

External Deficits in the Baltics 1995 to 2007: Catching Up or Imbalances

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This paper studies economic trends in the Baltic States between 1995 and 2007 using the European Commission (DG ECFIN) QUEST III model calibrated to the Baltic economies.

After the economic liberalization in the first half of the nineties, GDP was growing at a very fast pace in the Baltic States. Growth was primarily domestically driven with both households' consumption growth and particularly investment growth exceeding GDP growth in each country. These trends were accompanied by very high external deficits over the entire period. Starting from around 2001, this pattern became further accentuated as GDP, consumption, investment and especially housing investment accelerated enhanced by falling risk premia and easing access to credit. Real housing prices also increased at a spectacular pace.

These developments led many analysts to warn of an *overheating* of the Baltic economies. Indeed, as pointed out in Reinhart & Rogoff (2008), the run-up in housing prices is one of the best leading indicators of financial crisis in countries experiencing large capital inflows and large external deficits. High and increasing GDP growth rates also belong to the crisis indicators. In the Baltic States, all of these factors were present simultaneously. At the same time, external deficits may also be part of a *fast catching-up process*, which is likely to have characterised the Baltic economies, as capital is expected to flow to countries with high return opportunities. Such external deficits can be considered equilibrium phenomena and are not problematic as long as foreign funds are well invested allowing for the servicing of the debt over time.

The paper gives a quantitative assessment of the contribution of three factors (TFP growth, fall in foreign risk premia and easing access to credit) to driving the observed macroeconomic trends. In addition, we study reversal scenarios to highlight some restructuring mechanisms that may be at work in the current downturn.

The analysis is based on a small-open-economy dynamic stochastic general equilibrium model calibrated to the Baltic economies. The model features three production sectors (traded goods, non-traded goods and housing) and heterogeneous households (credit-constrained and unconstrained). The detailed specification of trade linkages may be expected to well capture foreign-trade-related developments. In addition, the extension for the financial accelerator, specified as a collateral constraint for a fraction of agents, allows for a study of the impact of balance sheet effects on the economy.

The results show that the three factors together can reasonably well track the external deficit and other key macroeconomic indicators over the period under consideration. In particular, TFP growth is found to account well for trends until around 2001. Thereafter, the role of TFP growth seems to have decreased and financial factors are found to have played an

increasingly dominant role in driving the observed trends. These financial factors represent higher risks for two reasons: their impact on production is found to be significantly smaller than that of TFP growth; thereby, these factors do not automatically ensure production levels from which debt could be serviced at later stages without a decrease in consumption and / or an increase in work effort. In addition, these factors are more easily reversible than the level of productivity.

During the entire period, positive growth outlook is likely to have played a significant role in the build-up of the external debt position. Simulation results illustrate that less optimistic expectations about future productivity would have led to smaller trade deficits in early periods and a faster reallocation of resources towards the traded sector.

Finally, reversal scenarios confirm the need for a readjustment of the external debt position. In particular, if either future growth expectations become more pessimistic or benign financing and credit conditions are reversed, the model shows a sudden turn around in the trade balance which requires substantial restructuring and a fall in the external-debt-financed domestic demand.