Phoenix from the Ashes: The Recovery of the Baltics from the 2008/09 Crisis

CASE Conference

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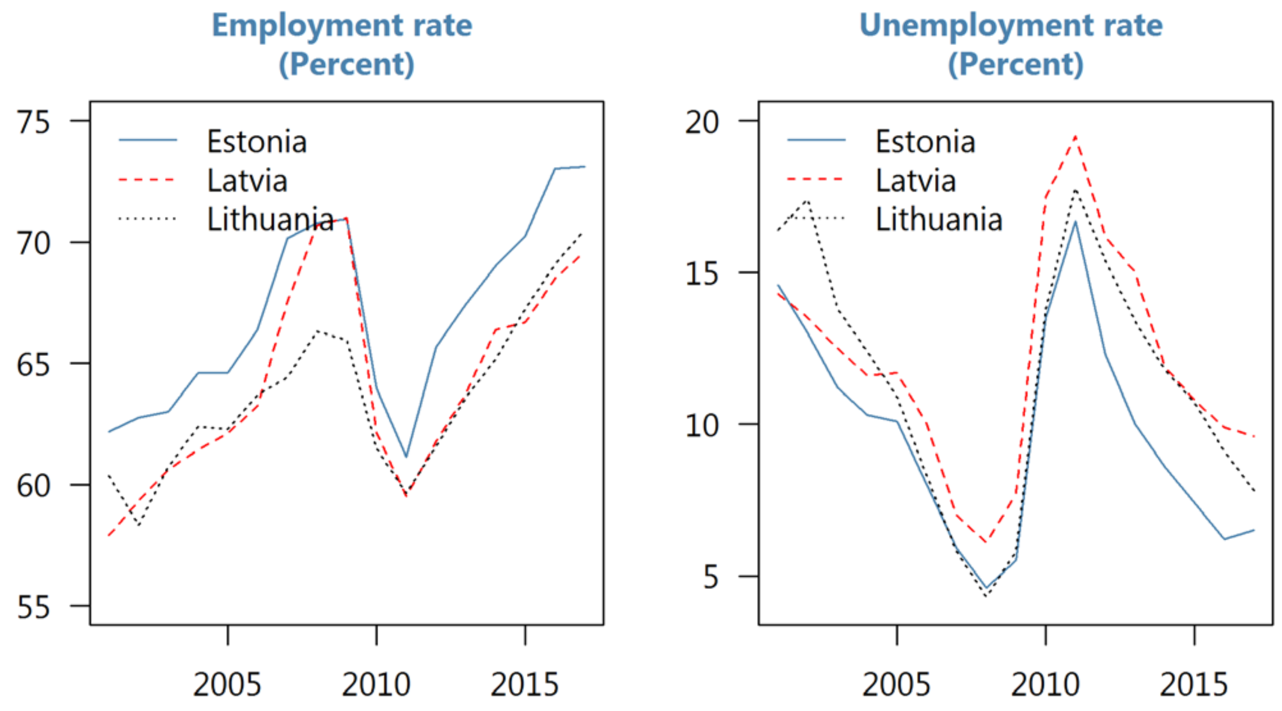
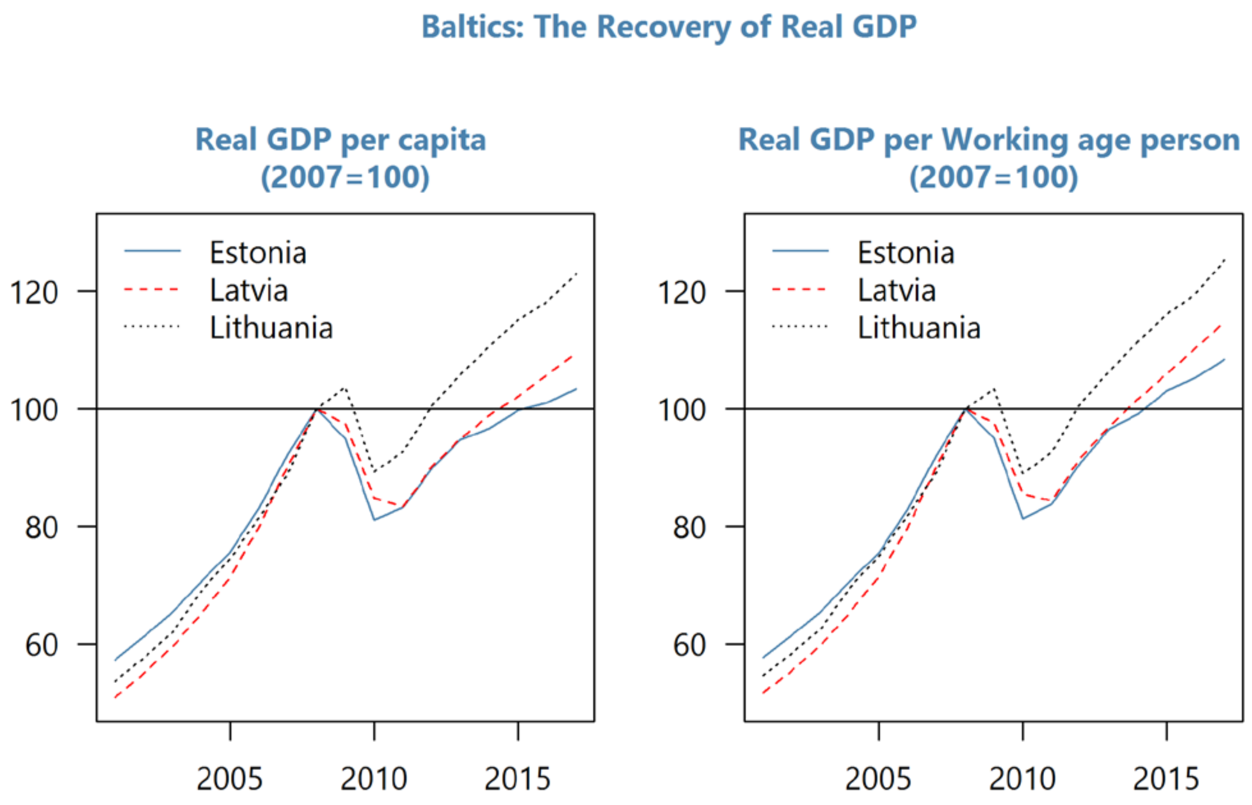
After a deep recession in 2009, unemployment rates are back to pre-crisis levels

Baltics: The Recovery of Employment

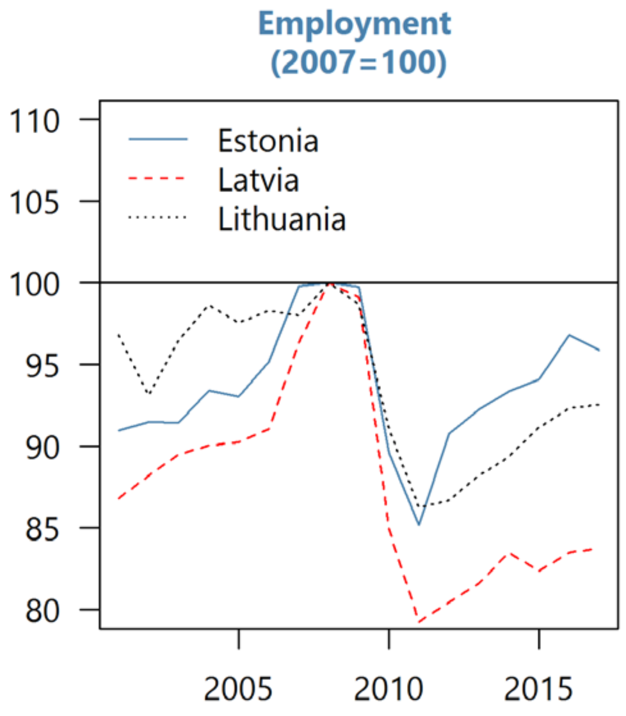


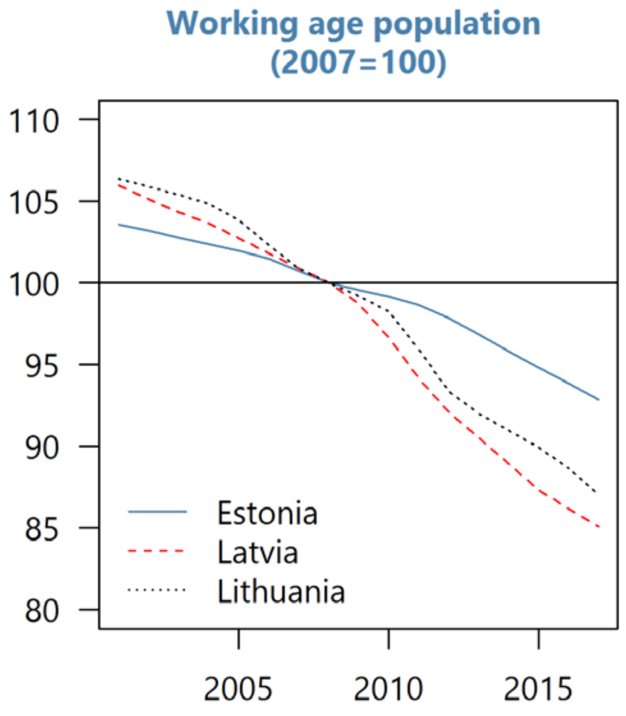
…and GDP per capita is above pre-crisis levels



Recovery in per capita terms was helped by decline of working age population

Baltics: Employment and Working Age Population

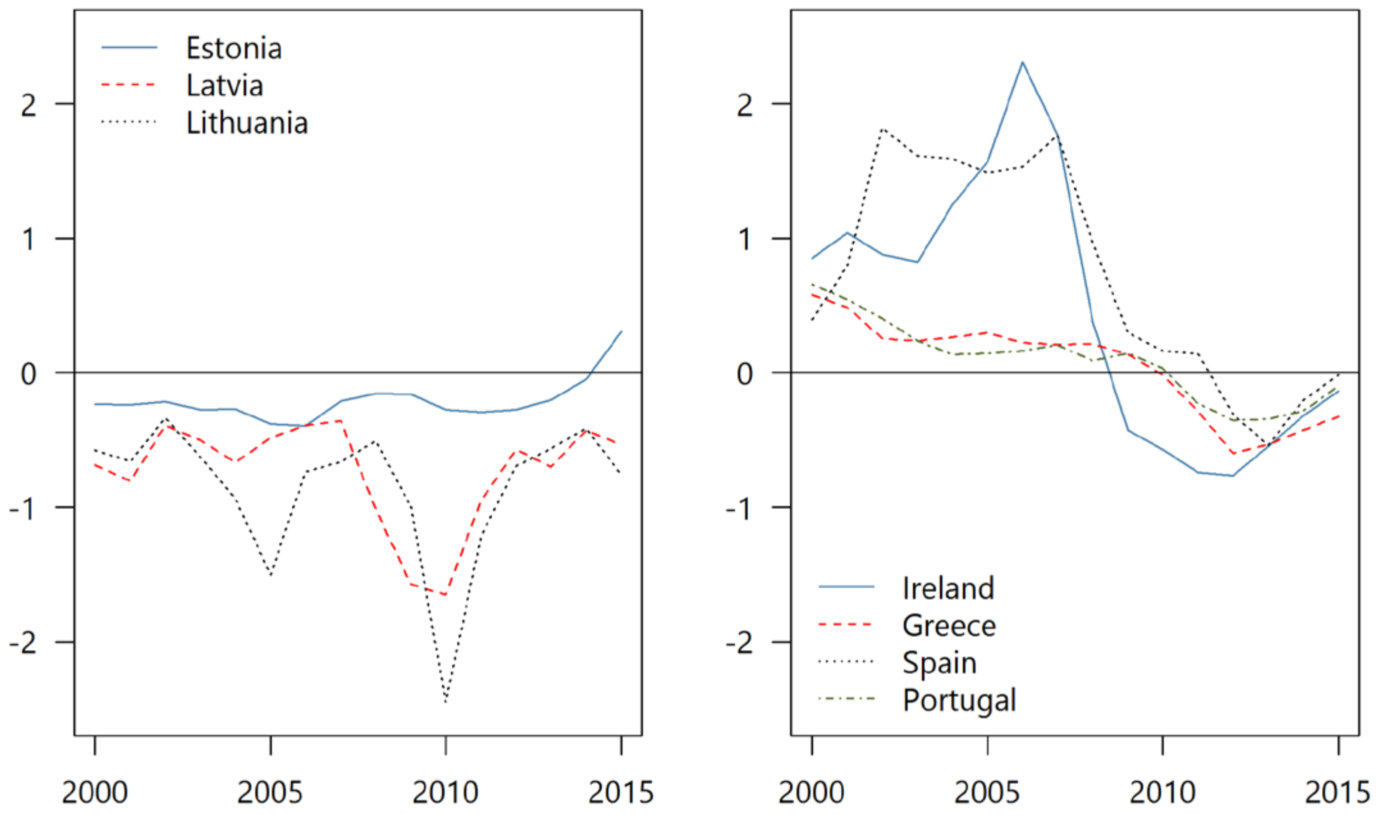




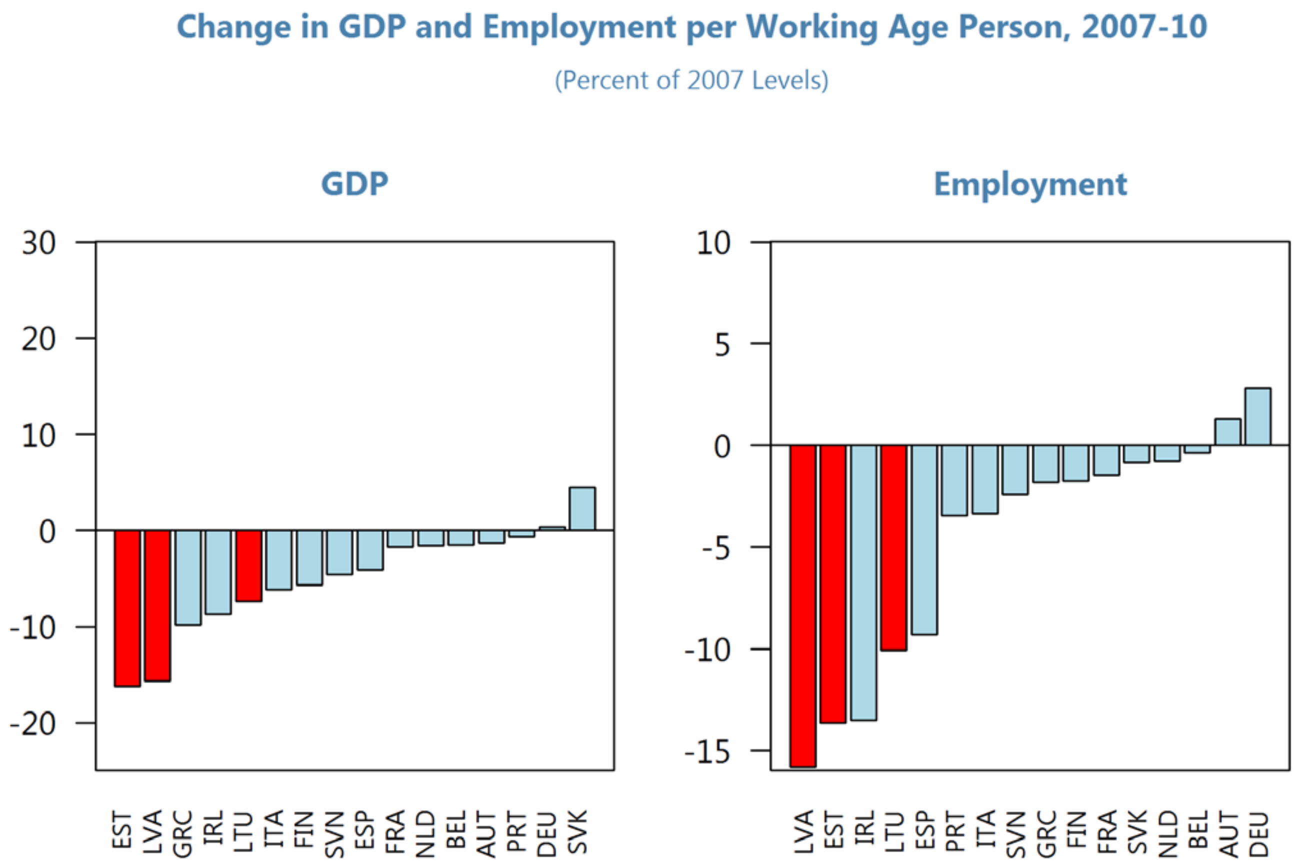
Emigration accelerated during crisis.

Net migration

(Percent of total population in previous year)

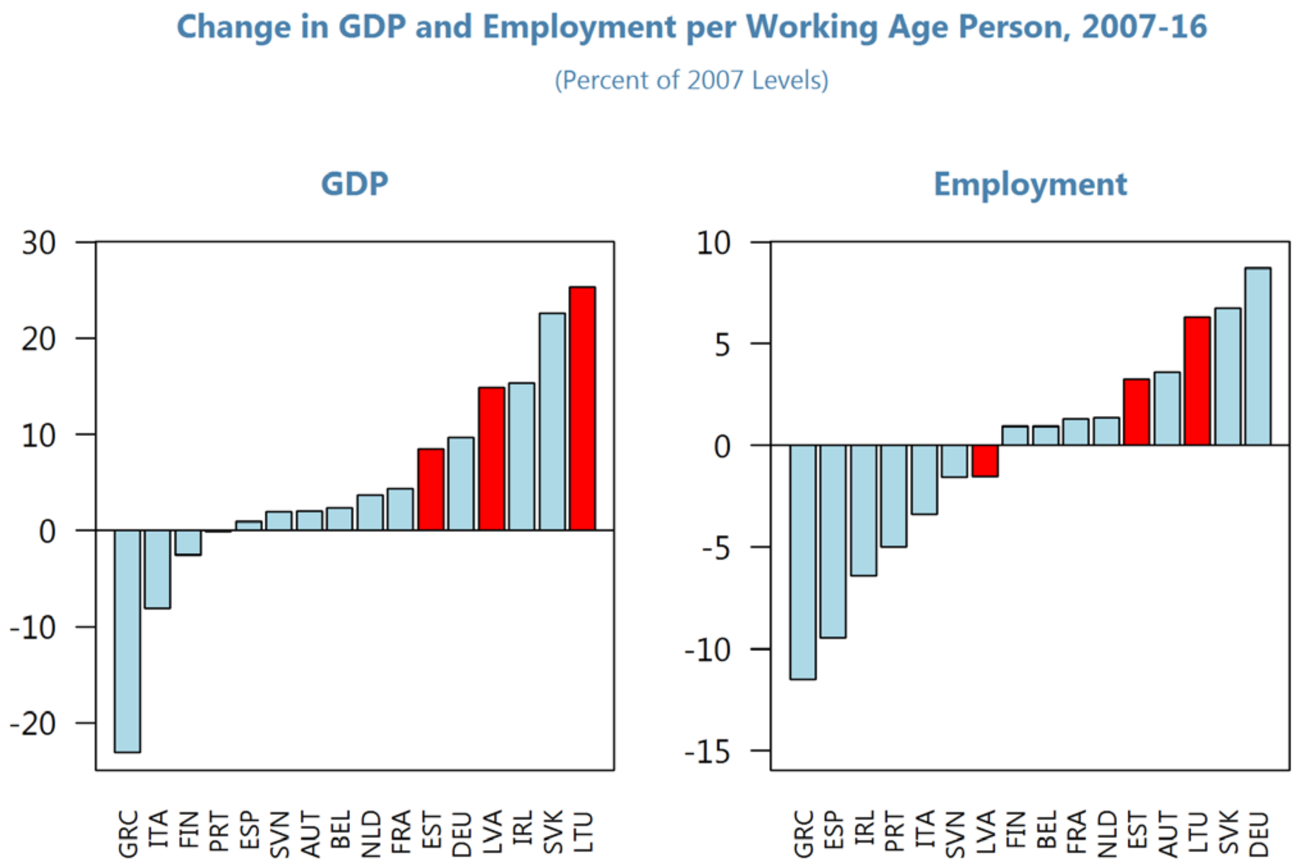


In per capita terms, compared with Eurozone, the Baltics had the most severe downturn initially…



But also the strongest recovery…

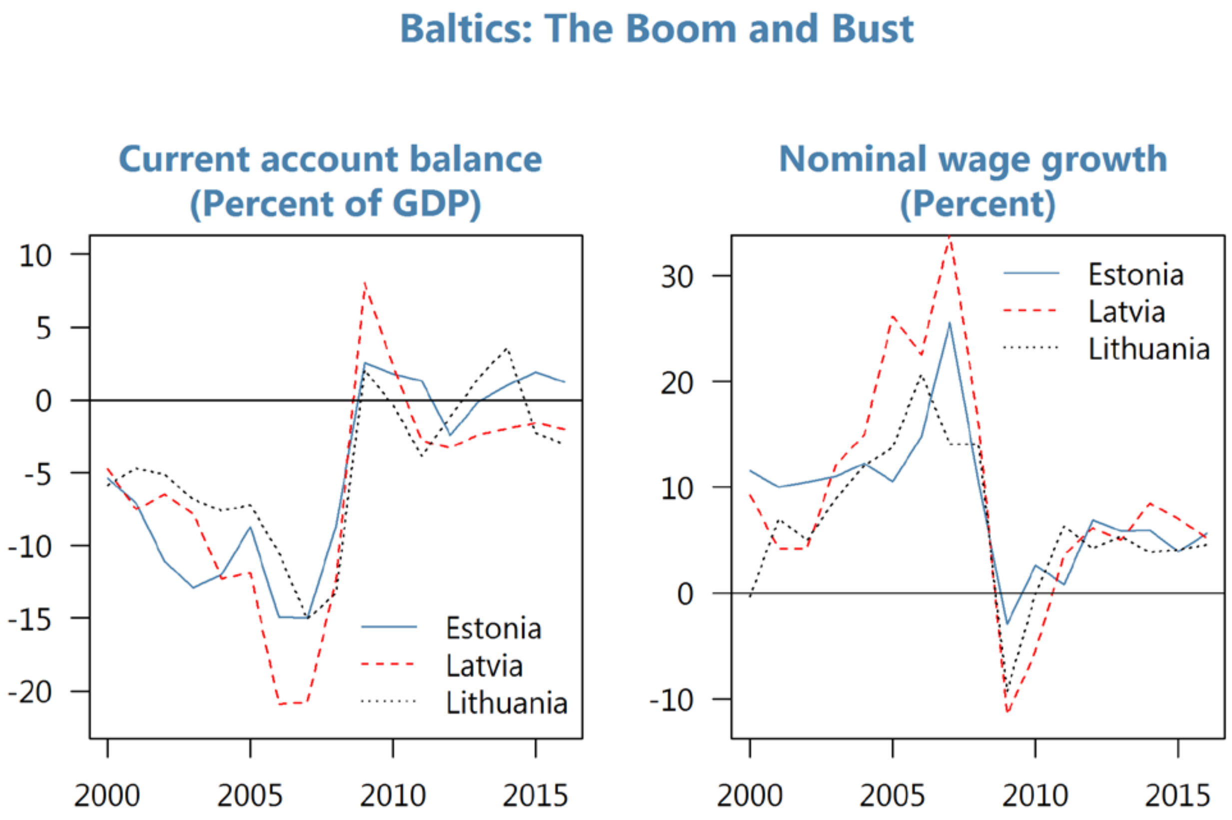
And over 2007-16 period, GDP and employment growth was relatively strong—in per capita terms



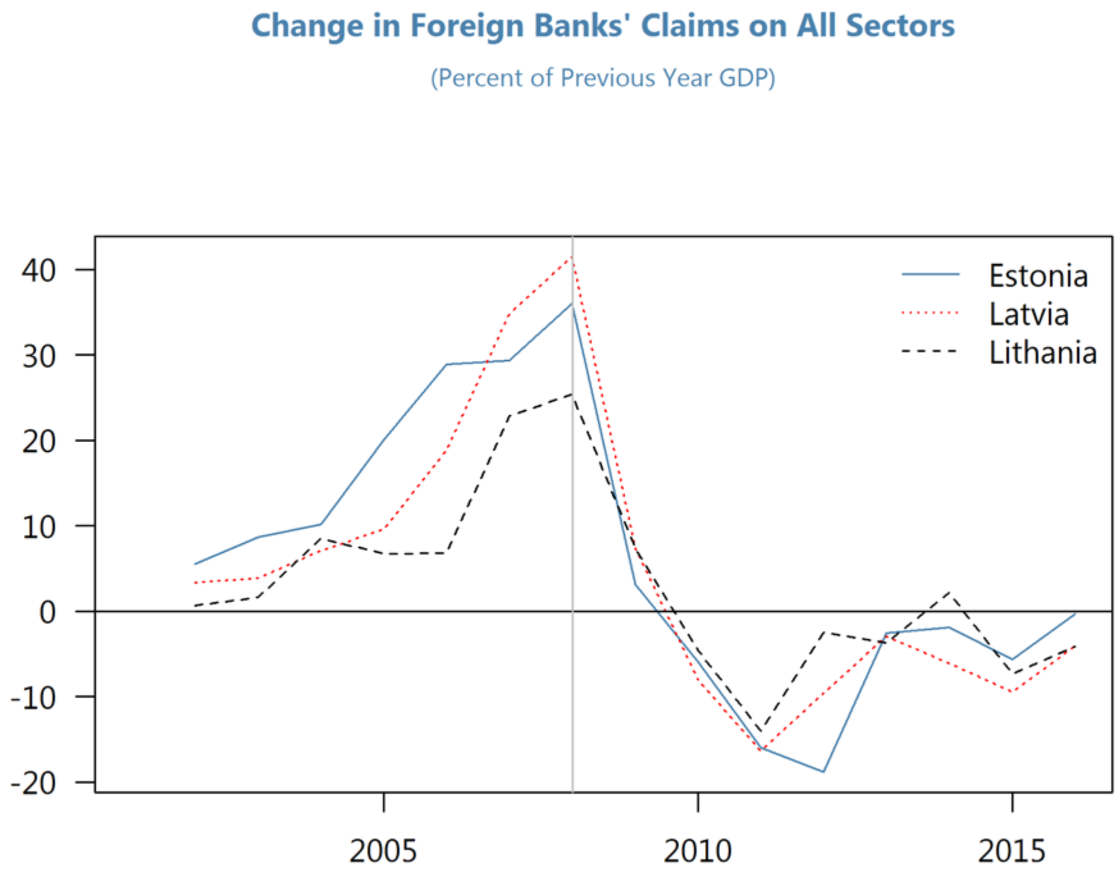
Why has recession been so deep and recovery so strong?

- Recession was so deep because
  - Very large drop in private capital flows forced large and rapid adjustment of the private sector
  - Desire to maintain currency boards pre-empted exchange rate adjustment
  - With falling revenue and surging risk premia, public sector needed to tighten as well

Pre-crisis, large capital inflows fueled overheating and large imbalances



In 2008, the capital-inflows fueled boom ended, and bank flows dropped very sharply



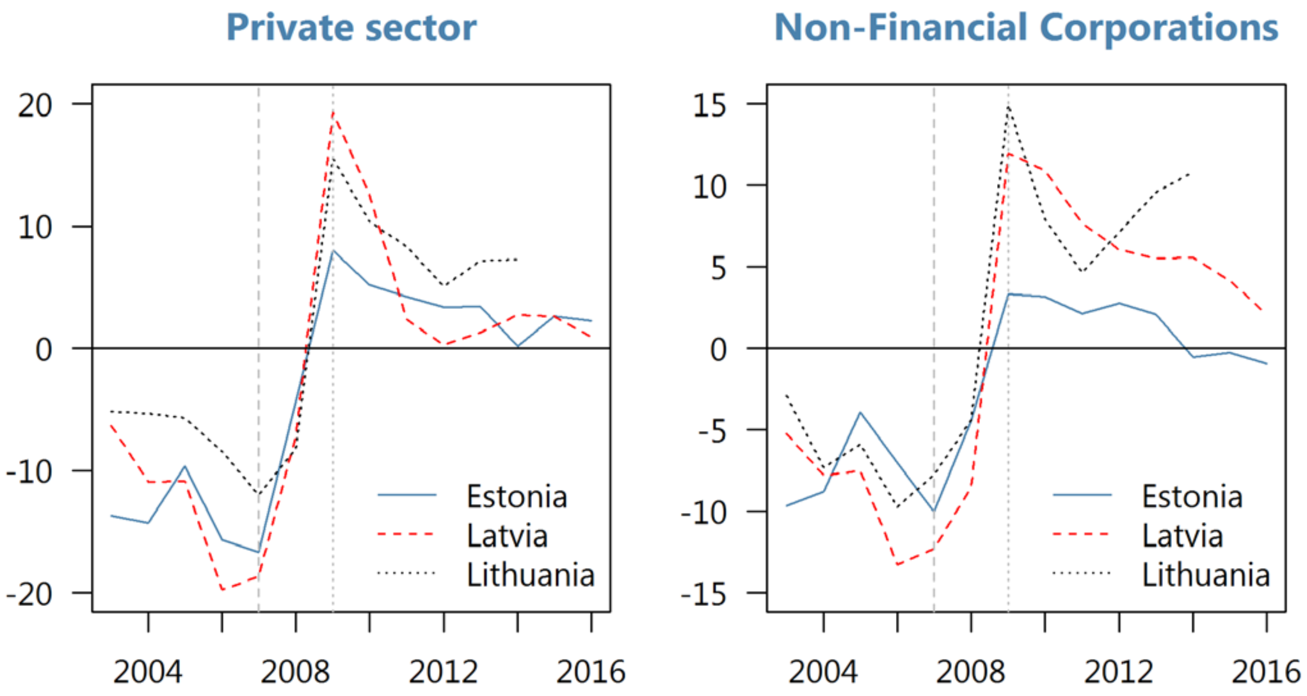
The drop in capital flows forced a rapid adjustment

- Exchange rate adjustment was not considered an option
- There were no large other, compensating capital flows (Target 2, ECB)
  - Latvia had IMF/EU loans, but scale was small compared with drop in capital flows

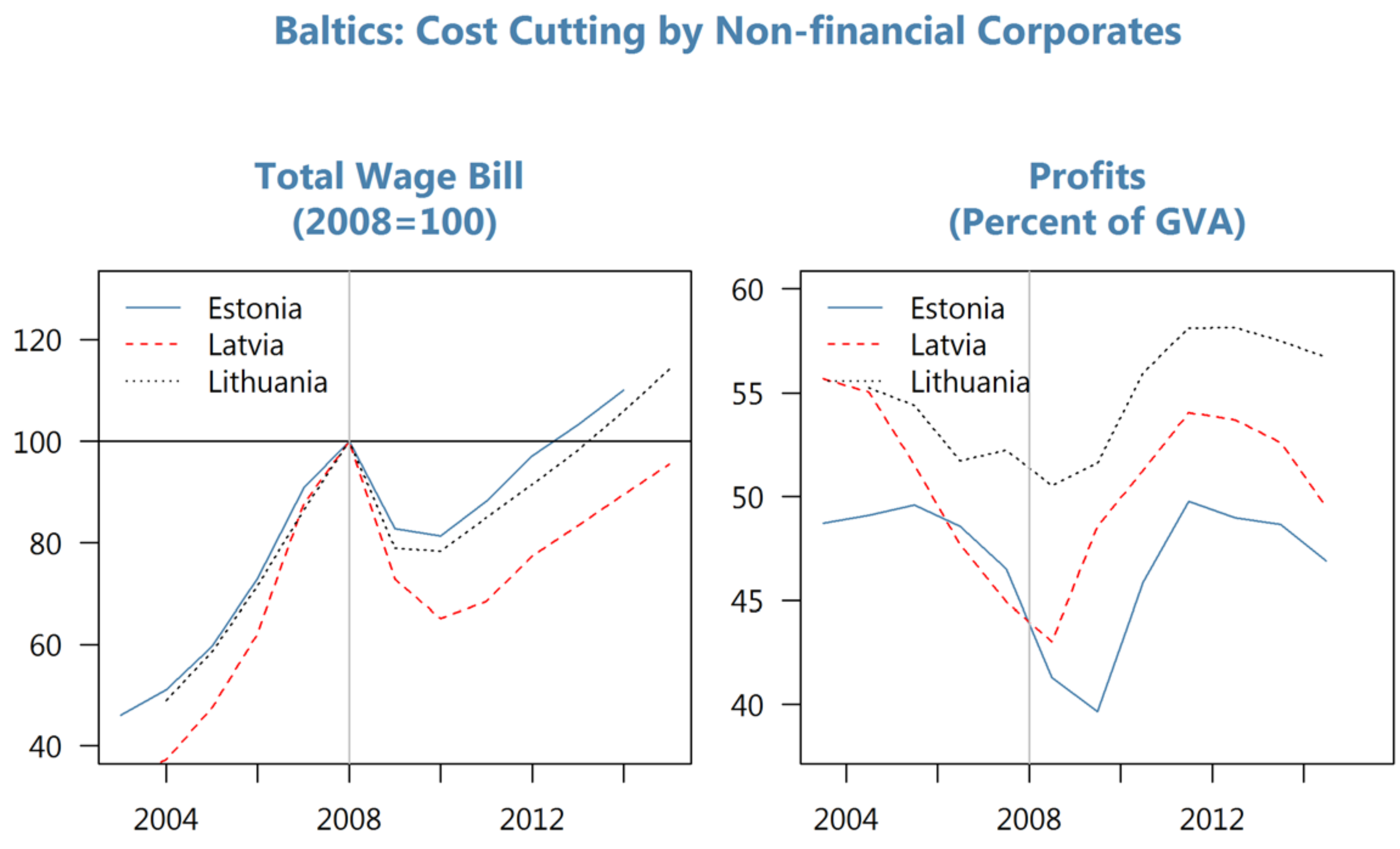
The private sector adjustment was very sharp

Baltics: Net lending Private Sector

(Percent of GDP)



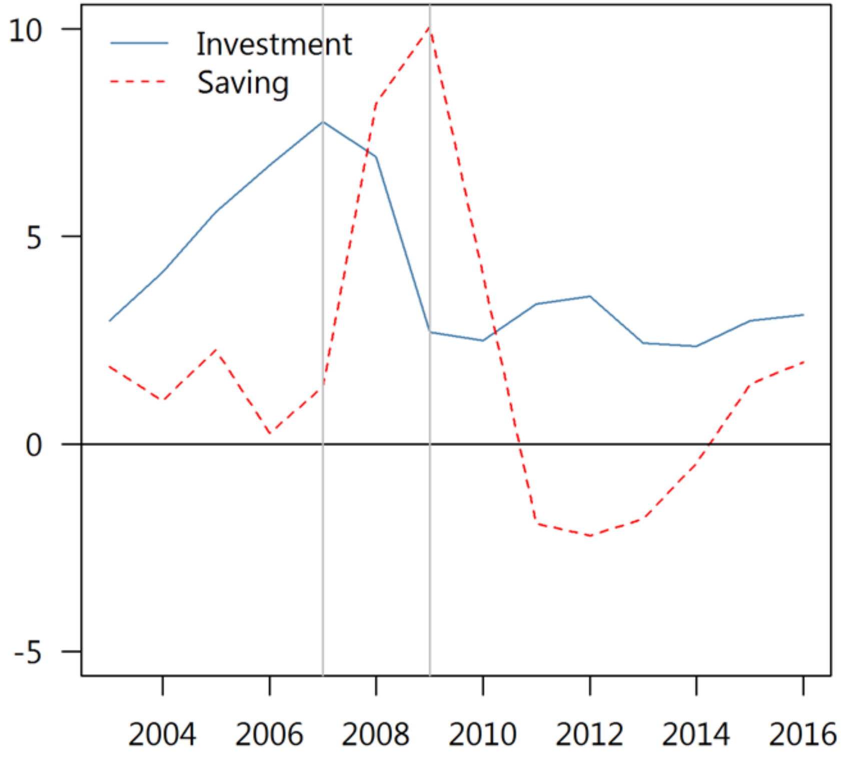
Firms reduced investment, and cut costs to restore profits



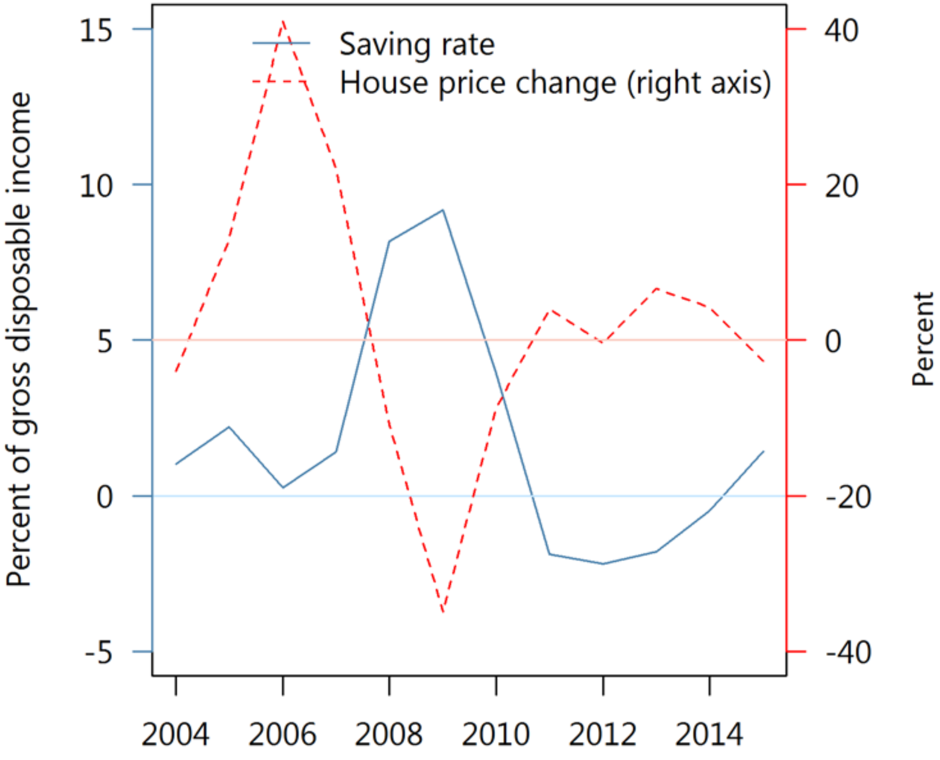
Household investment plummeted, and saving surged as housing prices plunged

Latvia: Household Investment and Saving

(Percent of GDP)

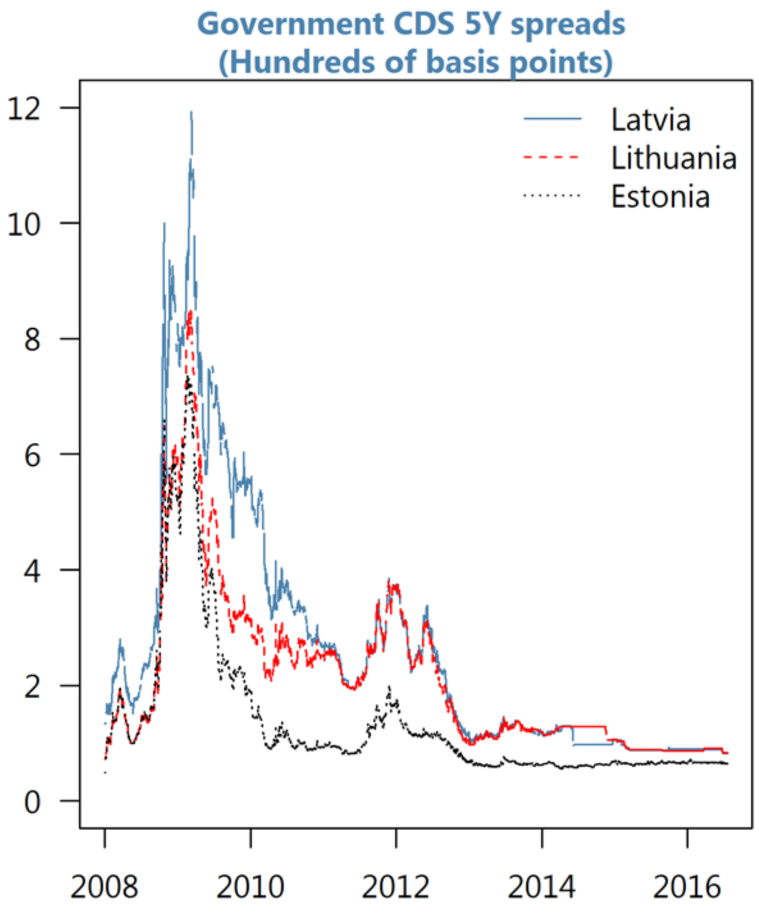


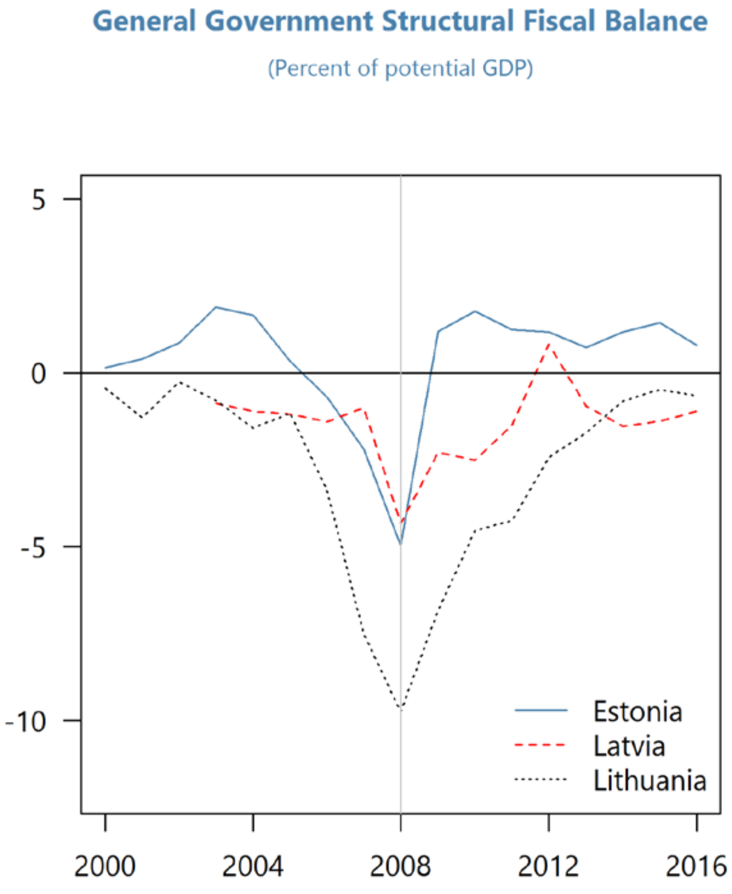
Latvia: Housing Prices and Household Saving Rate



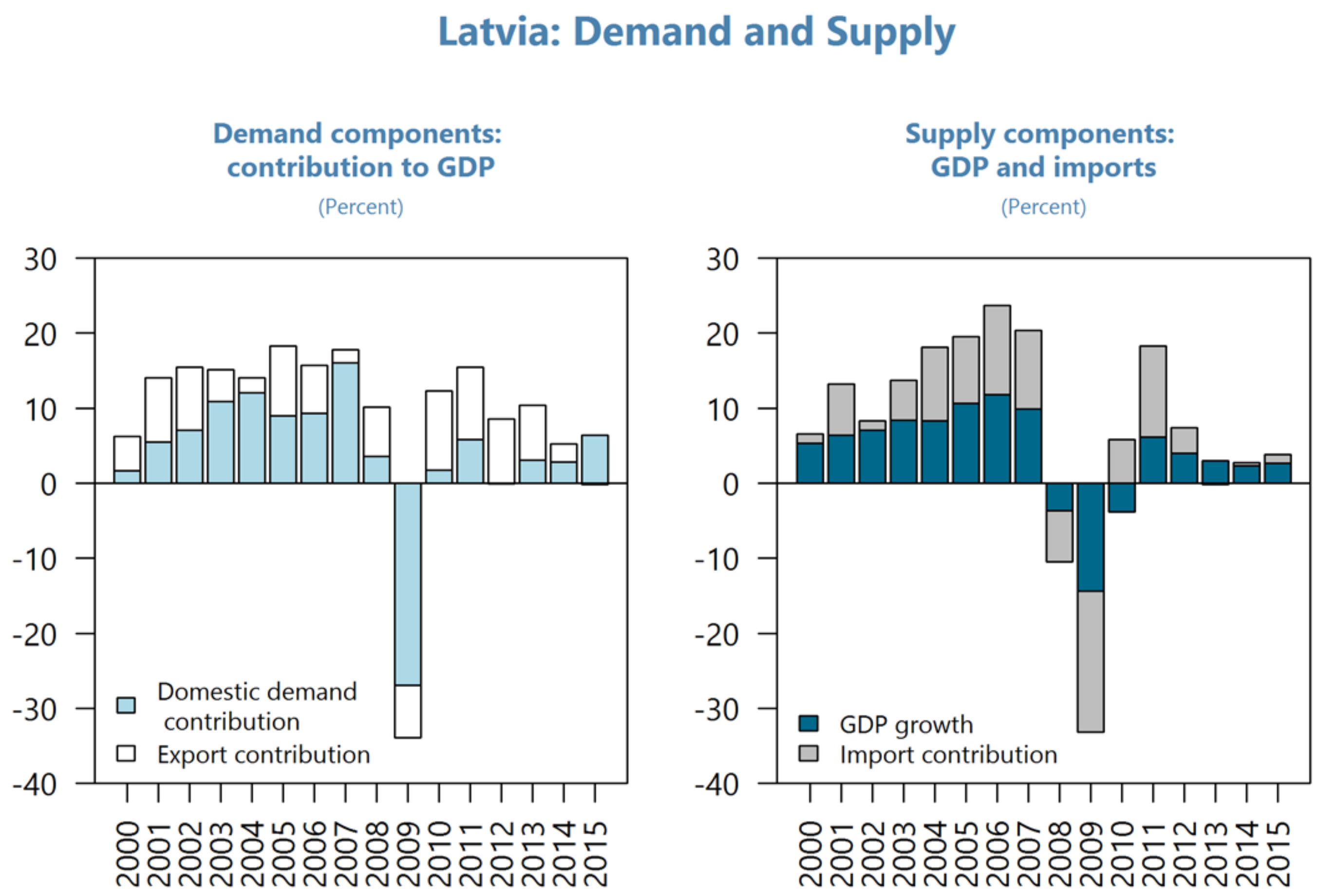
Note: Housing prices have been deflated by the PCE deflator.

As risk premia surged, governments tightened belt





With all sectors adjusting, domestic demand fell very sharply—as did GDP and imports



Why was Recovery so Strong?

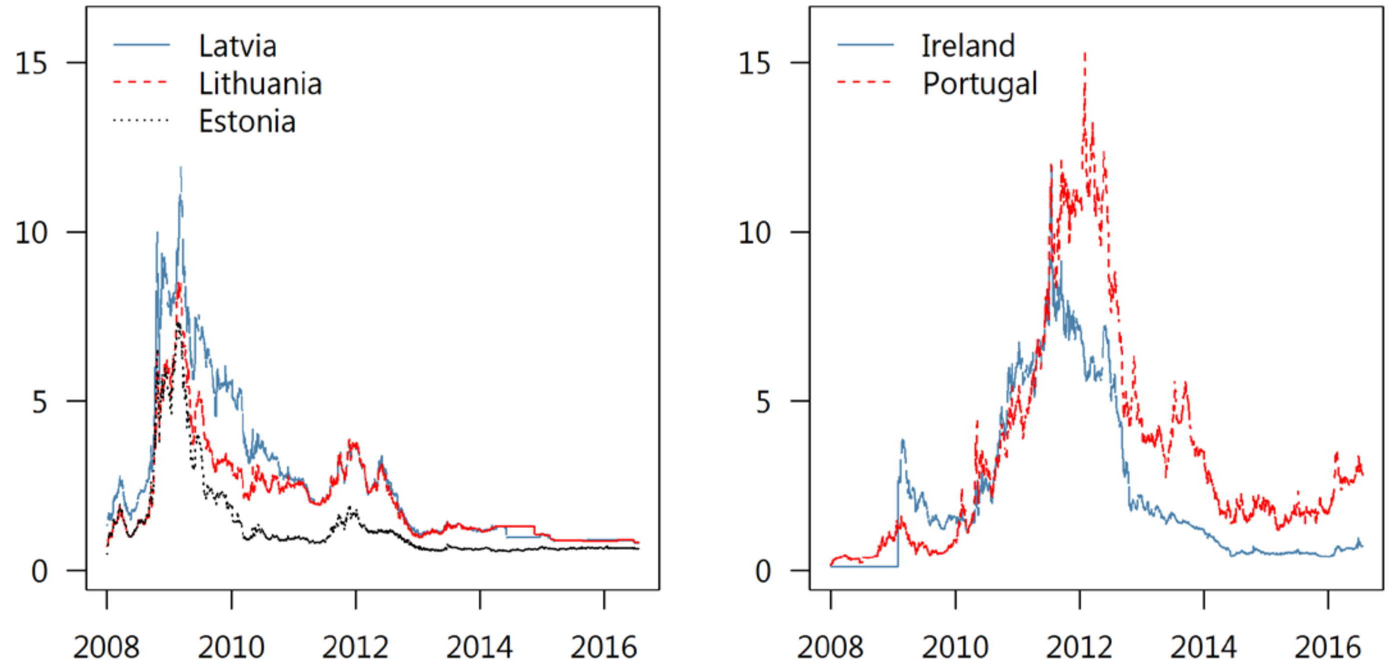
By 2010 adjustment was largely over

- Corporate cost cutting was complete, further helped by drop in wages
- Most of fiscal adjustment had been done; fiscal drag on recovery was modest
- Household saving rate had surged and could now drop as confidence improved

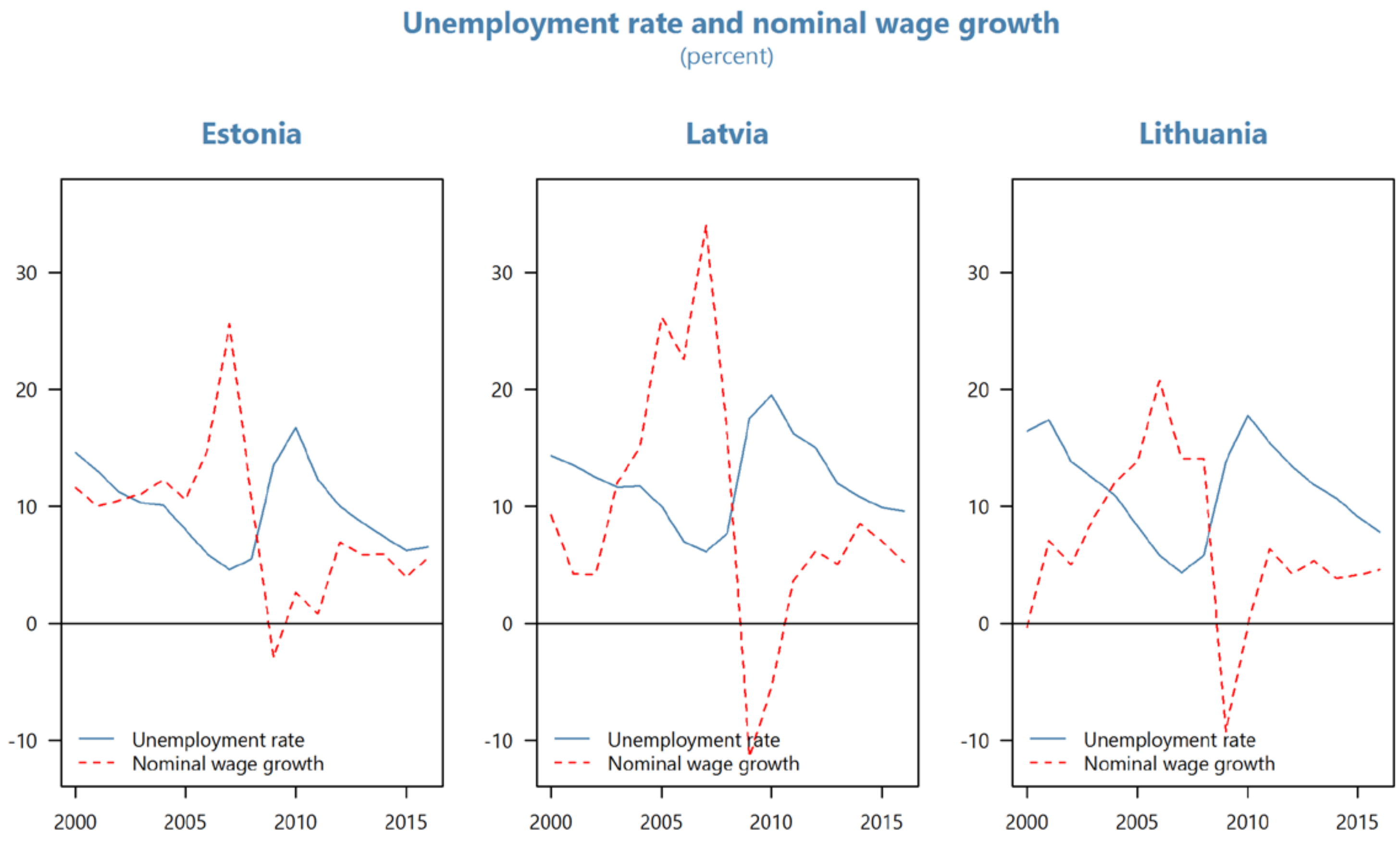
Recovering further boosted by falling risk premia—which stayed low during euro crisis

5 Year Government CDS Spreads

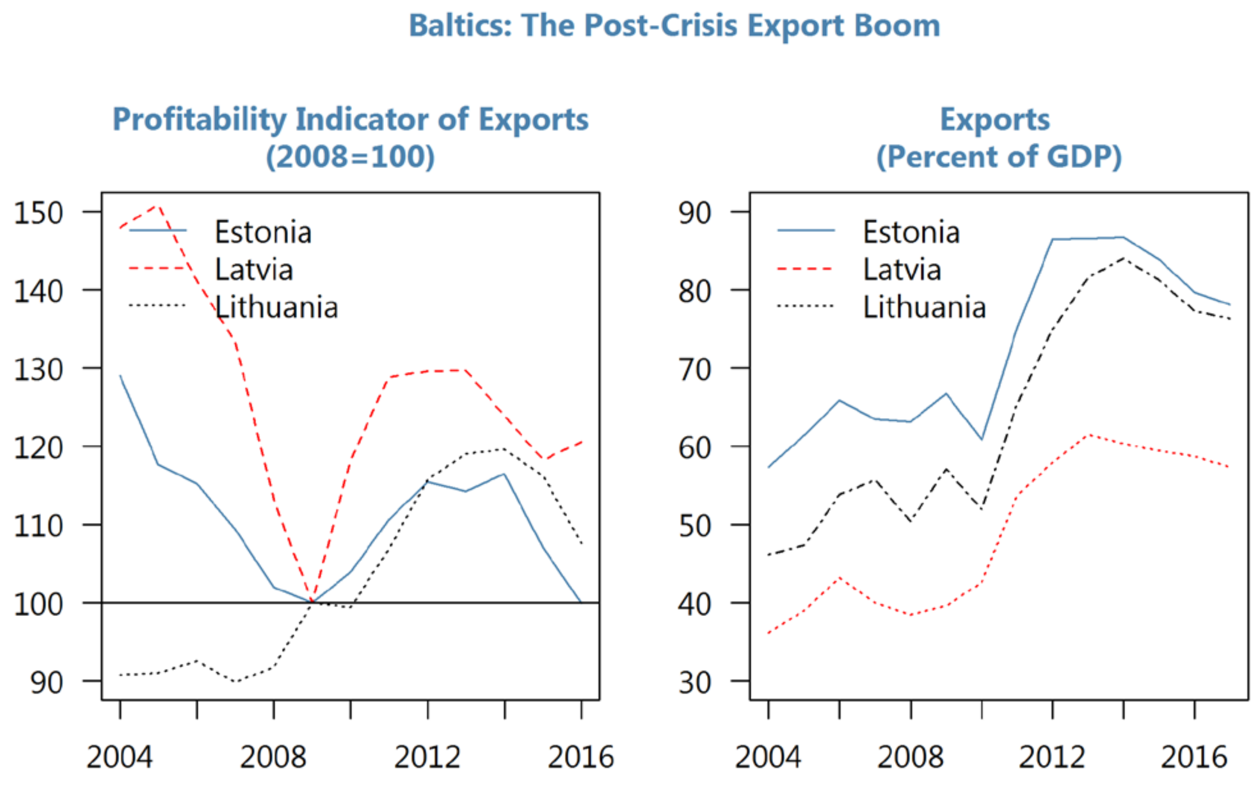
(Hundred of basis points)



Wages had adjusted very quickly

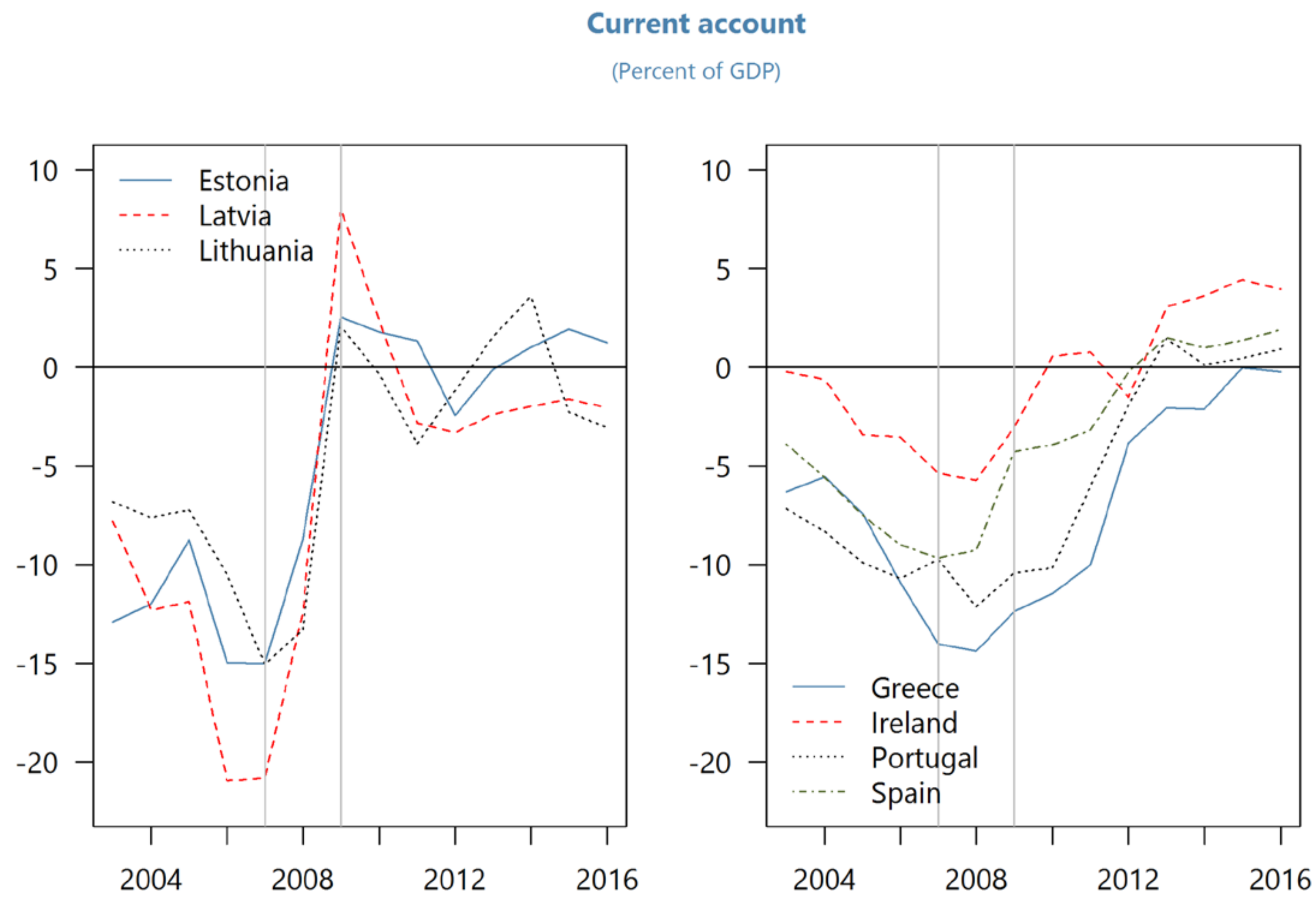


Competitiveness gains now led to export boom



Note: Profitability indicator of exports is the ratio of relative export prices to relative unit labor costs of manufacturing.

Current account adjustment was much faster than in Eurozone crises countries

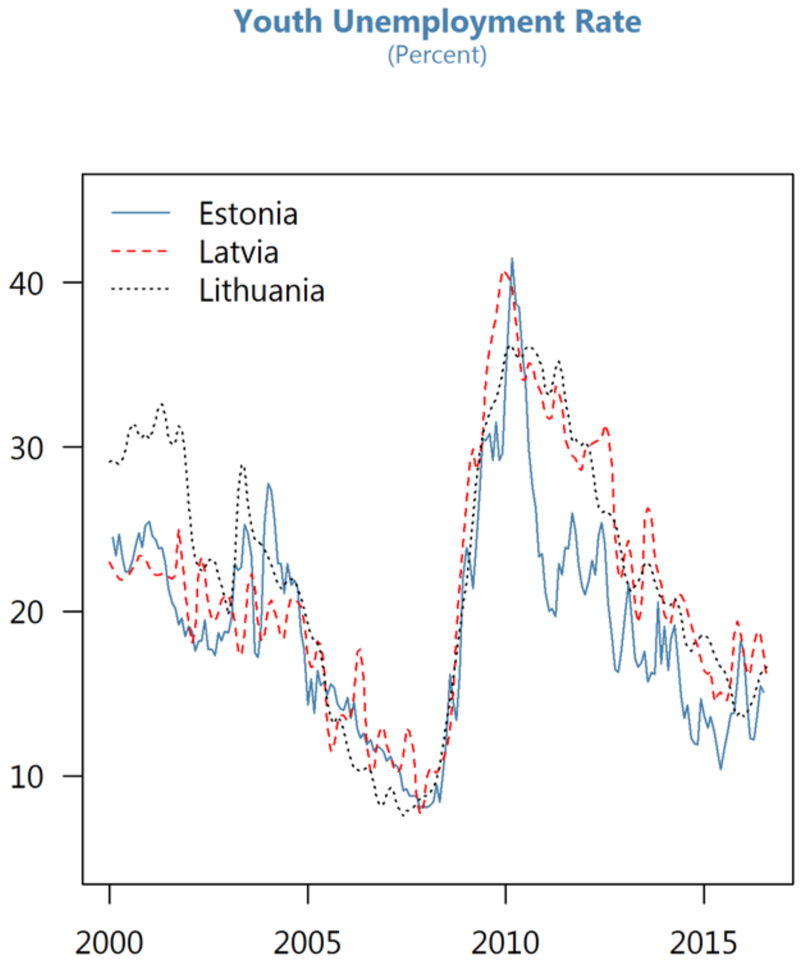


What are the lessons we can draw from boom-bust recovery?

- 1. Given size of initial imbalances, adjustment was going to be painful. Would have been best to avoid these imbalances.
- 2. Given that Baltics are small and very open, export-led recovery was viable option. For this rapid wage adjustment helped. Export-led recovery may not be option for large and more closed economies.
- 3. Increase in unemployment was mitigated by pickup in emigration—not option for all countries

Social costs of deep bust were high

- Youth unemployment increased to 40 percent in 2010 in Latvia
- Emigration picked up
- Poverty increased



Challenges going forward

- Labor markets are tightening rapidly, and wage growth has picked up.
- Competitiveness has deteriorated, and exports have performed relatively poorly more recently.
- The NAIRU is very high—around 10 percent. It is a bit a puzzle why it is so high.
- Potential output growth may disappoint
  - Demographics are dismal
  - TFP growth has declined sharply
  - Investment rates are too low, given the relatively low capital stock per worker.

Thank you