

ECONOMICS: EASTERN EUROPE, MIDDLE EAST AND AFRICA PERSPECTIVES—FEBRUARY 5, 2010

Markets Are Correctly Differentiating Between the Baltic States

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The economies of all three Baltic States are undergoing substantial domestic adjustment to tighter financing conditions. The amount of adjustment needed differs, however, as do country-specific risks. Financial markets are correctly pricing these differences.

There are three key points to be considered when analyzing the current state of the three Baltic economies. The first is that economic adjustment is evident in varying degrees in all three states. This adjustment is reflected in declining CDS spreads, which have occurred despite Greek CDS spreads moving in the opposite direction as a result of continued deterioration in market confidence in its fiscal outlook **(Display 1)**. In addition, the successful \$2 billion Eurobond placement by Lithuania this week amid the concern over Greece reflects the market's acknowledgement of the adjustment being undertaken by Lithuania. Overall, the adjustment process in the Baltics suggests that creditworthiness is likely to improve and risk premiums decline over the next several years.

Second, idiosyncratic risk among the three states is varied. Estonia has the strongest sovereign creditworthiness, followed by Lithuania, and then Latvia. This distinction has been reflected in relative CDS spreads for some time **(Display 1)** and is based on three main issues—growth, competitive-

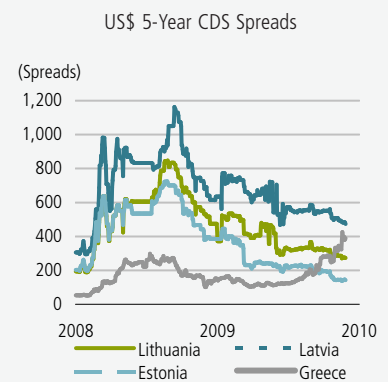
ness and fiscal positions—that we will review below (these issues were discussed in more detail in *What Are the Contagion Risks from Latvia?* dated October 9, 2009).

Third, a major risk to this adjustment stems from events in Greece. In the event that market confidence in Greece deteriorates further, the new EU member states would be impacted through real and financial channels. As we have argued previously, the EU has a vested interest in preserving market confidence in eastern Europe to minimize the impact on western European economies and banking systems. Thus, in an extreme scenario we would expect additional IMF-EU financing to be forthcoming to the Baltic States, since these countries are small and have successfully undertaken painful fiscal adjustment measures.

Evidence of Adjustment

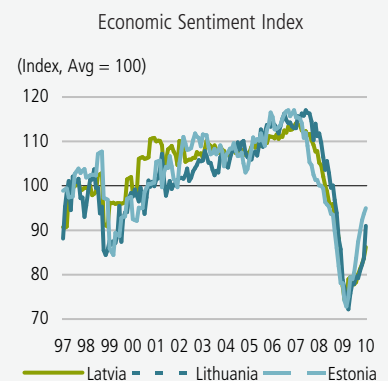
The rebound in growth has been strongest in Estonia, but weakest in Latvia **(Display 2)**. This pattern is evident in coincident sentiment indices, which have

Display 1
Baltic Spreads Have Improved Despite Greece



Source: Bloomberg

Display 2
Economic Activity Has Started to Rebound



Source: European Commission

strong historical correlations with real GDP growth. This divergence is a function of both external and domestic factors. Externally, Estonia has the greatest share of exports in GDP (**Display 3**). This exposure has allowed Estonia, followed by Lithuania, to benefit more from the rebound in external demand.

Domestically, Estonia's economy does not face a further drag from fiscal tightening this year as it was the first to start tightening in mid-2008. Lithuania and Latvia both started tightening fiscal policy in 2009. Private sector and bank de-leveraging is likely to weigh on domestic demand in 2010 and 2011 in all three economies. Leverage is least in Lithuania, however, where private sector credit is 64% of GDP, as compared with Estonia (103%) and Latvia (91%).

Regarding competitiveness, all three countries have made progress in devaluing their real exchange rates through lower prices and private sector wages (**Display 4**). Their fixed exchange rates to the euro have remained intact. The decline in wages stems from tightening fiscal policy, reducing public sector wages and generally flexible labor markets. On a relative basis, Lithuania's nominal wage decline of -11.5% year over year has been largest, followed by Estonia at -5.4%, and then Latvia at -3.0%. The resulting decline in imports, lower real exchange rates and rise in national savings rates have swiftly shifted current account balances to

surpluses from large deficits.

Finally, all three countries have introduced strong fiscal packages to reduce fiscal deficits. Estonia's fiscal position is the strongest (**Display 5**), since its government conducted the most prudent fiscal policy in the run-up to the global financial crisis. In addition, policy was anchored by the prospect of euro adoption, with Estonia expected to join the euro in January 2011. This history of benign fiscal deficits has resulted in public sector debt of only 10% of GDP.

Lithuania and Latvia entered the crisis with similar fiscal positions. Both countries have equivalent levels of public sector debt to GDP, and both loosened fiscal policy before the crisis. However, implementing an austerity program has proved much more difficult in Latvia than Lithuania. Latvia's government repeatedly delayed implementing its commitments to the IMF during 2009, and the largest party in its governing coalition voted against the program in a final parliamentary fiscal vote of the year. Execution of Latvia's fiscal plan will remain a key issue this year in the run-up to parliamentary elections in October.

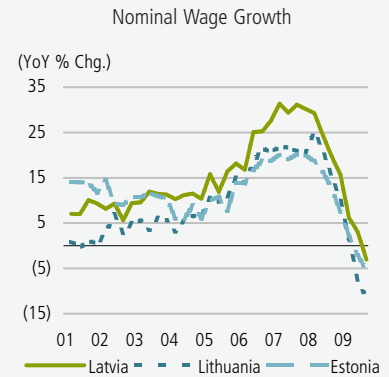
Lithuania's government has so far successfully implemented its fiscal plan, enabling it to raise market financing. If global financial markets were to tighten, Lithuania would be a strong candidate for IMF-EU funding. ■

Display 3
Export Exposure Helps Drive Sequence of Recovery



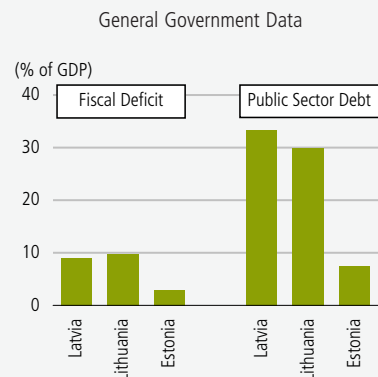
Source: Haver Analytics and AllianceBernstein

Display 4
Wage Adjustment Has Been Substantial



Source: Haver Analytics and AllianceBernstein

Display 5
Estonia's Fiscal Position Is Strongest, While Risk Are Highest In Latvia



Source: European Commission

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