# BALTIC CLUSTER REPORT 2014 CLUSTER CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE BALTIC COUNTRIES

INTERNATIONAL MONETARY FUND

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IMF Country Report No. 14/116

# BALTIC CLUSTER REPORT

May 2014

## 2014 CLUSTER CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE BALTIC COUNTRIES

IMF staff regularly produces papers covering multilateral issues and cross-country analysis. In the context of the 2014 Cluster consultation with the Baltic countries, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 2, 2014, following discussions that ended on March 4, 2014 with the officials of the Baltics on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 15, 2014.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 2, 2014 consideration of the staff report that concluded the cluster consultation report.
- A **Statement by the Executive Director** for the Baltic cluster countries.

The document listed below has been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

# BALTIC CLUSTER REPORT

## STAFF REPORT FOR THE 2014 CLUSTER CONSULTATION

April 15, 2014

## KEY ISSUES

The Baltic economies have performed well in the last two decades relative to other transition and emerging market economies, but they face some common challenges calling for national and regional policy responses. These challenges relate to their ability to sustain economic growth going forward, particularly as members (or prospective members) of the euro area.

The Baltic economies have all experienced creditless recoveries following the global financial crisis, though with some underlying differences. In Estonia, real credit is no longer contracting. In Latvia and Lithuania, where credit expansion is yet to resume, measures aimed at reducing the private sector debt overhang—such as improvements in insolvency regimes—could spur credit demand, while reducing credit risk and thus encouraging supply. Over the medium term, the Baltic economies could explore initiatives to deepen capital markets and reduce dependence on bank credit.

The Baltics aspire to move into high-skill, high value-added, exports in rapidly growing markets, but they are competing with other countries in search of the same markets. National policies to improve education and training would help, but collective efforts to improve infrastructure links to the rest of the European Union are also necessary to improve competitiveness.

While labor markets have shown considerable resilience and flexibility, the Baltics appear to be at or near full structural employment but with still high unemployment rates (around 10 percent). This suggests scope for policies to reduce structural employment, including reductions in the labor tax wedge (particularly for lower-wage workers) and emphasis on education, training, and other active labor market policies that have shown cost-effectiveness in the Baltics or their Nordic neighbors.

Approved By
**Mahmood Pradhan and Mark Flanagan**

A staff team visited Riga on March 4, 2014 to hold discussions with the authorities of Estonia, Latvia, and Lithuania as well as observers from Denmark, Finland, Norway, and Sweden. The staff team included T. Dorsey, J. Kozack, M. Pradhan (heads), R. Abdoun, S. Aiyar, B. Augustyniak, G. Everaert, C. Klingen, W. Lian, G. Srour, (all EUR), and A. Diouf (SPR). A. Groenn (OED) joined the discussion. Substantial contributions were also made by C. Ebeke, R. Lama, S. Saksonovs, E. Tereanu, and H. Zhao (all EUR), F. Ohnsorge and S. Zhang (both SPR). N. Geng (EUR) and S. Choi (ICD) also participated in the mission.

## CONTENTS

# INTRODUCTION

1. **This report examines common themes and challenges facing the three Baltic countries—Estonia, Latvia, and Lithuania** (henceforth the Baltics). The aim of the report is to identify common features (including in the Baltics' revealed preference of economic model) and common challenges, and to discuss policies—both national and joint—that could help to address these challenges. The Baltics are good candidates for a discussion of common challenges and policies, given their similar features and economic model, interlinkages (including with the Nordic countries), and shared history. The challenges and policies covered in this report complement and provide background for those discussed during the individual Article IV consultations for each of the three Baltic countries.

2. **The Baltic economies have performed well over the last two decades.** Income convergence with the most advanced economies that follow similar economic models (e.g., the Nordic economies and the "Anglo-Saxons") has been more rapid than in transition economy or emerging market peers.[1] Nevertheless, recent economic performance has not always been smooth.

3. **The global financial crisis exposed vulnerabilities that had built up in the Baltics, but the post-crisis recovery revealed inherent strengths as well**. The Baltics experienced a phenomenal credit boom in the period leading up to the global financial crisis: by 2007, annual credit growth reached an average of 36 percent (and was reflected in surging household and corporate debt), current account deficits soared to 18 percent of GDP, inflation rose to 10 percent, and bank loan to deposit ratios shot up to over 200 percent. However, the Baltics' rapid post-crisis adjustment was supported by decisive policy action and steadfast adherence to their economic model. After very deep recessions in 2009, they began to bounce back and already in 2011 had the fastest GDP growth rates in the European Union (EU). The recovery was export-led, reflecting the improvements in competitiveness achieved after the crisis. Imbalances that had built up during the boom were largely unwound: current account deficits are now near balance, bank loan-to-deposit ratios have fallen considerably, inflation is low, and household and corporate debt have declined.

4. **The Baltics face common challenges, including those posed by (current or prospective) membership in June in the euro area**. Given similarities in their size and economic model, the Baltics also have other shared concerns. The challenges that are the focus of this report relate to their ability to sustain robust economic growth: (i) laying the basis for a

[1] This report and the Selected Issues paper use a largely standard set of comparator countries. The Nordics are Denmark, Finland, Iceland, Norway, and Sweden; the "Anglo-Saxons" are the majority Anglophone OECD countries (Australia, Canada, Ireland, New Zealand, the United Kingdom, and the United States); the CE4 are the Czech Republic, Hungary, Poland, and the Slovak Republic; and DEU/NLD is the average of Germany and the Netherlands. Comparisons with these and other groups are explored further in the first chapter of the Selected Issues paper.

sustainable recovery of credit; (ii) ensuring a vibrant export sector; and (iii) tackling high unemployment. Progress in each of these areas will be essential to cope with idiosyncratic shocks within a currency union, maintain competitiveness, and underpin continued income convergence.

5. **Addressing these common challenges calls for policy action at both the national and regional level**. National policies are necessary to address all of the challenges, but collaboration is important or essential in some areas (e.g., infrastructure, in support of a vibrant export sector).

# THE BALTIC MODEL AND CONVERGENCE

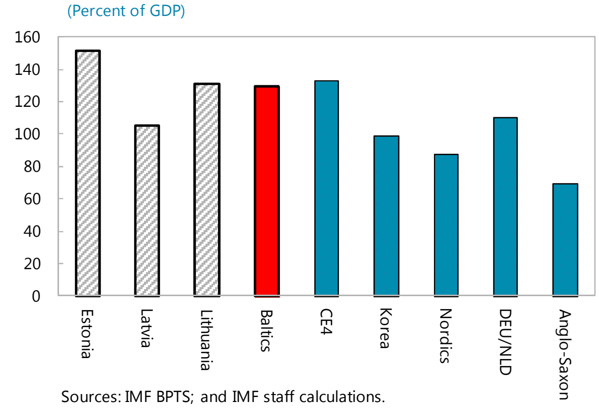
6. **The Baltics form a distinct group within a tightly integrated Nordic-Baltic region**. They are small open economies that have adopted a similar economic model of limited government, generally prudent fiscal policy, a relatively favorable investment climate, and flexible labor markets. However, they differ from the Nordics in part because of the legacy of the Soviet economic structures and the challenges they faced upon independence and transition. As a result, the Baltics have large differences with the Nordics in income, institutions, infrastructure, and other physical capital, notwithstanding the strong links between them.

7. **The Baltics also stand apart from their transition peers**. Both groups came under central planning in the Soviet era. However, countries such as Poland, the Czech Republic, Hungary, and the Slovak Republic had a greater degree of autonomy and more institutional continuity before 1991. The Baltics had a more abrupt transition but also more of a "clean slate."

## A. The Baltic Economic Model: Openness and Flexibility

8. **The Baltics are small, highly open, economies with strong economic links to the Nordic countries and each other**. Their financial sectors are among the most open globally, and their economies are characterized by high levels of FDI and trade. Baltic banking systems are dominated by Nordic-headquartered banks and reliance on parent bank funding is high (but declining fast), suggesting strong financial linkages with the Nordic countries. However, the non-bank financial sector is relatively undeveloped. With respect to trade links, the Nordics and other European countries (including those in emerging Europe) are the Baltics' main trading partners, although there has been some recent re-orientation of exports toward other destinations. The Baltics also trade increasingly with each other, in part as a result of increased EU integration.

**Exports and Imports of Goods and Services, 2005–2012**
(Percent of GDP)




Sources: IMF BPTS; and IMF staff calculations.

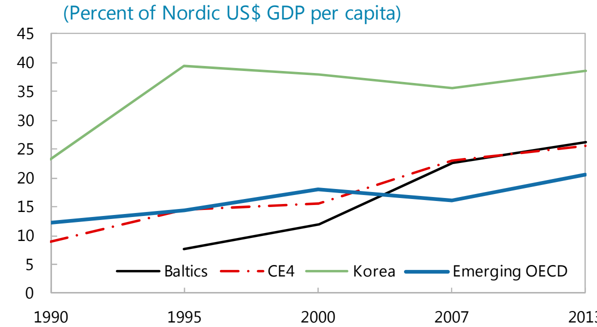
**9. These three economies share a broadly common macroeconomic model (Figure 1)**.

- **Small government**. Government expenditure-to-GDP ratios are low, consistent with light taxation of income, capital, and wealth. But, social security contributions (labor taxes) are relatively high, especially when compared with the incidence of capital and wealth taxation.
- **Prudent public finances**. Fiscal deficits in the Baltics have generally been low (or non-existent), but a major effort was needed to contain them after the crisis. Public debt now stands at around 30 percent of GDP for the region and is well below the average for advanced and emerging economy comparators.
- **Limited monetary policy tools**. Currency board arrangements helped anchor inflation since the early days of transition, supported by flexible labor and product markets. Estonia and Latvia have adopted the euro, and Lithuania is applying to do so in 2015.
- **Relatively favorable investment climate**. The Baltics score well on most business climate indicators, reflecting substantial reforms and general ease of doing business (with the exception of some Transparency International ratings on corruption perceptions). Labor markets tend to be flexible, but more in line with the laissez-faire Anglo-Saxon model rather than the Nordic model ("flexicurity").[2]
- **Moderately high income inequality**. The Baltics' tax and expenditure policy mix entails a moderate degree of redistribution, and this may contribute to higher levels of income inequality (as measured by Gini coefficients) than in the Nordics. However, income inequality—which has remained roughly constant in the Baltics over the past decade—is similar to that in the Anglo-Saxons and lower than that in emerging OECD economies, such as Chile and Mexico.

## B. Income Convergence: Substantial Progress

**10. Income levels are converging toward those of advanced economies**. Whether because of their economic model, the links to the Nordics, membership in the EU, or other factors, the Baltics have made substantial progress in reducing the income gap with advanced economies over the last two decades. In this, they are a counter-example to the "stuck in transition" phenomenon explored in the recent European Bank for Reconstruction and Development (EBRD) Transition Report.[3]

**GDP per Capita**
(Percent of Nordic US$ GDP per capita)



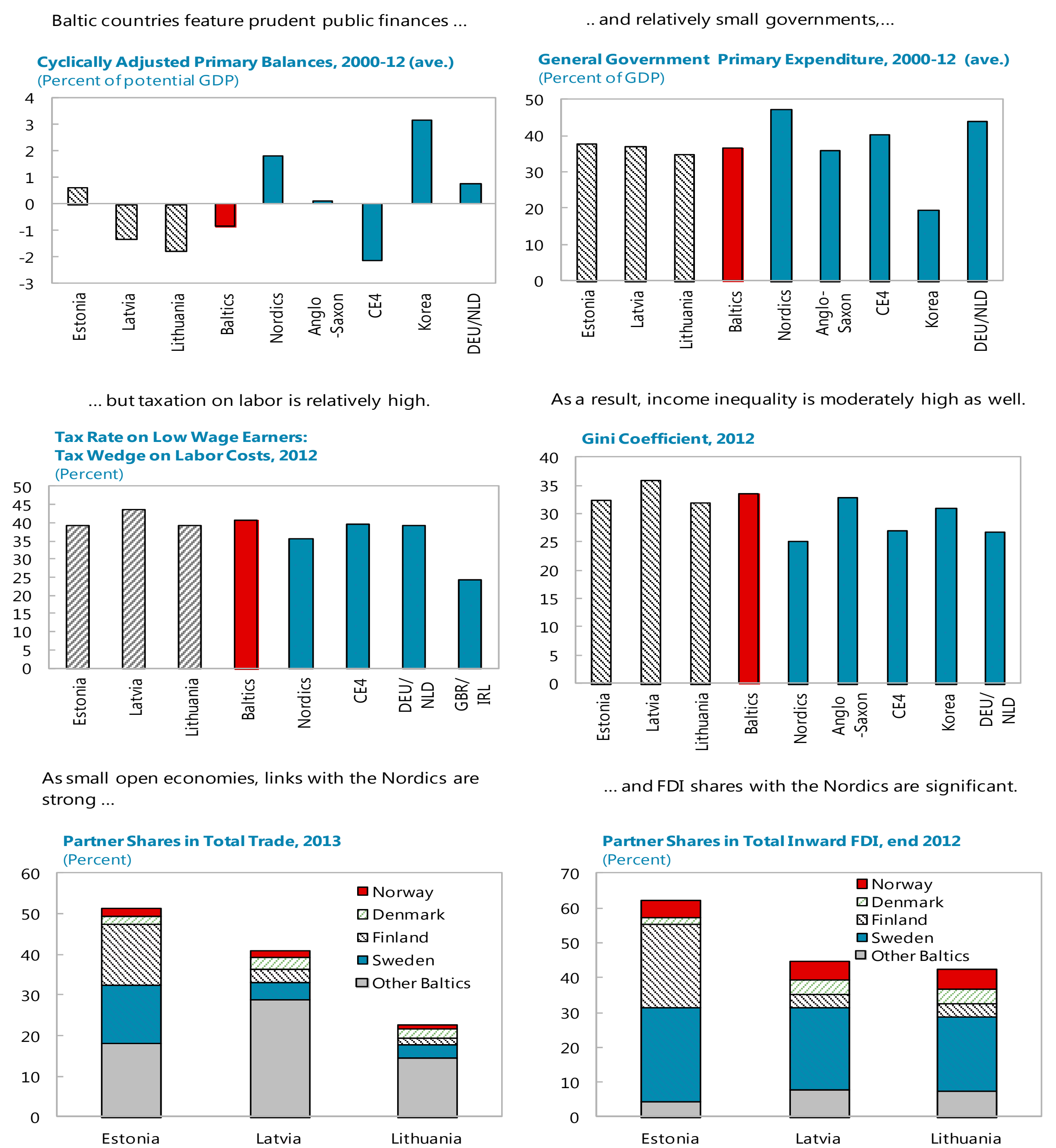

Sources: IMF WEO; and IMF staff calculations.

[2] The Nordic model of "flexicurity" combines generous social welfare policies (supported by high taxes) with very flexible labor and product markets.

[3] European Bank for Reconstruction and Development, 2013 "Transition Report 2013: Stuck in Transition?" London.

Starting from income levels of around ten percent of the Nordic and Anglo-Saxon countries in 1995, the Baltics have tripled their income levels as a share of Nordic and Anglo-Saxon per capita GDP. Moreover, they have even surpassed the income levels of the CE4 and emerging OECD economies, notwithstanding the generally good performance of these peer groups.

## Figure 1. Common Features of the Baltic Countries




Sources: DOTS; WEO; Eurostat; and IMF staff calculations.

# COMMON CHALLENGES

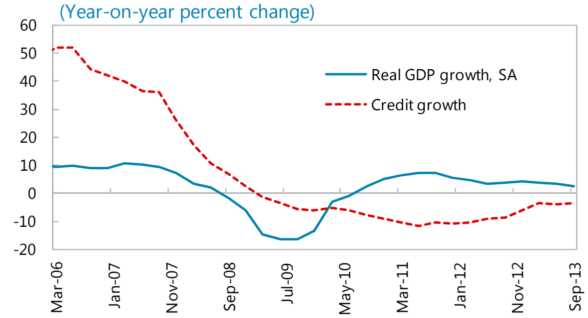
**11. Against this background of resilience and progress, the Baltics face a number of common challenges**. In an overarching way, these challenges relate to the Baltics' ability to sustain their impressive economic recovery going forward, particularly as members of the euro area. The topics chosen for this cluster analysis all fall in this category.

- **Resuscitating credit growth**. Significant progress has been made since the crisis in improving the resilience of the Baltics' financial systems, but they are not yet providing credit to support the ongoing recovery. Credit is still declining in Latvia and Lithuania in spite of the recovery, while it is weak in Estonia—in other words, the Baltics are experiencing a creditless recovery. Reviving credit will be essential to sustain growth and, in the longer term, foster convergence.
- **Securing vibrant export growth**. The Baltic's post-crisis recovery has been characterized by high export growth. Export-to-GDP ratios have grown rapidly in Latvia and Lithuania and have remained very high in Estonia. However, despite this favorable outcome, some aspects of the Baltics' export performance—including a high concentration in labor-intensive goods—raises questions as to how well positioned they are to extend their good export performance.
- **Addressing high unemployment**. Unemployment has remained high in the Baltics even though the labor force has been declining. Staff estimates suggest that much of this unemployment is structural in nature, despite relatively flexible labor markets. At the same time, labor taxation is high and there are substantial skill and education mismatches.

## A. Resuscitating Credit Growth: Turning Around the Creditless Recovery

**12. The Baltic countries have all experienced a creditless recovery (Figure 2)**. The credit-fueled domestic demand boom prior to the crisis ended in severe recessions, a collapse in domestic demand, and a sharp reduction in credit in all three countries. Yet despite the strong economic turnaround and substantial economic rebalancing, four years after the crisis, credit continues to decline, raising concerns that it might curtail the recovery.

**Baltic Countries: Real GDP and Credit Growth**
(Year-on-year percent change)




Sources: Haver; and IFS.

**13. The creditless recoveries in the Baltics largely conform to past cross-country episodes**. The rapid credit expansion and subsequent sharp correction are features that are found to significantly increase the likelihood of a creditless recovery. But, the rebound in credit in the Baltics—especially in Latvia and Lithuania—appears to be lagging behind what would have been expected at this stage of the recovery, based on past observations. In Latvia and Lithuania, real credit continues to contract, while in Estonia, it has ceased to contract but remains very weak. Private debt-to-GDP ratios in all three Baltic countries have declined considerably but remain elevated compared to pre-boom levels. It may be that the Baltics should expect a somewhat longer-than-average period of negative credit growth, owing to their steeper-than-average boom-bust cycle. That said, the empirical record is clear that a creditless recovery cannot be indefinitely prolonged. If past experience is any guide, the Baltics are at or near the stage when credit growth should resume.

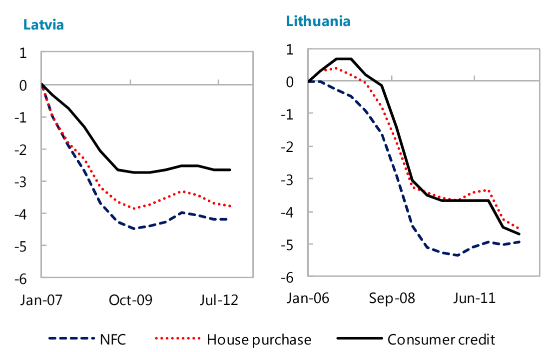
**14. Constraints on both credit demand and credit supply appear to be responsible for the continued contraction in credit**. Staff analysis suggests that constraints on credit demand and credit supply have both played a role in the evolution of credit during the boom, the recession, and the recovery (defined as the three years after the recession). These findings are based on both regression analysis as well as anecdotal evidence collected during Article IV missions.

- **Boom**. During the boom, domestic demand appears to have been a key driver of credit growth. Debt-to-GDP ratios soared as private balance sheets rapidly became more leveraged: non-financial private sector credit peaked at 110 percent of GDP in Estonia and Latvia (from 30 and 40 percent of GDP six years earlier, respectively) and 70 percent of GDP in Lithuania (from 20 percent of GDP six years earlier).

- **Recession**. During the recession, credit supply factors appear to have mattered more. Deteriorating bank asset quality (a credit supply factor) was strongly associated with the contraction of credit during this period. And because asset quality deteriorated by a large amount, the economic impact through this channel was very substantial.

- **Recovery**. During the recovery, domestic demand again played a role in determining credit, although to a lesser extent than during the boom. Supply factors also remained at play. Lending standards—which were tightened considerably during the recession—have not been substantially relaxed during the recovery, at least in Latvia and Lithuania.[4] Non-performing loans (NPLs) have declined substantially but remain high. Discussions with Nordic bank subsidiaries (responsible for the bulk of domestic lending in the Baltics) suggest that, with greater emphasis on credit risk after the crisis, monitoring costs for small and medium enterprises (SMEs) are often regarded as too high,

**Cumulative Changes in Lending Standards**
(Percentage points)



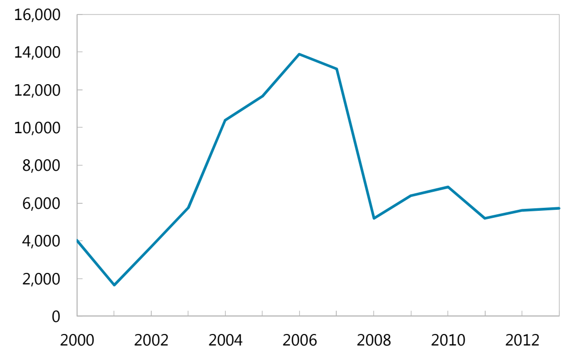

Sources: Survey of banks; Bank of Latvia; and Bank of Lithuania.

[4] Cumulative changes in lending standards (ACLS) are constructed based on financial institutions' responses to the *Survey of Credit Institute Lending* in Latvia and the *Bank Lending Survey* in Lithuania. More negative value of ACLS means a tighter lending standard. For cumulation, it is assumed that the magnitudes of lending standard changes are similar across periods.

effectively rationing many firms from bank credit. In Estonia, however, supply factors are less important: bank balance sheets are healthier—as reflected in much lower NPL ratios—and real credit has stopped contracting.

**15. The non-bank financial sector is not sufficiently developed to provide a significant alternative source of credit at this point**. Like most emerging economies (and many European economies), the financial system in the Baltics is bank dominated. Capital markets are small and mainly comprise government bond markets (with the exception of Estonia, where public debt is modest). Stock market capitalization is low and venture capital financing is embryonic.

**Baltic Stock Markets Capitalization**
(Million of Euros)




Source: OMX Nasdaq Baltic.

**16. That said, the Baltics have made progress in financial integration among themselves and with the Nordics.** Such integration into broader investor pools is important, given the small size of domestic markets. Securities exchanges share a common trading platform with the Nordic exchanges, underpinned by coordinated regulations and supervision. Nonetheless, in the short run, reviving credit will depend on the banking system.

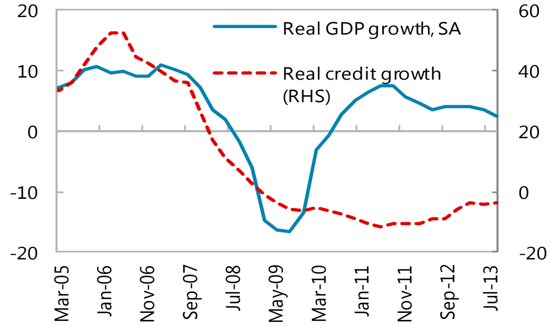
***Authorities' views***

**17. The authorities agreed that low credit growth was an issue facing their countries, but views differed on the underlying causes**. The Estonian delegation saw weak credit growth a result of poor demand for credit, noting weak investment activity, high retained earnings, and weak external demand. They also emphasized that credit in Estonia is growing, in contrast to the other two Baltic countries. The Latvian and Lithuanian authorities felt that credit supply constraints were also an important factor alongside demand factors, and concurred with staff that anecdotal evidence supported this view.

## Figure 2. Creditless Recovery in the Baltics

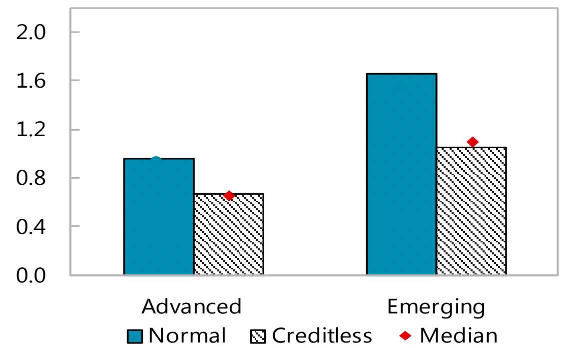
Credit growth remained negative, despite strong GDP recoveries.

**Baltics: Real GDP and Credit Growth**
(YoY, percent )



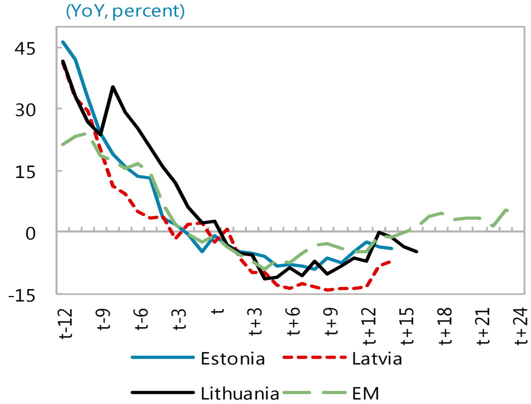

Historically, creditless recoveries have been associated with lower GDP growth, and have affected EMs more than AEs.

**Mean and Median QoQ GDP Growth in Recoveries**



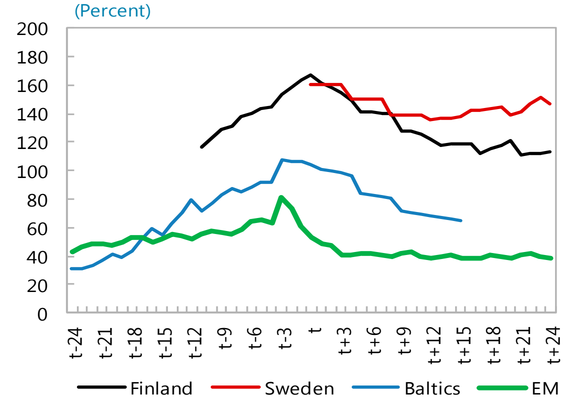

The Baltics experienced slower credit growth than other EMs that experienced creditless recoveries ...

**Baltics and EM: Real Credit Growth**
(YoY, percent)



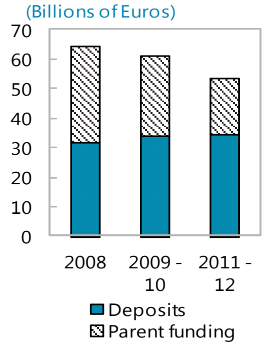

... and the debt overhang has not been fully resolved in the Baltics.

**Baltics: Credit to GDP Ratio**
(Percent)

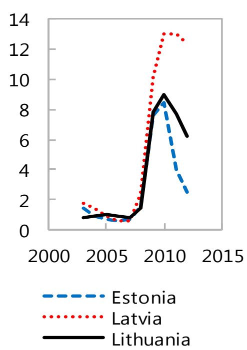



Parent bank funding shrank and asset quality deteriorated, making banks more cautious.

**Liabilities of Monetary and Financial Institutions**
(Billions of Euros)

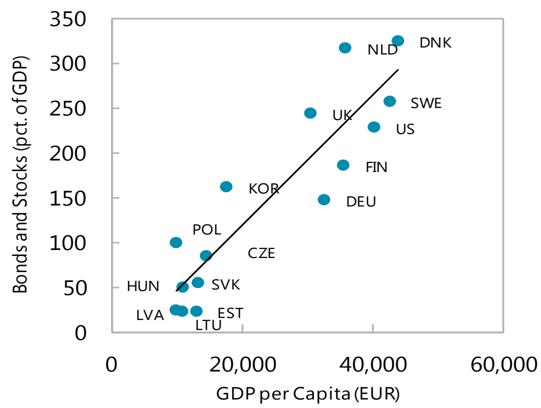



**Loan Loss Reserve to Loan Ratio**
(Percent)




Non-bank financial markets are under-developed in Baltics, in line with their relatively low GDP per capita.

**Non-bank Financial Market Developments**




Sources: WEO; Haver; national authorities; and IMF staff calculations.

## B. Securing a Vibrant Export Sector: Building on Recent Success

**18. Baltic export performance in recent years has been strong (Figure 3)**. Since 2000, Latvian and Lithuanian exporters have increased their world market shares by 100 and 150 percent, respectively, while Estonia, which had already secured a very strong position prior to 2000, managed a 70 percent increase. Market share gains were broad-based for Latvian and Lithuanian exporters, but more confined to the Nordics and the United States in the case of Estonia. Market shares are lower when focusing on the domestic value-added component of exports, but the trend in market share gains is similar to the one for gross exports. Increases in the export-to-GDP ratio, especially in the post-crisis period, were also impressive.

**19. This strong performance rests on price competitiveness, trade reorientation, and strong services exports**.

- **Improved price competitiveness**. A combination of wage restraint and productivity advances in the post-crisis period reduced Baltic unit labor costs by 10 to 20 percent relative to those of western European competitors.[5]
- **Diverse trading partners**. The EU as a whole has been the most important export destination from the mid-1990s. But there has been a steady rise in the importance of trade among the Baltic economies and with Central Eastern and Southeastern Europe. The Nordic countries are consistently important export destinations, above all for Estonia with a share of around 40 percent. The share of the CIS collapsed in the 1990s but made a partial comeback after the Russian crisis in 1999 and remains sizable, especially in Latvia and Lithuania.

**Decomposition of ULC Change 2008-12**
(Percent)

| | Relative to Western Europe | Nominal ULC |
|---|---|---|
| Estonia | | |
| Relative change in ULC | -10.5 | -1.5 |
| Labor compensation | -6.3 | 4.0 |
| Labor productivity 1/ | -4.6 | -5.5 |
| Latvia | | |
| Relative change in ULC | -21.7 | -13.9 |
| Labor compensation | -10.3 | -0.5 |
| Labor productivity 1/ | -14.6 | -15.6 |
| Lithuania | | |
| Relative change in ULC | -14.2 | -5.6 |
| Labor compensation | -3.5 | 7.0 |
| Labor productivity 1/ | -12.4 | -13.4 |
| CE4 | | |
| Relative change in ULC | -8.8 | 0.4 |
| Labor compensation | -6.2 | 4.1 |
| Labor productivity 1/ | -2.8 | -3.7 |
| CESEE | | |
| Relative change in ULC | -5.2 | 4.3 |
| Labor compensation | -6.4 | 3.9 |
| Labor productivity 1/ | 1.2 | 0.4 |

1/ Negative sign indicates negative impact on ULCs and an improvement in labor productivity.
Sources: Eurostat; and IMF staff calculations.

- **Importance of services exports**. In all three countries, external services accounts have always been in surplus, reflecting large exports of transportation services related to Russian imports that are landed in Baltic ports and transported through Baltic territory to their final

[5] For greater detail on the competitiveness improvements in the Baltics, and measures taken to realize these, see individual Article IV reports from 2010, 2011, and 2012, as well as Bakker and Klingen eds., 2012, *How Emerging Europe Came Through the 2008/09 Crisis: An Account by the Staff of the IMF's European Department*.

destination. However, sophisticated and particularly dynamic services exports, such as information and communication technology (ICT) or "other business services," play an important role only in Estonia.

- **Globally dynamic exports**. A fair proportion of Baltic exports is concentrated in globally dynamic product categories, and Baltic exporters managed to gain market share in most of them. During 2008–12, 35–45 percent of Baltic exports comprised products in markets that expanded relatively strongly at the global level. At the same time, however, there is scope to increase the exposure of Baltic exports to globally dynamic product categories.

**20. The Baltics have managed to attract substantial FDI**. Estonia's FDI stock (at about 80 percent of GDP) is roughly twice that of Latvia and Lithuania, but all are still above the global median. Swedish companies are the most important foreign direct investors in all three countries, followed by Finland in the case of Estonia, the Netherlands in the case of Latvia, and Poland in the case of Lithuania. The availability of skilled labor at affordable prices and a favorable business environment seem to be the key attractions of the Baltic economies for FDI investors.

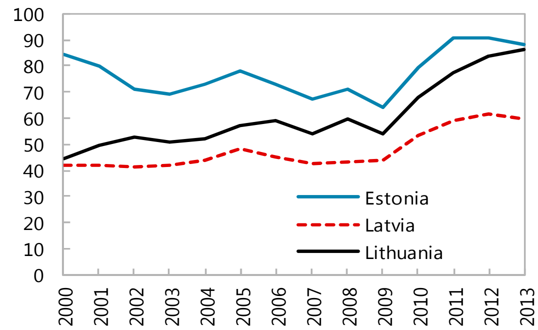
**21. The Baltic economies also achieved a fairly good linkup to global value chains (GVCs)**. According to the GVC participation index, Latvia and Lithuania are linked up as much as the global average, while Estonia has substantially higher participation. Nonetheless, all three Baltic economies are considerably less involved in GVCs than the CE4, whose pivotal role in the German supply chain is well known and documented.[6]

[6] IMF, 2013, "German-Central European Supply Chain—Cluster Report."

## Figure 3. Trade Linkage and Export Performance in the Baltic Countries

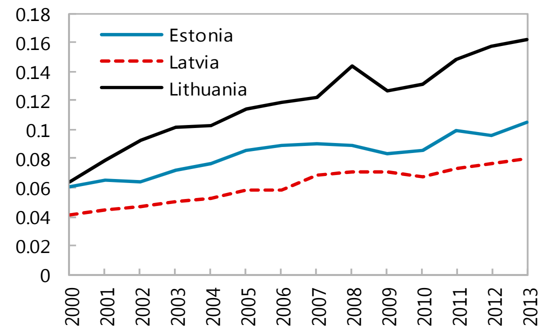
Export performance in the Baltics has been impressive...

**Share of Exports**
(Percent of GDP)



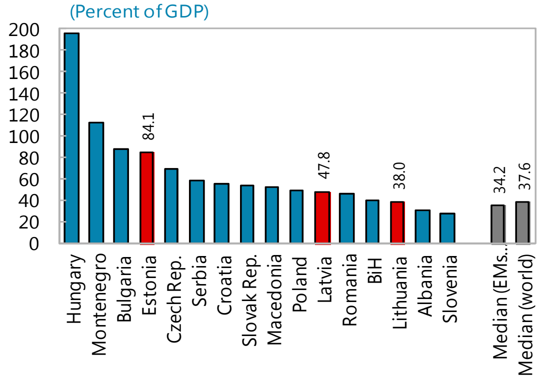

... in the last decade, market shares more than doubled.

**Share of Exports in World Exports**
(Percent)



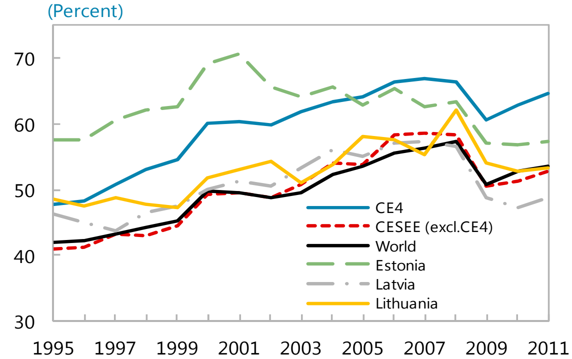

FDI inflows have been relatively strong...

**Foreign Direct Investment, 2012**
(Percent of GDP)



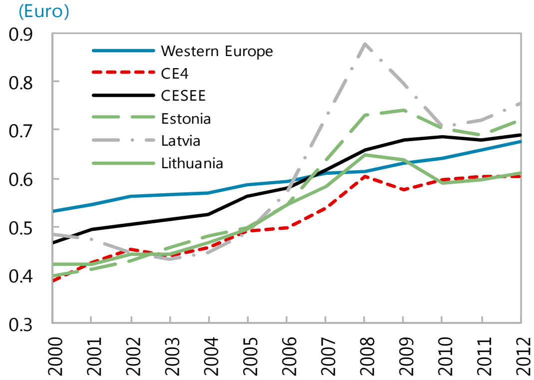

... allowing the Baltic countries to achieve a fairly good integration in Global Value Chains.

**Global Value Chain Participation 1/**
(Percent)



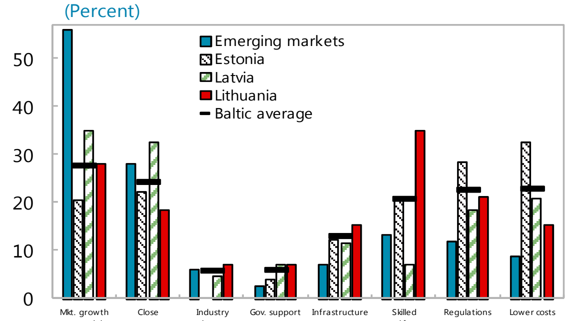

To secure a vibrant export sector, the Baltic countries will need to maintain competitiveness...

**Nominal Unit Labor Cost in the Baltic Countries, 2000-12**
(Euro)




... and remove impediments to FDI and investment.

**Baltic Countries: FDI Projects' Most Frequent Motives and Determinants, 2003-13**
(Percent)




1/ Foreign value added of exports plus domestic value added of exports that are used as inputs for exports in country of primary destination. Both are expressed as shares of exports.
Sources: WEO; WIOT; Consolidated Direct Investment Survey, IMF; FDI Markets; Eurostat; and IMF staff calculations.

**22. However, the Baltics may face challenges related to their export performance**. Despite their past good performance, future success of the Baltic export sectors should not be taken for granted. Export volume growth has come down sharply from the double-digit rates achieved in the early years of the post-crisis recovery phase. The Baltic economies have also been less successful in attracting FDI in recent years—their share of global FDI declined from about 0.4 percent during 2005–07 to about 0.2 percent during 2010–12. In any event, continued success of the Baltic export sectors will hinge on their ability to adapt to a fast-changing global economy.

- **Quality of exports**. The bulk of the quality catch-up for the product mix that the Baltics export seems to have already taken place to the extent that quality can be measured by relative prices. After strong improvements from the mid-1990s to the mid-2000s, the estimated quality of Baltic export goods has broadly evolved in line with global trends, but has not improved faster than in global market generally. With the bulk of the estimated quality catch-up of the existing product mix already accomplished, the ability to fetch higher prices in global markets going forward will depend on the capacity of Baltic exporters to shift to new products and enhance non-price competitiveness.

- **Labor-intensive exports**. The sophistication of Baltic exports has increased over time, but their revealed comparative advantage remains in labor intensive goods and services, although Estonia has carved out a small advantage in knowledge intensive services in recent years. Major Baltic exports with high revealed comparative advantage are wood, food products, animals and vegetables, as well as fuels in the case of Lithuania, reflecting to a large extent the countries' resource endowments. Classifying exports according to their technology intensity confirms that high and medium-to-high technology goods account for a relatively low share of Baltic exports compared to the CE4 countries and the euro area as a whole (this latter asymmetry could put pressure on the Baltics' labor intensive production model over time).

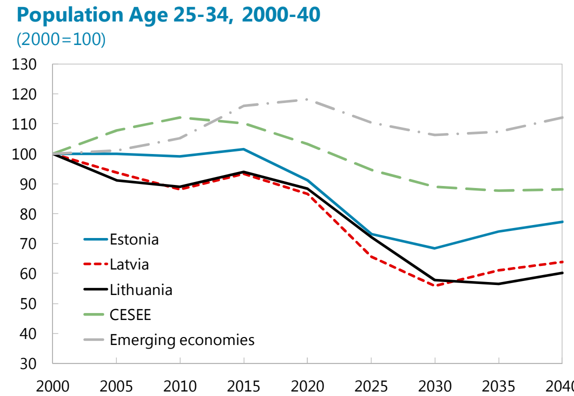
**Baltic Countries: Revealed Comparative Advantage by Industry Groups**
(In terms of DVA exports, 2007-09 average)

| | Estonia | Latvia | Lithuania |
|---|---|---|---|
| Agriculture and mining | 0.30 | 0.39 | 0.31 |
| Labor-intensive manufacturing | 2.58 | 1.89 | 1.73 |
| Capital-intensive manufacturing | 1.07 | 0.72 | 1.09 |
| Knowledge-intensive manufacturing | 0.56 | 0.30 | 0.37 |
| Labor-intensive service | 2.17 | 5.07 | 3.99 |
| Capital-intensive service | 1.51 | 2.24 | 2.82 |
| Knowledge-intensive service | 1.07 | 0.54 | 0.26 |
| Public service | 0.79 | 1.51 | 0.68 |

Sources: WIOT; and IMF staff calculations.

- **Lower trading partner growth**. Fast growing imports of trading partners facilitated the expansion of Baltic exports in the past. However, according to the latest World Economic Outlook (WEO) projections, trading partner import growth for all three Baltic economies is projected to decline substantially and fall below global trade growth—a sharp contrast with the past decade when it enjoyed a premium.

- **Adverse demographic trends**. Demographic aging represents a key challenge for Baltic export sectors, including their ability to attract FDI. Birth rates in all Baltic countries collapsed some 25 years ago in early transition—and have yet to recover decisively. The associated drain on labor supply is a particular challenge when the export sectors are specialized in the provision of labor-intensive goods and services. It will also make it more difficult to attract foreign investors who have traditionally flocked to the Baltic region because of the availability of affordable and skilled labor.



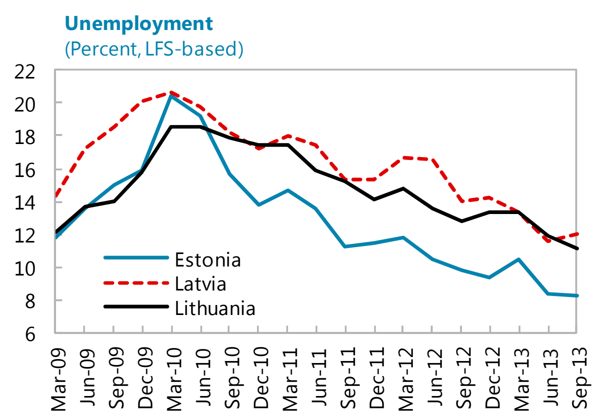
Sources: UN Population Division; and IMF staff calculations.

***Authorities' views***

**23. The authorities agreed that future export success cannot be taken for granted, but felt confident that they would be able to meet the challenge.** Demographic aging and potentially lower trading partner growth were serious issues, but they saw room to further benefit from the ongoing upgrading of the quality of the export product mix and noted that the flexible nature of the export structure would help to smooth the adjustment to external strains. They also saw that, with income convergence advancing, the shift away from labor-intensive products would continue to evolve naturally. While acknowledging that their economies were not as involved in GVCs as the CE4, they noted that their export success was based on small, nimble firms, operating in niche markets, which could be an alternative successful strategy. They stressed that exports had become significantly more sophisticated and diversified over time.

## C. Addressing High Unemployment: Achieving the Full Potential of the Labor Force

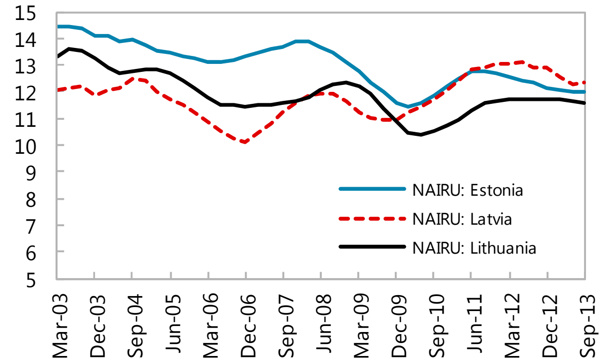
**24. Unemployment remains persistently high in the Baltics and represents a key challenge**. While it has fallen significantly from its post-crisis peak, it remains in the 8–12 percent range. It is particularly high for youth, and about half the unemployed have been out of a job for more than one year. Thus, reducing high unemployment is a key challenge for the Baltics.



Source: Eurostat.

**25. Staff analysis suggests that high unemployment is likely structural in nature**. Using regression techniques, staff estimates that the NAIRU (the level of structural unemployment) in the Baltics is high, stable, and close to the current level of unemployment. For Lithuania and Latvia, the time-varying point estimate ranges between 10 and 13¾ percent, while for Estonia it ranges between 11½ and 16½ percent. Current levels of unemployment are close to the estimated NAIRU (in 2013) for Latvia and Lithuania and somewhat below the estimated NAIRU (in 2013) for Estonia. This implies that with output growing at potential, unemployment would not drop significantly without rising wage and inflationary pressures.

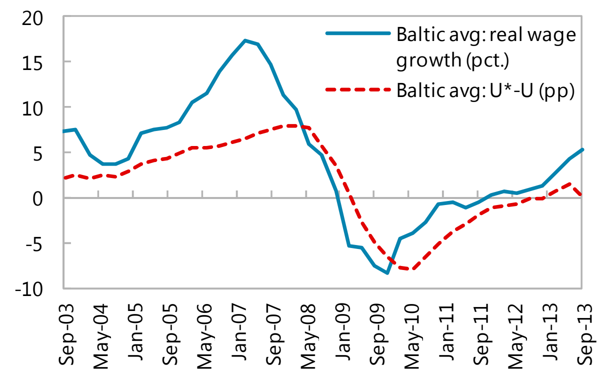
**Structural Unemployment in the Baltics**
(Estimates from State-Space Model, in percent)




Sources: National authorities; and IMF staff calculations.

**26. This finding is supported by a number of robustness checks**. First, staff estimates of the NAIRU are not out of line with the historical average of unemployment. Second, real wage behavior around staff's NAIRU estimates suggests that real wage growth accelerates when unemployment falls below the NAIRU, as theory predicts. Third, staff analysis suggests that the Beveridge curve and the Okun's Law coefficient (beta) have remain ed stable over time, suggesting that structural unemployment has also been stable. Finally, staff's estimates of the NAIRU are broadly in line with estimates of other international organizations.

**Real Earnings Growth and Deviation from NAIRU**



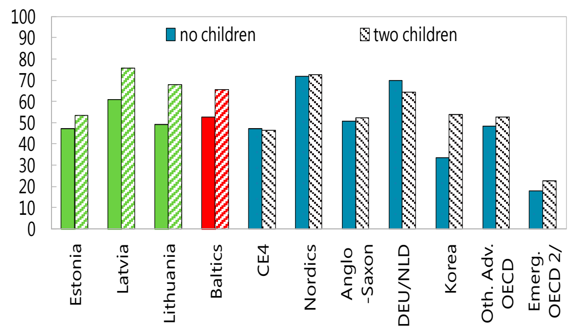

Sources: National authorities; and IMF staff calculations.

**27. Labor markets appear flexible**. Minimum wages do not appear excessive: expressed as a share of the mean wage, they are below or close to the average found in the OECD. Unemployment benefits are much less generous than in OECD countries on average, providing strong monetary incentives for the unemployed to seek work. Employment protection is also in line with the OECD average. This suggests that labor market impediments are not likely to be a cause of structural unemployment.

**28. High labor tax wedges could contribute to high structural unemployment**. Economic theory suggests that high tax rates on labor income depress labor supply and employment, and expand the shadow economy. Specifically, the tax wedge—a measure of the difference between labor costs to the employer and the net take-home pay of the employee—should be one of the main determinants of the level of structural unemployment. Reductions in the tax wedge are found to be associated with declines in structural unemployment in both cross-country and event studies.

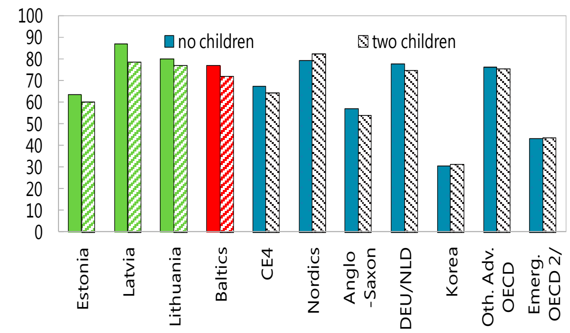
**29. Unemployment and inactivity traps may also contribute to high structural unemployment**. High taxes on labor, when combined with the loss of certain social and/or unemployment benefits upon finding employment, also decrease the attractiveness of participating in the labor market, especially for lower-wage earners. This effect—known as the unemployment and inactivity trap—is generally higher in the Baltics than in the CE4, the Anglo-Saxons, and other emerging OECD countries.

**Inactivity Trap (wage earners at 50% of average wage) 1/**
(Percent)




1/ Participation tax rate for transition into full-time work for persons without entitlement to unemployment insurance but entitled to social assistance. It measures how much the gain from working is reduced (or taxed away) after taking into account the loss of net income from higher labor taxes and reduced benefits.
2/ excl. Mexico.
Source: OECD.

**Unemployment Trap (wage earners at 50% of average wage) 1/**
(Percent)




1/ Participation tax rates for a transition into full-time work for persons receiving unemployment benefits at the initial level. It measures how much the gain from working is reduced (or taxed away) after taking into account the loss of net income from higher labor taxes and reduced benefits.
2/ excl. Mexico.
Source: OECD.

**30. Skill mismatches appear important amid mixed education outcomes**. Despite relatively strong participation in education, mismatches exist both in terms of the degree of educational attainment needed within a profession/sector and in terms of training in the right profession or sector. All three Baltics score worse than average with respect to skill mismatch. Skill mismatches and educational attainment also interplay with regional divides. For example in the case of Lithuania, rural unemployment—which is much higher than urban unemployment—is concentrated in workers with below-tertiary education.

**31. Training and active labor market policies to address mismatches are not widespread**. Spending on active labor market policies (ALMPs) amounted to 0.5 percent of GDP in the Baltics, compared with over 2 percent in the Nordics. Of this, only 0.1 percent of GDP was spent on training in the Baltics—less than half that in the Nordics. Moreover, "passive" forms of labor market support, including out-of-work income benefits and (in the case of Latvia and Lithuania) early retirement, account for a significant share of total ALMP spending in the Baltics. Low spending does not appear to be the result of high efficiency of ALMPs, but rather reflects very low participation in these programs. Longer-term averages of unemployment (especially for youth) seem to show a negative correlation with spending on ALMPs, indicating their potential in addressing skill mismatches.

***Authorities' views***

**32. The authorities agreed that structural unemployment was high, although views differed on the precise level.** The Latvian and Lithuanian authorities agreed that current levels of unemployment mostly reflected structural factors, while the Estonian authorities felt that the NAIRU was probably somewhat below staff's estimates. Still, they agreed with staff that structural unemployment is likely high. The authorities from all three countries felt that skill and education mismatches were important contributing factors, and that the tax wedge could be an issue, especially for lower-income earners. The Estonian and Latvian authorities felt that skill mismatch was a key cause of high structural unemployment in their country, and emphasized the role played by the opening of the EU common labor market and the impact this has had on labor markets and migration.

# POLICY AGENDA

**33. The Baltics have made significant progress since independence in transforming their economies**. This progress is a testament of their willingness to undertake deep reforms. The post-crisis policy response has led to a number of other reforms, including to fiscal and macroprudential frameworks. Structural reforms have also continued. Against this background of progress and relative success, new policies will need to be adopted to cope with the challenges posed by a rapidly changing global economy, euro area membership, and demographic trends.

**34. Staff and the authorities agreed that addressing the common challenges identified in the cluster work will require policy action**. National policies should address these issues, but joint action and policy coordination could help all three countries move forward.

## A. National Policies to Address Challenges

**35. Policy action at the national level will be essential to address the challenges facing the Baltics**. Although the three countries face common challenges, individual country circumstances suggest that policy action is needed first and foremost at the national level. This will allow the Baltics to design policies that best fit their unique circumstances, taking into account legal, tax, and other specificities. At the same time, necessary policies fall into broad categories for all three countries and are elaborated below.

**36. To help resuscitate credit growth, national policies should aim to address factors affecting both credit demand and credit supply**. Measures to support balance sheet repair could help induce higher credit demand (by further reducing the private debt overhang) and boost credit supply (through improved perceptions of credit risk). Debt ratios remain well above their pre-boom levels, despite substantial deleveraging since the crisis. All three countries have made progress in strengthening their insolvency frameworks, which is important to help them manage idiosyncratic shocks within a currency union. Restructuring and resolution of household and corporate debt could nonetheless be facilitated through further improvements in the administration of the insolvency regimes. This could include fast-tracking the legal system to clear cases, improving implementation of existing procedures where necessary, and exploring arbitration procedures to reduce the caseload on regular courts. Latvia, for example, has recently created more courts to reduce the backlog of legal cases, and allowed cases to be shifted from overburdened courts to other jurisdictions. Insolvency procedures could be further speeded up by encouraging alternatives to the formal legal system, such as mediation or arbitration. At the same time, it is important to recognize that, beyond addressing informational barriers to SME lending, the Baltics may have few direct levers to improve credit supply, given the large presence of foreign banks.

**37. Policy action can help the Baltics secure a vibrant export sector, including by strengthening the attractiveness of FDI and linking up with global supply chains**.

- **Maintaining competitiveness**. The improvement in competitiveness that occurred post-crisis will need to be maintained going forward. This implies that productivity gains will need to continue and that wage growth will need to be aligned with productivity growth, especially given the Baltics' lack of exchange rate flexibility. Infrastructure investments (see below) will help improve the productivity of existing firms, but a broader and sustained increase will require expansion by productive firms, and entry into new markets involving higher skills. The investment to support this will in turn need to be supported by credit expansion. Other potential barriers to entry—including in product and services markets—may also be present: this is an area that could be explored going forward.
- **Integrating into global supply chains and attracting FDI**. The Baltic countries ranked among the best on the World Bank 2014 Doing Business indicators, outperforming most of their EU peers. However, the IMD World Competitiveness Report paints a less favorable picture as the region's competitiveness is dragged down by limitations in the R&D environment (except for Estonia) and inefficiencies in the legal environment and public services. Similarly, while the Baltics score above average overall in the WEF's Global Enabling Trade Report (2012), there are areas for improvement: shortcomings in services and infrastructure seem to stand in the way of transshipment connectivity, hiring of foreign labor appears to be difficult, and trade financing is reportedly not easy to come by. Many of the policy recommendations to upgrade skills will also help the Baltic countries remain an attractive destination for FDI—offering an additional source of finance for investment and providing a basis for further integration into global value chains (with the knowledge transfer that this could entail).

**38. The Baltic economies will need to adopt more effective employment policies to reduce structural unemployment**. Such policies will help them address adverse demographic labor force trends, and raise productivity and competitiveness.

- **Reconsidering labor taxation**. Cross-country experience suggests that reductions in the tax wedge can be associated with declines in structural unemployment. At the same time, revenue to GDP ratios in the Baltic countries are already low, suggesting that reductions in labor taxation need to be carefully considered and offset with other sources of revenue.

Options include increasing taxation on capital and wealth, base broadening, and improvements in revenue administration. In all cases, changes to the tax system would need to be complemented with improvements in revenue administration to maintain revenue, and adjustments in tax rates could be considered in a coordinated manner across countries.

- **Improving education outcomes**. Policies could include better coordination between universities and employers and improvements in the quality of secondary education relative to peer countries, particularly in Latvia and Lithuania. Given their small size, the Baltic countries may, over time, need to exceed educational outcomes in other countries to continue to attract FDI and other investment.

- **Increasing spending and participation in ALMPs**. There is ample scope to utilize ALMPs to help reduce skill mismatches, especially among the unemployed. Given the Baltics' tight links with the Nordics, and the Nordics' effective use of ALMPs, a policy dialogue which seeks to draw lessons from the Nordic experience could help inform policy choices. Available EU funds could support stronger ALMPs.

- **Reviewing disincentives for work in the benefits systems**. While a more thorough analysis is needed, there may be problems with "benefits traps" in which the structure of benefits and taxes discourages moving from unemployment to work that merit further investigation. With respect to rural unemployment, tax incentives for those engaged in agricultural activity and employment in the informal economy in rural areas may be behind the high number of rural unemployed, at least in Lithuania. Policies to address these issues combined with ALMPs could help reduce unemployment.

***Authorities' Views***

**39. The authorities agreed with the recommendations on national policies but raised some countervailing concerns and qualifications to the recommendations.** On credit growth, they agreed that there were few direct levers to influence credit supply by mainly Nordic banks. The Latvian and Lithuanian authorities sought more detailed advice on policy measures to ease credit supply bottlenecks, especially against the background that different national insolvency regimes have not resulted in notable differences in credit dynamics, suggesting that additional measures might be needed to achieve results. On trade and FDI, the authorities noted that they are taking action to improve infrastructure links and the R&D environment. On unemployment, the authorities acknowledged that labor taxes are high. Shifting the tax burden from labor toward consumption is the strategy of the Estonian authorities, and the Latvian and Lithuanian authorities are also working in this direction. They also stressed that not only the quantity, but also the quality of ALMPs needs to be taken into consideration. The Latvian authorities emphasized that increasing vocational training has a role to play in addressing high structural unemployment.

## B. Joint Action Can Further Boost Resilience

**40. Although much of the work to address the Baltic countries' common challenges must take place at the national level, joint action can bring benefits in some areas.** Given the small size of the Baltic economies and their similarities across several dimensions, there is scope for further integration, harmonization, and collaboration to achieve economies of scale.

- **Developing the non-bank financial sector**. The regional integration that has taken place over the last few years should facilitate cross-border investment and enhance firms' ability to raise capital and lower financing costs. Additional financial sector integration—including through further harmonizing regulatory requirements (accounting, tax, etc.)—would support the existing initiatives. However, these efforts are likely to benefit mainly large and well-established firms. Other measures—including alternative exchanges with less stringent reporting requirements, regional ratings agencies, and securitization—could be explored to improve funding for SMEs. Over the medium term, regional working groups could be established to explore ways to strengthen the alternative exchange market First North, develop regional rating agencies, establish a credit guarantee system, and introduce securitization tools, together with fostering institutional investors in the region to efficiently use the region's savings. At the same time, it will be essential to ensure that supervision of the non-bank financial sector is bolstered to safeguard financial stability.

- **Upgrading the energy sector**. Energy prices are an important cost factor for exports. The Baltic energy sectors remain highly dependent on Russia as their dominant supplier, which also limits the scope for unleashing the full forces of competition in the energy sector. Currently, the Baltic countries face among the highest energy costs in Europe (when adjusted for purchasing power), which weighs on investment and competitiveness. Lithuania has done the most to secure alternative energy options in both electricity and gas, and Estonia has built large-capacity electricity connections to Finland, but all countries could do more, and there are economies of scale from joint projects. Policy makers in the Baltics have rightly made a priority to build the infrastructure that secures access to a variety of energy sources and lift energy efficiency over time.

- **Investing in infrastructure**. Given the strong trade links between the Baltic countries, steps toward developing a common, modern, infrastructure would reduce transport costs, improve transshipment connectivity, and advance integration, particularly with Central and Western European countries. Joint action can also help overcome cost issues that often face small economies.

- **Harmonizing rules and practices**. This could include harmonizing disclosure and accounting rules for firms, procedures and requirements for acquiring licenses to operate businesses, rules for recognizing foreign degrees and qualifications, and procedures for hiring non-EU workers. These steps could add to the Baltics' attractiveness as an FDI destination. It could also contribute to investors starting to perceive the region as a larger, economically-integrated entity where they can count on similar standards to apply.

- **Coordinating labor market policies**. To the extent that the Baltic authorities agree on the desirability of re-orienting taxes away from labor and toward other revenue sources, there could be good economic and political reasons to do so in a coordinated way to avoid the reality or perception of creating an uneven playing field among the three countries.
- **Enhancing the policy dialogue**. Policy fora on key issues, such as tackling high unemployment, could provide a venue for Baltic policymakers to draw on and learn from each other's experiences. These fora could be expanded to include their Nordic partners in areas where there is a long tradition of relative success, such as in education and training policies.

***Authorities' Views***

**41. The Baltic authorities broadly agreed on the merits of coordinated policy-making among themselves and within the Nordic-Baltic region.** They noted that such coordination and consultation is extensive and works well. On harmonizing rules and practices, they noted that the EU directives had already gone a very long way toward this goal. For labor market taxation, they acknowledged the merits of coordinated action should decisions be taken to lower labor taxation, but they were not fully convinced that the benefits of such tax reductions offset their drawbacks. With regard to energy and other infrastructure (notably improving links between each other and with the EU), the authorities noted that a lot has already been done or is at an advanced stage, but they agreed that more work would be needed to agree on common approaches in some areas such has rail links.

# STAFF APPRAISAL

**42. The Baltic economies have performed well in the last two decades, both relative to other transition economies and emerging markets globally.** While they have not articulated a "Baltic Model" along the lines of the Nordic Model of their neighbors, their economic policies share common features, and their economic performance has common strengths.

**43. The Baltics' performance has been associated with mostly orthodox economic policies.** These have included prudent fiscal policies, low inflation in the context of exchange rate-based stabilizations, and free-market approaches to economic regulation similar to those of the Nordic but also the Anglo-Saxon countries.

**44. Nevertheless, the Baltic economies face some common challenges, and there are both national and regional policy responses that seem appropriate.**

**45. The Baltic recoveries have been characterized by robust growth amid contracting credit.** Going forward, continued anemic credit could constrain investment and forestall further growth. In Latvia and Lithuania, efforts to reduce the private sector debt overhang by improving the insolvency regime could spur both the demand for and supply of bank credit. Estonia experienced a much lower increase in NPLs and a more rapid decrease to more normal levels, and real credit has ceased to contract. Over the medium-term, the Baltic countries could explore several promising initiatives to deepen non-bank sources of finance.

**46. The Baltics have done well in upgrading product quality and expanding export markets shares in the last two decades.** However, the gains from product upgrading in the transition from central planning have largely been realized, and all three countries face new headwinds in the form of adverse demographic trends and likely slower growth in trading partners. While the Baltic countries perform well on various indices of competitiveness and business environment, further efforts are needed to maintain export growth. Collective efforts are however necessary to improve infrastructure and infrastructure links to the rest of the European Union, particularly for energy and rail infrastructure.

**47. Finally, labor markets in the Baltics have performed well, showing considerable resilience and flexibility during the crisis.** Wage flexibility undoubtedly cushioned the impact of the very severe recessions on employment and helped speed the recovery. Nevertheless, the Baltics appear to be at or near full structural employment even though unemployment rates are just above or just below 10 percent. In this context, there would seem to be scope for structural policies to reduce structural employment. Two possible areas for improvement stand out: labor taxation and active labor market policies. Labor tax wedges are high in the Baltics, particularly for low-wage workers, and reductions should be considered in the context of fiscally-neutral tax reforms. Also, while there have been recent increases in spending on active labor market policies, there appears to be considerable scope to reduce skills mismatches and improve productivity through training and education.

## Table 1. Estonia: Selected Macroeconomic and Social Indicators, 2008–14

Population (2013): 1.33 Million
Life expectancy at birth (2012): 81.1 (female) and 71.2 (male)
Main products and exports: Machinery and appliances, wood, and furniture and metals

Per capita GDP (current US$, 2013): US$18,451
Per capita GDP (PPP, 2012): US$23,631
Literacy rate (2011): 100
Key export markets: Finland, Sweden

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 Est. | 2014 Proj. |
|---|---|---|---|---|---|---|---|
| **Output** | | | | | | | |
| GDP (billions of Euro) | 16.2 | 14.0 | 14.4 | 16.2 | 17.4 | 18.4 | 19.6 |
| Real GDP growth (year-on-year in percent) | -4.2 | -14.1 | 2.6 | 9.6 | 3.9 | 0.8 | 2.4 |
| Output gap (percent of potential GDP) | 6.3 | -9.1 | -8.5 | -1.8 | -0.6 | -1.8 | -1.2 |
| **Saving-investment balances (percent of GDP)** | | | | | | | |
| National saving | 21.2 | 21.9 | 22.3 | 25.9 | 25.3 | 25.4 | 24.8 |
| Domestic investment | 30.0 | 18.7 | 19.7 | 26.8 | 28.2 | 26.9 | 27.2 |
| Foreign saving | 8.7 | -3.1 | -2.5 | 0.9 | 2.9 | 1.5 | 2.4 |
| **Employment (annual percent change, unless otherwise indicated)** | | | | | | | |
| Unemployment rate (annual average, in percent of labor force) | 5.5 | 13.5 | 16.7 | 12.3 | 10.0 | 8.6 | 8.5 |
| Real average monthly gross earning | 1.1 | -3.6 | -7.2 | -0.6 | 2.6 | 4.0 | 2.7 |
| Labor productivity (real GDP at factor cost per worker) | -3.9 | -5.1 | 7.2 | 3.2 | 2.0 | -0.2 | 2.3 |
| **Prices** | | | | | | | |
| HICP, end of period | 7.5 | -1.9 | 5.4 | 4.1 | 3.6 | 3.2 | 2.8 |
| HICP, period average | 10.6 | 0.2 | 2.7 | 5.1 | 4.2 | 3.5 | 3.2 |
| **General government (percent of GDP)** | | | | | | | |
| Revenue | 36.7 | 42.8 | 40.7 | 38.8 | 39.2 | 38.1 | 38.0 |
| Expenditure | 39.7 | 44.8 | 40.6 | 37.6 | 39.5 | 38.3 | 38.4 |
| Fiscal balance | -2.9 | -2.0 | 0.2 | 1.2 | -0.2 | -0.2 | -0.4 |
| Gross debt | 4.5 | 7.1 | 6.7 | 6.1 | 9.8 | 10.0 | 10.2 |
| **Money and credit (year-on-year growth in percent)** | | | | | | | |
| Broad money (end of period) 1/ | 3.2 | -0.3 | 2.8 | 30.9 | 5.7 | 6.3 | ... |
| Domestic credit to nongovernment 2/ | 6.6 | -5.0 | -5.2 | -3.3 | 0.0 | 4.8 | ... |
| **Balance of Payments (in percent of GDP, unless otherwise specified)** | | | | | | | |
| Current account | -9.2 | 2.7 | 2.8 | 1.8 | -1.8 | -1.0 | -1.3 |
| Trade balance for goods | -12.6 | -5.0 | -1.9 | -2.0 | -4.5 | -4.7 | -4.3 |
| Exports of goods and services (volume change, in percent) | 1.0 | -21.3 | 23.7 | 23.4 | 5.6 | 2.2 | 4.4 |
| Imports of goods and services (volume change, in percent) | -7.0 | -31.1 | 21.1 | 28.4 | 9.0 | 2.5 | 6.0 |
| Gross external debt/GDP (percent) | 117.5 | 123.5 | 114.9 | 94.5 | 96.1 | 87.9 | 83.4 |
| **Exchange rates** | | | | | | | |
| Exchange rate (EEK/US$; euro/US$ - period averages) 3/ | 10.7 | 11.3 | 11.8 | 1.39 | 1.28 | 1.33 | ... |
| Real effective exchange rate (annual changes in percent) | 6.8 | 1.1 | -1.9 | 1.3 | -0.5 | 2.7 | ... |

Sources: Estonian authorities; World Bank; Eurostat; and IMF staff estimates and projections.
1/ Beginning in 2011, data are for contributions to euro area M2 aggregate.
2/ Domestic credit to nongovernment euro area resident sectors beginning in 2011.
3/ The Estonian kroon was pegged at 15.6466 kroons to the euro. Estonia adopted the euro on January 1, 2011.

## Table 2. Latvia: Selected Economic Indicators, 2008–14

Population (2013): 2.035 million
Life expectancy at birth (2012): 78.90 years (women), 68.90 years (men)
Main products and exports: Wood and articles of wood; food and agricultural products, metals and articles of base metal; machinery and mechanical appliances.

Per capita GDP (current US$, 2012): US$13,900
Per capita GDP (PPP, 2012): €18,058
Literacy rate (2011): 99.8 %
Key export markets: Lithuania, Russia, Estonia, Germany, and Sweden

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| | | | | | | Est | Proj |
| **Output** | | | | | | | |
| GDP (in billions of euros) | 22.7 | 18.6 | 18.2 | 20.5 | 22.1 | 23.3 | 24.5 |
| Real GDP growth (annual percent change) | -2.8 | -17.7 | -1.3 | 5.3 | 5.2 | 4.1 | 3.8 |
| Output gap (percent of potential GDP) | 3.5 | -13.5 | -12.2 | -5.9 | -2.4 | -0.7 | -0.2 |
| **Saving-investment balance (in percent of GDP)** | | | | | | | |
| Gross national saving | 18.0 | 29.2 | 22.7 | 22.7 | 23.0 | 22.0 | 21.5 |
| Gross national investment | 31.2 | 20.5 | 19.8 | 24.9 | 25.5 | 22.9 | 23.1 |
| Foreign net savings | 13.2 | -8.7 | -2.9 | 2.1 | 2.5 | 0.8 | 1.6 |
| **Employment (annual percent change, unless otherwise indicated)** | | | | | | | |
| Unemployment rate (annual average, in percent of labor force) | 7.7 | 17.5 | 18.7 | 16.2 | 15.0 | 11.9 | 10.7 |
| Real average monthly gross earnings | 4.4 | -6.8 | -2.3 | 0.0 | 1.3 | 4.3 | 2.9 |
| Labor productivity | -2.1 | -4.8 | 4.8 | 3.1 | 3.5 | 2.0 | 2.6 |
| **Prices (annual percent change)** | | | | | | | |
| CPI, end of period | 10.4 | -1.4 | 2.4 | 3.9 | 1.6 | -0.3 | 2.4 |
| CPI, period average | 15.3 | 3.3 | -1.2 | 4.2 | 2.3 | 0.0 | 1.5 |
| **General government finances (percent of GDP)** | | | | | | | |
| Revenue | 35.6 | 36.2 | 36.0 | 35.6 | 37.0 | 35.9 | 35.3 |
| Expenditure | 39.0 | 43.3 | 42.4 | 38.7 | 36.9 | 36.7 | 36.4 |
| Fiscal balance | -7.5 | -7.8 | -7.3 | -3.2 | 0.1 | -1.3 | -1.1 |
| General government gross debt | 17.2 | 32.9 | 39.7 | 37.5 | 36.4 | 35.1 | 35.1 |
| **Money and credit (annual percent change)** | | | | | | | |
| Broad money (end of period) 1/ | -3.9 | -1.9 | 9.8 | 1.5 | 4.5 | 2.2 | 5.3 |
| Private sector credit (end of period) | 11.0 | -6.9 | -8.4 | -7.4 | -11.4 | -5.7 | -2.0 |
| **Balance of payments (in percent of GDP, unless otherwise specified)** | | | | | | | |
| Current account balance | -13.2 | 8.7 | 2.9 | -2.1 | -2.5 | -0.8 | -1.6 |
| Trade balance for goods | -17.9 | -7.1 | -7.0 | -10.7 | -10.4 | -9.0 | -9.4 |
| Exports of goods and services (volume change, in percent) | 2.4 | -13.1 | 12.5 | 12.4 | 9.4 | 1.0 | 3.1 |
| Imports of goods and services (volume change, in percent) | -10.2 | -31.7 | 11.8 | 22.3 | 4.5 | -1.7 | 4.4 |
| Gross external debt | 130.9 | 156.8 | 165.1 | 143.9 | 136.4 | 130.6 | 130.5 |
| **Exchange rates** | | | | | | | |
| Real effective exchange rate (annual percent change) | 9.9 | 5.5 | -6.0 | 0.2 | -1.6 | -1.3 | … |
| Exchange rate (Lats per euro, period average) 1/ | 0.71 | 0.70 | 0.70 | 0.70 | 0.70 | 0.70 | |

Sources: Latvian authorities; Eurostat; and IMF staff estimates and projections.
1/ Latvia formally adopted the euro and joined the Euro Area on January 1, 2014

## Table 3. Lithuania: Selected Economic Indicators, 2008–14

Population (2011): 3.029 million
Life expectancy at birth (2009): 78.3 years (women), 67.5 years (men)
Main products and exports: mineral, chemical, agricultural and wood products, machinery and equipment

Per capita GDP (current US$, 2012): US$14,014
Per capita GDP (PPP, 2012): €17,700
Literacy rate (2011): 99.7 %
Key export markets: Russia, Latvia, Germany, Poland

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| | | | | | | Est. | Proj. |
| **Output** | | | | | | | |
| GDP (in billions of euros) | 32.4 | 26.7 | 27.7 | 31.0 | 32.9 | 34.6 | 36.2 |
| Real GDP growth (annual percentage change) | 2.9 | -14.8 | 1.6 | 6.0 | 3.7 | 3.3 | 3.3 |
| Output gap (percent of potential GDP) | 7.8 | -7.4 | -6.2 | -2.5 | -0.9 | -0.2 | 0.0 |
| **Saving-investment balance (in percent of GDP)** | | | | | | | |
| Gross national saving | 14.1 | 15.2 | 17.4 | 17.5 | 18.1 | 19.9 | 20.3 |
| Gross national investment | 27.1 | 11.4 | 17.3 | 21.3 | 18.3 | 18.5 | 19.8 |
| Foreign net savings | 12.9 | -3.7 | -0.1 | 3.7 | 0.2 | -1.5 | -0.6 |
| **Employment (annual percentage change, unless otherwise indicated)** | | | | | | | |
| Unemployment rate (year average, in percent of labor force) 1/ | 5.8 | 13.8 | 17.8 | 15.4 | 13.4 | 11.8 | 10.8 |
| Real average monthly gross earnings, real | 8.1 | 9.1 | -9.7 | -1.9 | -0.5 | 3.8 | 2.8 |
| Labor productivity (annual percentage change) | 4.7 | -7.8 | 7.3 | 5.5 | 1.9 | 1.9 | 2.8 |
| **Prices (annual percent change)** | | | | | | | |
| CPI, end of period | 8.5 | 1.2 | 3.6 | 3.5 | 2.9 | 0.5 | 1.7 |
| CPI, period average | 11.1 | 4.2 | 1.2 | 4.1 | 3.2 | 1.2 | 1.0 |
| **General government finances (percent of GDP) 2/** | | | | | | | |
| Revenue (percent of GDP) | 33.9 | 35.5 | 35.0 | 33.2 | 32.7 | 33.0 | 33.0 |
| Expenditure (percent of GDP) | 37.2 | 44.9 | 42.3 | 38.7 | 35.9 | 35.2 | 34.9 |
| Fiscal balance (percent of GDP) 3/ | -3.3 | -9.4 | -7.2 | -5.5 | -3.2 | -2.1 | -1.9 |
| General government gross debt | 15.5 | 29.5 | 38.3 | 39.2 | 41.0 | 39.3 | 39.5 |
| **Money and credit (annual percentage change)** | | | | | | | |
| Broad money (end of period) | -0.4 | 0.3 | 8.9 | 5.0 | 7.2 | 4.5 | 11.1 |
| Private sector credit (end of period) | 17.8 | -6.9 | -7.6 | -5.7 | 0.3 | -3.0 | 2.5 |
| **Balance of payments (in percent of GDP, unless otherwise indicated)** | | | | | | | |
| Current account balance | -12.9 | 3.7 | 0.1 | -3.7 | -0.2 | 1.5 | 0.6 |
| Trade balance for goods | | | | | | | |
| Exports of goods and services (volume change, in percent) | 11.4 | -12.6 | 17.4 | 14.1 | 11.8 | 9.5 | 5.7 |
| Imports of goods and services (volume change, in percent) | 10.3 | -28.1 | 17.9 | 13.7 | 6.1 | 9.8 | 6.6 |
| Gross external debt 4/ | 71.0 | 84.2 | 81.6 | 76.9 | 70.9 | 64.5 | 62.1 |
| **Exchange rates** | | | | | | | |
| Real effective exchange rate (annual percent change) | 7.1 | 6.6 | -4.2 | 1.3 | -1.2 | 1.4 | 0.5 |
| Exchange rate (litai per euro, period average) | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 | … |

Sources: Lithuanian authorities; World Bank; Eurostat; and IMF staff estimates and projections.
1/ The latest population census has resulted in updated labor force survey (LFS) statistics for 2010-11 only. Further revisions for 2003-09 data are in progress.
2/ Passive projection; does not include government's stated commitment to further consolidation as measures have yet to be specified. According to national definitions unless indicated otherwise
3/ Fiscal balance for 2012 according to the definition for purposes of the Excessive Deficit Procedure (EDP).
4/ Includes guaranteed loans.

Press Release No. 14/203
FOR IMMEDIATE RELEASE
May 8, 2014

International Monetary Fund
Washington, D.C. 20431 USA

**IMF Executive Board Discusses Baltic Cluster Report on the Republics of Estonia, Latvia, and Lithuania**

On May 2, 2014, the Executive Board of the International Monetary Fund (IMF) discussed the Baltic Cluster Report on the Republic of Estonia, the Republic of Latvia, and the Republic of Lithuania, which complements the Article IV consultations for these countries. The report is part of an IMF pilot project on clustering Article IV consultations, which looks at logical groups of economies and considers policies in an integrated way. These consultations also aim to fill the gap between bilateral surveillance (on the ground appraisals of individual countries) and multilateral surveillance (oversight of the global economy). In this respect, it follows the recommendations of the 2011 Triennial Surveillance Review and is part of the IMF's efforts to strengthen work on interconnectedness.

The Baltic countries share similarities in their economic structure and their trade and financial linkages to the Nordic countries are important. As they are charting the course of economic convergence, they also face some common challenges.

While significant progress has been made since the crisis in improving the resilience of the Baltics' financial systems, the Baltic economies are not yet providing much credit to support the ongoing recovery. Hence, their recoveries have been so far largely creditless and credit is lagging that of other episodes of creditless recoveries. Reviving credit growth is essential to sustain economic growth, and, in the longer term, foster income convergence.

A key feature of the Baltic's post-crisis recovery has been their success in increasing exports. However, some aspects of the Baltics' exports performance—including a high concentration in labor-intensive goods—raises questions as to how well positioned they are to extend this good performance, but maintaining export competitiveness will remain important to extend the recovery.

The Baltic economies also still face high unemployment, with staff estimates suggesting that much of this unemployment is structural in nature. This is despite the presence of relatively flexible labor markets. At the same time, labor taxation is high and skill and education mismatches also appear present. Further progress on income convergence calls for the best use of available labor resources, especially in the context where the labor force is declining.

**Executive Board Assessment[1]**

Executive Directors welcomed the Baltic Cluster Report, which usefully complements the Fund's regular bilateral consultations with Estonia, Latvia, and Lithuania. Directors commended the authorities and staff for their successful collaboration in identifying common features and challenges, while highlighting scope for cooperative policy responses. They looked forward to further discussion of country-specific policies in the Article IV consultations of these countries respectively.

Directors noted that the Baltics share key economic features and linkages. While there is no articulated "Baltic Model," all three countries have made impressive strides in advancing income convergence with Western Europe over the past two decades, based on generally prudent macroeconomic policies, small governments, and a relatively favorable investment climate. Directors highlighted the Baltics' strong economic integration with Western Europe in general and the Nordic economies in particular, through banking, foreign direct investment, and trade.

Directors underscored that the "creditless recoveries" in the Baltics could become increasingly difficult to sustain. They commended the strong economic recovery from the 2008/09 crisis, but noted that it has been accompanied by contracting credit to the private sector. While not an unusual pattern in a boom-bust cycle, continued anemic credit could constrain investment and growth. In this context, they were encouraged by the recent real credit growth in Estonia. They recommended further improving the insolvency regimes to address remaining debt overhang and to improve banks' risk perception. Over the medium term, Directors encouraged the authorities to explore additional promising initiatives to deepen non-bank sources of financing, including alternative exchanges with less stringent reporting requirements, regional ratings agencies, and securitization.

Directors highlighted the importance of securing a vibrant export sector for the future. Strong export growth has been instrumental for the post-crisis recovery in the Baltics, with improved price competitiveness being a key factor that should be preserved. Directors noted, however, that future export success cannot be taken for granted, especially considering the Baltics' reliance on labor intensive exports in conjunction with adverse demographics. They stressed that structural reforms will be critical for longer-term competitiveness, including upgrading labor force skills and better labor force utilization, along with infrastructure improvements and efforts to further capitalize on the relatively favorable business environment.

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[1] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

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 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

[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"

export quality, which is particularly pronounced in Latvia and Lithuania among the Baltic countries.[2]

The authorities are also less pessimistic than staff with respect to the Baltic linkup to the global value chains (GVCs). While the Baltic countries' participation in GVCs had been smaller than that of the CE4 countries, their position in GVCs is rather favourable as they generally tend to move upstream.[3]

That said, the authorities fully share staff's view that maintaining competitiveness and further advancing the export product mix are essential elements in moving up the value chain and facing challenges posed by demographic trends and less dynamic external demand.

***High structural unemployment deserves further attention***

The authorities share staff's assessment that structural unemployment is high and it represents a key challenge for the Baltic countries. However, my authorities think that the uncertainty surrounding the structural unemployment rate estimates is rather high, particularly in the case of Estonia, where the current headline unemployment rate is significantly below staff's NAIRU estimate. While it seems that the recent crisis has not made permanent changes to structural unemployment, as it remains close to its historical level, increased policy attention is warranted to bring structural unemployment down to a more comfortable level.

High structural unemployment coexists with a rather flexible and efficient labor market in the Baltic countries. Remarkable wage adjustments, smooth reallocation of labor between different sectors of the economy, swift decline of the headline unemployment (from close to 20 percent during the peak of the crisis to close to 10 percent at present) and notable increase in labor participation are points in case. However, skills and education mismatch and tax wedge on labor, especially for lower income earners, deserve further attention. In this context, a shift of taxation away from labor (with appropriate compensatory measures to retain the revenue envelope) and more active use of active labor market policies (ALMPs) should be further explored. While spending on ALMPs has scope to increase, the authorities would stress that not only the quantity, but also the quality of these measures needs to be taken into consideration.

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[2] Benkovskis, K., and Wörz, J. (2012), "Non-Price Competitiveness Gains of Central, Eastern and Southeastern European Countries in the EU Market," Focus on European Economic Integration, 3, 27-47.

[3] Authorities' calculations based on Koopman, R., Powers, W., Wang, Z., and Wei, S.-J. (2010). "Give Credit where Credit is Due: Tracing Value Added in Global Production Chains," NBER Working Paper No. 16426, September.

***The scope for joint action***

While recognizing the need for coordinated policies within the Nordic-Baltic region, the authorities agree that much of the work to address the Baltic countries' common challenges should take place at the national level. The authorities see merit in closer regional cooperation and harmonization, recognizing that there is strong cooperation in the EU context and that the EU directives have already gone a long way toward harmonizing rules and practices between the Baltic countries. The authorities agree with staff's assessment that further upgrading the energy sector to lift energy efficiency and to open the energy market for additional competition is important. In addition, investing in infrastructure to reduce transport costs is needed, as correctly mentioned in the report.

***Set-up of the clustered analysis: Some thoughts for the future***

As the cluster approach to surveillance is still in its pilot stage at the Fund, learning by doing constitutes an important part of the exercise, and we would like to share some of our observations that might be useful for future reports.

Our experience suggests that it being an interactive process, the clustered analysis, among other things, adds value in promoting discussions and cooperation both among authorities and staff teams, providing fertile ground for policy discussions to address common challenges. We hope that such close cooperation and sharing of views between all parties involved will remain at the center of future clustered analyses.

The Baltic Cluster Report adds value in providing a useful horizontal (cross-country) comparison of the Baltic economies. Looking ahead, relevant vertical linkages with "gatekeeper" countries could be explored in more detail. A cross-country perspective is usually an irreplaceable element of Article IV reports, or indeed, any analysis of small economies. The Fund, however, is also the best-placed institution to provide analyses on vertical linkages. Therefore, with the benefit of hindsight, a combined Nordic-Baltic Cluster Report could have been more potent in exploring such links.

While our authorities clearly benefitted from the consultation process, broader coverage in selecting relevant clusters could add further value to the overall success of the Fund's regional surveillance. To this end we think it might be worth exploring possibilities to further advance the cluster selection framework, among other, aiming, in addition to regional, for thematic clusters.