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Statement by Mr. Groenn on Baltic Cluster Report - 2014 Cluster Consultation
Executive Board Meeting
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.

[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"

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 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

[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.

would stress that not only the quantity, but also the quality of these measures needs to be taken into consideration.

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.