

ECONOMIC RECESSION IN TRANSITIONAL EU COUNTRIES UNDER THE CURRENCY BOARD ARRANGEMENT: LITHUANIA'S CASE

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Abstract. New European Union member countries are experiencing a serious economic downturn brought on by growing internal and external imbalances. The financial crisis, which has intensified, has led to worsen funding conditions, deterioration in the confidence of economic agents and a dramatic fall in world trade, in that way straightening out a global recession. Governments worldwide started measures to stabilize the financial systems and promote economic activity, which helped prevent a further escalation of the financial crisis. In view of the reality that economic incentive measures require some time to take full effect, a deep recession must be predictable for next years. An economical recession especially puts pressure on countries with the currency board (CB) arrangements. Currency board provides central banking out of work for interest and exchange rate determination. Thereby, monetary policy is in reality outsourced. Foreign direct investment (FDI) in banking sector led to outsourcing of the second important central bank function, responsibility for banking supervision. Lithuania's and other Baltic States' experience with the CB and expanding foreign involvement in banking is reviewed. Empirical evidence from Argentina's CB during the crisis is discussed. The conclusion outlines the possible circumstances for currency board survival during a global economic recession in the new EU member states.

KEY WORDS: *Currency boards, recession, foreign banks, transitional economies, Baltic States, monetary policy.*

Introduction

Baltic States' economic recession is worsened by global slowdown. A previous run of strong growth but impractical macroeconomic and financial policies has produced little fiscal and financial sector buffers which, along with relatively inflexible labor and product markets, are discouraging the country conditions during the current turmoil. All four new EU member states of the pegged currency economies including Latvia, Bulgaria, Estonia and Lithuania are facing significant contractions in growth, and the reduction in FX reserves in their central banks through the third and fourth quarters of 2008 affirm that the pegs are coming under pressure.

In the case of Lithuania, its economy grew by 8 percent on average during 2000 - 07, supported by liberal economic and generally conservative fiscal policies. These policies supported Lithuania's currency board arrangement, which also secured low inflationary expectations. They also assisted rapid international financial integration. As a result, real per capita incomes converged quickly with those of European neighbors and now stand at about two-thirds of the EU average.

This paper offers a hypothetical discussion of currency board phenomena during the financial slowdown. Within this practical and theoretical framework the results of monetary policy in new European Union member states may be suboptimal; the currency board on one had is an efficient anchor for currency stability but potential level of monetary regulation is de facto outsourced. Therefore the economy could not attain at a flexible exchange rate and an individually set interest rate.

Moreover, so harshly fixed exchange rate regime probably could be particularly untied during the 2004-2007, according to Edward Lucas (2009), "to create credibility, all three Baltic countries adopted strictly fixed exchange rates. These gained totemic significance: The central banks that administer the currency pegs to the euro are the most trusted institutions in each country. Yet by 2004, it would have been far better to have the exchange rates more flexible. A revaluation in the boom years would have cooled overheating; devaluation now would stave off hypothermia."

Increasing Economic Disproportions

Foreign direct investment (FDI) in Baltic Countries' banking sector led to spillover of credit and outsourcing of the central bank functions (See Table 1-3). However this vigorous performance was eventually undermined by widening macroeconomic imbalances, and an erosion, although reasonable, of competitiveness. The external current account deficit topped 17 percent of GDP in Lithuania, 2008. Even worse situation is in Latvia.

These imbalances were financed through a combination of large foreign domestic investment inflows, as well as rising external liabilities in 2008 and were incurred almost entirely by the private sector. A good deal of this debt was owed by foreign-owned bank subsidiaries to their parents abroad and was used to finance rapid domestic credit growth.

Lithuania now faces a serious recession. While in part initiated by the desire of Scandinavian banks - which dominate the local market - to reduce their Baltic exposures, the downturn fed on its own imbalances,

and gained momentum from the global financial crisis. The economy growth contracted to 3 percent in 2008, and the IMF projects a further 15 percent fall in 2009.

The current account deficit has declined appreciably. Inflation is falling rapidly, slowing to 3 percent in March, while unemployment rose to 11 percent at first quarter of 2009. A rebound in activity is not expected before late 2010. However, the position remains uncertain given the global confusion and Lithuania's reliance on exports.

Banking sector

Europe's major problem is that its banks have greater exposure to the world's most vulnerable regions – East Asia and Eastern Europe. Western European banks are owed roughly 54 percent of the total of foreign bank loans to emerging economies in Asia and no less than 70 percent of the USD 1.8 trillion of foreign loans to Eastern Europe. Austrian banks alone have lent about USD 300 billion to Eastern Europe -- the equivalent of 68 percent of Austria's GDP. Some countries, including Hungary, have seen their currencies plummet, while in others, such as Ukraine, the default risk premium on bonds has soared. The situation increasingly resembles a 1980s Latin American debt crisis, only this time Western Europe, not the United States, must deal with it.

Governments have recently fallen in Latvia, Hungary, and the Czech Republic, but Western European leaders are separated about how to respond. The Germans specifically adhere to the notion that they are more fiscally virtuous than the Americans, and have no desire to commit their taxpayers' money to a general Eastern European bailout. It's hard to imagine, however, that they will idly watch while a European Union member goes into default.

General situation with commercial banks regulations has been changing due to concentrated lobbying activities by banks during the last century. A hundred years ago a typical European bank's assets-to-capital ratio was four to one. According to Niall Ferguson; “By the 1970s bankers regarded a 10/1 or 12/1 ratio as prudent. But over the past two decades such ratios have gone up. A good example is the U.S. investment banks. From 1993 to 2002 the average leverage ratio (assets divided by equity capital) was 21 for Morgan Stanley, 24 for Goldman Sachs, 27 for Merrill Lynch, and 32 for Bear Stearns. By 2006 those figures had risen to as high as 33 for Morgan Stanley, 26 for Goldman Sachs, 32 for Merrill Lynch, and 34 for Bear Stearns. Thus in four years these four investment banks went from having assets that were, on average, 26 times their capital to assets that were 31 times their capital” (Ferguson, 2009). Besides common sense tells us that borrowing on such a level is dangerous.

Table 1. Structure of Bank Ownership in Estonia

FOREIGN BANKS
AS Eesti Krediidipank
AS Hansabank
AS SEB Bank
Balti Investeeringute Grupi Bank
Marfi Pank Eesti AS
Tallinna Aripanga AS
FOREIGN BRANCHES
AB Bank Snoras
AS Parex Bank
AS UniCredit Bank
Allied Irish Bank
Bank DnB NORD
Danske Bank
Nordea Bank
Svenska Handelsbanken
Scania Finaas Bank
Siemens Financial Services Bank

Source: Estonian Banking Association

Table 2. Structure of Bank Ownership in Lithuania

FOREIGN BANKS
AS UniCredit Bank
MP Investment Bank
Balti Investeeringute Grupi Bank
Allied Irish Bank
Danske Bank
Nordea Bank
AB DnB NORD Bank
AB Parex Bank
AB bankas Hansabank - Swedbank
LOCAL BANKS
AB Ukio bankas
AB bankas FINASTA
AB bankas Snoras
UAB Medicinos Bankas

Source: Bank of Lithuania

Table 3. Structure of Bank Ownership in Latvia

FOREIGN BANKS
SEB (AB Sweden)
UniCredit Bank
DnB NORD Bank
HANSABANK
AS Bank Snoras
Latvijas tirdzniecības bank
JSCB Bank of Moscow
PrivatBank
SMP Bank
AB Pivdenny
FOREIGN BRANCHES
Nordea bank
Svenska Handelsbanken
Allied Irish Bank
Danske Bank

Source: Association of Latvian Banks

Asset Denomination Issues

Lithuania's (as well as the all Baltic countries) banking system, is almost entirely foreign owned (see Table 3) and so far quite profitable, also faces asset quality issues. Banks' access to their parents' support and confidence in the currency board have facilitated rapid financial deepening - but also led to a buildup of a large loan portfolio, much denominated in foreign currency. The share of nonperforming loans remains remarkably small, and sizable bank profits allowed institutions to accumulate comfortable financial buffers. But they face increasing risks, especially as asset quality is being eroded by the recession, and confidence is sensitive to events in the region. Baltic States policymakers have responded primarily with measures aimed at improving public finances, where further actions may be necessary. The 2009 budget attempted to address the authorities' near-term goals of maintaining their fiscal buffer and meeting the Maastricht deficit criterion, but was overtaken by essential measures.

Additional Budget

The rapidly worsening economic outlook prompted a supplementary budget in Baltic States in February 2009, including expenditure cuts of additional percentage points of GDP. The government has expressed its resolve to undertake additional measures, as necessary, to keep the budget deficit under the Maastricht ceiling. Reducing the growth of current expenditures will be basis in this respect. Financial sector elasticity is being boosted as well. Most importantly, an emergency liquidity assistance facility has been agreed between

the central banks of Baltics and Sweden, providing the two largest banks, which are Swedish owned, with access to liquidity if necessary. The bank resolution structure is being strengthened through legislation under preparation.

Argentina Currency Board Crisis

Argentina's 1990's experience demonstrates what can happen with a currency board during a financial crisis. Argentina's monetary policy has operated very much as a currency board would have since April 1, 1991, when the country's congress approved a convertibility law. The law obligated the central bank to issue domestic currency (the peso) only against the dollar value of foreign reserves. The law also fixed the exchange rate at 1:1, or \$1 per peso. This standard is the basic rule for money creation under a currency board arrangement. Very similar currency boards are adopted by Estonia, Lithuania and Bulgaria.

Under the convertibility law, Argentina's base money and foreign reserves should move very much in tandem. This pattern is typical of currency board regimes, under which base money increases as foreign reserves rise and decreases as foreign reserves fall. Foreign reserves started to fall in Argentina in January 1995, when the "tequila effect" spread and investors withdrew capital from the country in fear of devaluation. It makes apparent that currency boards are not seen as everlasting protection against devaluation. The reason is because the same currency board features that prevent devaluations can exacerbate fears that the currency board will be abandoned. Under a currency board, a relatively minor liquidity crisis can become a full-blown financial panic almost overnight. This is what happened in Argentina. In such circumstances, governments come under rising pressure to restore the lender of last resort function that is part of monetary policy under a central bank but is incompatible with a currency board regime. Nevertheless Argentina's case seems not very relevant to the EU member states. Moreover the recent nearly two decades history of the currency boards in the EU countries shows wiliness to sustain that arrangement much more sincerely.

How Immediate Do Currency Boards Modify

It is a comprehensive dispute. Some believe that currency boards – because of their fixed exchange rate – bring about adjustment of external imbalances very slowly. Currency boards cannot and do not depreciate the currency, and that is assumed as a problem. Because of the financial crisis in the post-2008 world, East European countries cannot attract as much capital inflow as before - so their current account deficits should decrease quickly. For the time being it is happening.

In the case of EU new member states under the currency boards the trade deficit started decreasing rapidly. Within three months the deficit decreased by two thirds. The decrease of the trade deficit year on year is around 40 percent in first quarter 2009 – and the current account deficit is also down by 40 percent year on year the same period. That is quite a substantial adjustment within just a few months (see Table 4). With this momentum, the big current account deficit will be history very soon.

Table 4. Lithuania's Current Account Forecast

	2007	2008	Latest Period 2009 March	2009f	2010f
Imports, EUR billion	16.81	19.94	0.91	16.48	16.36
Exports, EUR billion	12.52	16.15	1.02	15.95	16.30
Trade balance, EUR billion	-4.29	-3.79	-0.11	-0.54	-0.06
Current account, percent of GDP	-14.62	-12.40	-	-1.12	0.6

Source: Bank of Lithuania/Business Monitor International Calculations.

Emerging Market Dependences

The new EU member countries are most of the time small and open emerging market economies. Willem Buiter is among the leading European monetary economists who are providing commentary on the relating crisis (Buiter, 2009). He wrote a short time ago: “The prospects of the emerging markets depend:

- First, on their dependence on external demand
- Second, on their dependence on external finance and,
- Third, on the scope for expansionary domestic demand management and the ability of the authorities to use it intelligently and flexibly. “

The three Baltic countries face this sequence of economic difficulty with many essential policy keys out of reach. The understandable step would be to devalue their currencies, but because they are secured by the currency board and by the outsourced commercial banks, that move would shake each country to its fundamentals while also bankrupting the many households and firms that have loans in euros, US dollars, UK pounds or Swiss francs. The Baltic States have little opportunity to change monetary policy. Neither can they use fiscal policy to ease the damage, i.e., borrowing money to increase state spending. The main intention is that all three countries are trying to join the euro area and to meet the three percent budget deficit criterion in a few years.

According to Edward Lucas “the Baltic states are pushing through an “internal devaluation,” cutting wages and pruning bureaucracy in the hope that these measures will boost their exports and attract renewed foreign investment. The sole cushion is money from the European Union and other international lenders. It could work” (Lucas, 2009). The Baltic economies have already shown that they can change direction. They did this in 1991 under far tougher conditions and again in 1998, after the Russian financial cataclysm. In spite of everything, these severity measures require unusual patience and a high acceptance for pain among voters who will see their living standards go down for the next few years. In addition it requires Scandinavian and other foreign banks to continue the trace on their bad loans.

Closing Remarks

Financial imbalances that have deepened during the last year economical recession, led to worsen monetary policy conditions especially for countries under the currency board arrangement. In addition these have decreased the confidence of economic managers and a significant decline in the world trade. Governments worldwide started measures to stabilize the financial systems and promote economic activity, which helped prevent a further escalation of the financial crisis. In view of the reality that economic incentive measures require some time to take full effect, a deep recession must be predictable for a few next years. Currency board provides central banking out of work for interest and exchange rate determination. Thereby, monetary policy is in reality outsourced. Foreign direct investment in banking sector led to outsourcing of the second important central bank function, responsibility for banking supervision. Empirical evidence from Argentina’s shows obvious weaknesses of the currency board. However in the EU new member countries currency board demonstrates quite efficient self adjustment mechanism with severe decrease of current account balances. In Baltic States governments are going to internal devaluation to keep on the run their pegged exchange rates regimes. Even so under the strict currency board arrangement and prudential government policy the possibility for currency board survival in Lithuania and in other similar EU states is quite promising during a global economic recession.

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