The Economic and Financial Development of the Baltic States

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Introduction

The Baltic states are currently experiencing strong economic growth after the slowdown following on their independence at the beginning of the 1990s. Likewise, the financial sectors of all three countries are undergoing rapid and predominantly healthy development after the banking crises earlier in the 1990s. As for other emerging markets the strong economic growth is accompanied by large current-account deficits related to the considerable growth in the countries’ investments. The financing of substantial deficits on the current account of the balance of payments requires the countries to conduct a stable economic policy and to have a healthy financial sector, subject to effective supervision. The economic policy of the Baltic states is maintaining this course, and this has created the necessary confidence among foreign investors who finance a large proportion of the current-account deficits via investments and lending. Despite the substantial current-account deficits the Baltic states are therefore in structural and institutional terms in a relatively favourable position. A contributing factor is the implementation of extensive stability-oriented economic programmes supported by the IMF.

Macroeconomic development

In the period immediately after the collapse of the Soviet Union all three countries experienced a strong drop in output measured by real GDP. It was only as from 1996 that real GDP growth really became positive, cf. Chart 1.

In Estonia growth in real GDP reached 10 per cent in 1997, primarily as a consequence of strong growth in private consumption, private investments and exports. In Latvia and Lithuania growth was also broad-based, with considerable growth in investments. In 1997 real GDP rose by approximately 6 per cent in both Latvia and Lithuania.

GDP per capita in 1997 has been compiled provisionally at $3,200 in Estonia, $2,200 in Latvia and $2,500 in Lithuania. For comparison, Denmark's GDP per capita is approximately $30,000, while GDP is approximately $10,000 in Portugal, which had the lowest GDP per capita in the
EU in 1997. However, measured by purchasing-power-adjusted GDP per capita the differences will be smaller.

The three countries’ greatest economic problem today is their current-account deficits. These deficits are a natural consequence of the major structural changes which the countries are currently undergoing in conjunction with the rebuilding of the capital stock. The strong domestic demand has entailed that imports have increased considerably more than exports. Estonia's current-account deficit was approximately 13 per cent of GDP in 1997 as a consequence of a trade deficit of approximately 25 per cent and a service-balance surplus of approximately 12 per cent. In Lithuania the current-account deficit also exceeded 10 per cent in 1997, while in Latvia it was almost 7 per cent, cf. Chart 2.

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1) For the Baltic states the data originates from EBRD, while Eurostat is the source for Denmark and Portugal, where GDP is compiled in current prices. It should be noted that the figures for the Baltic states are subject to great uncertainty.

2) By using the purchasing-power-adjusted GDP the generally lower price level in the Baltic states is taken into account. However, it has not been possible to determine a consistent purchasing-power-adjusted GDP measure for the Baltic states in 1997.

3) A significant problem in conjunction with compilation of Estonia's balance of payments is the scale of transit trade. Therefore, in 1998 Estonia's central bank developed a method to exclude transit trade from the compilation of the balance of payments.
The major current-account deficits entail that the countries expose themselves to a considerable risk with regard to non-residents' continued willingness to invest. Since the current-account deficit must be financed by an equivalent capital-account surplus the countries are strongly dependent on foreign investments and opportunities to borrow abroad.

If the capital-account items consist mainly of short-term loans or portfolio investments which can be quickly withdrawn, the countries' risk will be further increased compared to a situation where capital inflows consist of medium- or long-term loans and Foreign Direct Investments, (FDI). Estonia is the country with the largest proportion of portfolio investments and this share has been increasing in recent years, while on the other hand the proportion of FDI has been falling since 1994. In Latvia and Lithuania the volume of FDI has been rising significantly, while portfolio investments are modest. FDI as a proportion of GDP was 2.8 per cent in Estonia in 1997, 7.6 per cent in Latvia and 3.6 per cent in Lithuania.\(^1\) It should be stated that FDI are not necessarily long-term investments and since the figures are subject to data uncertainty and major fluctuations from year to year, partly due to privatization, they should be interpreted with great caution.

The ratio between total foreign-exchange reserves and monthly current-account expenditure can be taken as an indicator of whether the countries' foreign-exchange reserves match the continuously growing current-account deficits. It is normally considered appropriate that the foreign-exchange reserves are on average equivalent to approximately three months' current-account expenditure (or merely import expenditure). Measured by this rule of thumb the countries' reserves appear to be slightly less than appropriate, cf. Table 1.

The high inflow of capital to the countries as a consequence of the financing of the current-account deficits means that the economic policy must have a contractive effect in order to counter overheating and inflation. The greater the proportion of capital imports devoted to consumption rather than investments, the more important it is to pursue a contractive economic policy and for excess liquidity to be absorbed by e.g. issuing government bonds. Even though the general-government finances of the Baltic states would appear to be sound measured in EU terms, a tighter fiscal policy is an effective means to dampen consumption, since it is extremely difficult to influence the private sector's savings behaviour directly. As Chart 3 shows, the general-government budgets in the three countries have clearly improved since the mid-1990s. Both Estonia and Latvia thus showed a surplus on their general-government budgets in 1997.

The positive development in the general-government budgets is the result of tight management of general-government expenditure and moreover also increasing revenues as a consequence of higher GDP growth in 1996 and 1997 and a falling level of interest rates. In Latvia a further reason for the budgetary improvement is more efficient tax collection, while Lithuania raised a number of VAT rates in 1997.

Inflation has clearly declined in all years, but from a high starting level. The countries have thus moved from average annual consumer-price increases of around 200 per cent in 1991 to 11 per cent in Estonia, 8 per cent in Latvia and 9 per cent in Lithuania in 1997, cf. Table 2 (the EU average

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<td>Estonia</td>
<td>2.5</td>
<td>2.3</td>
<td>2.0</td>
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<td>Latvia</td>
<td>4.6</td>
<td>3.0</td>
<td>2.9</td>
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<td>Lithuania</td>
<td>2.8</td>
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Note: For Lithuania monthly import expenditure from the trade balance is used. Figures for 1997 are estimates.
was 1.7 per cent in 1997 measured by the harmonized index of consumer prices). In recent years inflation has tended to stagnate at around 10 per cent without declining further, which is a familiar problem for a number of other countries which previously had very high inflation rates. The consumer-price increases for recent years are e.g. attributable to major price increases for price-regulated goods such as housing, electricity, water and heating, which were previously subsidized.

The development in wages has adhered to the general decline in price development, although in some years there have been strong increases in real wages in certain sectors.

A significant factor behind the relatively speedy reduction of inflation is the countries' consistent fixed-exchange-rate policy, cf. Table 3. Estonia uses a "currency board" whereby the circulation of notes and coins is covered by the country's foreign-exchange reserve.1) This guarantees conversion of the Estonian kroon to D-mark, which is the anchor currency. Lithuania has chosen to switch gradually from the present "currency board" in US dollars to an ordinary fixed-exchange-rate policy vis-à-vis

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1) "Currency board" in Estonia and Lithuania covers note and coin circulation and also private banks' deposits with the central bank, and in Lithuania also the government's deposits with the central bank and liabilities denominated in litas, including liabilities with the former Soviet banks.
the euro or a basket of currencies comprising the dollar, the euro and possibly other European currencies. The switch away from the "currency board" is combined with amendments to the central-bank act to increase the independence of the central bank. Latvia pursues a fixed-exchange-rate policy vis-à-vis SDR, but even though there has never been an official "currency board", the country's circulation of notes and coins has in reality been covered by the foreign-exchange reserves.

The fixed-exchange-rate policy vis-à-vis respectively the D-mark (Estonia), SDR (Latvia) and the dollar (Lithuania), together with the countries' relatively high inflation, has led to a significant appreciation of the real effective exchange rates, cf. Chart 4. However, since the exchange rates were locked at a very low level and moreover the countries have seen major improvements in productivity, competitiveness has been maintained and the exports of all three countries have increased considerably since 1992.

In view of the Baltic states' major current-account deficits and their consequential reliance on foreign investors' confidence the Baltic states also

Table 2

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<td>Estonia</td>
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<tr>
<td>- inflation</td>
<td>89.8</td>
<td>48.0</td>
<td>29.0</td>
<td>23.0</td>
<td>11.0</td>
<td>12.0</td>
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<td>- wage development</td>
<td>93.3</td>
<td>72.2</td>
<td>35.7</td>
<td>23.5</td>
<td>19.6</td>
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<td>Latvia</td>
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<tr>
<td>- inflation</td>
<td>108.0</td>
<td>35.9</td>
<td>25.0</td>
<td>17.6</td>
<td>8.4</td>
<td>6.0</td>
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<td>- wage development</td>
<td>-</td>
<td>60.0</td>
<td>24.1</td>
<td>14.9</td>
<td>21.6</td>
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<td>Lithuania</td>
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<tr>
<td>- inflation</td>
<td>410.4</td>
<td>72.1</td>
<td>39.5</td>
<td>24.7</td>
<td>8.9</td>
<td>6.4</td>
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<td>- wage development</td>
<td>233.0</td>
<td>82.0</td>
<td>43.0</td>
<td>31.0</td>
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Note: Inflation is compiled as consumer-price changes (annual average) and wage development is for monthly gross earnings for employees in industry.

Figures for 1997 are estimates, while figures for 1998 are forecasts.

Table 3

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<td>Estonia</td>
<td>&quot;Currency board&quot; since 1992, 8 kroon = 1 D-mark.</td>
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<tr>
<td>Latvia</td>
<td>Fixed-exchange-rate policy vis-à-vis SDR since 1994, 0.7997 lat = 1 SDR.</td>
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<tr>
<td>Lithuania</td>
<td>&quot;Currency board&quot; since 1994, now transition phase away from &quot;currency board&quot; to ordinary fixed-exchange-rate policy. 4 litas = $1.</td>
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depend on other emerging markets around the world experiencing stable development which is not interrupted by unrest. The crisis in Asia has had no serious impact on the three Baltic states, although in the autumn of 1997 Estonia experienced short-lived pressure on the kroon which led automatically to a raising of interest rates as a consequence of the "currency board". A certain impact could also be observed in connection with the current crisis in Russia.

The three Baltic states are thus enjoying a period of high growth where the development in the balance of payments is the most obvious risk. The countries pursue a tight public-expenditure policy and inflation has been brought below or close to 10 per cent. The fixed-exchange-rate policy has led to major real appreciation of the exchange rates which in the long term can cause the balance of payments to deteriorate further, should increases in productivity subside and if the relatively high inflation, particularly in Estonia, is not brought down further.

The development in the financial sector

The financial sectors of all three Baltic states have undergone a remarkable development since the beginning of the 1990s. Particularly in the last couple of years growth in the sector has been very substantial. Whether
this development will continue depends on such factors as the economic and financial development in Russia. In this connection it is important to exercise caution in connection with transactions with Russia.

*The banking sector*

All three Baltic states experienced banking crises after independence. Estonia in 1992 and Latvia and Lithuania in 1995 and 1996. In the latter two countries, however, there was no systemic risk. During the last couple of years the financial sectors of all three countries have stabilized and the number of banks has been reduced. However, in connection with the most recent consultations with the countries the IMF called for further measures to ensure continued positive development, cf. Box 1.

As Chart 5 shows, there has been strong growth in lending in Estonia since 1993, while the banking crises in Latvia and Lithuania have continued to dampen lending. This effect is most pronounced in Latvia, since its central bank did not bail out any banks and thus did not act as "lender of last resort". In Lithuania the central bank was considerably more active in alleviating the crisis. However, the initial growth in lending does indicate more confidence in the banking sector.

Measures are still being taken to increase confidence in the financial sector. The central banks are improving and extending the regulation of the

**Chart 5**  
*The banks’ lending to the private sector*

Box 1  

**Statements by the IMF**

The IMF's Executive Directors issued the following statements concerning the development in the financial sector in connection with the most recent article IV consultations in the Baltic states:

**Estonia:** "Directors viewed with concern the rapid expansion of domestic bank credit, all the more so because the pace of such growth could outstrip the banks' ability to assess risks properly. They commended the Bank of Estonia for aggressively availing itself of the policy instruments at its disposal - within the limitations imposed by the currency board arrangement - to reduce the growth rate of commercial bank credit and to strengthen the banking system. They encouraged the authorities to implement vigorously the reinforcement of bank prudential standards in the coming months; to extend this effort to nonbank financial intermediaries; and to strengthen bank supervision."

**Latvia:** "Directors were encouraged by the increased confidence in the financial system and the steps taken by the authorities to achieve strong supervision of banks and an appropriate regulatory framework for the financial sector. They welcomed the authorities' intention to closely monitor the development of credit, and take action, if necessary, to curb credit growth and ensure the continued health of the banking system."

**Lithuania:** While acknowledging that the situation in the banking system has improved, Directors stressed that a further strengthening was needed, and called on the authorities to address the remaining weaknesses, especially those related to state-controlled banks. Directors recommended their speedy privatization, and emphasized the need to ensure that their operations in the meantime are in full compliance with prudential regulations and are carried out on a strictly commercial basis. Directors called on the Bank of Lithuania to remain vigilant in guarding against excessive reliance by the domestic banking system on short-term inflows from abroad."


financial sector. In all three countries the BIS capital requirements for cover of credit risk have been introduced and the requirements concerning cover of market risk are expected to be introduced soon. Deposit-insurance schemes are being introduced, but so far with limited coverage. The supervisory authorities of all three countries are being strengthened in a number of areas, including by establishing databases with extensive information on the commercial banks. In October 1997 Estonia tightened its capital-adequacy rules from 8 per cent to 10 per cent of risk-weighted assets as a
consequence of the strong growth in the banking sector. The requirements will be tightened further during 1998, if considered necessary. However, since the commercial banking sector in all three countries is relatively newly established, there is still a lack of credit-assessment expertise and general experience of banking operations. In this connection it can be stated that Eesti Maapank, which holds approximately 5 per cent of the banking market in Estonia, was subject to compulsory winding-up proceedings in June 1998 as a consequence of heavy losses on speculative transactions.

Supervision of banks in all three countries is under the auspices of the central bank, while supervision of the rest of the financial sector is managed by the ministries of finance. However, in Estonia for example, establishment of one supervisory body covering the entire financial sector is being considered. All three countries are planning to introduce the EU's Capital Adequacy Directive (CAD), including the provisions concerning market risk. The central banks of all three countries have a high degree of independence and the conditions in the financial markets are very liberal. All three countries hold "investment grade" ratings from the international rating agencies.

Virtually all banks in Estonia and Latvia are privatized or are being privatized. In Lithuania only around half of the banking sector is fully privatized and the banks which are only partly privatized are even exempt from the capital-adequacy requirements. However, this exemption is expected to be removed soon. The number of banks has been reduced significantly in all three countries in recent years. Most recently, in July 1998 Estonia's central bank approved two mergers: one between the largest and second-largest banks, Hansapank and Houipank, and the other between the third- and fourth-largest banks, Ühispank and Tallina Pank. After these mergers there are 9 banks in Estonia, of which the largest has a market share of almost 50 per cent and the second-largest approximately 35 per cent. Further consolidation of the banking sector in Latvia and Lithuania is also expected.

Considering the banks' lending and deposits in relation to GDP, Chart 6 shows that lending and deposits are significantly higher in Estonia compared to the other two Baltic states. In this connection, in December 1997 the IMF pointed out that "The banking system might overextend itself and face liquidity problems, should credit risks be poorly judged or capital inflows slow down". There is a certain lack of confidence in the banking system after the problems in Latvia and Lithuania in 1995 and 1996. Moreover, the slow privatization process and the high level of real-interest rates

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have also had a dampening effect. Collateral is required for by and large all lending, although this collateral often consists of assets which are not easily negotiable.

The largest banks in Estonia have established branches in Latvia and Lithuania and increasingly regard all three Baltic states as one future domestic market. The largest private banks in all three countries have either established branches in Russia, Belarus and the Ukraine, or have correspondent banks in these countries, primarily to service their domestic clients operating in these markets. The banks also undertake portfolio investments in these markets due to the high yields available in these countries. However, there appears to be great awareness of the risks associated with such investments. In Estonia a few banks raise loans in D-marks and relend in Estonian kroon at a far higher interest rate than the D-mark rate. The exchange-rate risk on these transactions is considered to be almost non-existent as a consequence of the "currency board", but this naturally requires that the fixed exchange rate be maintained.

Capital markets

Few business enterprises in the Baltic states have raised capital via the stock markets. At the end of 1997 the degree of capitalization (market value of the stock market as a ratio of GDP) was around 26 per cent in

Chart 6  Banks’ lending and deposits as a ratio of GDP in 1997

Estonia, 7 per cent in Latvia and 9 per cent in Lithuania. The level of capitalization in Denmark, which is relatively low among the western European countries, is around 50 per cent, while it exceeds 100 per cent in the USA. The stock market is dominated by bank shares in all three countries, where for example more than half of the market in Estonia consists of bank shares, while the market in Latvia is more diversified. All three countries have electronic stock exchanges which also trade short-term government bonds with maximum maturities of two years. The money markets of Estonia and Lithuania are under-developed, since the central bank is not active in the money market and does not use traditional monetary-policy instruments as a consequence of the "currency board". This is one of the reasons for Lithuania's wish to discontinue its "currency board" in favour of a traditional fixed-exchange-rate mechanism. The development of the capital market is also limited by the short supply of government bonds as a consequence of the general-government budget surpluses in Estonia and Latvia. Moreover, in several cases local authorities are prevented from issuing bonds.

Considering the development on Estonia's stock market, Chart 7 shows that the stock index (TALSE) rose strongly in the summer of 1997 (presumably as a consequence of a speculative bubble in connection with rumours of bank mergers) and then fell abruptly in the autumn, probably as a reaction to the crisis in Southeast Asia. As stated, the stock market is still of only moderate importance to the financing of business enterprises and therefore there were very few real-economic effects of first the increase and then the ensuing strong drop in the stock index. However, the development in the stock market is taken by foreign investors as an indicator of the economic climate, and the drop in share prices may therefore have had a dampening effect on the foreign investments. The 1-month interest rate (1M TALIBOR) was stable at around 6 per cent up to the end of October 1997, after which it rose to almost 15 per cent at the close of the year. The increase in interest rates was due to pressure on the exchange rate, possibly as a consequence of contagion from the currency crises in Asia which gave rise to a "safe haven effect" whereby investors moved their investments into the more traditional markets. This effect may have entailed that the currency markets wished to test other emerging markets with fixed exchange rates. However, the pressure was short-lived and ceased after the implementation of IMF-subsidized economic programmes entailing a significant tightening of economic policy. An important element of this programme

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was the establishment of a stabilization fund to which a proportion of the general-government surplus is contributed and invested in German government bonds. Interest rates rose again in the summer of 1998, which indicates some pressure on the Estonian kroon as a consequence of the crisis in Russia. The stock markets in Latvia and Lithuania likewise dropped in October 1997, mainly in reaction to the drop in stock prices in Estonia, and as a consequence of the withdrawal of Estonian investors from these markets. As in other emerging markets the stock indices fell significantly at the end of August 1998 as a consequence of the crisis in Russia.

In view of the moderate size of the stock markets it may in the longer term be relevant to merge the three stock exchanges, since alternatively companies will raise capital on other stock exchanges, e.g. those of the Nordic countries, which are considerably more liquid. Additional privatizations are expected, especially in Latvia and Lithuania, where only approximately 60 per cent of the economy is privatized. This is expected to significantly increase the provision of capital via the stock exchanges.

A lack of experience of credit granting and legislation concerning collateral security has led to significant growth in the leasing markets compared to traditional banking activities, and most of the banks have established independent leasing companies.
In all three countries there are plans to establish a funded pension system to replace the present "pay-as-you-go" systems. Mortgage-credit markets are also being established in all three countries. This will significantly improve opportunities for private individuals to raise loans. The insurance markets are also being expanded. In the long term, these measures are expected to lead to considerable development of the capital markets.

Contagion effects from Russia and Asia

So far the negative economic development in Russia has had only limited contagion effects in the Baltic states. The composition of the Baltic states' foreign trade is of some significance, since the countries predominantly import their goods from the western countries, while a large proportion of exports is still sold to Russia and other former Soviet republics. Estonia has the greatest volume of trade with western Europe, cf. Chart 8, but reservation must be made for the extensive transit trade through Estonia. Most of the exports of Latvia and Lithuania are to central and eastern European countries.

With regard to the financial sector the exposure to Russia consists mainly of the Baltic banks' loans to Russian clients, deposits with Russian banks and investments in Russian government bonds. However, there appears to be a high level of awareness of the risk entailed by such investments.

With regard to the contagion from the crisis in Asia it might be claimed that the crisis to a certain extent had a positive impact on the financial markets in Estonia. The stock market especially experienced a form of overheating in the summer of 1997 and the crisis in Asia therefore had a convenient dampening effect. Likewise, the pressure on the Estonian kroon in October 1997 can be considered as a derived effect of the Asian crisis. Latvia and Lithuania were by and large only indirectly affected via contagion from Estonia.

The underlying economic problems of the Baltic states must be evaluated as considerably less pronounced than in the crisis-stricken Asian countries and Russia. This applies notwithstanding the extremely high savings deficit as a consequence of the current-account deficit and that a tight fiscal policy is therefore necessary to ensure sustainable macroeconomic development. The Baltic states are also in a more favourable starting position than the crisis-stricken countries. In relation to the Asian countries this among other things applies to the regulation and supervision

1) Denmark participates in mortgage-credit projects in Latvia and Lithuania.
of the financial sector, although the improvement must be evaluated with some caution. It must be emphasized that the private sectors in the Baltic economies, especially the financial sector, operate under more liberalized conditions than is the case in several of the Asian countries. The high level of independence of all three Baltic central banks likewise contributes to strengthening the credibility of the economic policy.

**Summary**

In recent years, the Baltic states have shown impressive economic results with high growth rates and a strong dampening of inflation rates achieved by pursuing a consistent fixed-exchange-rate policy. However, inflation is still high, compared to e.g. the EU average, and the fixed-exchange-rate policy has therefore led to substantial appreciation of real exchange rates. In the longer term the current-account deficit should be reduced in order to ensure stable economic development.

The financial sector has likewise experienced positive development after the banking crises which affected Estonia in 1992 and Latvia and Lithuania in 1995 and 1996. The banking supervisory bodies are subject to constant expansion and measures are still being taken to improve confidence in the
financial sector. The stock markets are also undergoing strong growth, but as yet are of only minor significance as a source of financing for private enterprises. Future introduction of mortgage-credit systems and financed pension systems are expected to lead to considerable expansion of the financial sectors of all three countries.

The crisis in Asia has had only limited real-economic impact in the Baltic states and with regard to trade will only be able to affect the countries via e.g. generally lower economic growth in their trading-partner countries. The major drop in stock prices in Estonia in the autumn of 1997 came as an indirect reaction to the crisis in Asia after strong price increases during the summer. The exacerbated economic problems in Russia have affected a number of emerging markets, including the Baltic states.