GLOBAL CRISIS AND ECONOMIC PROCESSES IN LITHUANIA AND OTHER BALTIC COUNTRIES

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Abstract. The article deals with the main reasons of financial and economic crises as well as their consequences. The links between real estate markets and markets of securities, credit expansion and growth of investment are described. It is shown that the processes in real estate and securities markets inflated the prices of real estate and created the so-called real-estate bubble the burst of which was the main reason of the global financial crisis. The main anti-crisis measures in the EU and USA are presented. The situation of Lithuania in the context of the global crisis is discussed. The concrete factors that have caused the economic crisis in Lithuania are analysed. The means of the government's economic policy in Lithuania and other Baltic countries are discussed in the context of the global crisis. The analysis of the indices of macroeconomic processes in the Baltic countries showed that economic processes were similar without essential differences in all Baltic countries. The analysis showed that economic revival of the Baltic countries will depend both on the foreign market restoration and restoration of the domestic markets and modernisation of production.

Key words: anti-crisis measures, economic policy, global financial crisis, macroeconomic processes in the Baltic countries

JEL classification: E20, H62, H63

Introduction

The onset of the current financial crisis is considered to be 2007, when the Federal Reserve System of the USA had to interfere and grant liquidity to the bank system (Soros, 2008). Economic cycles are an immanent feature of the market economy, because the evolution of the market economy is uneven and there is no other mechanism to equalise disproportions of uneven evolution than periodical shocks – crises. Thus, although crises entail great losses, both economic and social, they are inevitable. On the other hand, the proper economic policy is able to reduce the after-effects of cri-
Although economic cycles, i.e. economic booms and recessions, are inevitable in the market economy, apart from common features, each economic cycle is different. Specific reasons that cause economic recession are also different.

Despite the fact that no economic cycle is apt to repeat, the analysis of its causes has a sense for the sole purpose of avoiding the economic policy errors made. For example, the experience available today has enabled us to control the global crises much more expeditiously and faster than in 1929-1933. Though we have to accept the fact that today the world experiences less an economic depression on a no smaller scale indeed than that in the years of the Great Depression (Eichengreen B., O’Rourke K. H., 2010).

In the article, the main causes of the global financial crises as well as their effect on the Baltic countries economics are analysed. The dynamics of the main macroeconomic indices (the GDP, the budget deficit, the state debt, the inflation rate, the unemployment rate, the volume of import and export) are analysed in the period from 2004 to 2010 by using the data of the Eurostat database. The dynamics of these indices shows the main macroeconomic tendencies in the Baltic countries. Measures of the state economic policy in the USA, the EU and the Baltic countries are discussed in the context of global crisis.

The main causes of the worldwide financial crisis and anti-crisis measures in the USA and the EU

The current global crisis is not the only worldwide crisis in the new history of humanity. We are aware of such economic crises that have affected more than one state and therefore they can be called worldwide crises (Dash, 2001; Feldstein, 1991; Sylla, 2009). The current global crisis stands out from the previous ones by its measures. It affected the majority of world countries. In this respect it even surpassed the Great Depression of 1929-1933. On the other hand, both crises have got common features. Actually, both crises arose due to some troubles in the US financial markets. Their major features are vast credit expansion and financial novelty. The truth is that the current crisis stands out by application of very complicated derivative financial measures and insufficient assessment of risk, though these derivative measures were created namely to diversify and diminish the risk. It should be stressed that the severe lessons of the Great Depression were not in vain and the governmental response to economic recession was much more expeditious than in 1929. The Great Depression impelled to create the economy regulatory theory the methods of which allowed us manage the time challenge (Romer, 2009).

As back as 2005 the journal ‘The Economist’ warned about the so-called real estate bubble in progress in the USA and it possible consequences. Namely, the processes in the real estate market were the detonator that invoked the world crisis of finance and economy. Real estate was always treated as a safe investment, the price of which will never fall down (Manson, Rosner, 2007). A great demand for real estate raised its price and that in its turn, increased investments into real estate. Side by side with the expansion of the real estate market, mortgage credits increased as well. Having noticed that
the value of their credit mortgage (houses under construction) was growing, thereby decreasing the risk of borrowing, banks also decreased the requirements of credit distribution. Thus, the credit and real estate markets were in full swing. Banks grouped the newly given credits and turned them into the so-called collateralised debt obligations and sold them to various investment banks and companies. These later turned the securities bought into secondary debt securities and sold them in the markets of securities.

However, the growth of prices of real estate has limits. As the real estate marked was saturated and its demand began to decrease, its price sank as well. With a decrease of the value of mortgage the amount of bad credits of banks is increasing which thereby entailed liquidity problems of banks. The latter fact pushed banks into a complicated situation. Borrowing becomes risky which, in its turn, entails the growth of credit interest. On the other hand, with a decrease of the value of mortgage, security of obligations also decreases which turns derivative financial means into worthless papers. Thus, the liquidity problems and decline of the value of securities led even big banks and investment companies to bankruptcy. It means the onset of the global crisis.

Globalisation also facilitated the expansion of the crisis. The consequence of globalisation is integration of economics, finance, culture, and other spheres of world countries. Globalisation has both positive and negative consequences. As Kropas (2007) states, the intensifying integration of financial markets is related to the growing risk and uncertainty. Therefore, it is difficult to predict its consequences. On the other hand, with an increase of interrelations and dependences between global financial markets and economics, the risk of problem transmission increases as well.

Famous American economists – Paul Krugman (2008) and Joseph Stiglitz (2006) wrote about a possible financial crisis in the USA before its onset. J. Stiglitz paid attention to a deteriorating economic situation of the country and criticised the Central Bank of the USA with regard to their inflationary policy in progress. Rather long before 2007 indicators of the American economics such as price of real estate, a high long-term deficiency of the current account and decreasing rates of economic growth of the country showed that the country was on the verge of financial crisis (Felton, Carman, 2008). The global crisis, though to a lesser extent than in the USA, had a bad effect on the EU countries as well.

However, both the USA and the EU institutions took anti-crisis measures rather resolutely. The Federal Reserve System of the USA, later the Bank of Great Britain and the European Central Bank began to decrease the basic interest rate with a view to stop the growth of the market interest rate. However, during a depression, even a very low size amount of basic interest does not help vivify the economic activity (Mises, 2009).

Therefore the financial system of the USA was subsidised with large sums to support bank liquidity and later the major share of state expenditure was assigned to stimulate consumer’s expenses and social programmes. In 2008, the European Commission (Commission of the European Communities, 2009) prepared a restoration plan of economics which implied the increase of demand by enlarging the purchasing capacity of population and restoring the confidence of investors. However, only the largest states of the EU can afford the necessary resources for restoring their economics.
The particular reasons of economic crisis in Lithuania

The main reasons of economic crisis in Lithuania were the negative tendencies in the real estate market, irresponsible economic policy of the Government and adverse situation in the international markets. 2004-2007 were the years of the fast economic growth in Lithuania as well as in other Baltic countries. Decreasing unemployment, increasing income, hard currency and financial support of the EU were the main factors of growth which, according to Rosenberg (2008), were unprecedented in postwar Europe. These factors have laid the basis, as evident at present, to cherish grounded hopes as to the future of the country. Guided by those hopes, both enterprises and households began borrowing for consumption and business ever more and all the more the banks granted loans with engaging interest. The largest share of loans received by a household was aimed at the real estate market. This process was stimulated by state given tax privileges for lodgings loans which established conditions for forming a real estate bubble. According to the data of the Bank of Lithuania, the volume of loans to acquire lodgings has grown from LTL 50 million in 2004 up to LTL 720 million in 2007. Such an expansion of credit had decisive influence to form a ‘bubble’ in the Lithuanian real estate market.

In the period before the crisis the Lithuanian economics was growing due to the growth of domestic demand which was also maintained by domestic demand-stimulated import growth. However, the import increase was not equivalent to an adequate export increase and the balance of foreign trade was in deficit up to 2009. In such a situation, economic growth was feasible only by borrowing in the international financial market. Constant foreign trade deficit also determined the growth of the current account deficit of the account. In line with the data of the Bank of Lithuania, the current account deficit in Lithuania has grown by almost 300% from 2004 to 2007 and exceeded LTL 14 billion.

Despite rather high growth rates of GDP of the country, year after year budget expenditure exceeded receipts income. Though the budget deficit before the crisis was not so high (Fig. 1), under the conditions of fast economic growth, it increases overheat of the economy.

On the other hand, the constant budget deficit increased the country’s debt which is unacceptable under the conditions of the economic growth (Zucchelli, Kirsebom, 2009). Due to the global crisis, increased interests stopped the flow of foreign credits and shook the economic growth basis of the country. As the data basis of the Lithuanian Department of Statistics show, the rate of the country’s GDP growth in 2007 amounting almost up to 10%, fell down up to 3% in 2008 and in 2009 it slowed down up to 15% (Fig. 2) by pushing Lithuania among the countries that most suffered from the crisis. Lithuania was not ready for such a situation, because its strategies for economic development, as noted by Rakauskiene and Krinickiene (2009), were based on the premises of macroeconomic stability and continuous economic growth. It shows that such strategies were created in a formal and unqualified manner.
Fig. 1. Lithuanian Government deficit in 2005-2010


Fig. 2. Lithuanian GDP in 2005-2010 (at market prices) in litas

After the burst of the “bubble” in the Lithuanian real estate market, the credit interest, given by the banks operating in Lithuania, has grown as well. That negatively affected the subjects of the Lithuanian economy. Only the processes in the county’s real estate market could invoke economic depression, however, it was mostly outside factors that have affected our economics. The global crisis predetermined slowdown of economic growth and consumption decrease of many world countries. Decreasing consumption of foreign countries restricted the chances of the Lithuanian export and that was one of the most important factors that determined the country’s economic depression. The domestic market of Lithuania is too small to maintain the growth of economics and to compensate the decrease in export. With the revival of markets of foreign countries, Lithuania’s possibilities have improved as well. In the opinion of the same authors, improvement of business conditions in such export-oriented sectors as industry and tourism help countries as small as Lithuania revive (Rosenberg, 2008).

Anti-crisis measures in Lithuania and other Baltic countries

It should be admitted that Lithuania met the crisis being quite unprepared to it, though the seen of the global crisis reached Lithuania. This fact was determined by both political reasons and governmental incompetence as well as the lack of responsibility. For motion of a budget in deficit under the conditions of rapid economic growth contradicts not only the economic principles but also the common sense: the excess surplus budget would prevent ‘overheat’ of economy and establish conditions to mitigate the consequences of the crisis. Meanwhile, the Estonian political forces showed much better responsibility in making co-ordinated decisions (Andersen, 2009). It is true, in 2007 the Fiscal Discipline Law (the Law) was passed the purpose of which was to ensure the financial stability of the governmental sector and a stable development of the economy. The Law determined that the deficit of the governmental sector in 2008 could not be higher than 0.5 % of the GDP. It is evident that the Law was adopted too late and its requirement could not be realised when the crisis had already started. In the presence of the crisis, the Bank of Lithuania and the Parliament of the Republic of Lithuania have decided: to diminish the mandatory reserve norm from 6 to 4% and to increase the deposit insurance sum up to EUR 100.000 with a view to vivify the domestic market using additional financial resources. Though those decisions were correct and adopted in time, unfortunately, their effect seemed to be insufficient. To maintain the market activity a more intensive promotion of economy was necessary. However, due to an inadvertent and irresponsible budget policy persuaded in the years of economic rise progress, there were no resources to stimulate the economics. Therefore, nothing else remained but to take measures that were usually applied at the time of economic growth and not during the period of depression. The newly elected Parliament of the Republic of Lithuania and the Government undertook to apply the measure of restrictive fiscal policy: to decrease expenditure and increase taxes in order to stabilise state finances, which was persistently recommended by the European Commission.

At the end of 2008, a decision was made to increase the rate of value-added tax up to 19% (later on it was increased up to 21%), income-tax, excise duty on fuel, cigarettes and alcohol, as well as to eliminate the majority of reduced tariffs of the value-added
tax. The so-called ‘night’ tax reform came into effect on 7 January 2009. The tax reform was aimed more at collecting more budget revenues and stabilising the state finance system than at neutralising the consequences of the crisis. However, in 2009 much less state budget revenue was collected than in 2008. Naturally, such a result was largely determined by the economic depression; however there are little doubts that the ‘night’ tax reform was a great governmental lapse and that it was damaging rather than useful for the country’s economy.

In the years of economic growth before the crisis, the state budget was not only formed in deficit but also its expenditure was constantly increased. Therefore, as a result of the crisis, with a slump in budget revenues huge budget deficit appeared as the state liabilities to finance various spheres all remained the same. Due to that reason the budget deficit, as showed by the databases of the Lithuanian Department of Statistics, amounted up to 3.2% in 2008 and even up to 9% of the GDP in 2009, i.e. almost three times higher than the Maastricht criterion.

Thus, the Government had to adopt an undersubscribed decision – to pursue the so-called retrenchment policy, i.e., to diminish government expenses by lowering the employees’ and officials’ salaries, pensions, and social benefits, whereas such a policy is assessed ambiguously. On the one hand, it allows diminishing government expenses, on the other hand, it decreases income of the population and thereby consumer demand. The decrease in demand even more weakens the home market. The domestic market will revive only if income of the population starts growing and consumer demand increases. We are far from that as yet.

Apart from the above-mentioned financial stabilisation measures, the anti-crisis governmental plan provided for the improvement of business environment and financial support to business, promotion of export and investments, utilisation of the EU structural support, and renovation of the block of flats. However, this business promotion plan has not yet been put into practice and has yielded no tangible results so far.

At the end of 2008, the Latvian Saima approved the programme of stabilisation and revival of the Latvian economy (Embassy of the Republic of Latvia in Vilnius). The programme obliged the Government to pursue a strict fiscal policy decreasing the state budget deficit, to establish the stabilisation reserve into which money could be transmitted in case the budget is balanced and the growth of the GDP exceeded 2%. The structural reforms were provided in the plan in order to decrease the expenses of public management by 15%, while financing of social protection measures would not be decreased. The Bank of Latvia was obliged to keep a fixed ratio between the latas and the euro. In line with the programme, from 2009 the Government of Latvia plans to decrease the tariff of residents’ income tax by 2%, to increase the rate of the value-added tax by 3%, to eliminate the majority of reduced tariffs of the value-added tax, to increase the excise duty for fuel, coffee and alcohol as well as to tax dwelling apartments of habitants from 2010. In 2010, the Latvian Government submitted a new plan of economic revival to Saima. The stimulation of export, the manufacture of home commodities for replacing import, orientation of production to manufacture commodities with high added values as well as stimulation of the sectors of economy grounded on the knowledge and innovations have been provided in the plan.
In 2008, the International Monetary Fund, the World Bank and the financial institutions of the EU granted a credit to Latvia amounting to 7.5 billion euro (1.7 billion euro of which was granted by the IMF) to make reforms. Despite the fact that the creditors fixed a low interest for credit, they required the fulfillment of strict conditions, i.e. to decrease the state budget deficit to 3% of GDP within three years, not to increase pensions, to decrease salaries, to set new taxes, to diminish governmental management expenses by 30% instead of 15%.

Thus, the anti-crisis measures are similar both in Latvia and in Lithuania. The revival of economy is grounded on strict fiscal policy and saving in both countries.

Estonia began executing strict fiscal policy earlier than the other Baltic countries, i.e. before the start of the crisis. In the years of the fast economic growth that country began forming a surplus state budget and accumulating fiscal reserves. The accumulated reserves allowed Estonia to avoid the necessity of borrowing in the international financial markets by paying high interest during the global crisis. Although Estonia did not have a formal anti-crisis plan, as it hoped to naturally overcome the economic difficulties, it was also forced to apply the saving mode. The Estonian Government has also adopted decisions to decrease state expenditure, especially in the sphere of health protection and education, pensions and salaries (by 15%), to increase the rate of value-added tax from 18 to 20%, the excise duty on tobacco products and alcohol and to introduce new taxes (Statistics Estonia). Therefore, the accumulated financial reserves permitted gaining obvious advantages for Estonia in comparison with the other Baltic countries. Despite the fact that Estonia pursued an expedient fiscal policy before the crisis and accumulated fiscal reserves, the character of macroeconomic processes in all of the Baltic countries was very similar and differed insignificantly. It is true that the accumulated financial reserves permitted Estonia to avoid additional difficulties in the sphere of public finances confronted by the Lithuanian and Latvian economies.

**Macroeconomic situation in the Baltic countries during the crisis**

The analysis of macroeconomic situation in the Baltic countries is made by using the data of the Eurostat database. As mentioned above, for a number of years the Baltic countries were marked by a considerably faster economic growth than the other EU states. The maximum rate of GDP growth before the crisis amounted to almost 10% in Lithuania, almost 8% in Estonia and exceed 12% in Latvia. However, as the global trade shrank as a result of the world economic crisis, the export-oriented economy of the Baltic countries plummeted to an all-time low: in 2009, the real GDP of those countries decreased by 14-18% (14% in Estonia, 17% in Lithuania and 18% in Latvia) as compared to 2008 data. In 2010, the Baltic countries have already shown some signs of recovery in their economies (Fig. 3).

Like many other EU countries, Latvia and Lithuania are facing the budget deficit problem: proportion of fiscal deficits to GDP largely exceeds the limit of 3% prescribed by the Treaty of Maastricht. According to the data of the Eurostat database, in 2009 this figure amounted to 9.2 % in Lithuania and 10.2 % in Latvia, but in 2010 their fiscal deficits decreased to 7-8 % of GDP. Information regarding government debt is
not satisfactory as well. As to 1 July 2010 the proportion of the government debt to GDP equalled to 43% in Latvia and to 34% in Lithuania and these figures satisfied the Maastricht criterion, i.e. they did not exceed 60% of GDP, but in the last two years they were increasing very fast. Therefore, Lithuania and Latvia will have to face a difficult task, i.e. reduce their fiscal deficits to the permissible limit (Fig. 4).

**Fig. 3. GDP of the Baltic states in 2005-2010 (at market prices)**

![GDP of the Baltic states in 2005-2010](http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home)

**Fig. 4. Government deficit of the Baltic states in 2005-2010**

The situation in these spheres is much better in Estonia. Estonia has no problems with budget deficit due to accumulated reserves. However, one must admit here that Estonia did manage to maintain its financial discipline at the level likely to be envied by other countries with much more economic power. In 2009, the Estonian budget deficit was as low as 1.7% of GDP. Even though in 2010 the Estonian budget deficit amounted to 2.2% of GDP, it still did not exceed the limit of 3% of GDP, thereby satisfying the Maastricht criterion. Moreover, according to the data of the Eurostat database, the Estonian foreign debt, though constantly increasing during the crisis, constituted only 7% of GDP, which is substantially less than required for a country to be accepted to the euro zone. Therefore, Estonia is the only state from all of the EU countries that satisfies the Maastricht criteria. It allowed the country join the European Monetary Union from 1 January 2011. The most important factors which subsequently led to such remarkable achievements were a well thought-out economic policy, concentration of all national political powers upon one common aim and, as mentioned above, strict financial discipline. The support that Estonia receives from the Nordic countries cannot be underestimated either (Fig. 5).

Fig. 5. Government debt in the Baltic states in 2005-2010

All the three countries – Lithuania, Latvia and Estonia – are coping with the problem of emigration. If emigration processes are not suppressed in these countries, they will face serious economic problems in the future. Moreover, in spite of intensive emigration, unemployment has become a serious and large-scale problem in the Baltic countries. According to data of the Eurostat database, unemployment rate in these countries has reached unprecedented heights during the crisis and now amounts to 14-18% (14% in Lithuania and Estonia and 18% in Latvia). It is unlikely that this year any considerable changes would take place in the labour markets of all the countries concerned (Fig. 6).
According to the data of the Eurostat database, in 2004-2008 inflation constantly increased in all three Baltic countries: from 1.2% in 2004 to 11.1% in 2008 in Lithuania, from 3% in 2004 to 10.6 in 2008 in Estonia and from 6.2% in 2004 to 15.3 in 2008 in Latvia. During 2008, the level of inflation sharply fell down, i.e. to 4.2% in Lithuania, to 0.2% in Estonia, and to 3.3% in Latvia. In 2010, the Baltic countries underwent inflationary pressures from abroad, determined by the growth of prices of raw materials, energy supplies and grain in world exchanges. Bearing in mind the fact that, in comparison with the EU average, common price level in the Baltic states is quite low (75% in Latvia, 68% in Lithuania), it might be presumed that inflation in the Baltic states will be faster than in the euro zone. Therefore, in order to introduce euro, these countries will have to cope with another serious problem and take steps to reduce the inflation rate.

Estonia is likely to be the most attractive to foreign investment among the Baltic countries. According to the data of the Eurostat database, direct foreign investment in Estonia was increasing even during the years of recession and in 2009 it reached almost 9% of the GDP. Despite the slight decrease in direct foreign investment in Estonia in 2010, it nevertheless exceeded 8% of GDP. Meanwhile, direct foreign investment in the Latvian and Lithuanian economy was likely to decline (from 3.8% of GDP in 2008 to 0.3% of GDP in 2009 in Latvia and from 3.9% of GDP in 2008 to 0.9% of GDP in 2009 in Lithuania) and in 2010 reached negative values.

Thus, the situation in Lithuania and Latvia is not easy. Internal market in Lithuania is underdeveloped with no visible signs of recovery, loan granting for business purposes is absolutely dependent on foreign banks, and foreign investments seem to be insufficient. Though Lithuania’s government debt falls within the permissible limits and is much less than prescribed by the Treaty of Maastricht, its repayment may cause a number of problems, bearing in mind the insufficiently developed internal market and lack of investment that could contribute to a strengthened efficiency of production.
processes. The reduction of fiscal deficit is another and equally serious problem. The country’s situation is also burdened by emigration leading to the depletion of qualified staff resources. The most important factor of economic recovery in this country is export and Lithuania’s competitiveness in foreign markets.

The situation in Latvia is similar to the situation in Lithuania – recession of the economy is very severe, internal market is poorly developed, like in Lithuania, budget deficit is high and emigration is reaching large scale. However, the gap between Latvia and Lithuania can be surmounted and filled. Latvia’s advantage is that it pays much less interest for the loans granted by the International Monetary Fund as compared to Lithuania.

With reference to the above, Estonia has deserved its accession to the EMU as it seems to be in a markedly better position than Lithuania and Latvia according to the key indicators. Among the Baltic states, Estonia is the most attractive to invest in, it has the most effective public sector, the situation of public finances faces no problems and its economic policy is coherent. From other points of view, Estonia only slightly differs from the other Baltic countries.

Conclusion

Such small countries of open economics as the Baltic ones had no chance of avoiding the effect of the global crisis on its economics. Thus, the domestic and external reasons caused the economic crisis in the Baltic countries. The analysis of macroeconomic processes in the Baltic countries showed that economic processes were similar without essential differences in all the Baltic countries, with the exception of the spheres of public finances and foreign investment where Estonia had obvious advantage in comparison with Lithuania and Latvia. All the Baltic countries are coping with the problems of production decrease, emigration, unemployment, inflation, foreign investment (with the exception of Estonia), state budget deficit (for Lithuania and Latvia only). It must be noted that the measures taken to stabilise the state finances had a negative influence on the development of the domestic markets in all of the Baltic countries. Thus the economic revival of the Baltic countries will depend both on the foreign market restoration and restoration of the domestic markets and modernisation of production processes with a view to all state-of-the-art technologies.

References


GLOBALINĖ KRIZĖ IR EKONOMINIAI PROCESAI LIETUVOJE IR KITOSE BALTIJOS ŠALYSE

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Reikšminiai žodžiai: antikrizinės priemonės, ekonominė politika, makroekonominiai procesai Baltijos šalyse, pasaulinė finansų krizė.