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

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It is well known that the Baltics had a very deep recession in 2008/09

- Strong boom in pre-crisis years fueled by large capital inflows from Western banks
- Growth in Latvia in 2005-07 averaged almost 11 percent
- In 2008, sudden stop in capital flows led to end of boom
- Deep downturn: GDP in Latvia declined by 21 percent between 2007 and 2010; unemployment rose from 6-19 percent
It is less well known that it has also had a very strong recovery

- Employment rates are back to pre-crisis levels
- Output gaps have disappeared
- Per capita GDP is well above pre-crisis levels
Indeed, no group of European countries has seen such a deep bust and strong recovery as the Baltics.
Baltics experience raise questions

- Why was the bust so deep?
- Why was the recovery so strong?
- What are challenges going forward?
WHY DID THE BALTICS HAVE SUCH A DEEP BUST?
Why did the Baltics have such a deep downturn?

- In pre-crisis years, Baltics—like other CESEE countries—experienced credit-fueled surge in domestic demand
- Boom was fueled and financed by unprecedented capital inflows from Western banks
- Credit booms contributed to rapid GDP growth, but also led to sharp increase in current account deficit and overheating
- By 2007, growth pattern had become vulnerable to sudden stop in capital inflows
Pre-crisis imbalances were severe
In 2008, the capital-inflows fueled boom ended, and bank flows dropped very sharply.
Sudden stop had strong impact

- Unlike with later stops in euro area crisis countries, not compensated by intra-European financing mechanism such as Target 2 or ECB facilities
- Latvia received IMF/EU support, but not enough to offset sharp drop in capital flows
- Adjustment not facilitated by exchange rate depreciation: desire to keep peg.
Result of sudden stop was that net lending gaps of non-financial private sector were compressed very quickly.
Firms reduced net lending by cutting investment and cutting costs

- Important part of cutting costs was cutting wage bill
- This boosted profitability and hence retained earnings (i.e., corporate saving)
Wage bill was reduced by cutting employment and further helped by adjustment of wages...

**Baltics: Employment and Wages in the Private Sector**

(2008=100)
Wages in Baltics are very sensitive to unemployment.
Overall wage bill fell much sharper than decline in GVA
The result was a sharp increase in profit margins
Household investment plummeted, and saving surged as housing prices plunged.
As risk premia surged, fiscal policy needed to be tightened.
Decline in domestic demand was exacerbated by drop in exports: result was sharp decline in GDP and imports.
WHY DID THE BALTICS HAVE SUCH A STRONG RECOVERY?
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
Improvement in profitability in manufacturing now led to an export boom.
Early fiscal adjustment helped shelter the Baltics from euro area crisis.

5 Year Government CDS Spreads
(Hundred of basis points)
GDP per capita is well above pre-crisis levels
Employment rates are back to pre-crisis levels

Baltics: The Recovery of Employment

Employment rate (Percent)

Unemployment rate (Percent)
Recovery in per capita terms was helped by decline of working age population
Decline in working age population is the result of both aging and emigration.
COMPARISON WITH EUROZONE COUNTRIES
In per capita terms, compared with Eurozone, the Baltics had the most severe downturn initially...
But also the strongest recovery.
And over 2007-17 period, GDP and employment growth was relatively strong—in per capita terms.
Initial demand shock in Baltics was much larger

- Between 2007 and 2009 total demand (exports plus domestic demand) declined by 42 percent in Estonia, compared with 11 percent in Greece
- Largely because domestic demand fell more
  - More private sector adjustment, including cost-cutting by firms
  - Fiscal policy was tighter (expansionary in euro area)
- Underlying these different behavior was differences in risk premia, which had increased sharply in the Baltics, and remained relatively muted in euro area initially.
Post-2010 demand in the Baltics rebounded, while it fell further in the euro area crisis countries.

- Rebound in Baltics due to rebound in domestic demand and surge in exports.
- The decline in euro area crisis countries was result of decline in domestic demand, which was not compensated by boom in exports.
  - Decline of domestic demand in euro area crisis countries was result of rising risk premia, which forced governments to reduce high fiscal deficits and forced firms to adjust further, reducing investment and cutting costs.
Baltics

Baltics: Demand Developments
(Percent of 2007 GDP)
Change in Demand from 2007

Lithuania

Estonia

Latvia

Change in Exports and Imports from 2007

Lithuania

Estonia

Latvia
Euro area crisis countries

Portugal, Spain, Greece and Ireland: Demand Developments
(Percent of 2007 GDP)

Change in Demand from 2007

Portugal
Spain
Greece
Ireland

Change in Exports and Imports from 2007

Portugal
Spain
Greece
Ireland
Exports in euro area crisis countries did not surge because wage adjustment had been much slower.
Not because of more favorable export markets
LESSONS AND CHALLENGES
What are lessons to be drawn from boom-bust-recovery?

- Global developments matter for small economy (global surge in risk aversion post-Lehman; drop and recovery of global trade)
- Given size of pre-crisis imbalances any adjustment was likely to be painful; best would have been to prevent imbalances
- Given small and very open economies, export-driven recovery was option for Baltics. Would have been more difficult for larger and more closed economies
- Increase in unemployment was mitigated by pick-up in emigration; option that is less open to larger economies
Challenges going forward

- Labor markets are tightening rapidly, and wage growth has picked up.
- Competitiveness has deteriorated, and market shares have softened.
- The NAIRU is high—wage growth accelerates at relatively high unemployment rates.
- 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