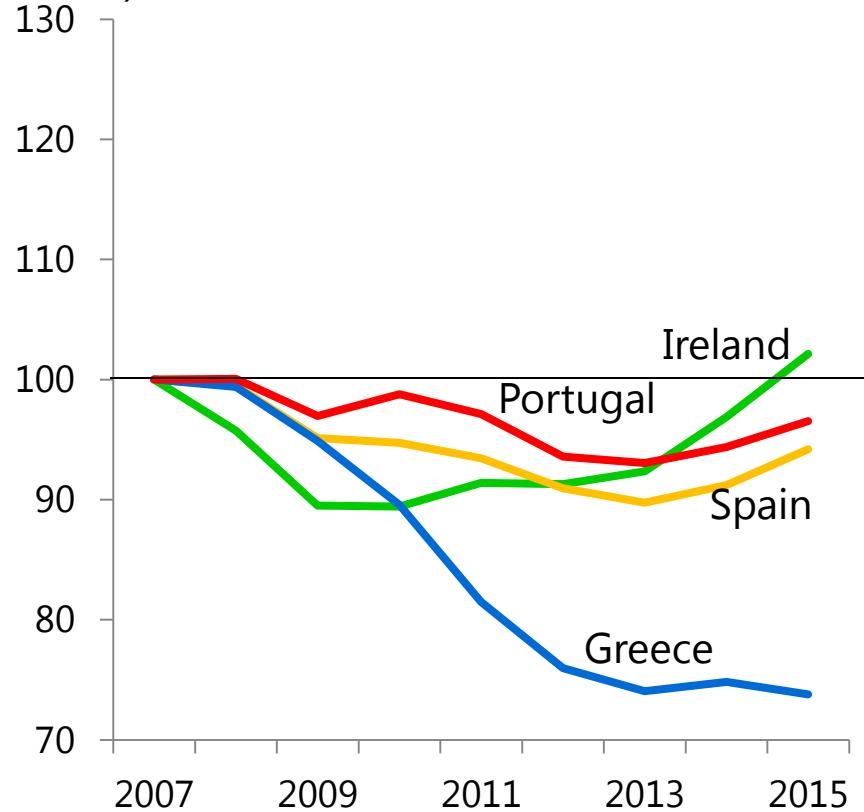
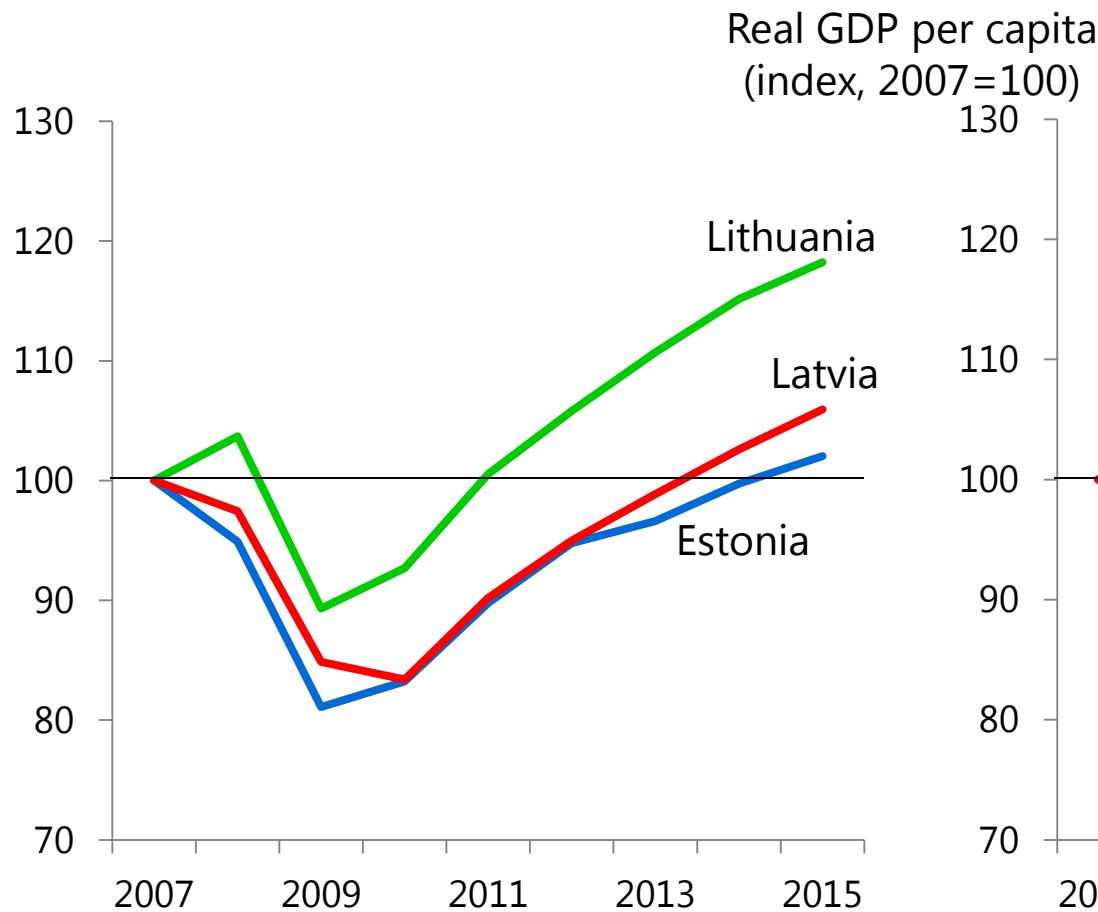
- Risk premia in advanced countries were no longer lower than in emerging Europe



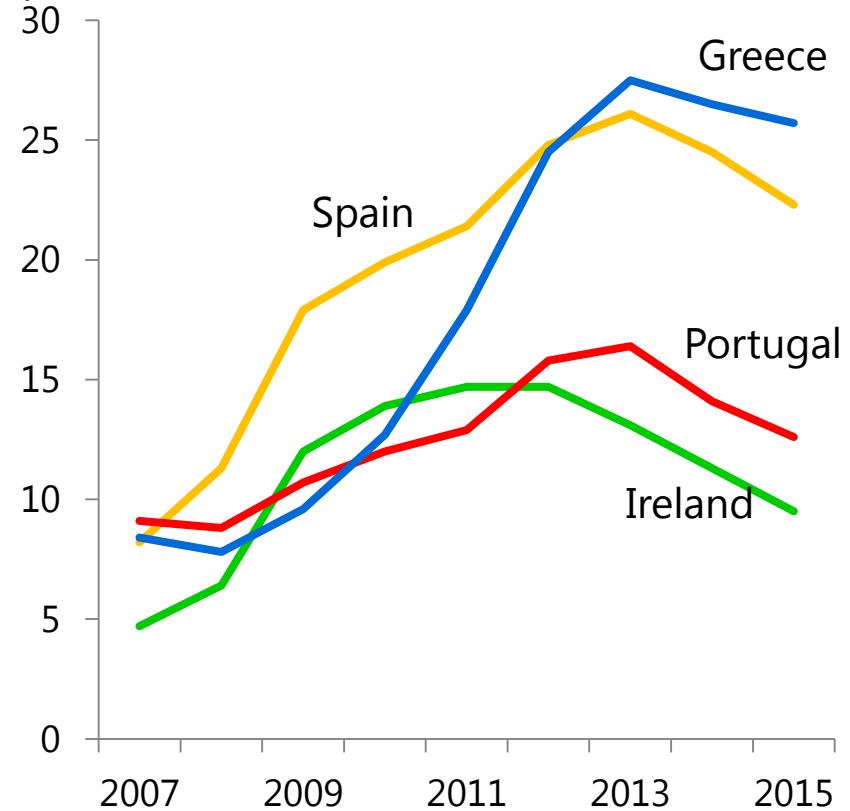
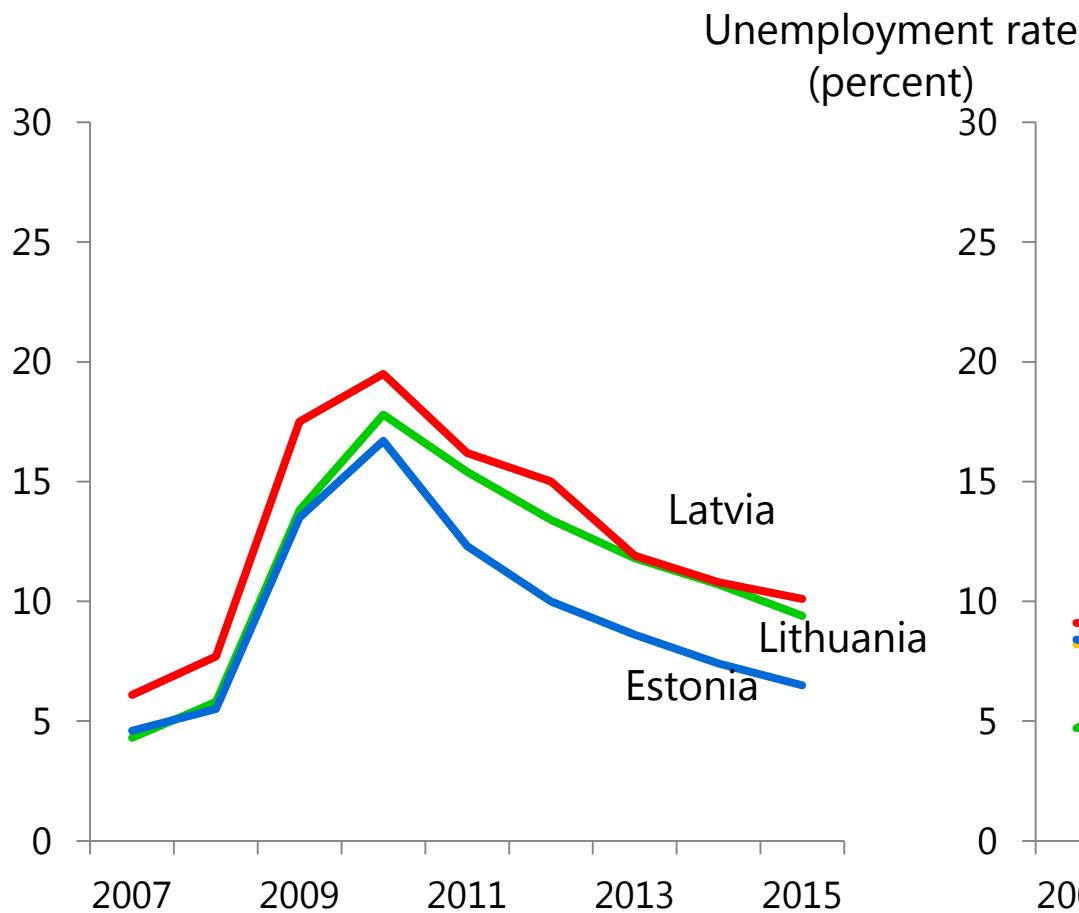
Euro area recovered in 2014, after adjustment programs and QE had brought down interest rates in periphery



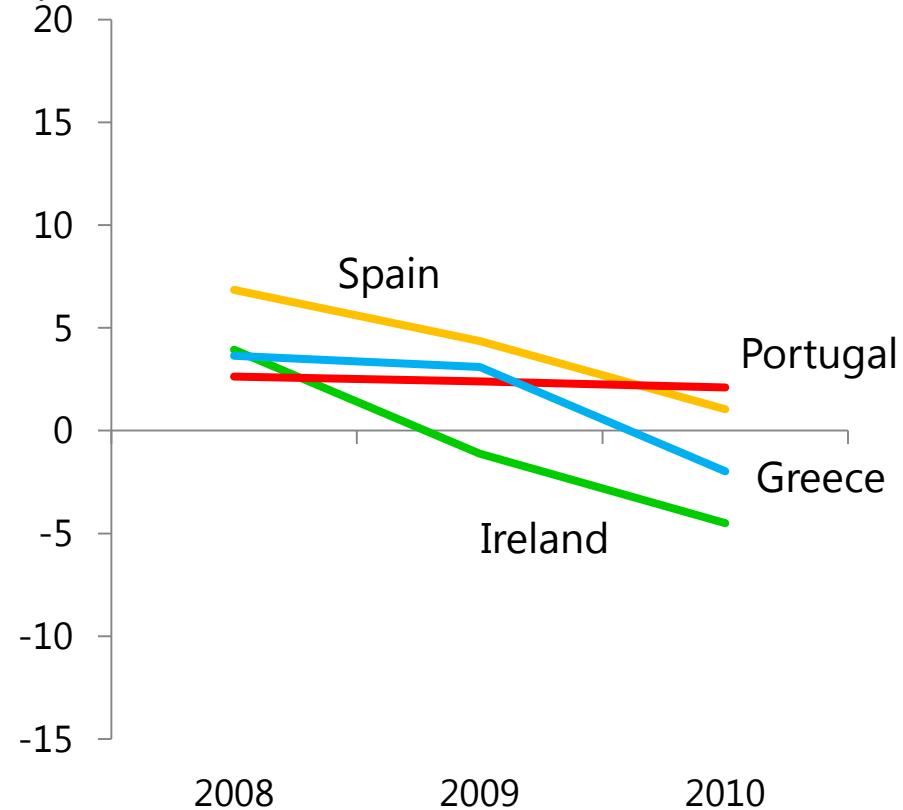
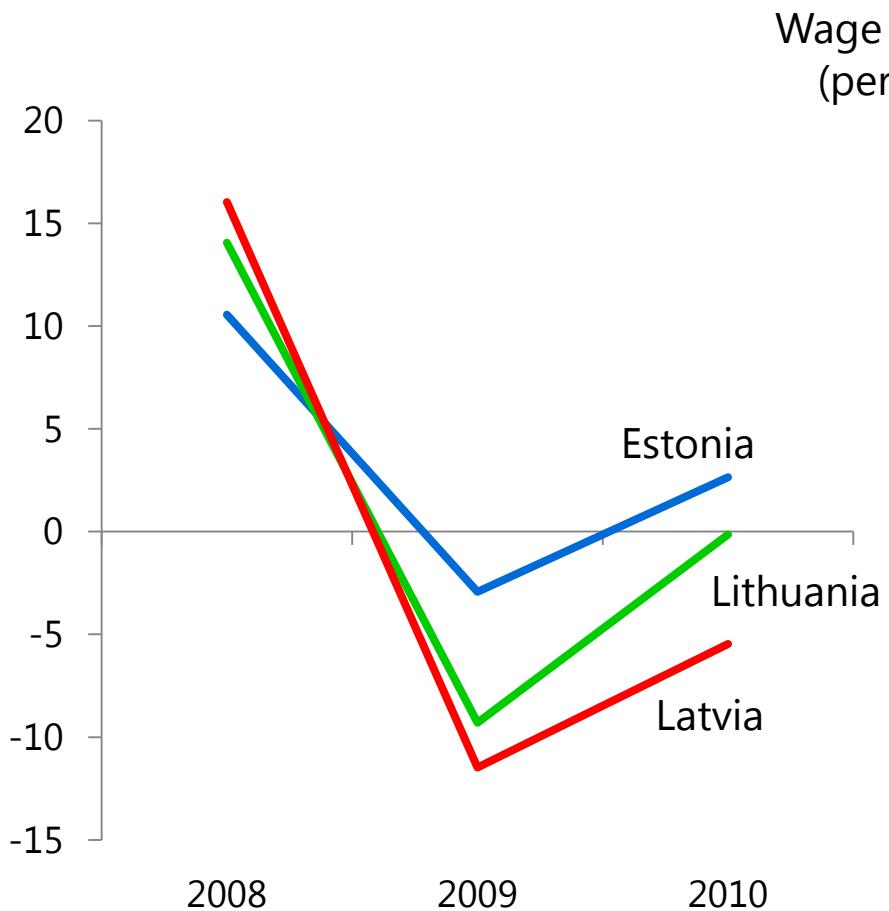
Overall, crisis in Baltics was deeper than in euro area periphery, but shorter



# Most notable difference was unemployment



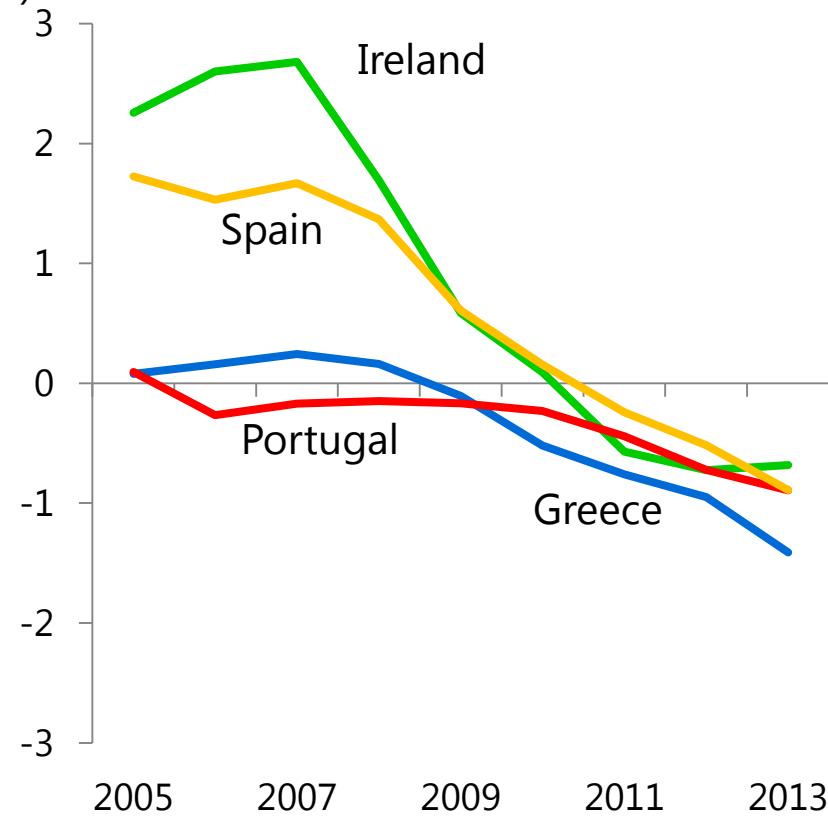
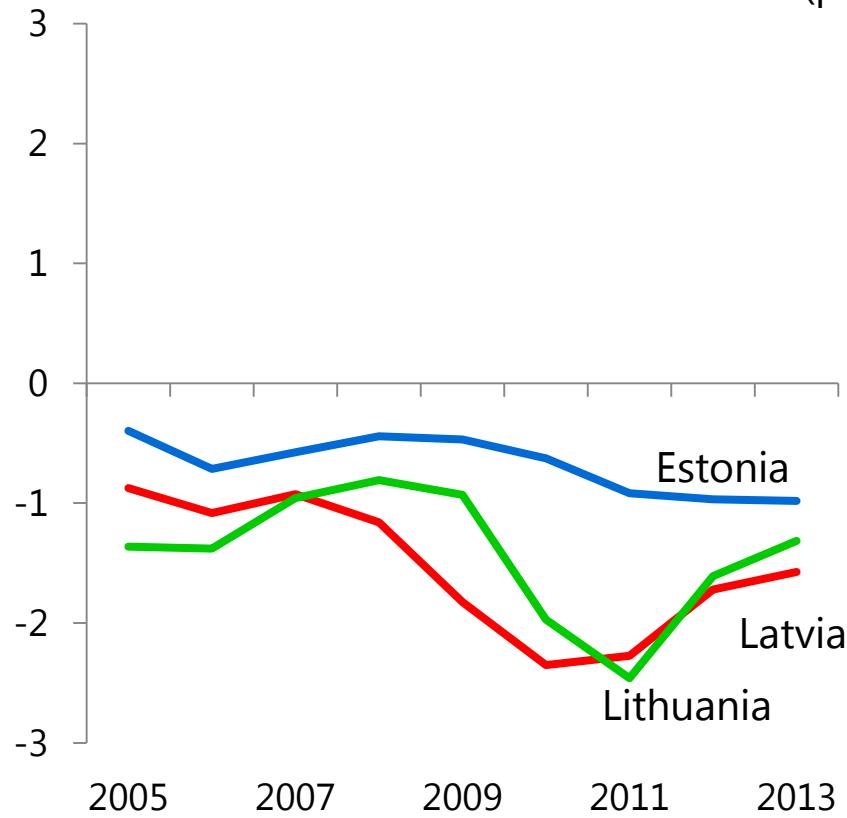
...which may be related to more rapid  
adjustment of wages



# Differences not the result of changes in emigration!



Working age population dynamics  
(percent)



## 2. Current advantages of "Advanced country status"

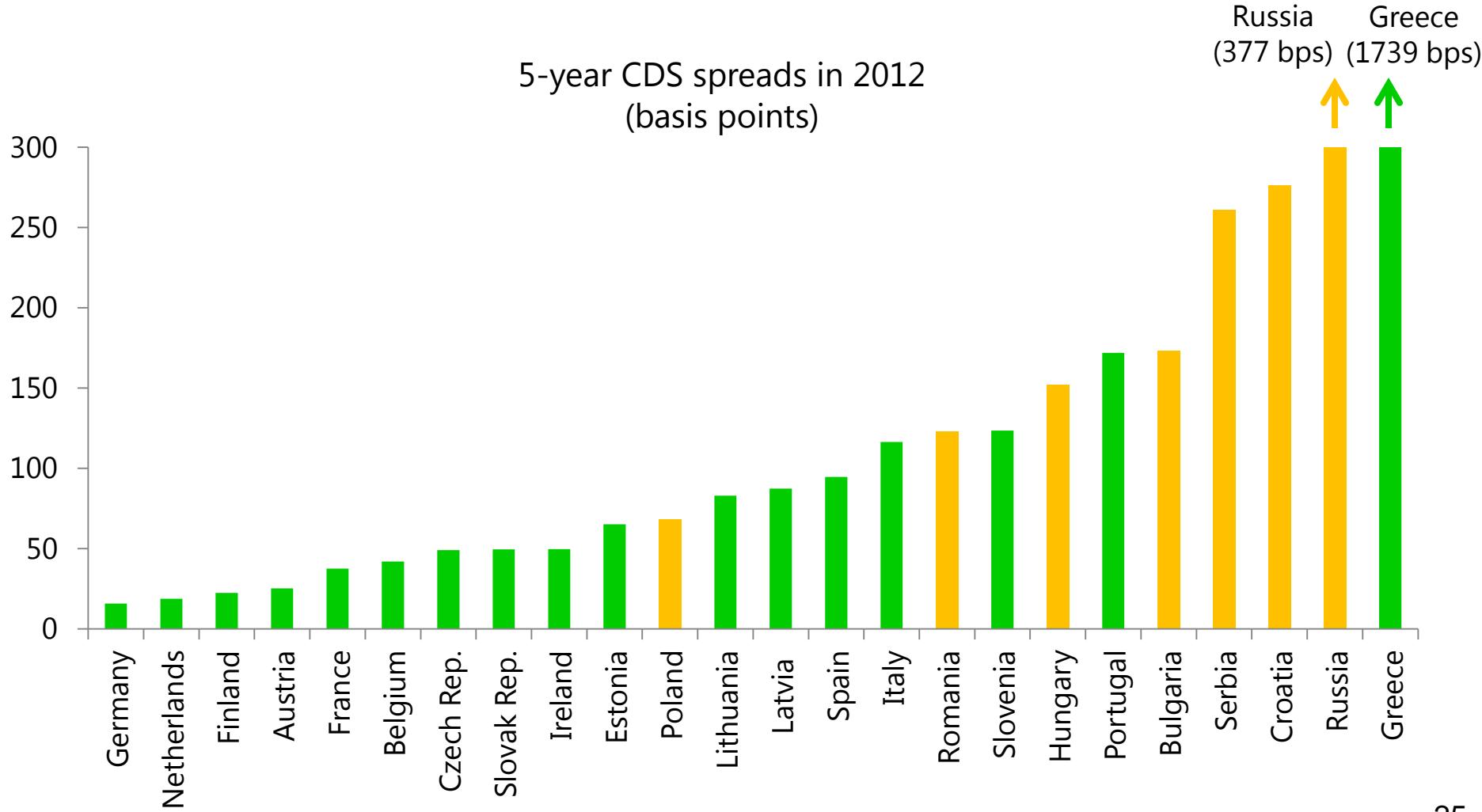


- Advanced country label may no longer be a big advantage
- Large number of crises in advanced countries in past decade
- Investors care more about policies than about status

# Weak advanced countries have higher risk premia than strong emerging market countries



5-year CDS spreads in 2012  
(basis points)



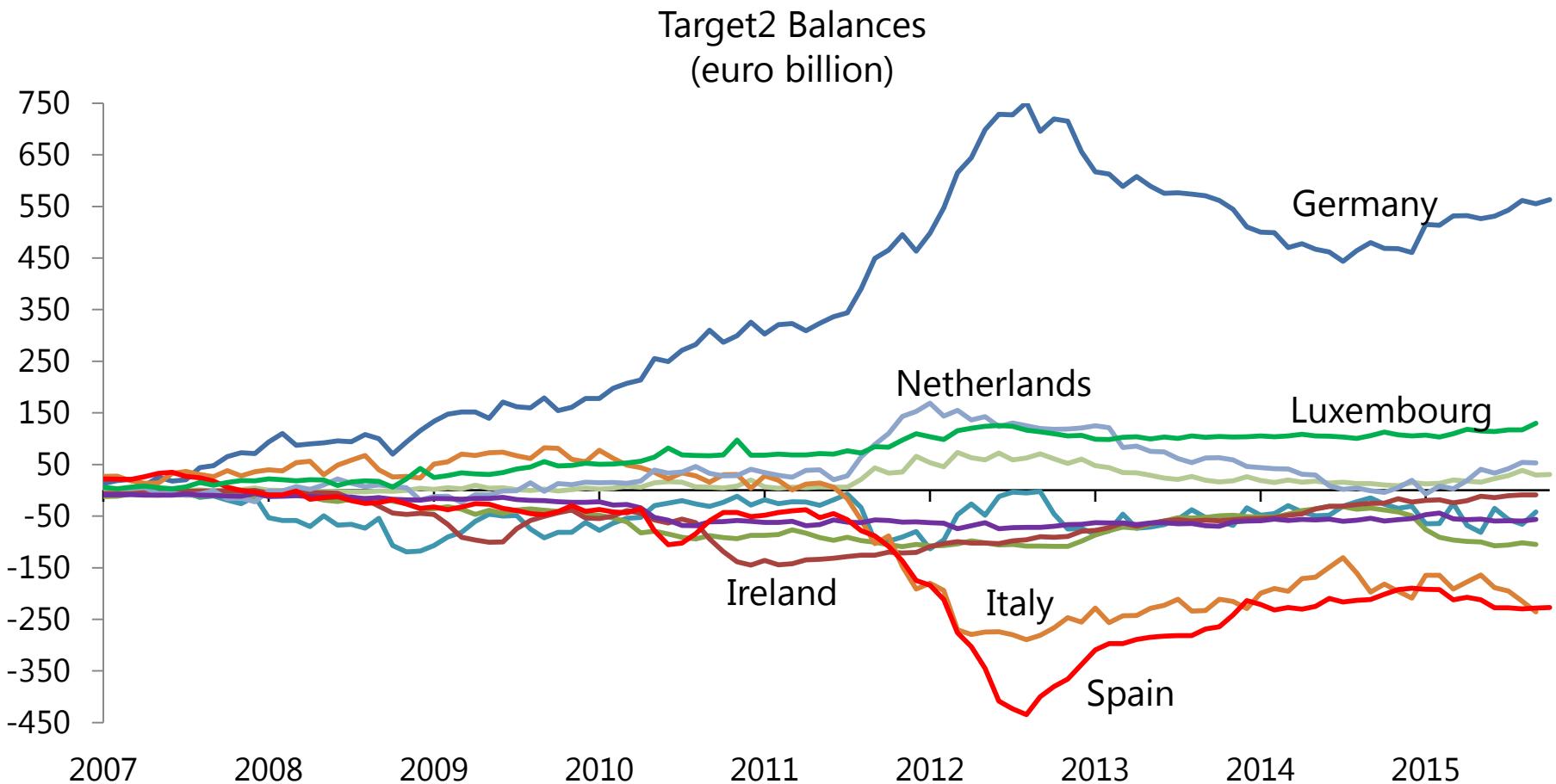
Note: Emerging markets as of 2012 in orange

### 3. Current advantages of Euro area membership



- More important may be euro area membership
- Removes any residual exchange rate risk
- Lender of last resort
- In future: banking union

# Target 2 and ECB make liquidity shocks much less likely



## 4. Challenges for Lithuania in euro area

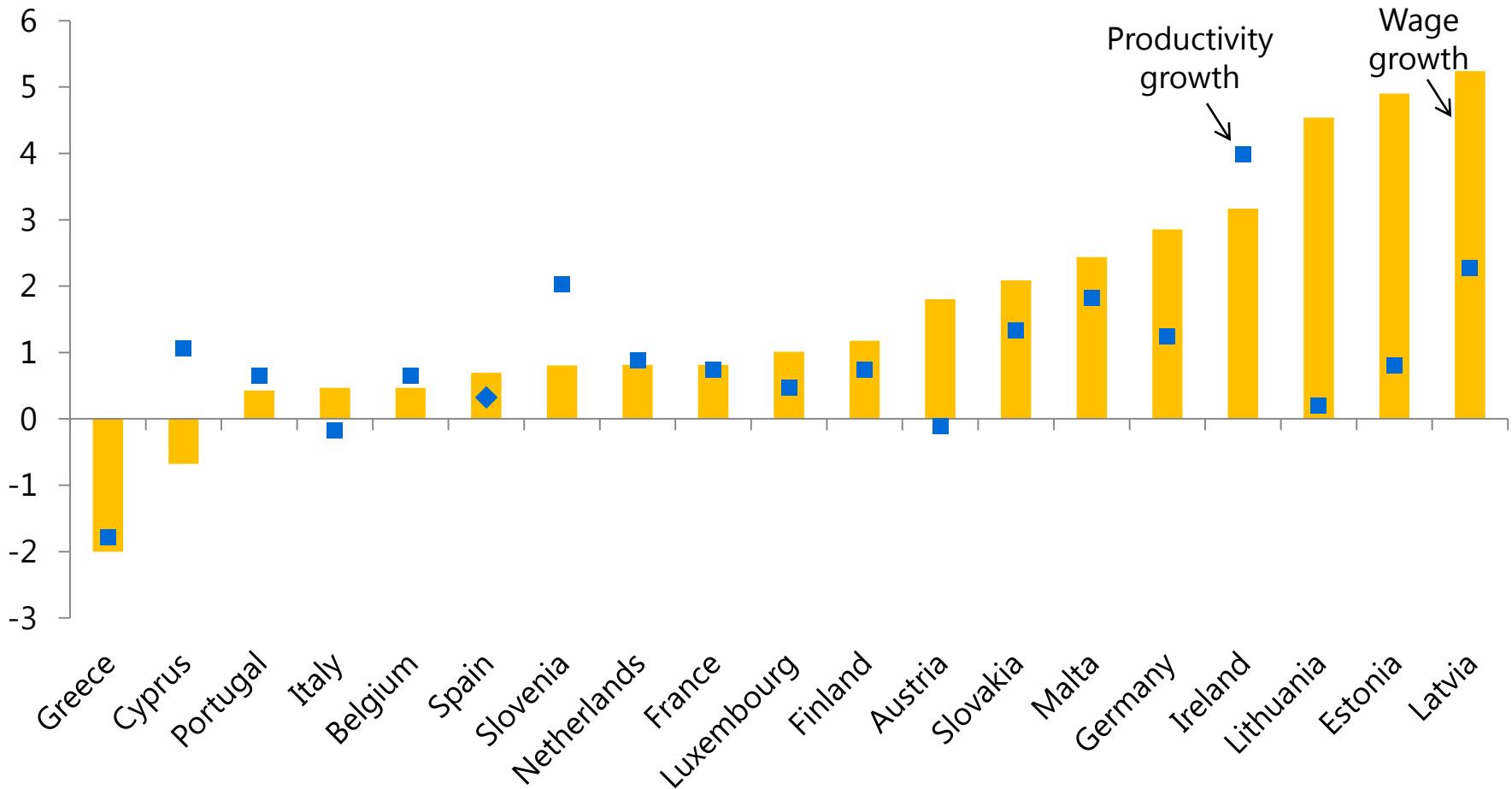


- Lithuania has no independent monetary policy  
(of course, has not had it for long time)
- How do you prevent future boom-busts?

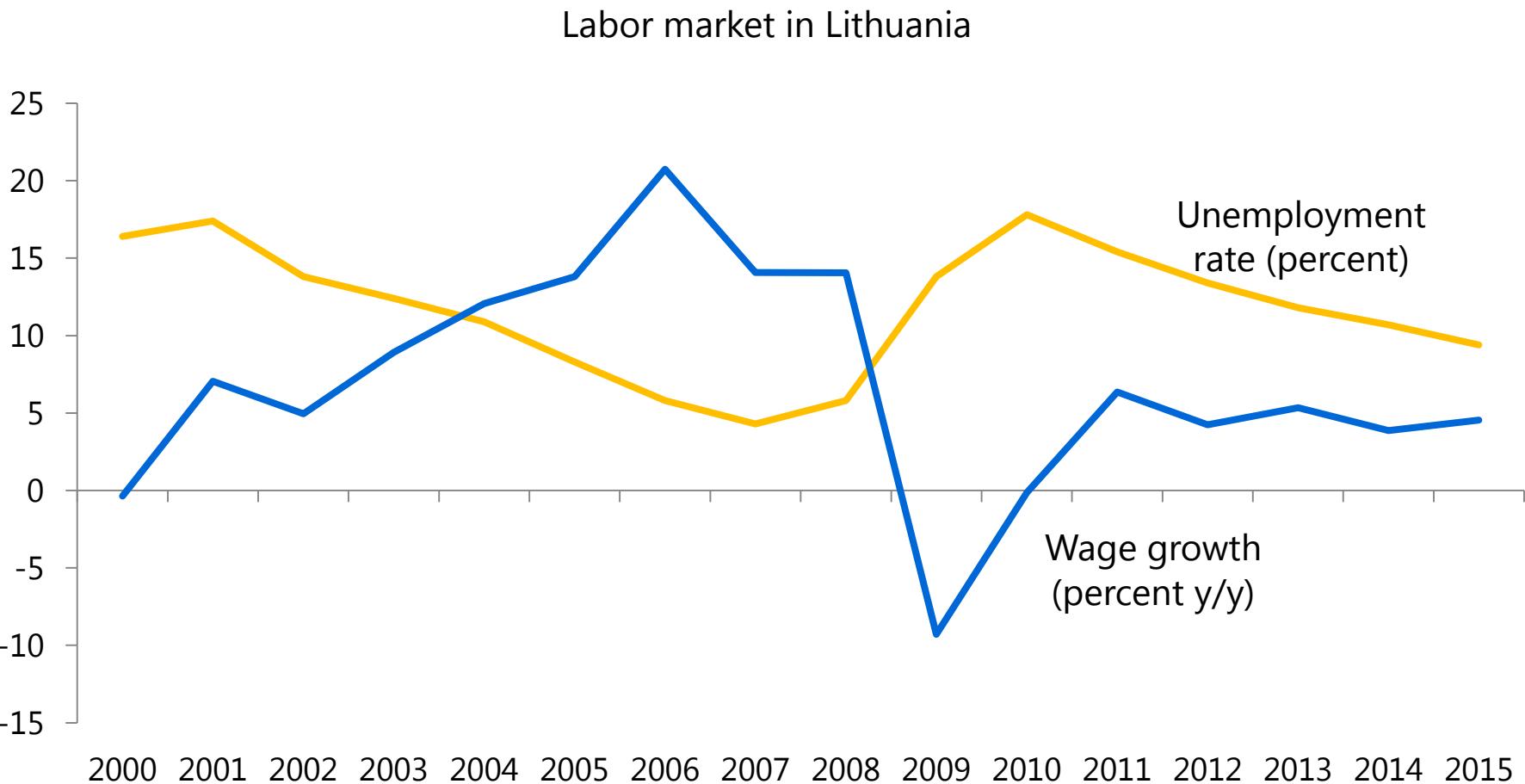
# Wage growth in the Baltics is already high compared to rest of euro area



Nominal wage and real productivity growth, 2015  
(percent)



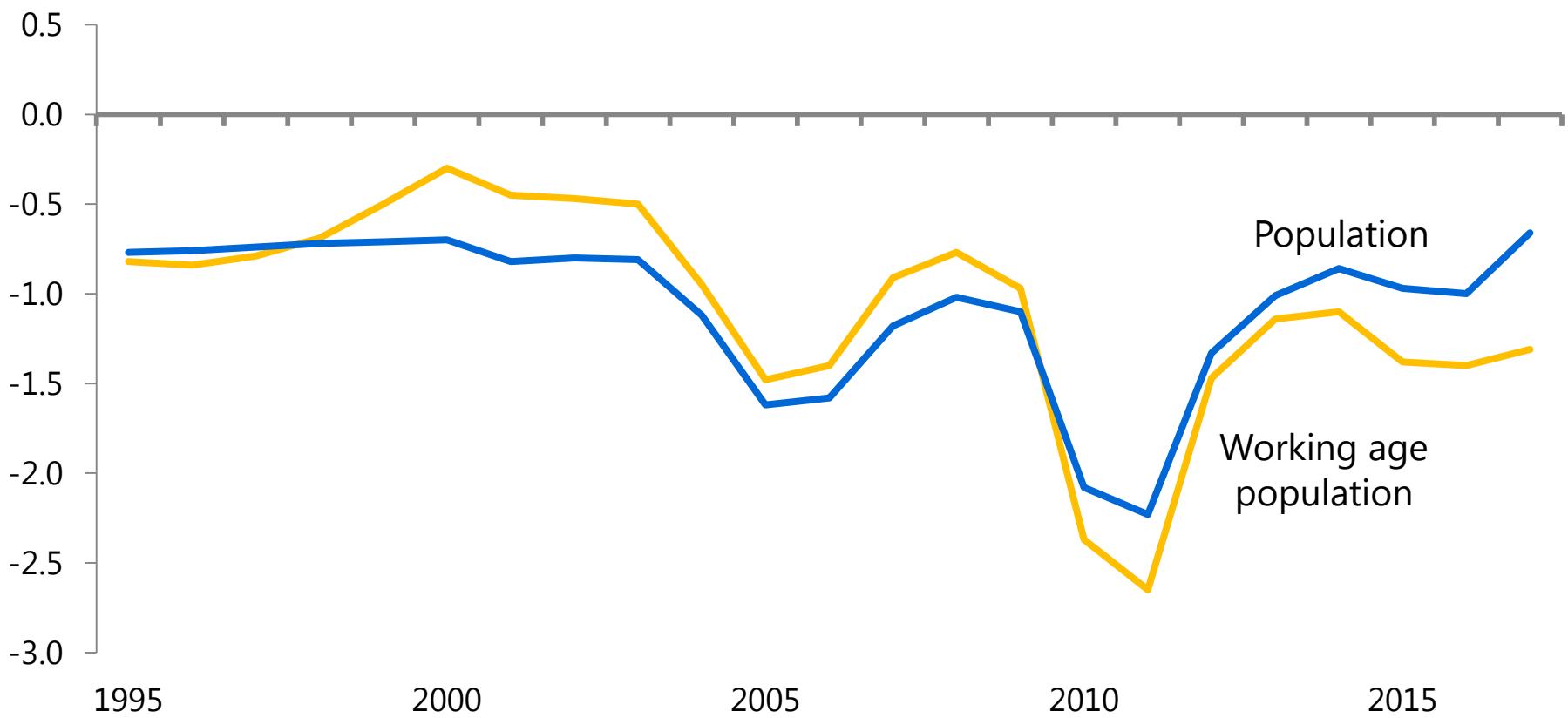
# Unemployment is falling rapidly. How do you prevent renewed overheating?



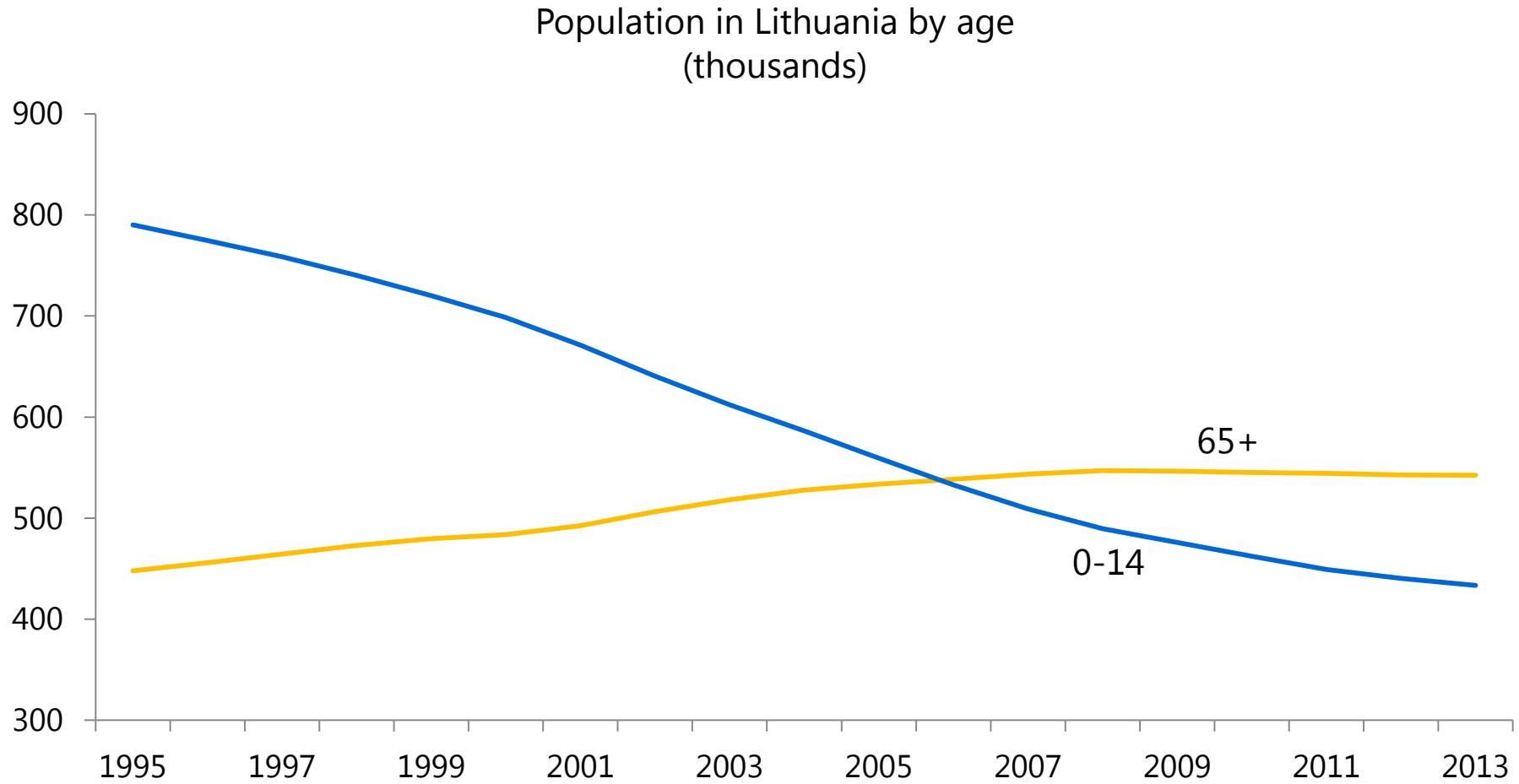
# Decline of working age population does not help!



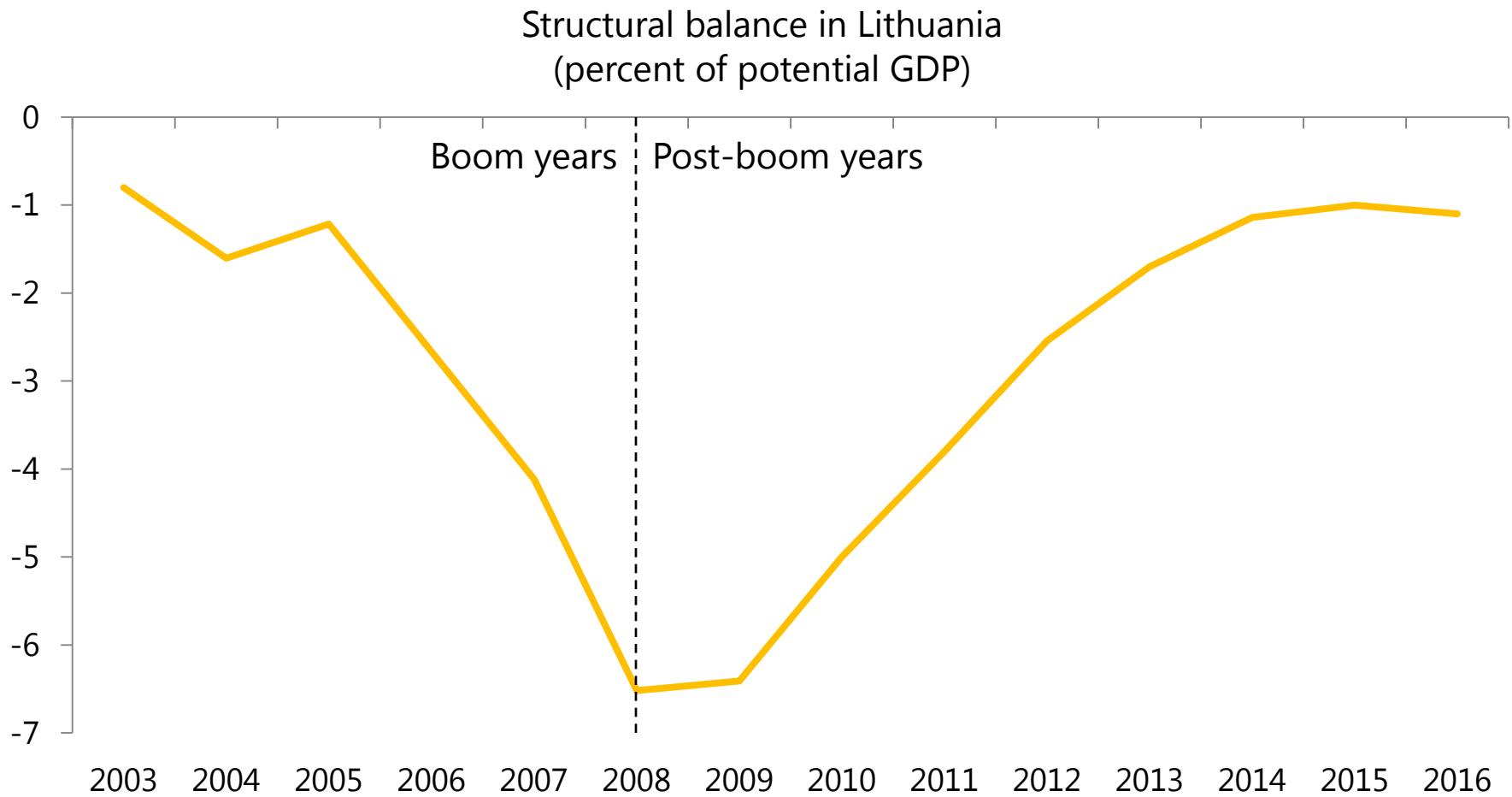
Population dynamics in Lithuania  
(percent)



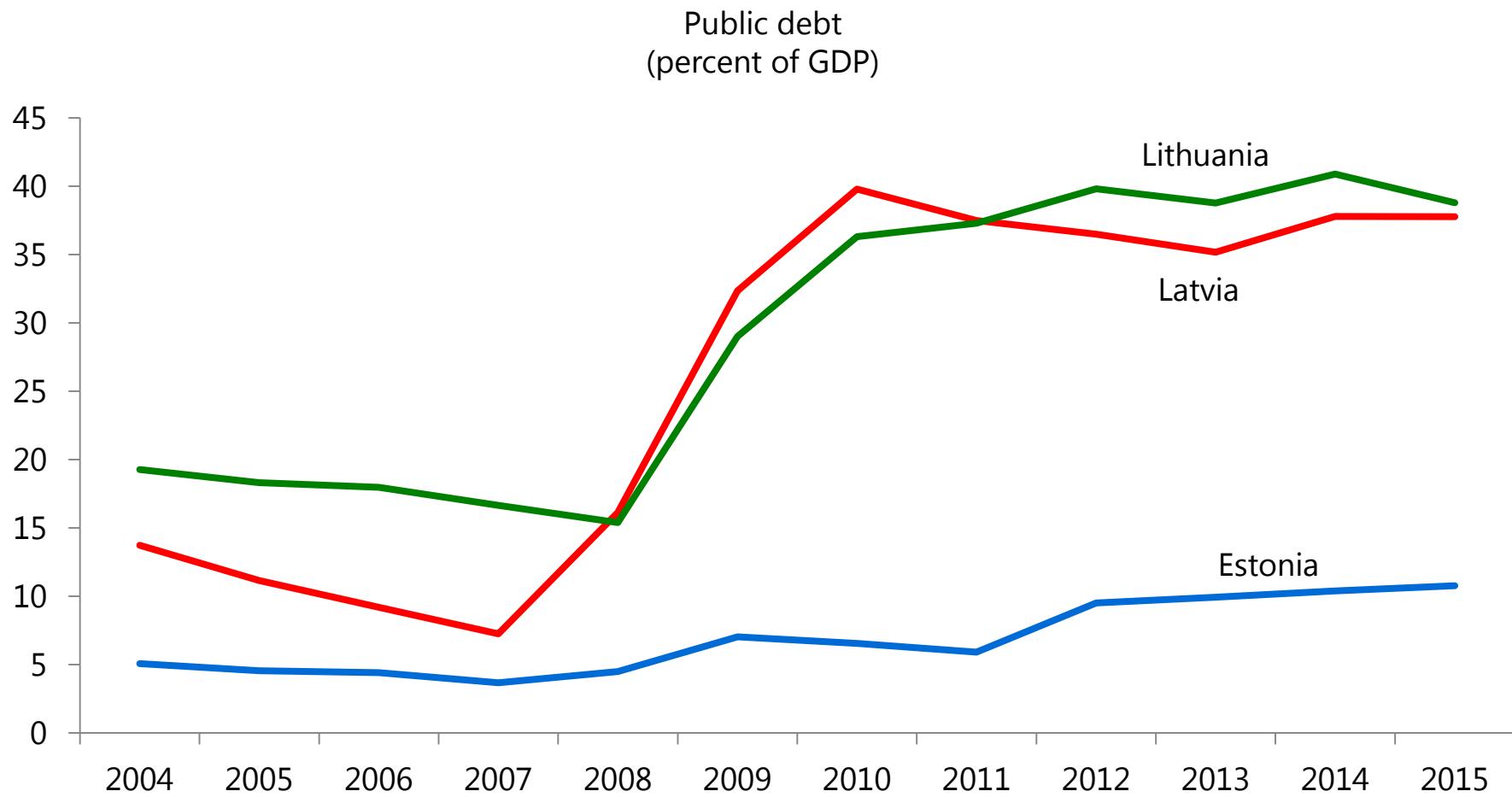
# Working age decline to continue



In future, fiscal policy may need to lean more against the wind—not add to the boom



# This would also help to rebuild buffers

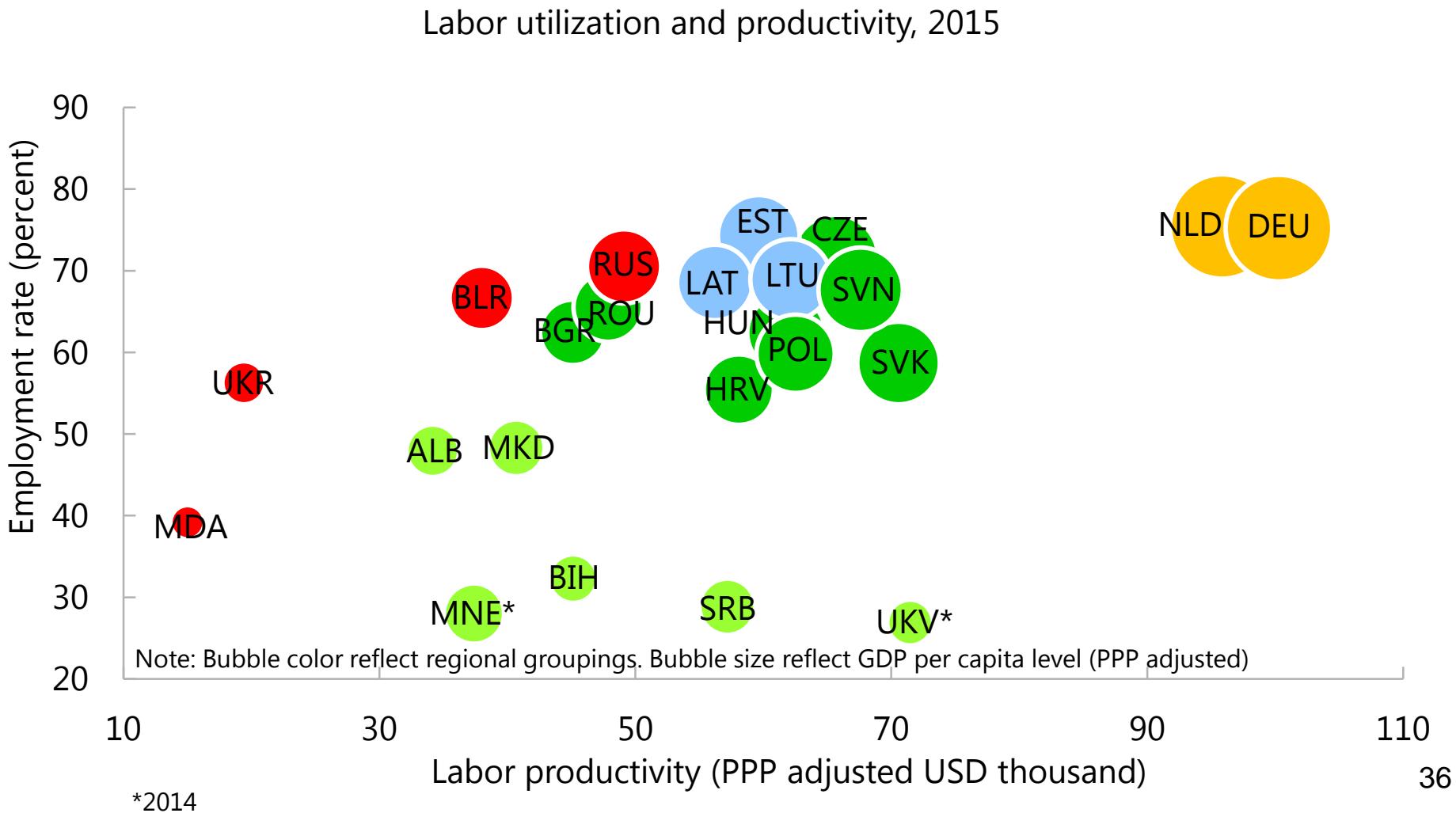


# Macro-prudential policy may also need to play a role



- With banking system largely foreign owned, close cooperation between home and host-supervisors needed
- (Neglect home country supervisors during pre-2008 boom did not end well).

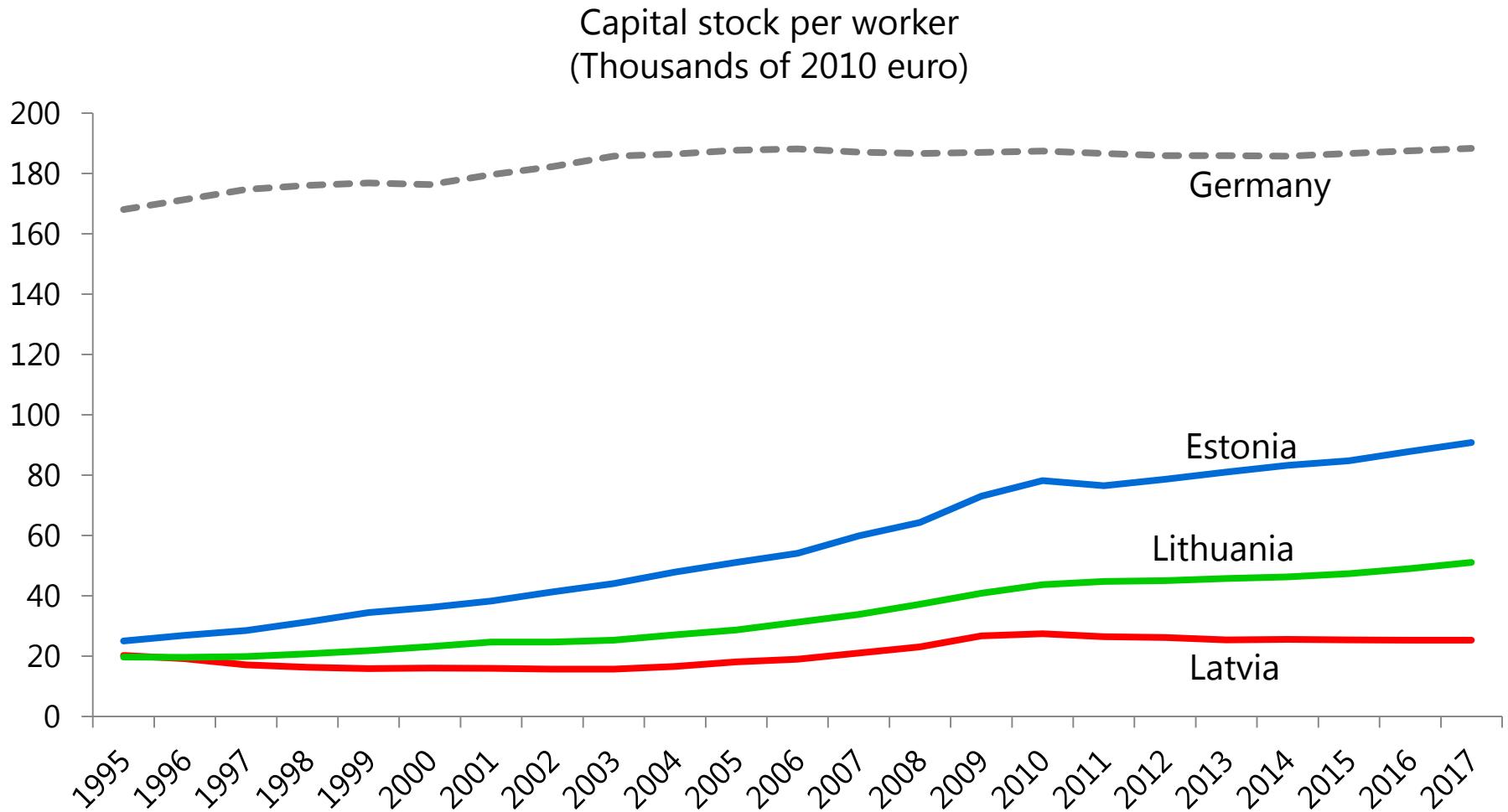
# Future catch-up will need to be driven by productivity increases



# There is less scope to increase employment rate than in the past



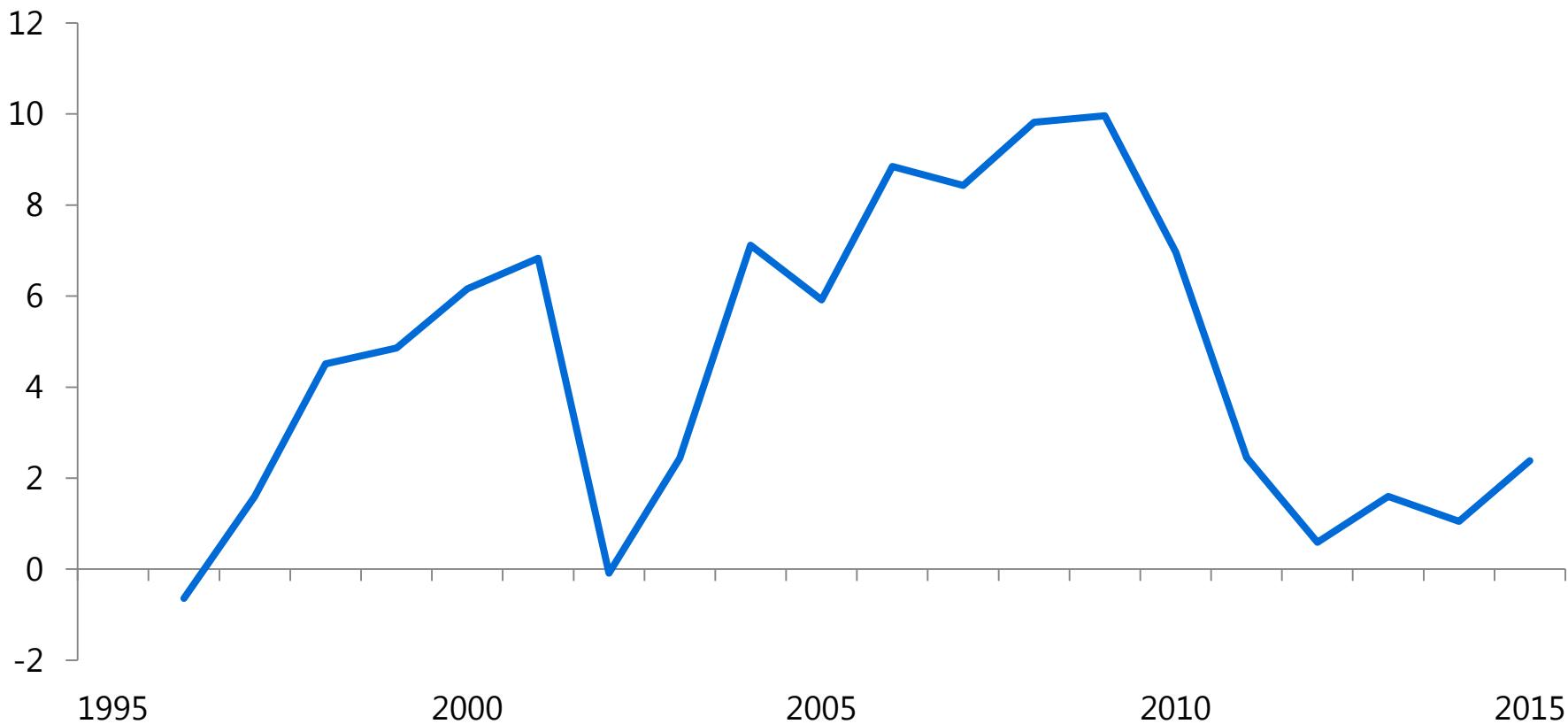
# Capital stock per worker is still low



# But growth of capital stock has slowed down



Lithuania: growth rate of capital stock per worker  
(percent)



## 5. Conclusion



- Lithuania is now an “advanced economy”
- Nice recognition of the important changes that have been made since transition.
- However, it is unlikely to bring much changes—either to financial markets or to economy
- Sports analogy:
  - Champions are champions because they play so well
  - It is not that champions play so well because they are champions

# Euro area membership brings benefits— but also constraints



- For a small open, and catching-up economy important to prevent future boom-busts
- With no independent monetary policy, fiscal policy main remaining instrument
- Macro-prudential policy may also help



# Thank you