Directors expressed concern about the still high unemployment in the Baltic economies. Despite considerable resilience and flexibility in labor markets in the wake of the crisis, Directors considered current unemployment largely structural in nature. They recommended two areas for improvement: a reduction of the Baltics' relatively high tax wedge in a fiscally-neutral manner, and greater emphasis on education, training, and other active labor market policies to tackle skill mismatches.

Directors encouraged the authorities to supplement national policies with joint action as they address potential challenges in credit, export, and labor markets. In this context, Directors supported active regional cooperation, particularly for upgrading the energy sector and exploring alternative energy options, investing in transportation infrastructure, and developing the non-bank financial sector.

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Statement by Mr. Audun Groenn, Executive Director for the Baltic Countries
May 2, 2014

On behalf of my authorities in Estonia, Latvia and Lithuania, I welcome the Baltic Cluster Report and thank staff for the comprehensive set of papers. The report provides a useful cross-country perspective on the state of the Baltic economies and sheds light on both their common successes and policy challenges. While recognizing the systemic linkages, common economic policy issues and other similarities between Estonia, Latvia and Lithuania, the authorities also see differences between the three Baltic countries that can further be explored in individual Article IV reports. The papers thoroughly discuss the Baltic growth model and provide a useful input for the authorities' future policy agenda.

We share staff's discussion of the main elements of the Baltic model in the report. The small size and high openness of the economies provides ample opportunities to diversify into niche markets, resulting in a high degree of flexibility that helps to withstand rapid changes in the external economic environment and sustain rapid growth. The transition to a market economy and the external shocks experienced thereafter have also given the Baltic countries valuable lessons on the importance of maintaining policy and market flexibility. The authorities recognize that this feature is important for a successful participation in the euro area.

My authorities broadly agree with the identified challenges and share most of the proposed policy recommendations. Since the authorities' views are well-documented in the report, we limit our remarks to the following areas.

Credit growth: The role of supply and demand factors

We agree with staff's assessment that significant progress has been made over the past years in improving the resilience of the Baltics' financial systems. However, credit growth currently remains subdued, driven by both anemic demand for loans as well as supply constraints. It should be noted that the Baltic countries are at somewhat different stages in their recoveries, with Estonia slightly ahead of the other Baltic countries. This is evident also in the credit cycle where supply constraints have dissipated and the modest credit growth hinges on the demand side.

While sluggish credit demand in the Baltic countries may be largely explained by an ongoing deleveraging in the household sector, high retained corporate earnings and a greater reliance on funds borrowed from abroad, including from parent companies, as well as large uncertainty surrounding external demand and weak investment activities, the authorities broadly share the view that reviving credit is needed to sustain growth and foster convergence in the longer term. To this end, the authorities felt that measures to ease credit

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supply constraints deserved a more detailed exploration in the case of Latvia and Lithuania, as the ongoing balance sheet repair and the improvement of insolvency regimes, while necessary, may not be sufficient to restore a healthy credit growth path. While recognizing the challenging nature of estimating the optimal credit level, doing such an exercise might be instrumental to assess the scope for further deleveraging and gauge if the departure of the Baltic countries from the historical patterns is indicative of a failure to end a creditless recovery.

As regards the interplay of credit demand and supply factors during the past boom, the authorities would like to emphasize that the surge in lending activities was driven by both increased demand and, at least equally, by increased supply of credit. The global environment with its abundant liquidity and low risk aversion as well as the growing confidence following the EU accession contributed to capital inflows that nurtured credit expansion. A myopic risk assessment brought interest margins significantly down and eased lending conditions, thereby facilitating access to credit and extending loan maturities.

Competitiveness and potential for further export sophistication

The strong performance of the Baltic countries' exports rests on price competitiveness, flexibility of trade reorientation and healthy growth of services exports, as noted in the staff report. A combination of wage restraint and productivity advances significantly reduced Baltic unit labor costs during the crises and contributed to the export-led recovery. As a result, the Baltic countries have witnessed a marked increase in both export-to-GDP ratios and in world export market shares.

The authorities agree with staff that while exports have expanded significantly, there is scope to increase the exposure of Baltic exports to globally dynamic and sophisticated product categories. However, while supporting the general thrust of the policy recommendations, they are somewhat more optimistic about the Baltic export prospects.[1] The authorities believe that quality catch-up of the Baltic exports has been uninterrupted and there is strong potential for further export sophistication in the medium term.

The approach used to assess export quality in the staff report takes into account relative unit values (UVs), omitting another important component – i.e. export volumes. A more detailed analysis could provide a less somber picture, as the declining UVs can also be interpreted as improved price competitiveness. Indeed, there is evidence pointing to the ongoing increase in

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[1] We are referring to Baltic Cluster Report—Selected Issues (SM/14/90, 4/16/14) "Exports and Global-value-chain linkups: Experience and Prospects for the Baltic Economies"

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