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Is Eastern Europe on the Brink of an Asia-Style Crisis?

Mary Stokes | Jun 10, 2009

The collapse of the Thai baht in July 1997 helped spark the Asian financial crisis. Could events in Latvia spawn a similar contagion? Eyes are focused on this small Baltic economy, amid growing talk of a devaluation, due to the potential for spillover effects into its fellow Baltics, Sweden and the broader Eastern European region.

Strong trade and financial linkages, not to mention similar macroeconomic vulnerabilities, mean a Latvian crisis would almost surely have knock-on effects on neighboring Estonia and Lithuania, as detailed in this RGE EconoMonitor post in early May. A Latvian crisis would also have negative spillover effects into Sweden via Swedish banks' heavy exposure to the Baltic trio. The wildcard is how a Latvian crisis would affect the greater Central and Eastern European (CEE) region. Direct trade and financial linkages between Latvia and CEE economies, outside of the Baltics, are limited. Nevertheless, many of these countries – particularly Bulgaria and Romania – share similar macroeconomic vulnerabilities with Latvia, meaning a crisis there could 'wake up' investors to the potential for crises in the rest of the region.

What's the Matter with Latvia?

Once an investor darling, Latvia's booming, double-digit growth earlier this decade was accompanied by massive imbalances - a current-account deficit approaching 25% of GDP (among the world's widest) and an external debt load that peaked at over 140% of GDP. T he correction in these imbalances would have been challenging under any circumstances, but the global financial crisis and consequent drying up of capital inflows have raised the likelihood of a full-blown balance of payments crisis. Latvia's currency, the Lat (LVL), is pegged to the euro within a ±1% fluctuation band, and such pegs do not tend to survive harsh economic adjustments like that now underway. In countries with flexible exchange rates, domestic demand does not have to bear the full brunt of correction in external imbalances as currency depreciation can shoulder some of the burden.

Latvia's economy is currently on life support. Although agreement was reached in December on a €7.5 billion (US$ 10.4 billion) IMF and EU-led rescue package, the government is now forecasting an 18% contraction in growth in 2009 , making it one of the world's fastest shrinking economies. The immediate focus is on whether Latvia will receive the €1.7 billion (US$ 2.4 billion) installment of its loan package due in late June. The key stumbling block is Latvia's ability to meet the 5% of GDP budget deficit limit laid out in the loan terms. The problem is not that Latvia's government has been

spending recklessly. Rather, the issue is that the drop-off in Latvian growth has been so precipitous, far beyond that envisioned when the loan agreement was signed just six months ago, that extreme fiscal belt-tightening is now required to meet the loan terms. A 5% GDP contraction was assumed in the original agreement, as compared to the 18% now forecast.

Latvia has been going to agonizing extremes to make the June payout happen, dramatically slashing public sector salaries. More spending cuts are in the works. As Prime Minister Dombrovskis has pointed out, these belt-tightening measures will likely trigger an even deeper recession. Even with the cuts, Latvia's budget deficit is still expected to come in above the limit, and it remains unclear whether the IMF and European Commission are willing to relax the loan conditions. As RGE Monitor warned in early May: if Latvia does not receive the latest tranche of its IMF-led loan, the country will likely be facing a double whammy of default and devaluation.

Signs suggest that even with the June payout, Latvia may not avert devaluation. On June 3, the government failed to find any takers for the LVL 50 mm (US$ 101 mm) in bonds it was hoping to sell. While government officials still speak out adamantly against devaluation, many commentators now see devaluation as inevitable. A former prime minister has called for a 30% devaluation, and Bengt Dennis – a former Swedish centr al banker who now advises Latvia – recently said devaluation is unavoidable. At the same time, Latvia's central bank has been burning through its foreign reserves in its efforts to maintain the currency peg. From a peak of around US$ 6.6 billion in mid-2008, foreign reserves had plunged to US$ 4.1 billion at the end of May.

Why Hasn't Latvia Already Devalued?

A key part of Latvia's motivation in keeping its peg was its desire to adopt the euro early next decade. That euro adoption goal, however, increasingly looks like wishful thinking given the current economic woes. Some have argued that Latvia is clinging to its currency peg to avoid mass defaults, due to the high level of foreign currency-denominated lending there (around 90% of total loans). However, as RGE Monitor argued in December , mass defaults will occur, regardless of whether Latvia devalues or adjusts via internal deflation. The key difference is that devaluation will likely lead to a more rapid wave of defaults over a shorter period of time, which could magnify stress on the banking system.

Potential for Contagion

Among the numerous reasons the IMF's senior representative for Central Europe and the Baltics, Christoph Rosenberg, gave in January for supporting Latvia in its desire to maintain the peg was the idea that a devaluation in Latvia would have far-reaching effects beyond this small Baltic country. "[D]evaluation in Latvia would have severe regional contagion effects, especially given the fragile global funding environment. The spillovers could well go beyond pressures on countries with fixed exchange rate in the Baltics and South-East

Europe. For example, market confidence in foreign banks invested in the Baltics and similar countries would likely be affected, with implications for their ability to access wholesale financing."

Estonia and Lithuania

Strong trade and financial linkages, not to mention similar macroeconomic vulnerabilities, mean a Latvian crisis would almost surely spread to Estonia and Lithuania's economies. Latvia's fellow Baltics are its top trading partners. Meanwhile, the same Swedish banks that dominate Latvia's banking sy stem also dominate those in Estonia and Lithuania, providing another channel for contagion. Latvia is the weakest link of the three, having built up the largest imbalances. Nevertheless, the other two Baltics also experienced booming growth earlier this decade, along with double-digit current-account deficits, and all three are in the midst of severe recessions. Most importantly, Estonia and Lithuania also have currency pegs to the euro, and Latvia's struggles are raising questions about the sustainability of their fixed exchange rates.

Sweden

While Sweden is not looking at a full-blown crisis, its strong financial linkages with the Baltics could dramatically cut in to the Nordic country's growth prospects. Swedish banks have issued loans to Baltic borrowers equivalent to over 20% of Sweden's GDP. According to Danske Bank, the loans could cost Sweden a total of anywhere from 2% to 6% of its GDP over several years, depending on how many Baltic borrowers default. Fitch Ratings recently used a number of stress test scenarios to examine Swedish banks' ability to absorb losses in the Baltics and according to the results, Swedbank - one of Sweden's largest banks - could be particularly affected. Nevertheless, Danske said in late May that all Swedish banks operating in the Baltics should remain solvent in a devaluation scenario. Some analysts have speculated that it may not be long before the Swedish state has to step in with direct financial assistance to help its banking sector.

Central and Eastern Europe (CEE)

The broader CEE region has minimal trade and financial linkages with the Baltics. So the key channel of contagion between the Baltics and the broader CEE region would be via the 'wake up channel' – meaning a crisis in Latvia could serve as a wake-up call to investors, alerting them to similar vulnerabilities elsewhere. So far, the evidence suggests the rest of the CEE will not go unscathed if Latvia devalues, despite their limited linkages. For example, the recent sell-off in the Polish zloty and Hungarian forint was largely attributed to concerns over potential spillover effects from a Latvian crisis.

CEE countries are not a homogenous bloc. Bulgaria and Romania, in particular, share a similar boom-bust trajectory to that being played out in the Baltics. External imbalances in these five countries rivaled, and in some cases exceeded, the build-up of imbalances in

pre-crisis Asia. For example, current account deficits in Southeast Asia from 1995-97 fell within the 3.0-8.5% of GDP range, whi le those in Romania, Bulgaria and the three Baltics were well over 10% of GDP in 2008. Like the Baltics, Bulgaria operates a fixed exchange rate system and a key concern is whether a Latvian crisis would shake confidence in Bulgaria's currency board.

Romania and Hungary may have flexible exchange rates, but like Latvia, they have needed IMF-led rescue packages. If Latvia descends into crisis, it would highlight the fact that a rescue package, in and of itself, is not sufficient to avert economic meltdown.

Other countries in the region – Czech Republic, Poland, Slovakia – also built up imbalances in recent years and are in the midst of their own sharp slowdowns. Nevertheless, their imbalances never reached the same proportion as those in the Baltics and Balkans. Overall, their economies are in stronger positions to weather any contagion. Slovakia successfully entered the Eurozone earlier this year, while Poland qualified for a US$ 20.5 billion flexible credit line (FCL) from the IMF. An FCL is a precauti onary facility, available only to countries with very strong fundamentals, which can be drawn upon at any time and without meeting any specific conditions. Such a facility should help provide Poland with a bulwark against contagion.

Latvia's woes are turning into a cautionary tale for other CEE countries vigorously pursuing euro adoption and could force a reassessment of the benefits. EU newcomers that have not yet adopted the euro are expected to participate in ERM II, a required currency stability test of at least two years for EMU hopefuls in which currencies are required to trade against the euro in a limited fluctuation band. A devaluation would force Latvia to start the challenging ERM II process anew.

Could a Latvian crisis affect the Eurozone?

If a balance-of-payments crisis occurs in the Baltics and it spills over into other Eastern European economies (please note that this is a big 'if'), then the Eur ozone could be affected. The Eurozone's exposure results from Western European banks' heavy exposure to Eastern Europe, via subsidiaries, where they hold 60-90% market share (as a % of assets), depending on the country. Given the CEE's strong financial linkages with Western Europe, the health of Eastern Europe's economies and its banks could potentially afflict Western European banks, as detailed in this recent RGE EconoMonitor post.

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