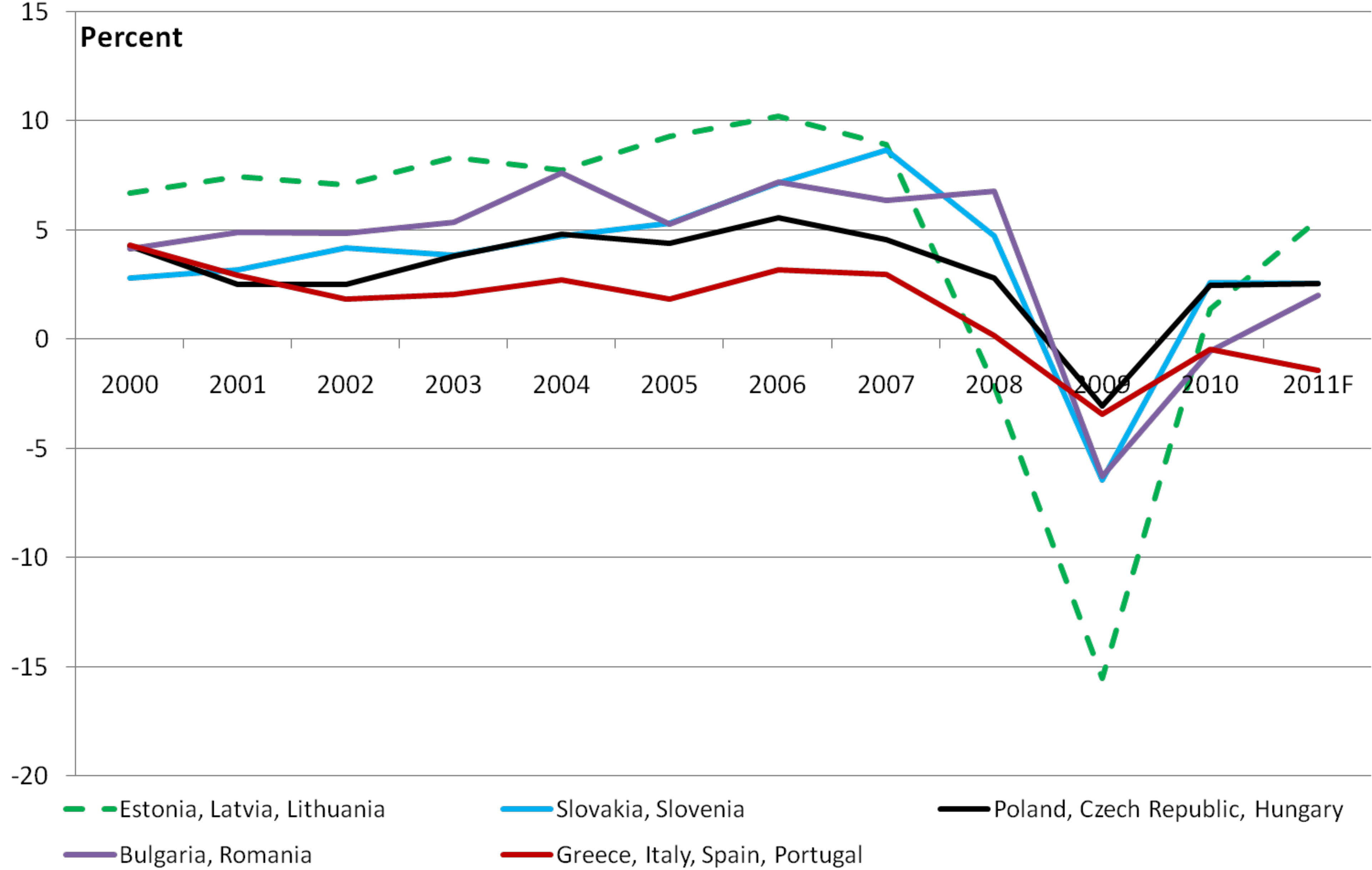
The Financial Crisis of 2007-10 in Eastern Europe and the Baltics

Anders Åslund
Senior Fellow
Peterson Institute for International Economics, Washington, DC

GDP: Boom and Bust

– High growth 2000-7,
– 2009: Big fall in Baltics, growth in Poland, average declines elsewhere
– Almost all back to growth in 2010
– Baltics back on top, Hungary remains the laggard

GDP Growth: Boom 2000-2008, Bust 2009, Growth 2010

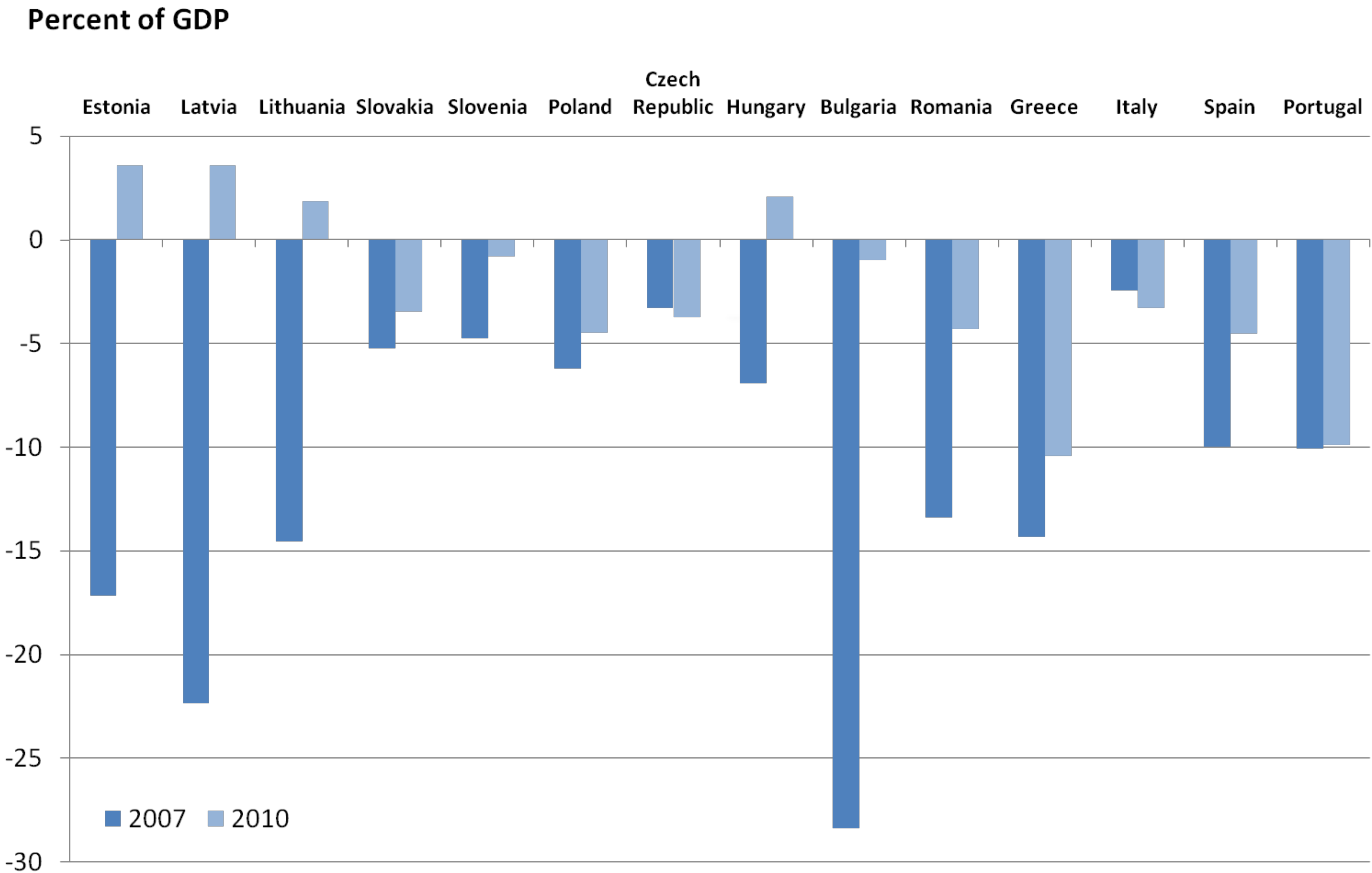


Source: IMF

Indicators of Overheating

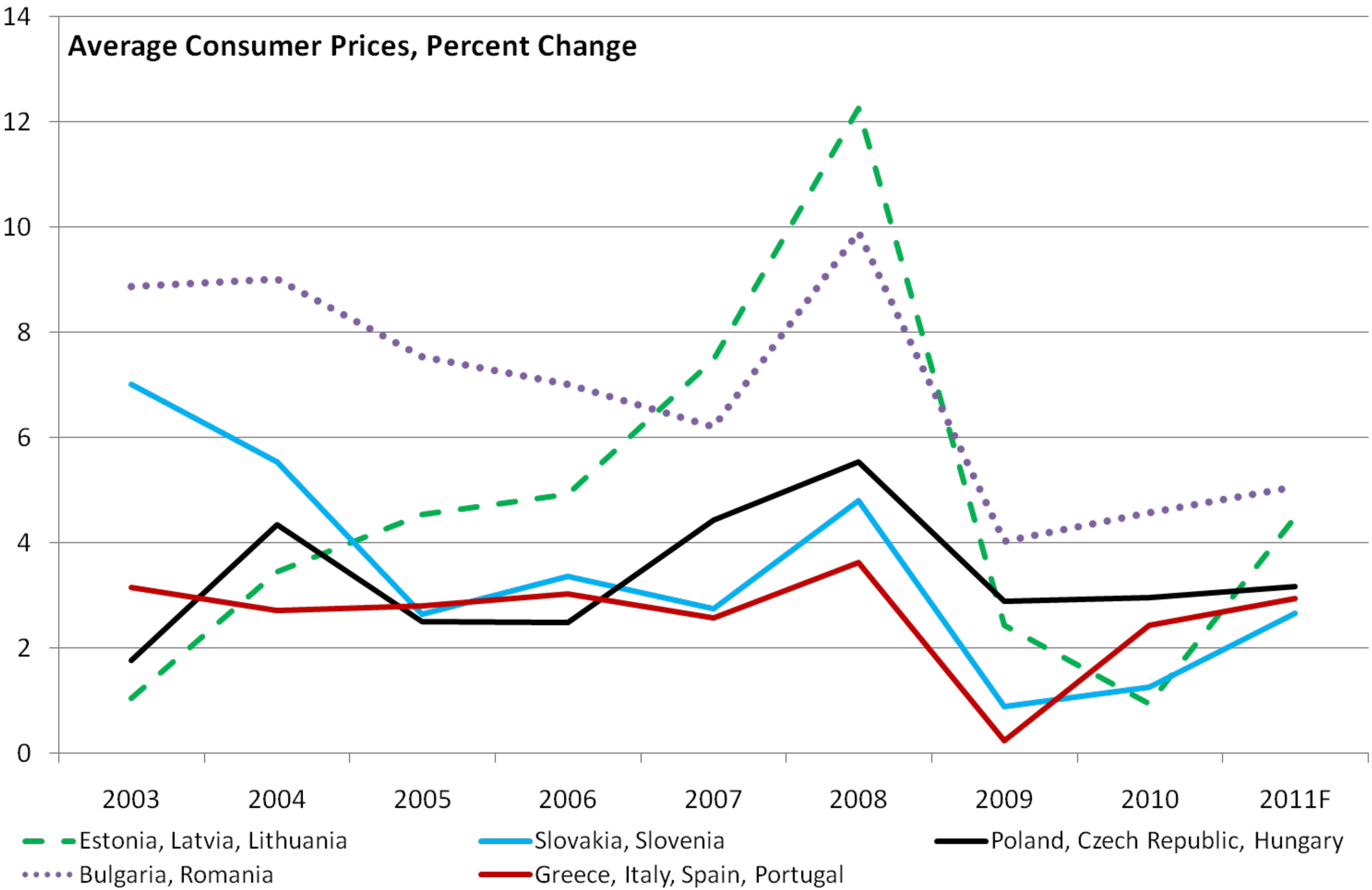
- Large current account deficits
- Excessive credit expansion
- High and rising inflation

Current Account Balances Swung around, 2007 vs 2010



Source: IMF

High Inflation Fell to Normal Level, 2003-2011

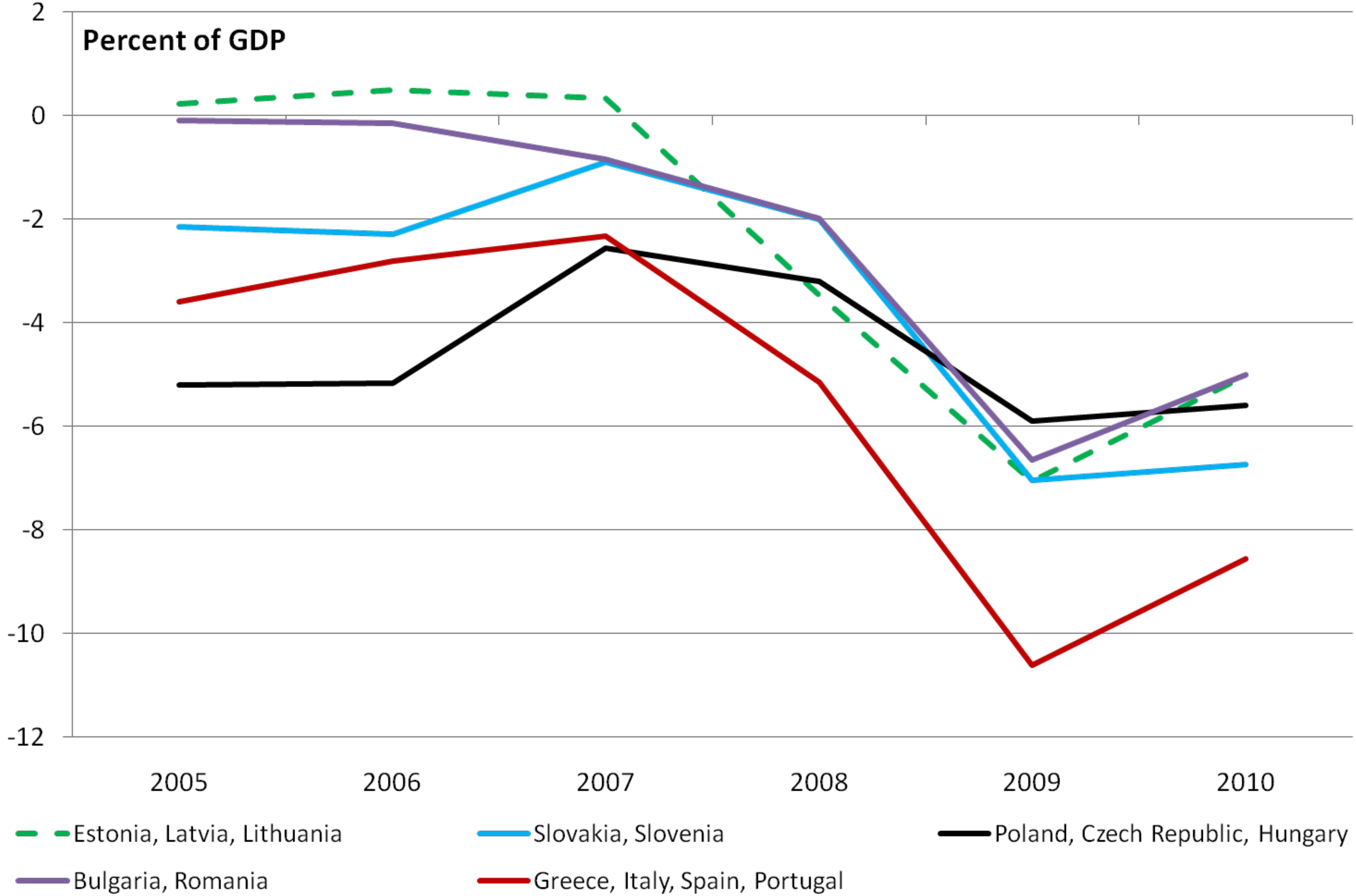


Source: IMF

Fiscal Consequences of Crisis

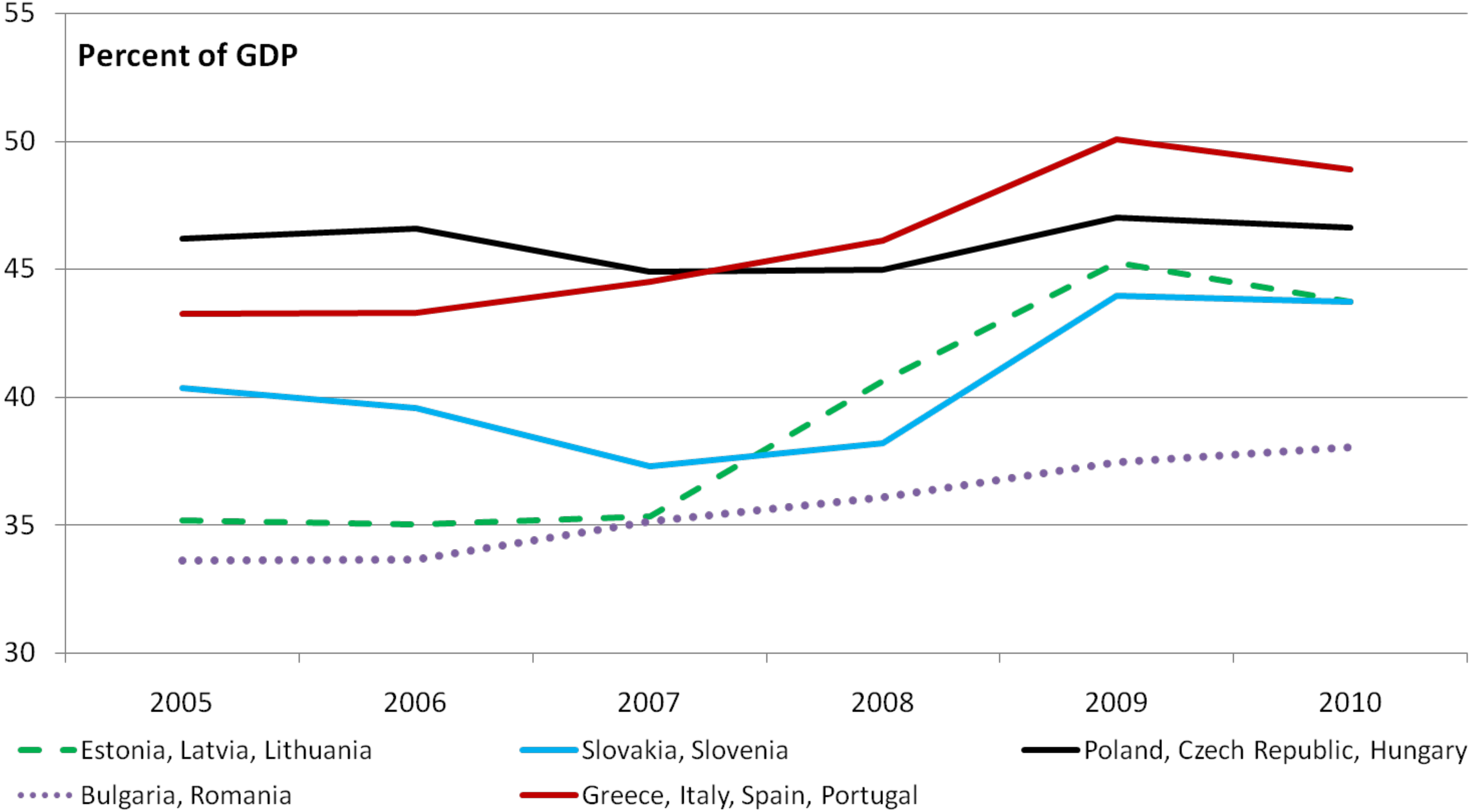
- Sharply rising budget deficits: checked
- Surging public expenditures: major lingering concern

Budget Deficits: Minimal in 2007, 6% of GDP in 2009



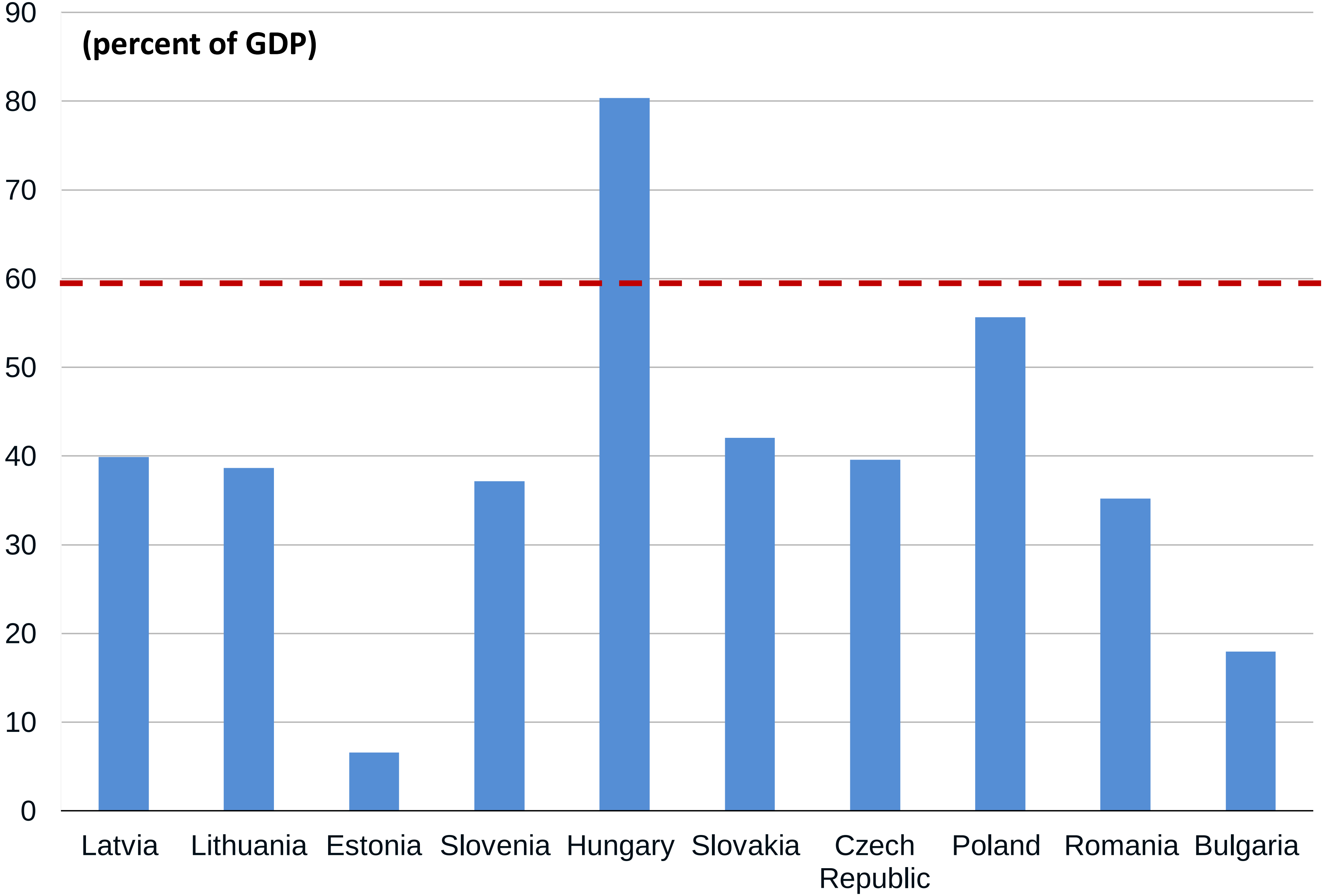
Source: Eurostat

Public Expenditure as Share of GDP: Rose by 10 percentage points in Baltics



Source: IMF

Public debt remains limited, end 2010



1. Substantial Fiscal Adjustments

- Balts: Public adjustment of 9% of GDP in 2009
- Latvia reduced public salaries by 28% in one year
- Closed half state agencies
- Sacked 30% of public employees

Major Public Sector Reforms

- Public administration trimmed
- Education reforms
- Health care reforms
- But pension reforms reversed to save the poor

Maastricht Criteria More Respected in CEE

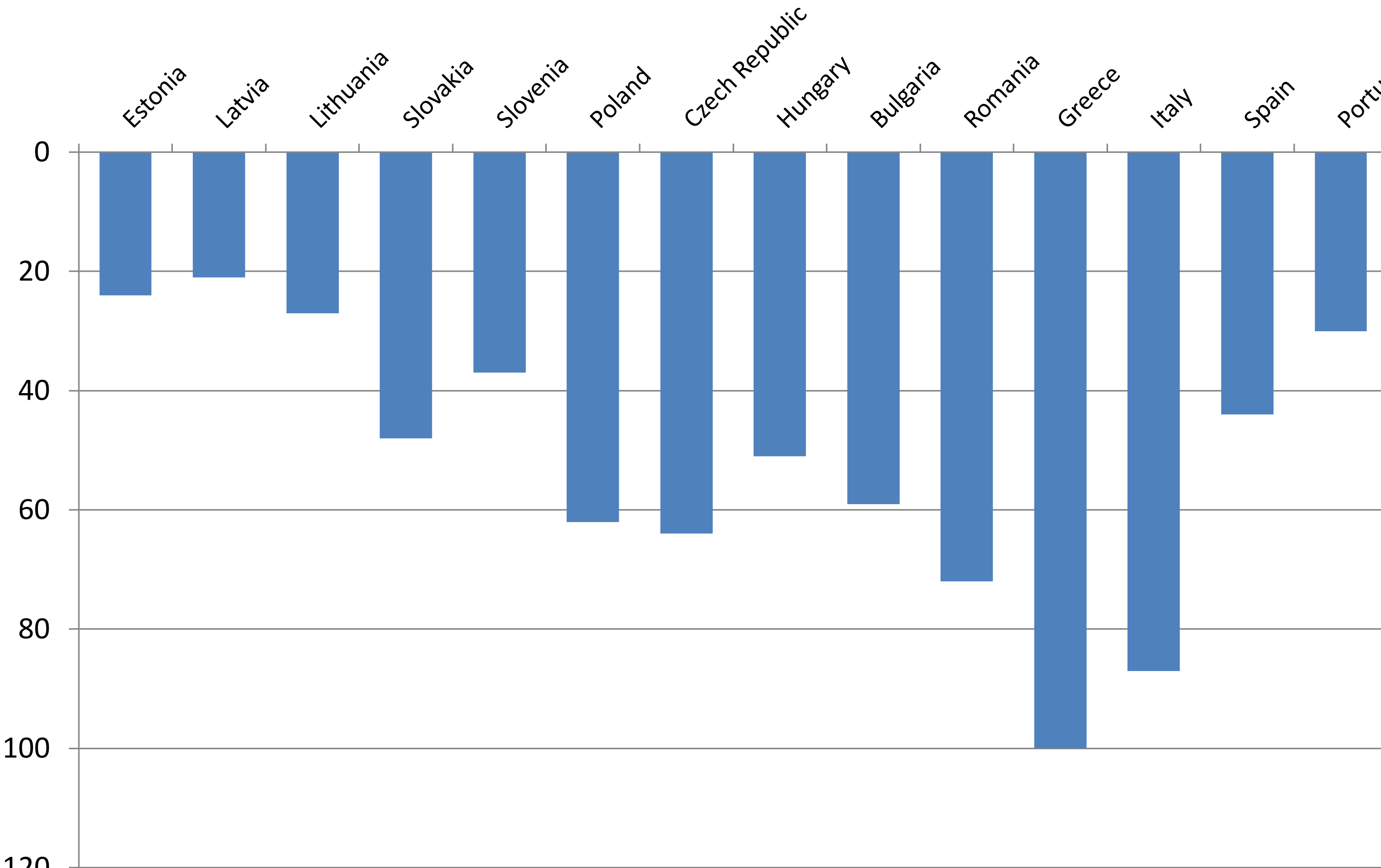
- Average public debt in 10 CEE 39% of GDP in 2010, but 85% of GDP in eurozone
- Only Hungary has exceeded the Maastricht debt ceiling, but 12 of 14 Western EMU members

Will CEE BE Competitive?

- Public expenditures must be brought down
- Business environment?
  - Ease of doing business
  - Corruption
- Real unit labor cost
- Real effective exchange rate
- Investment ratio

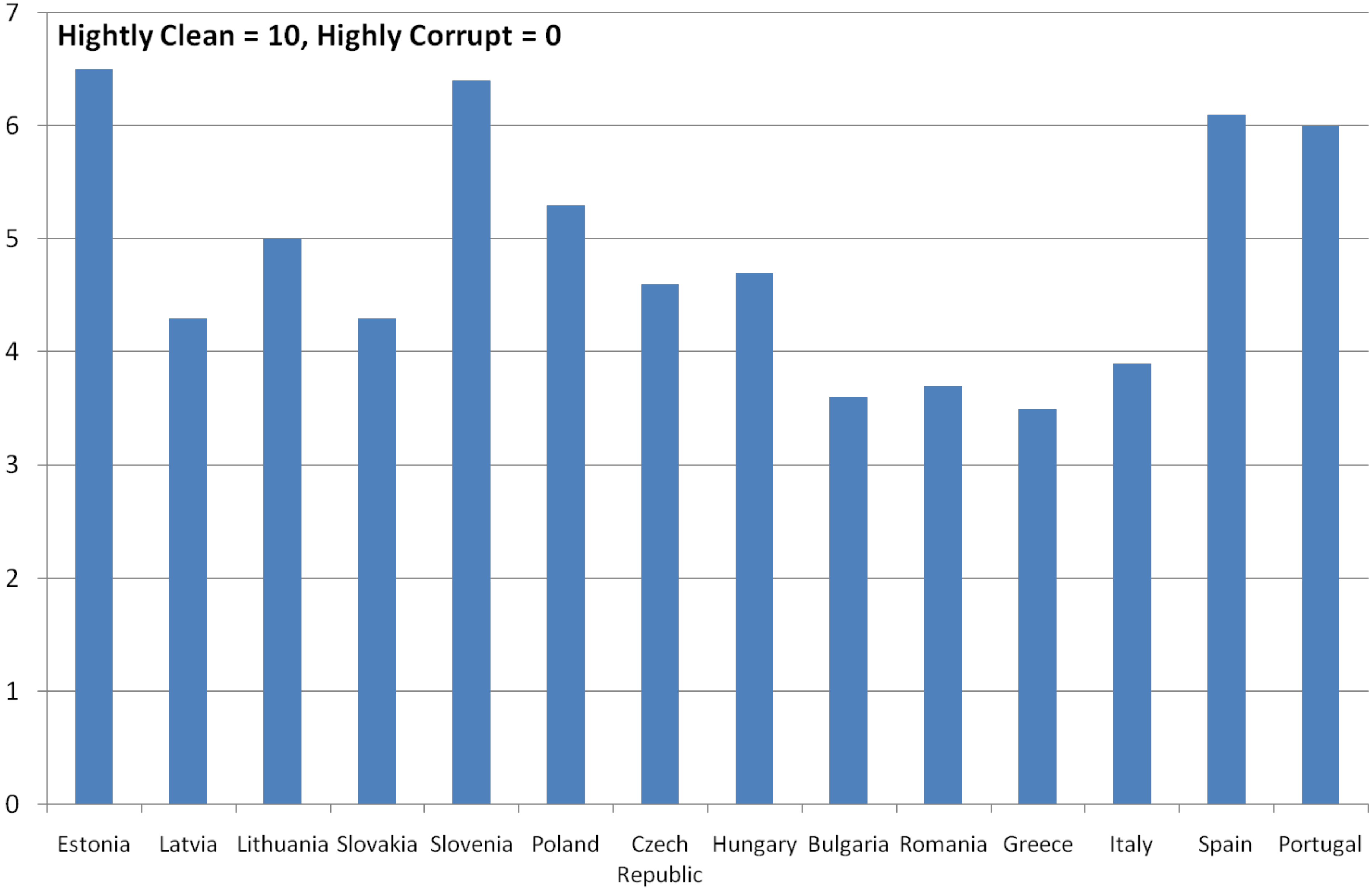
Ease of Doing Business, 2012: Decent, Baltics Lead

Lower score indicates greater ease of doing business



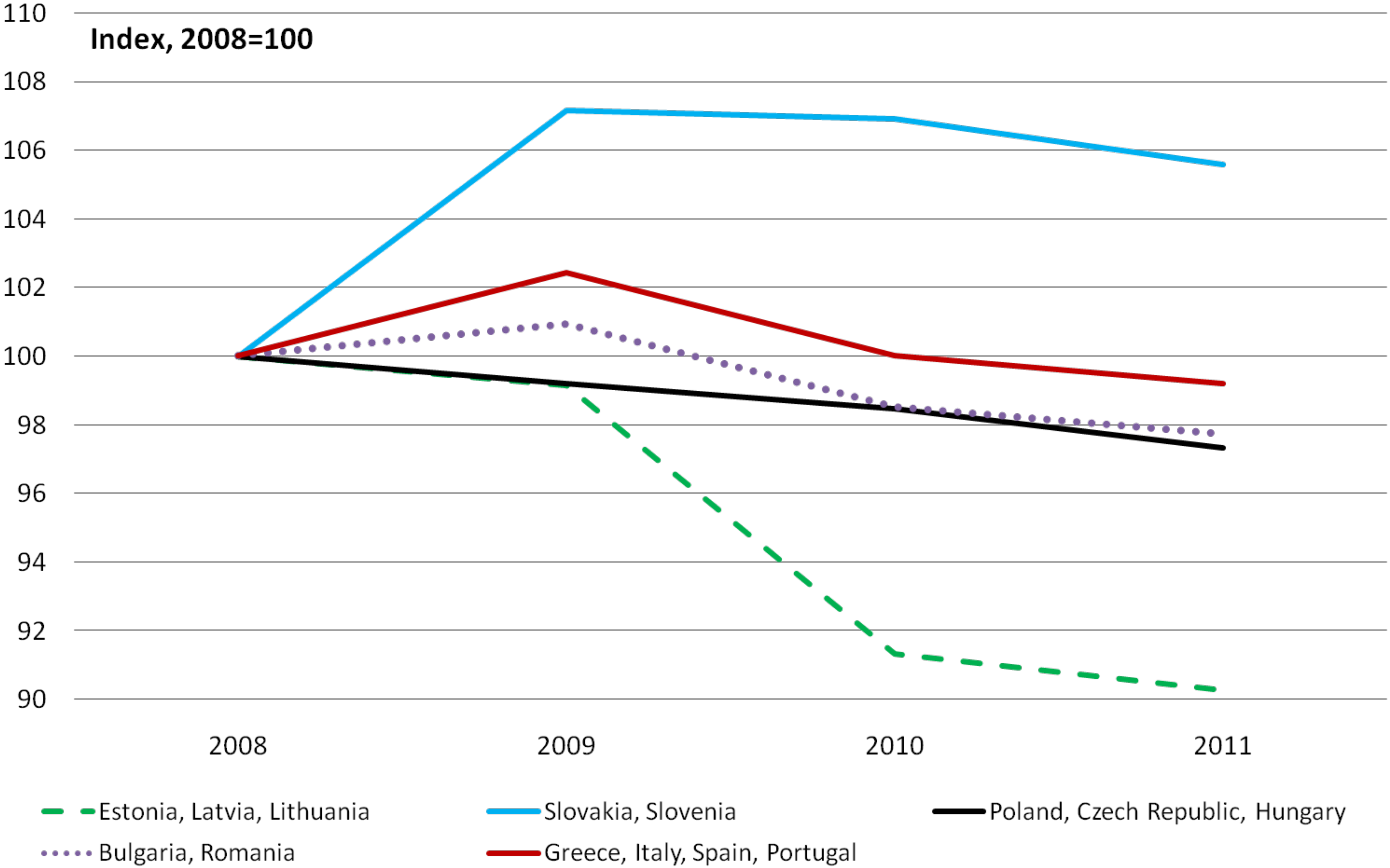
Source: World Bank

Corruption Perception Index, 2010: Est and Slo lead



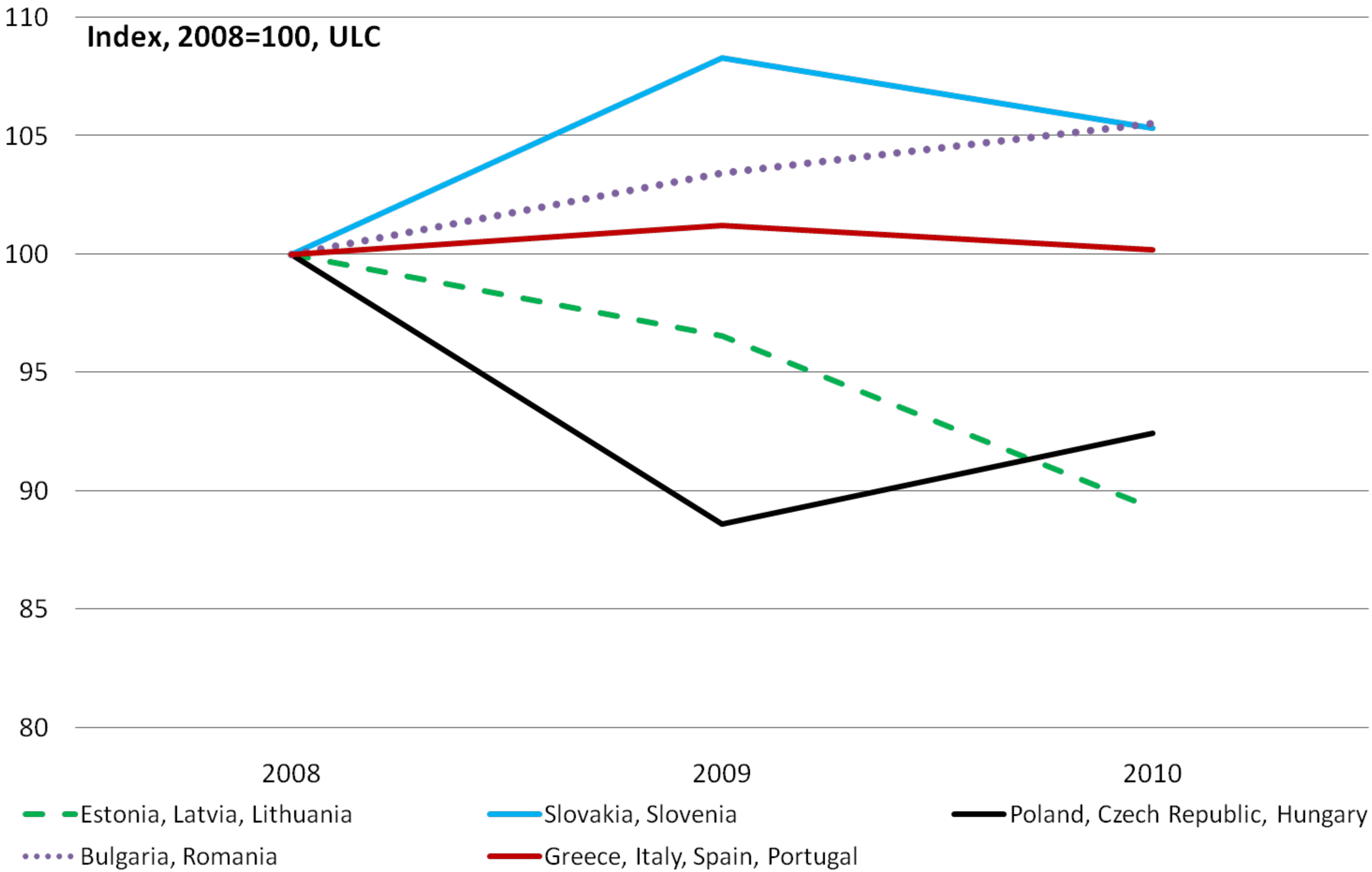
Source: Transparency International

Real Unit Labor Cost, 2008-2011: Only Balts Improved



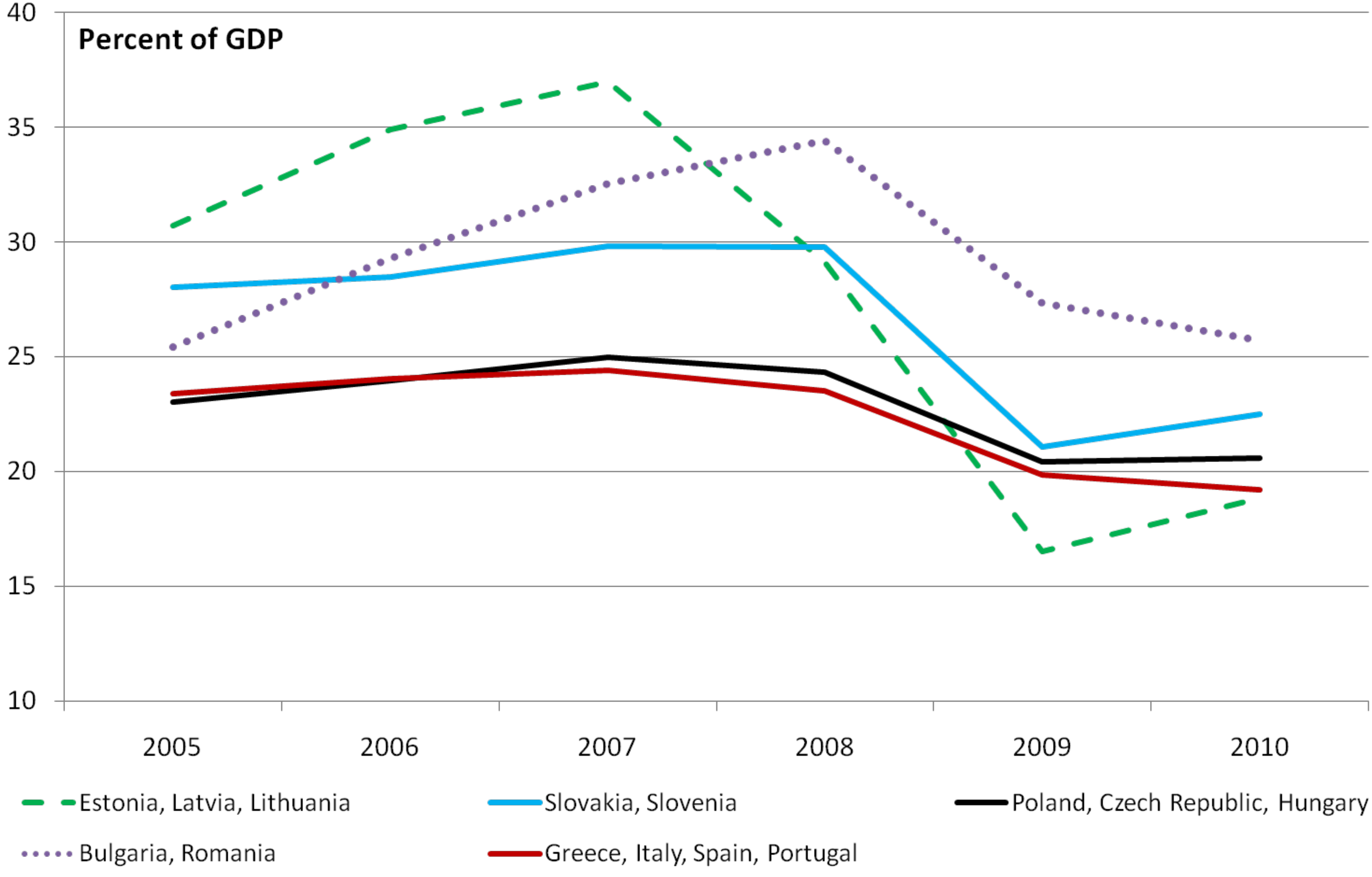
Source: Eurostat

REER, 2008 – 2010: Balts & Pol Improved Greatly



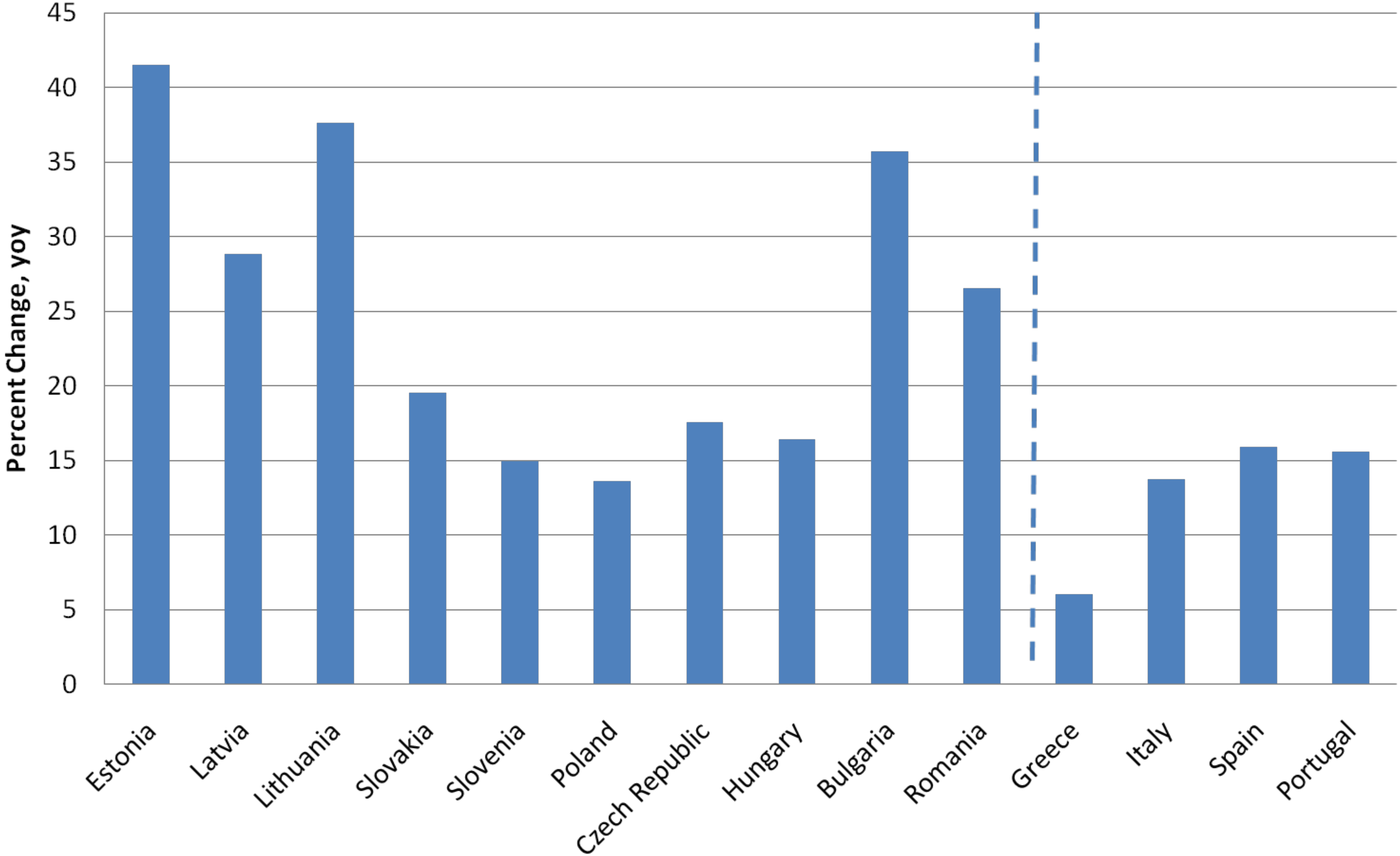
Source: Eurostat

Investment Was Sound, But Must Recover



Source: IMF

Total Exports, Percent Increase 2010 – 2011 (First Half, yoy): Increased Most Where Exchange Rate Fixed!

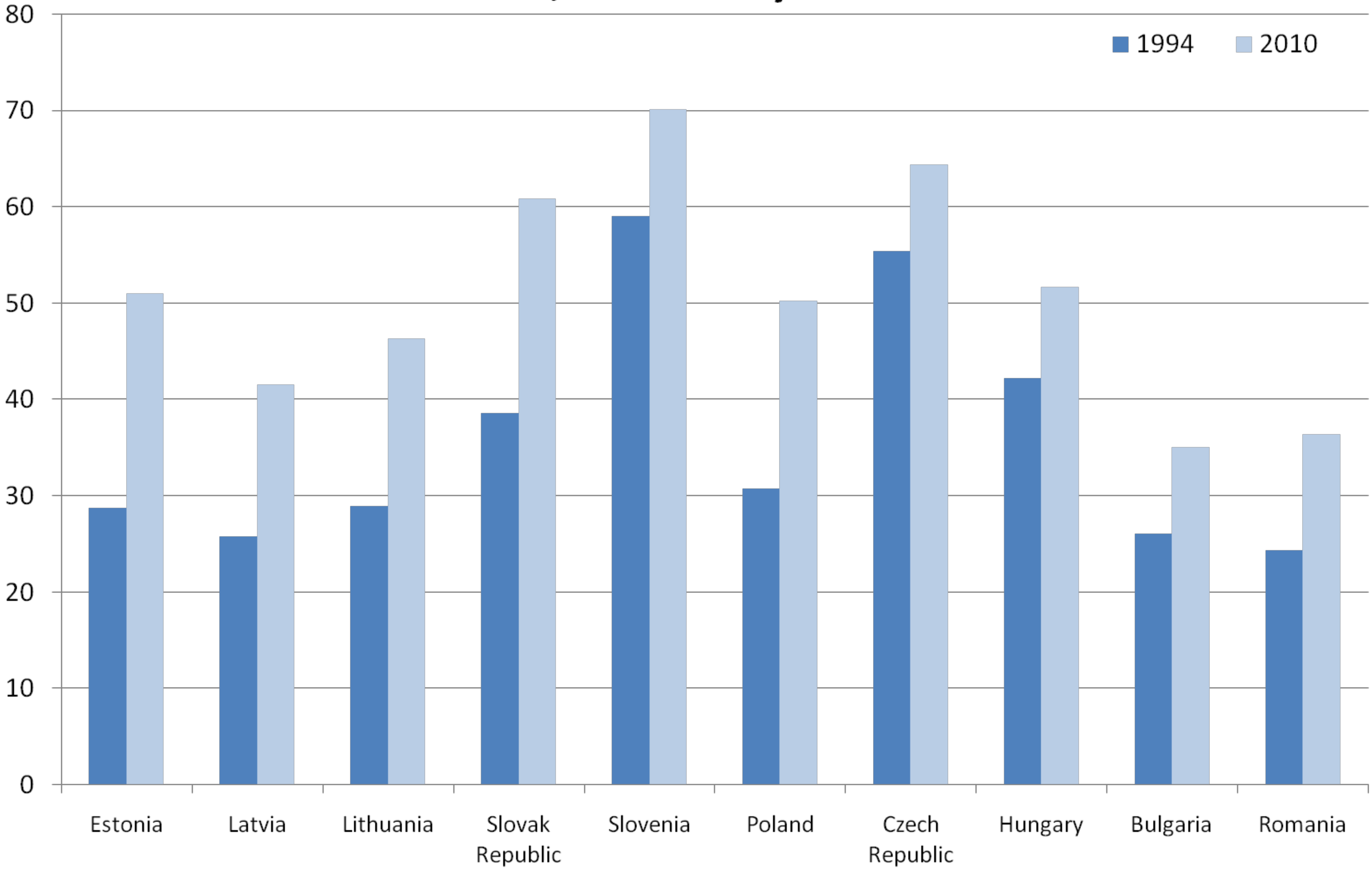


Source: Eurostat

Paradox: Currency Board Countries Increased Exports Most

- Nominal depreciation: Not necessary to kickstart exports
- Internal devaluation causes greater structural reforms than nominal devaluation
- The ultimate reason for greater reforms: undesired liquidity squeeze.
- Thus, currency board countries stay committed to euro adoption to avoid future liquidity squeeze.

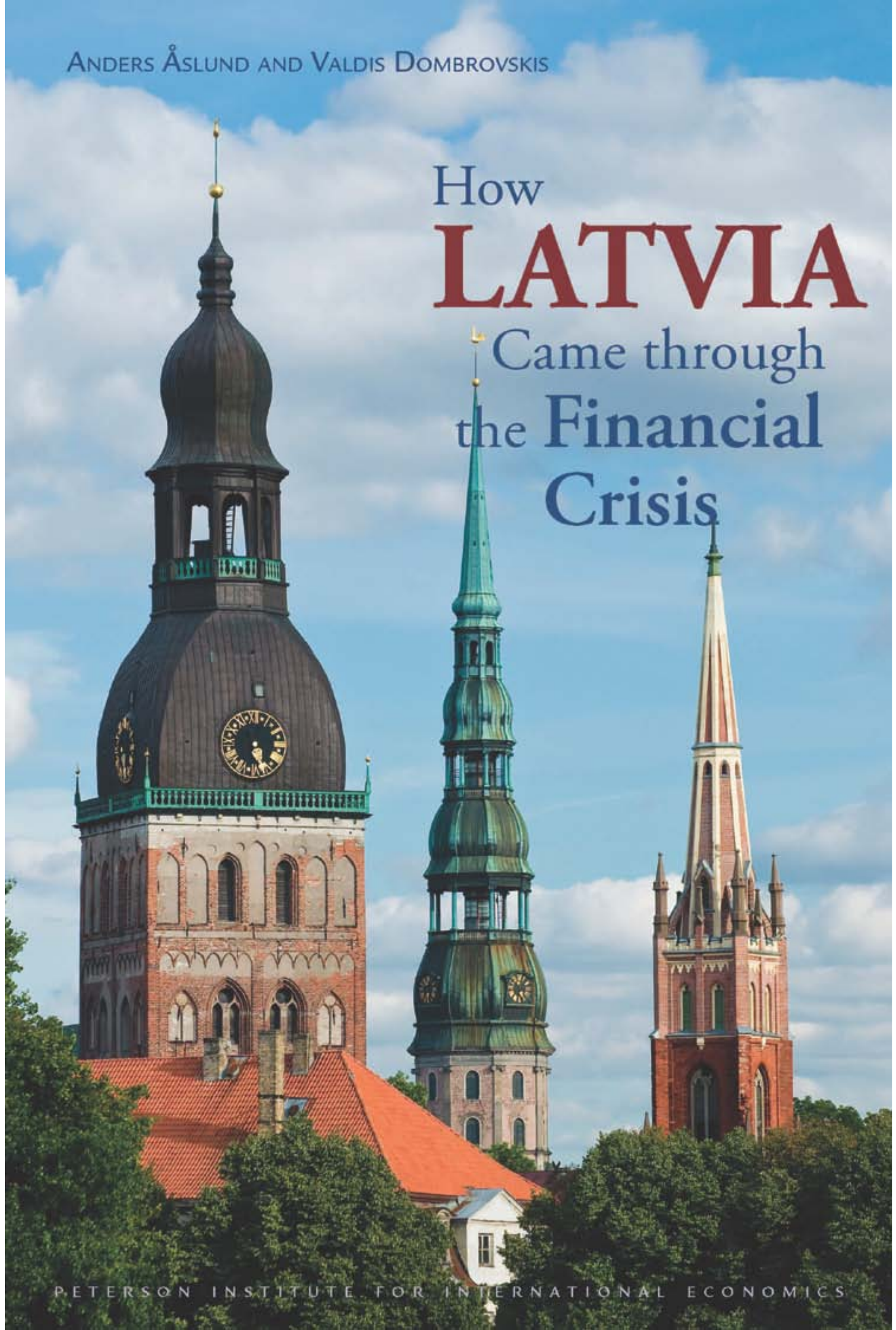
European Convergence, GDP in PPP as a % of EU: Substantial, and Likely to Continue



Source: World Bank

Conclusions

- Baltic countries have carried out most structural reforms – likely to enjoy most growth
- Hungary, Romania and Bulgaria: More austerity than structural reform – likely to see less growth
- Poland suffered no crisis & Czech Republic, Slovenia & Slovakia little – no major changes.
- But the whole region save Hungary looks good.



Anders Åslund and Valdis Dombrovskis
How LATVIA Came through the Financial Crisis
Peterson Institute for International Economics