The 2008 financial crises in the Baltic countries [1]

Executive summary

Following a period of rapid growth, the banking sector in the three Baltic countries faced significant challenges around 2008–09. Because of structural weaknesses in their economies at the time, the banking sectors in Estonia, Latvia and Lithuania were subject to considerable market stress around the time of the Great Financial Crisis (GFC) of 2007–09. Their banking sectors were exposed to liquidity shortages and, in response, special measures were put in place.

Stress emerged primarily because of unsustainable macroeconomic conditions. After restoring independence in the early 1990s, the three Baltic countries shifted from planned to market economies and pursued economic liberalisation, while pegging their exchange rates to either the US dollar, the SDR, the Deutsche mark or, later, the euro. All three countries experienced high rates of economic growth from the early 2000s until the GFC. Economic reforms pursued in the 1990s and after accession to the European Union contributed to a general boost in confidence. Over the same period of time, all of the Baltic countries experienced growing current account deficits, which coincided with steep increases in unit labour costs.

Bank credit had grown rapidly and supported macroeconomic expansion. From 2002–04, economic growth in the Baltic countries was driven increasingly by the financing of real estate activities. Bank credit grew by more than 40% per year over 2004–08. Eventually, this created asset price bubbles, especially in the real estate sector, raising questions as to whether the current account deficits and such high economic growth rates were sustainable.

An important feature of the banking sector in the Baltic countries was the large presence of foreign-owned banks. By the early 2000s, the banking systems in all three Baltic countries were characterised by a large presence of foreign banks. This was especially marked in Estonia and less so in Latvia, where one of the major banks remained under domestic ownership. Lithuania was an intermediate case. Baltic authorities saw foreign ownership of domestic banks as advantageous, as foreign banks could provide the knowledge and experience of running banking activities that was lacking in the Baltic countries after their emancipation from the Soviet Union. Thanks to their access to global markets, foreign banks also provided these countries' economies with more credit resources than would have been possible on a domestic basis.

From the mid-2000s, a consensus started to emerge that the Baltic economies had been overheating. High inflation, steep wage growth, widening current account deficits and increases in unit labour costs were indicative of a loss of international competitiveness. With the GFC and the associated global economic slowdown, exports from the Baltic countries dropped. Together with the broad-based economic contraction, this had an immediate effect on government finances: government expenditures increased as unemployment started to grow, all while government revenues shrank. Worries about the Baltic countries' economic situation started to emerge, raising speculation about the "unavoidability" of a devaluation.

[1] Patrizia Baudino (Patrizia.Baudino@bis.org) and Rastko Vrbaski (Rastko.Vrbaski@bis.org), Bank for International Settlements; Olga Lielkalne (Olga.Lielkalne@bank.lv), Bank of Latvia; Tomas Reichenbachas (TReichenbachas@lb.lt), Bank of Lithuania; Mari Tamm (Mari.Tamm@eestipank.ee), Bank of Estonia. The authors are grateful to Rodrigo Coelho, Reiner Martin, Stasys Jakeliūnas and to contacts who were employed by the Baltic financial authorities during the crisis (Thomas Auväärt, Akvilė Bareikaitė, Dainius Grikinis, Jeļena Ļebedeva, Jana Kask, Priit Kiilmaa, Helen Korju-Kuul, Andres Kurgpõld, Juris Kravalis, Simonas Krėpšta, Vilma Mačerauskienė, Mārcis Risbergs, Toma Sasnauskienė, Sigitas Šiaudinis, Kadri Siibak, Jaak Tõrs, Nijolė Valinskytė, Ludmila Vojevoda, Elmārs Zakulis, Audrius Želionis) for comments, but this does not imply that these persons share the views expressed herein. Theodora Mapfumo provided valuable administrative support.

In line with the scope of this series, this paper focuses on the policy response. Starting in 2006, the Baltic countries introduced various measures to try to cool their overheating economies, but they were insufficient.

The toolkit for banking sector measures that was available to the local authorities was limited in various ways. First, because all Baltic countries had decided early on to preserve the peg in order to eventually join the euro, the Baltic central banks were constrained in their ability to provide liquidity to financial markets. Second, the scope for regulatory and supervisory intervention was restricted in terms of its applicability. In particular, domestic authorities had little influence over the strategic decisions of foreign-owned banks, as foreign-owned banks that operated as branches fell outside the remit of the Baltic authorities. Lastly, fiscal space was limited.

The immediate policy response included an internal devaluation in all three countries, while different approaches were taken for the banking sector in terms of support measures, with varying implications for fiscal budgets. Given their commitment to the currency peg and the need to restore economic competitiveness, the three Baltic countries took fiscal consolidation measures. The weakening labour market and migration reduced wage pressures. European funds helped to reduce adjustment costs on the macroeconomic side. On the banking sector side, the three countries activated liquidity support measures, within the constraints of the peg. In addition, in cooperation with the foreign banks' home authorities, liquidity support was also provided to the branches and subsidiaries operating in the Baltic countries.

Capital support measures were needed for some banks in response to the increasing volume of non-performing loans. In that context, the support provided by foreign-owned banks was crucial. Their immediate response was to strengthen the capital positions of their local subsidiaries in Lithuania and Latvia, while no such measures were required in Estonia.

Implications for fiscal budgets differed for the three countries. In Estonia, higher capital levels, lower NPL rates and a conservative fiscal policy prior to the crisis meant fiscal implications were marginal. For Lithuania, the government had to increase government bond issuance, at relatively high costs. In Latvia, where a major domestic bank failed, authorities sought the support of an IMF/EU economic assistance programme.

Authorities introduced structural changes to the banking sector over the medium term. Also taking advantage of the adoption of the euro, over 2011-15, the countries introduced substantial regulatory and supervisory changes, spanning the creation of new authorities, the adoption of Basel III, the introduction of a macroprudential and bank resolution framework, and more.

Foreign banks adjusted their business strategies in the Baltic countries. In particular, while opting to remain active in the Baltic countries, they reduced their footprint and adjusted their funding structures to reduce their reliance on foreign funding.

The lessons from the episode of financial stress in the Baltic banking sectors are manifold. A fixed exchange rate masked mounting stress which would have otherwise materialised in the form of depreciation of the national currency. The exuberance associated with accession to the European Union and the expected adoption of the euro also contributed to a diminished awareness of risks. Foreign ownership of banks allowed for faster growth but could have become a source of financial sector vulnerability in a crisis. Finally, a well-developed toolkit for prudential and crisis management purposes, including macroprudential instruments and bank resolution powers, can strengthen the resilience of the financial sector. Key to the successful management of the crisis were the fact that foreign banks chose to remain active in the region and the public acceptance of the internal devaluation. These factors, however, were linked to specific features of the Baltic economies and societies and may not be easily replicated in other cases.