Issues of Convergence in Economies with a Fixed Exchange Rate – Experience of the Baltic Countries

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Continued from previous issue

In the previous part, we have sketched the development in the Baltic Region, which has currently resulted into imbalances reflected in the price development. It seems that explanations for the current acceleration of inflation are not only in the fundamentals, but also in pressures of an unbalanced nature. In this part, we give an overview of the factors behind this situation. We focus on:

- *development of domestic demand and GDP including a look at the external imbalance,*
- *overall and sectoral analysis of the labour market with a focus on the development of wages, productivity and its impact on inflation,*
- *issues of the credit market and the rising indebtedness of households,*
- *influence of fiscal policy on the economy.*

Finally, this part also contains a summary and an interpretation of the conclusions from the particular issues for further convergence of Slovak economy

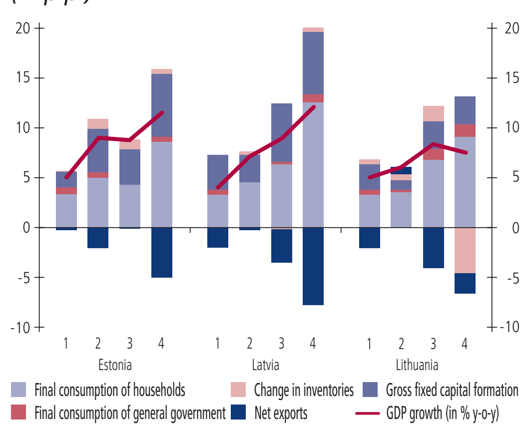
3. Strong economic growth and external imbalance

Economic growth of the Baltic countries has been culminating in recent years, having reached in 2006 the highest levels over the last decade in Estonia and Latvia. The current growth of the Baltic region is interesting primarily not because of its high levels, but rather because of its structure. A basic typical feature of the growth is private domestic demand being its main source, with an increasingly predominating consumption of households and, as second, gross investments. Government consumption has contributed to the growth to a relatively low extent – these countries have "a tradition" of low budget deficits or of surplus budgets (for details on the influence of fiscal policy on the economy see part 6 The importance of fiscal policy). Because these countries import considerably more goods than they export (the balance of services has been positive in the long run, but it does not compensate for the deficit in goods), the growth rate of the private demand has been exceeding that of GDP in the long run.

This relation between their growth rates poses a certain threat to the stability of the region. Reflections on a so-called hard landing, which would be associated with a "freezing" of economic growth, appear on the horizon of a near future. A slight slowdown of the growth has already occurred in 2006 in Lithuania, whereas the GDP growth should slow down slightly in all three countries in 2007 and 2008. According to predictions of the Eurostat so far, the trend of a faster growth of domestic demand as compared to that of GDP should continue.

Why do the Baltic economies experience negative contributions of net exports to GDP growth in the long run? It seems that the problem is with the trade exchange of goods, both on the import and export side. High imports are associated with the purchase of technologies, but also

Chart 15 Contributions to the GDP growth (in p.p.)



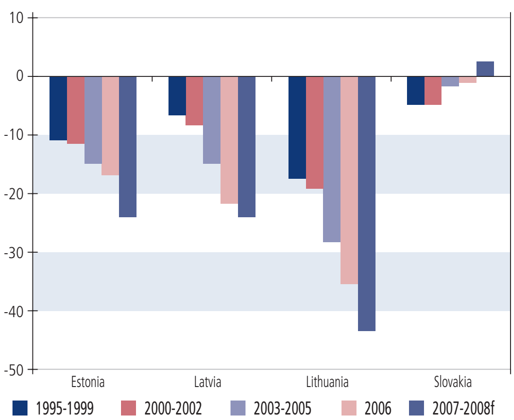
Source: Eurostat and calculations of NBS.
1 is the average over 1995-1999 (for Latvia and Lithuania 1996-1999), 2 over 2000-2002, 3 over 2003-2005, 4 the year 2006.

Table 2
Growth rate of domestic demand (% y-o-y) | *GDP growth rate (% y-o-y)*

	Growth rate of domestic demand					GDP growth rate				
	Cumulative 2000-2006	2005	2006	2007 (p)	2008 (p)	Cumulative 2000-2006	2005	2006	2007 (p)	2008 (p)
Estonia	75.6	9.7	12.6	12.9	10.9	65.6	10.5	11.4	8.7	8.2
Latvia	87.5	9.3	17.3	11.5	7.7	65.9	10.6	11.9	9.6	7.9
Lithuania	69.9	9.3	8.5	10.6	8.0	56.1	7.6	7.5	7.3	6.3
Slovakia	36.1	8.6	6.2	6.2	5.3	35.5	6.0	8.3	8.5	6.5

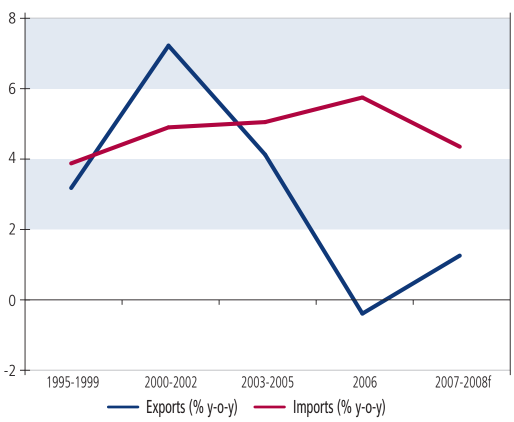
Source: Eurostat and calculations of NBS.
(p) Prediction according to the Eurostat.

Chart 16 Net exports on GDP (goods and services; in %)



Source: Eurostat and calculations of NBS.

Chart 17 Dynamics of exports and imports (average for the Baltic region - goods)



Source: Eurostat and calculations of NBS.

with the rapid growth of these economies, because of which the disposable income of their households is increasing. The strong domestic demand, not covered by own production, hence orientates towards imports. On the other hand, dynamics of Baltic exports has decreased, especially in recent years. Positive figures in the balance of services are not sufficient to compensate for the deficits in balance of goods. Deepening negative ratios of net exports to GDP are the result.

Similarly to the Baltic region, our economy has been experiencing a dynamic growth in recent years. There are, however, many differences in its structure as compared to the Baltic countries.

1. So far, Slovakia has had a 'healthy' relationship between the dynamics of GDP and of domestic demand, being in favour of the GDP. According to the Eurostat, the favourable relationship is expected to continue also in this and the next year.

2. A particularly good sign is the positive contribution of the net exports to GDP, which Slovak economy reached in 2003 and again in 2006.[1] However, it is necessary that our economy keeps or furtherly improves its export performance also after euro area accession.

3. Two warning signals result from a comparison of the growth structure. First, the relatively large contribution of the consumption of households to growth (being larger than the contribution of gross fixed capital formation). This contribution has been smaller in comparison with the Baltic countries so far, their experience, however, shows the possible consequences of its increase. The second warning is the relatively larger contribution of general government consumption to Slovak economy growth. In the forthcoming period, it will be necessary as much as possible to avoid impulses from public expenditures into economy (for details on government budgeting see part 6 The importance of fiscal policy).

4. Gross external debt of Slovakia is considerably lower than that of Estonia and Latvia – it reached 61% of gross national income in 2005. The structure of our debt is more favourable in terms of financial sector stability and its influence on domestic economy. The banking sector accounts for a relatively smaller part, around 25 percent, of the debt.

5. The foreign sector is relatively strong, not only in the Baltic region, but probably also in Slovakia. Investment income from direct investments on Slovak current account in 2006 reached around 5.1% of GDP. It can be expected that the strength of the foreign sector in Slovak economy will even increase as a result of further foreign direct investment inflows. The question is how foreign firms will distribute their profits between dividend payments and reinvested earnings. The latter item could influence the potential output (through investment in host economy), which is positive, on the other hand, it could exert a certain pressure on the price development through employee wages.

1 The contribution of net exports to growth was negative in 2004 and 2005; chart 15 contains average numbers for several years.

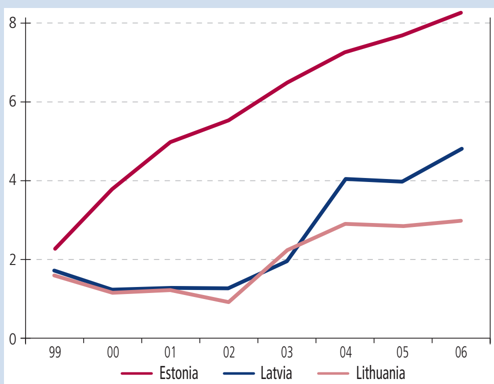
Box 4

External (im)balance of the Baltic Region

External position of the Baltic countries, except for level differences, is characterized by several common features.

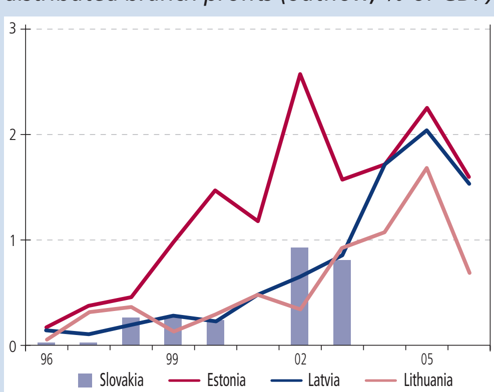
1. Typically, current accounts records deficit, associated to the deepening deficits of the trade balance, but also to the income balance deficits. The outflow of funds on this account is related to profit repatriation and to reinvested earnings of firms in foreign ownership. Concretely, the item income from direct investment within the income balance includes dividends and reinvested earnings. The growing share of this item on GDP (3-8 %) thus points to a growing strength and profitability of the foreign capital in the region. Dividend payments and distributed branches profits account only for some 0.7-1.6% of GDP.

Income balance of CA – income from direct investment (% of GDP)



Source: Eurostat and calculations of NBS.

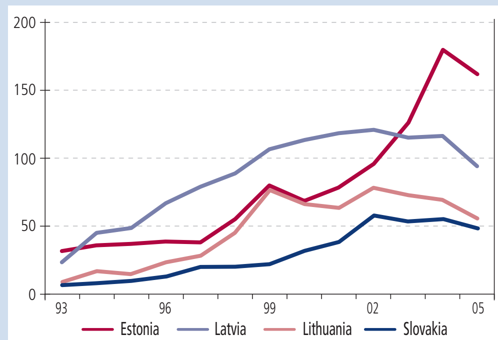
Income balance of CA – dividends and distributed branch profits (outflow; % of GDP)



Source: IMF (IFS, BOP) and calculations of NBS. Data for Slovakia are missing for the years 1996, 1997, 2001 and 2004-2006.

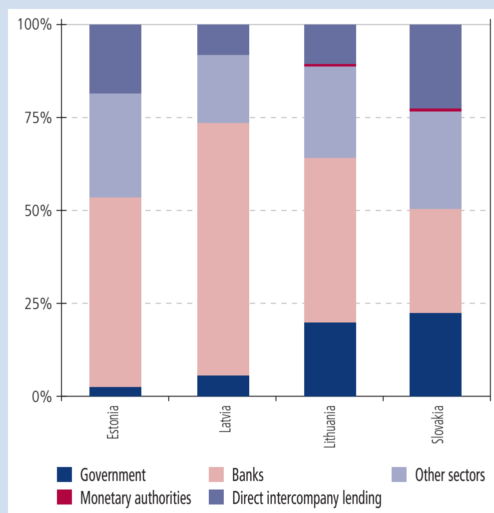
2. Financial account, in contrast, records surplus, mainly due to the inflows of foreign direct investment. Another source of inflows on the financial account, within "other investment", originates from the borrowing of banks from their mother banks abroad. Foreign direct investment inflows into theses economies probably have been an important driving factor to their production capacities. This is documented by the increasing marginal productivity (except for Estonia).

Stock of foreign direct investment (in the reporting economy; % of exports)



Source: UNCTAD.

Structure of gross external debt (Q2-06 to Q1-07)



Source: World Bank – World Development Indicators database, April 2007.

3. External debt has reached high levels in recent months particularly in Estonia and Latvia. In 2005, it reached 101.6% and 103.7% of gross national income, respectively; in Lithuania 52.5%. Banking sector has the largest share in external debt.

4. Influence of the labour market on inflation

The strong consumption of Baltic households results mainly from a fast growth of real wages on the tightening labour market. In addition, it is also backed by their considerable indebtedness. On the one hand, labour costs in these countries are growing, as a result of improving productivity

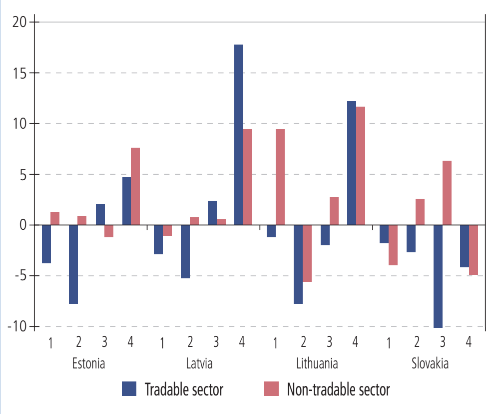
Box 5

Sector imbalances – impact on price growth

The problem appearing in real labour cost at the level of total economy in the Baltic region is also confirmed by a sectoral analysis.

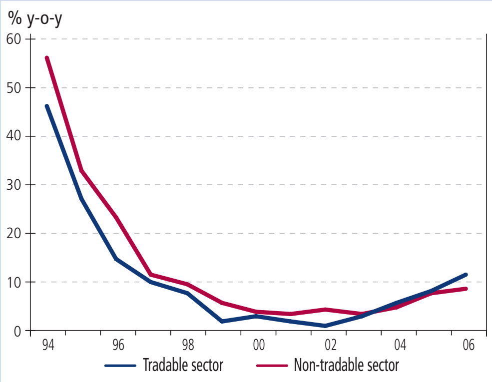
1. Rapid labour cost growth in these economies can be partly attributed to the convergence which entails adjustments in productivity, as well as in costs and prices. According to the concept on the Balassa-Samuelson effect, labour productivity (under international competition) usually grows faster in the tradable sector than in the non-tradable sector. Labour costs are increasing in the whole economy, as the wages in non-tradable sector (i.e. in the sector services) usually tend to follow the wage growth rates in the tradable sector. As a result, the growth of labor costs in the non-tradable sector exceeds that of the productivity. These assumptions have proved true both in the Baltic countries and in Slovakia.[2]

Differences in the annual dynamics of labour cost and productivity (in p.p.)



Source: Eurostat and NBS calculations [2].
Both variables are in real terms. 1 is the average over 1997-1999, 2 over 2000-2002, 3 over 2003-2005 and 4 the year 2006.

Price growth in the Baltic Region



Source: Eurostat and calculations of NBS [2]. Deflators of gross value-added.

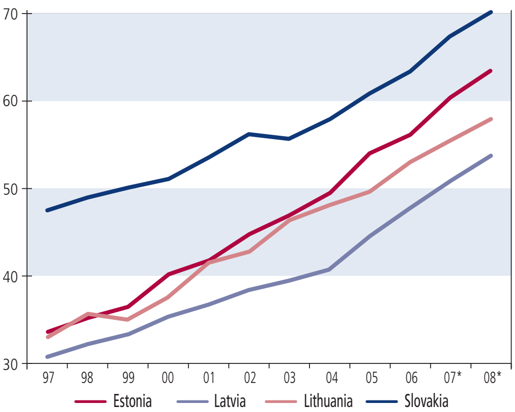
2. However, labour cost growth in these economies exceeds the productivity growth very considerably, thereby pointing to a presence of imbalances on the labour market. Importantly, however, an unfavourable relationship between the wage growth and productivity growth appears in both sectors – the non-tradable sector (services) and the tradable sector.

3. Wage pressures in each of these sectors have and upward effect on inflation.

3a) As for the sector of services, the difference between the faster growing labour costs and the productivity growth has been showing an upward trend as early as from the 90s. In 2006, this difference exceeded 7 percentage points in all three economies (reaching about 11 percentage points in Lithuania). The current acceleration in the prices of services thus may a result of this.

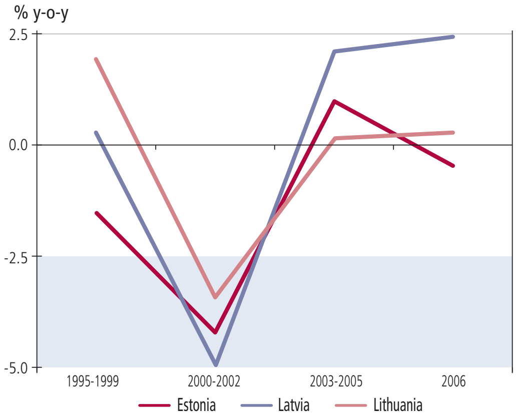
3b) The tradable sector also records a positive difference between the labour cost growth and the productivity growth; in the case of Latvia and Lithuania, it is even greater than in the services sector. This problem seems to influence the whole economy and exerts inflation pressures on the demand-side.

Chart 18 Productivity levels – GDP at PPP per employee (EU-15 = 100)



Source: Eurostat and calculations of NBS.

Chart 19 Growth of real unit labour costs



Source: European Commission, DG ECFIN.

2 *We have used quarterly data on gross value-added at constant prices according to the national accounts, on the number of employees and on the total real labour cost from the Eurostat database. Our "tradable sector" includes mining and quarrrying, manufacturing, electricity, gas and water supply and construction (branches c-f of the NACE classification). The "nontradable sector" includes wholesale and retail trade, transport, storage and communication, hotels and restaurants, financial intermediation, real estates, public administration and defence, education, health and social work, and the remaining activities (branches g-o of the NACE classification). A similar analysis see in the article of the authors Nenovsky, N., Dimitrova, K.: „Dual Inflation under the Currency Board: The Challengers of Bulgarian Accession." William Davidson WP No. 487, July 2002.*

in connection with the catching-up process, which is rather normal in converging economies. In the case of the Baltic countries, the relative productivity growth as compared to the EU-15 average (calculated from GDP in purchasing power standards per person employed) is even somewhat higher than for example in our economy (they had a lower initial base). On the other hand, productivity growth in these economies in comparison with increases in employersę labour cost is slowing down in real terms. The real labour cost reached approximately zero or a positive value in 2006. This shows that the strong wage growth also has reasons of an unbalanced nature.

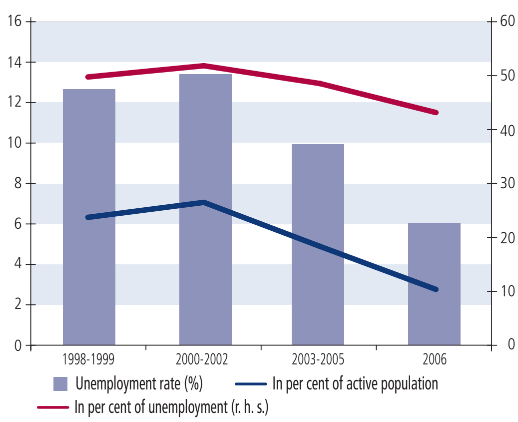
Despite certain differences between the individual Baltic countries, the imbalances on the labour market have common denominators:

1. The labour market in the region is tight as a result of labour force shortages. A persistent phenomenon is labour force emigration to foreign countries. The unemployment rate according to the Labour Force Survey, which includes the total national employment both in the home country and abroad, showed in 2006 record increases mainly in Estonia and Latvia – of 5.4% and 4.8% year on year, respectively. At the same time, unemployment rate has been falling constantly. A typical feature is that even workers discouraged in long-term return to labour activity.

2. Tensions on the labour market particularly concern some branches. Paradoxically, opening of the labour market by some member countries for the new members from the EU enlargement in 2004 has decreased their ability to adapt to shocks. Changes experienced by the economies, accompanied moreover by outflow of certain worker groups, have deepened the structural problems of the labour market. The resulting lack of workers, or workers with an appropriate qualification, is thus strongly passed through into wage pressures. Soft indicators in industry illustrate the situation from the perspective of businesses quite well: the level of capacity utilization is increasing, whereas demand represents a still smaller limitation to production. On the contrary, the perceived share of labour in the production limitations has increased considerably, especially in the last year.

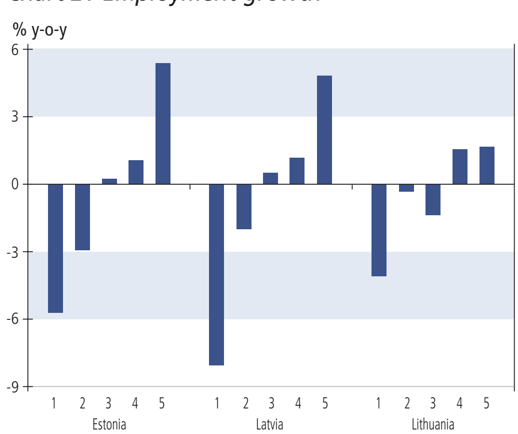
Real labour cost growth accelerated in 2003-2006 as compared to the 2001-2003 period most considerably in the health care, construc-

Chart 20 Long-term unemployment indicators – average for the Baltic region



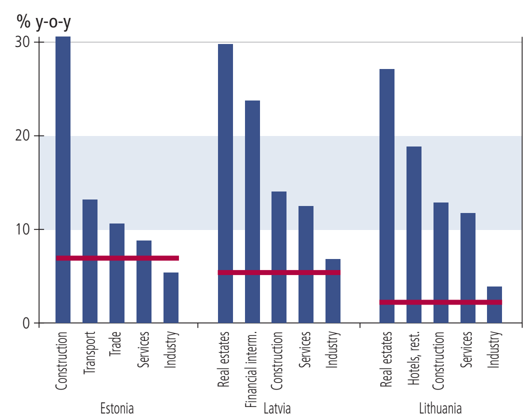
Source: Eurostat and calculations of NBS.

Chart 21 Employment growth



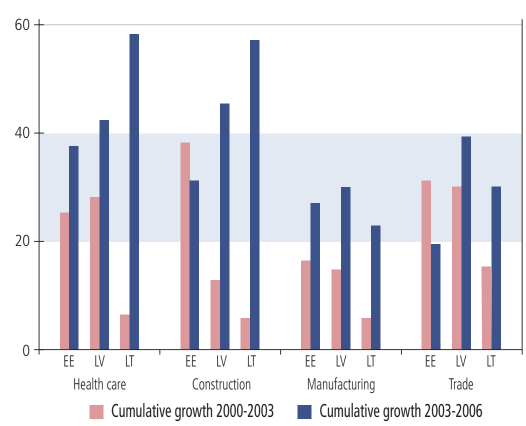
Source: Eurostat.
1 is the average over1992-1994, 2 over 1995-1999, 3 over 2000-2002, 4 over 2003-2005, 5 the year 2006.

Chart 22 Change in the number of employees in branches and total economy (2006)



Source: Eurostat and calculations of NBS.

Chart 23 Branches with highest real labour cost increases



Source: Eurostat and calculations of NBS.
EE- Estonia, LV- Latvia, LT- Lithuania.

tion, manufacturing and trade. Labour cost of employers in these branches increased in real terms by 19-57% cumulatively over the last three years, which, in comparison with the previous period, is a large increase (particularly in the health care and construction). Exceptions from this trend are the construction and trade in Estonia, where a decline has been recorded. Even there, however, the growth rates continued to exceed 30% and 19% in real terms respectively. Cumulative increases for the entire economy are also interesting: since 2003, labour costs have increased by 23% in Estonia, by 31% in Latvia and by 28% in Lithuania.

3. Although the health care is the sector to experience the fastest growth of real wages on average for the Baltic region, in terms of macroeconomic and price (in)stability, we consider construction to be the most critical branch. Building industry is closely associated with both the real estate market and the credit market. Eventual crisis in this field has the potential to negatively influence the whole economy. The building industry alongwith the real estate belong among the branches in the region experiencing a boom due to high investment inflows. Hiring a sufficient number of employees with an appropriate qualification to cover new orders is associated with high costs here. Boom in the two branches is backed by massive credit financing by mortgage loans and loans for house purchase (for details on the development on the credit market see part 5 Impact of the credit boom on stability). The construction industry, being the most critical branch, is "overloaded" because of the extraordinary attractiveness of the East European real estate market which is reflected on a possible price bubble creation[3]. Strong demand for real estates even intensifies the acceleration trend in the dynamics of construction work prices. Their annual growth exceeded 13% in the first quarter of 2007.

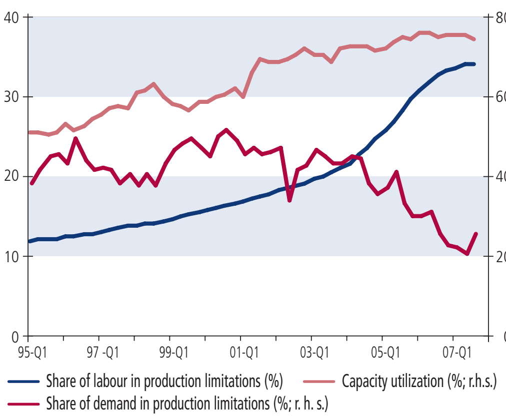
Similarly to Baltic countries, the Slovak labour market is rather small. According to comparable data available, however, its development appears to be healthier than in the Baltic region. There is a couple of positive differences.

1. Opening of the European labour market seems to have influenced Slovakia to a lesser extent than the Baltic countries. Slovak people recently are somewhat discouraged from occasional work stays also by the koruna appreciation. However, this issue is rather marginal within our labour market.

2. Employment growth and a rise in wage growth in Slovakia is more moderate and more evenly distributed over the individual branches. Quite many branches reached a cumulative real increase since 2003 being close to the figure for the whole economy (7.8%). Only some branches – financial services, education, electricity, gas and water supply – protrude from that picture.

3. We perceive the development rather positively also from the perspective of a simple sectoral analysis. The picture of dual inflation in Slovakia over the last four years clearly points to a presence of the B-S effect. This assumption is jus-

Chart 24 Soft indicators of industrial production (average for Estonia, Latvia and Lithuania)

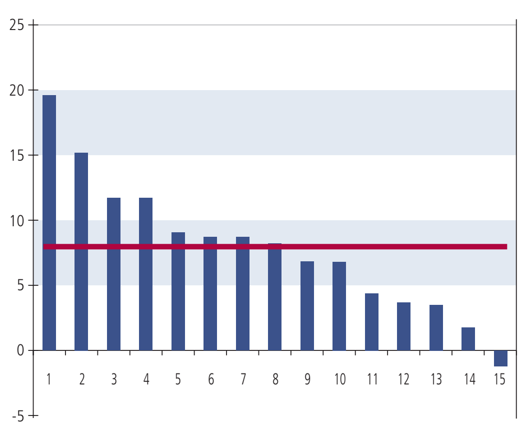


Source: European Commission. Seasonally adjusted data.

Chart 25 Credit boom and construction (average for Estonia, Latvia and Lithuania)

Source: Eurostat, National central banks and calculations of NBS.

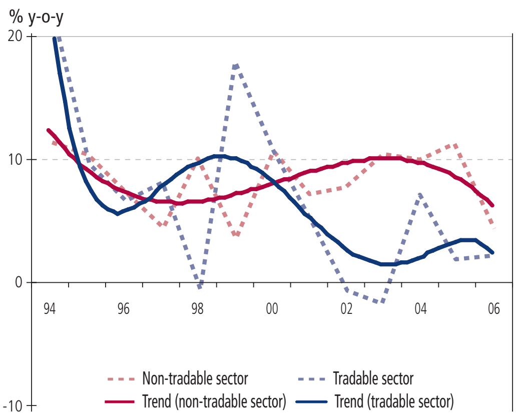
Chart 26 Cumulative real labour cost growth in Slovakia 2003 – 2006 (in %)



Source: Eurostat and calculations of NBS. The line – data for the whole economy.
1 financial intermediation, 2 education, 3 transport, 4 electricity, gas and water supply, 5 real estate, 6 services, 7 health care, 8 other services, 9 industry, 10 manufacturing 11 trade, 12 construction13 public administration, 14 mining and quarrying, 15 hotels and restaurants.

3 In 2006, the capitals of the Baltic region were among the top 10 in the global Knight Frank House Price Index. In the last quarter of 2006, the Latvian Riga was placed first with a 66 per cent year-on-year increase, the Lithuanian Vilnius exhibited a growth of 13.3% and the Estonian Talinn was placed tenth with 10.4%. Signs of cooling appear in this year (2007) on the real estate market in these countries.

Chart 27 Price growth in Slovakia



Source: Eurostat and calculations of NBS[2]. Deflators of gross value-added.

tified by negative differences between the growth of labour cost and productivity in the tradable sector and, until recently, by the positive differences in the sector of services. In 2006, productivity growth even exceeded the wage growth in all sectors of Slovak economy (chart in Box 5).

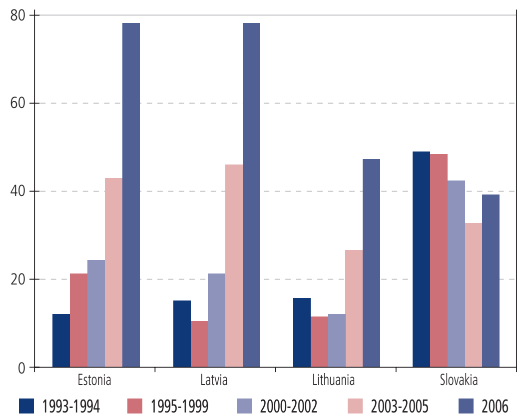
4. What can we expect after accession to the euro area for the labour market? Structural problems of the Baltic labour market might be one of the issues specific just for these countries, for which the fixed exchange rate regime is not responsible. On the other hand, we may, with a certain abstraction, perceive this situation as a warning, especially in connection with a concentration of economic activity to a small number of branches or to one single branch. Further investment inflows could increase labour demand for example in the automotive and electronics industry, which could contribute to pressures on the real wage growth. This points to the necessity of maintening flexibility and a suitable structure of the Slovak labour market. As the manufacturing industry belongs to the competitive tradable sector, it should not turn to be a source of excessive pressures. High demand for manufacturing products, however, could influence related and other branches in Slovakia as, for instance, the construction industry which is a critical branch in the Baltic region.

5. IMPACT OF THE CREDIT BOOM ON STABILITY

Overheating of the Baltic economies has been largely "facilitated" by a credit boom associated with financial deepening. Massive lending and the rapid credit growth became a problem for the Baltic economies from several perspectives. Consumer loans (alongwith other sources of borrowing) encourage an excessively strong household demand. Mortgage loans and loans for house purchase have contributed to a boom on the real estate market – with an impact on the construction sector and on the labour market already described in part 4 Influence of the labour market on inflation. Finally, the Baltic countries as small open economies are quite vulnerable in terms of (in)stability and importance of their banking sector.

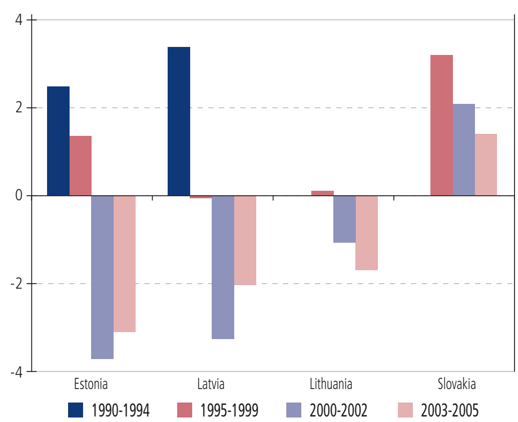
This is documented also by the ratio of loans to private sector on GDP. After a consolidation of the banking sector in the Baltic region approximately in the years 2000 – 2002, the ratio almost doubled over the following two years, increasing by a further third in 2006.

Chart 28 Loans to private sector (% GDP)



Source: IMF (International Financial Statistics) and calculations of NBS.

Chart 29 Net savings of households (% of gross disposable income)



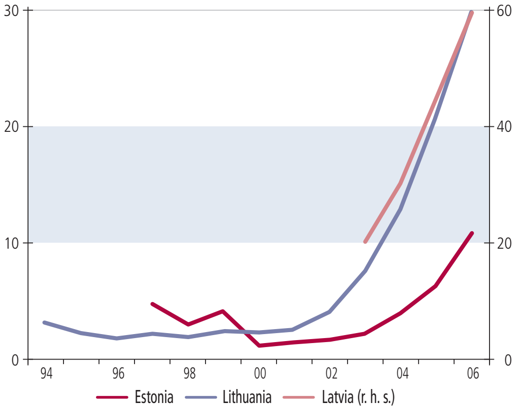
Source: European Commission (DG ECFIN) and calculations of NBS.

There are several reasons we perceive behind the booming credit growth in the Baltic countries:

1. The credit growth probably reflects the process of financial deepening. Households show a considerable propensity to indebtedness. Their net borrowing as a ratio on GDP reaches high levels in the Baltic countries, which is also evident from their negative savings. The share of loans to households for consumption purposes (the sum of consumer credit and the so-called other loans) in Latvia reached as much as 60% of the final consumption of households in 2006. Although the growth rate of loans to households has been decreasing slightly, increases in loans in absolute terms continue to show an upward trend.

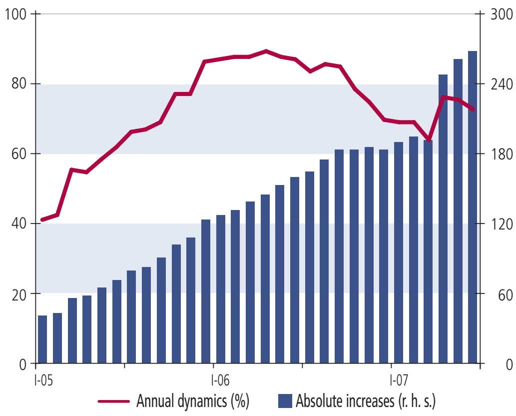
2. High credit demand is facilitated by low interest rate spreads against the euro area (the

Chart 30 Loans to households for consumption purposes (% of final household consumption)



Source: National central banks, Eurostat and calculations of NBS.

Chart 31 Loans to households (average for the Baltic region)



Source: National central banks and calculations of NBS.

spreads on the money market in the region had been some 0.1-1.5 p.p.). The real interest rates in the region had been negative given the actual inflation rates.

3. Massive lending is associated with a strong inflow of investments in some branches (one of such branches is the above-mentioned construction industry). In every of the past twelve years, the Baltic region attracted foreign direct investment of at least 3-5% of GDP. Still there are opportunities for the building industry and the associated credit financing, for example in infrastructure and other fields.

4. Competition in the Baltic banking sector has been intensifying as foreign investors gained a dominant market share with a control over more than 80% of the assets and 70 – 90% of the capital. Two competing Swedish groups – SEB and Hansapank[4] – dominate. Typically, banks in the region borrow resources from parent banks for local activities.

5. A specific feature of the Baltic credit market is that euro-denominated assets account for a major part of the loans (more than 70-80% of the portfolio) to private sector. Foreign currency operations seem to have a strong tradition in this region. This may be associated to the long-term experience of these countries with the fixation of exchange rates against foreign currencies (the US dollar, German mark, SDR and at present the euro).

The chosen monetary policy strategy (fixed exchange rate) is rather of disadvantage in the "credit problem" due to the fact that the Baltic countries actually have no possibility to dampen the credit expansion by interest rates. Minimum differences in interest rates between them and the euro area basically are a result of importing the monetary policy of the ECB. Moreover, given the high share of euro-denominated loans, a higher interest rate differential could eventually motivate to increased lending in euro. One of possible measures to dampen the credit growth remains the restricting of the bank supervisory rules. Higher minimum reserve requirements could have a similar effect. Baltic central banks have used this instrument several times over the last four years. However, loans last in their dynamics even after the capital adequacy measures tightened. Despite signs of cooling, which have occurred on the credit market over 2007 so far, it remains a source of risk for stability and further inflation development in the region.

The financial sector has gained on importance also in the Slovak economy; there are, however, some differences as compared to the Baltic region.

1. The level of indebtedness of Slovak households is relatively low – according to data of the European Commission (DG ECFIN), they actually are in a creditor position with net borrowing of 0.3% GDP. Loans to households represent about 15% of GDP in Slovakia (19 – 38% in the Baltic countries, about 5% in Estonia). Level of household indebtedness in Slovakia has not showed any considerable increase even under enlarged borrowing possibilities (consumer loans, leasing etc.)

2. The year-on-year credit growth and their ratio to GDP have not reached any 50% of the level of the Baltic region so far. Any dramatic change

Table 3

	2004	2005	2006
Loans to private sector (year-on-year growth in %)			
Estonia	44.6	66.5	62.1
Latvia	47.0	64.3	64.0
Lithuania	40.3	56.1	51.4
Slovakia	**6.2**	**26**	**22.9**
Ratio of foreign currency loans in the total loans to private sector (in %)			
Estonia	80.4	79.9	78.1
Latvia	60.9	70.0	70.9
Lithuania	58.3	65.8	52.8
Slovakia	**22.8**	**28.2**	**27.1**

Source: IMF, Staff Report for the 2007 Article IV Consultation, May 2007.

4 *According to Adahl, M.: "Banking in the Baltics – The Development of the Banking System of Estonia, Latvia and Lithuania since independence: The Internationalization of Baltic Banking (1998-2002)." OENB Focus on Transition 2/2002*

5 Based on the study Rosenberg, Ch., Sierhej, R.: "Interpreting EU Funds Data for Macroeconomic Analysis in the New Member States." IMF WP/07/77. The authors point out that quantification of the impacts of drawing EU funds is methodologically rather difficult.

in the credit development did not occur even after Slovakia's EU accession.

3. Will the credit market change after Slovakia accedes the euro area? It seems to us that the extent, to which the credit market has become a problem for economic stability in the Baltic countries, is largely their specific feature. On the other hand, this problem is directly associated with the fixed character of their currency exchange rates. Thus, the credit market is a warning also for Slovakia. It is possible that the level of household indebtedness will gradually rise in Slovakia because of the strong economic growth and changes in consumption patterns. Similarly to the Baltic region, after the introduction of euro, it will not be possible to actively influence the credit market through interest rates. In the near future, loans to industry businesses as well as lending for house purchase and consumer credit will intensify in Slovakia. The former loans would turn to business investments, while the two latter groups are directly associated with the borrowing of households and household consumption.

6. The importance of fiscal policy

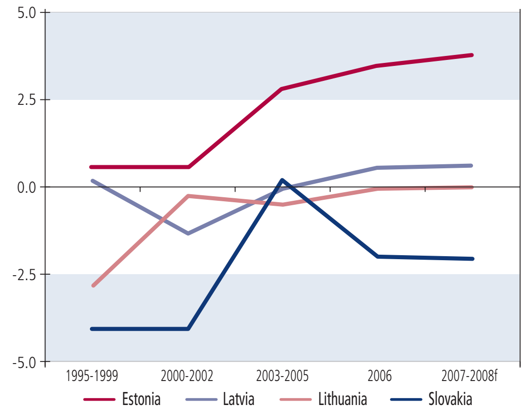
The macroeconomic stability of the Baltic region has been in the long run – and still is –influenced by the fiscal policy. In the 90s, its restrictive effect helped to stabilize hyperinflation, although at the cost of freezing the economic growth. General government balances traditionally result in low deficits (Latvia, Lithuania) or surpluses (Estonia). This corresponds with a low level of gross government debt, which does not exceed 20% of GDP in any of the three countries. Government expenditures have thus contributed to GDP growth only minimally in recent years.

Despite a seemingly healthy development of public finance, there are certain risks – both for the economic stability of the Baltic countries and for the stability of their price development.

1. According to DG ECFIN data, the budget deficit in Lithuania and Latvia deepened in 2006, from the macroeconomic perspective, however, the cyclically adjusted budget balance gives more evidence. This indicator reaches values close to zero in two Baltic countries and positive values in the case of Estonia. Due to the positive output gaps in 2006 this fiscal policy setting does not seem to have been sufficiently restrictive. Output gap estimates for converging economies, however, are subject to high uncertainty, and therefore do not allow a more direct evaluation. Further expected loosening in budgetary development in 2007 and the following years could cause a certain positive fiscal impulse into the economies.

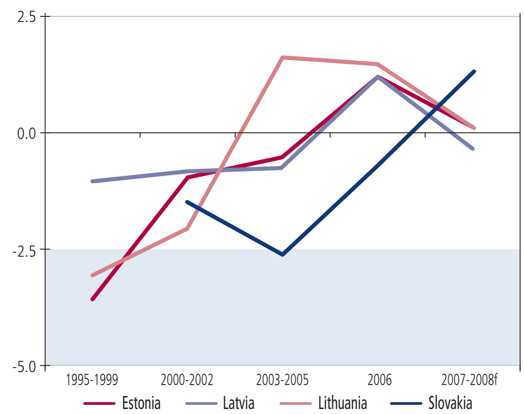
2. The fiscal impulse as such, resulting from a moderate loosening of the budgetary stance in the Baltic countries, should not be significant. It is necessary, however, to consider also the additional effects resulting from drawing sources of the EU funds. A fiscal impulse adjusted for these

Chart 32 Cyclically adjusted budget balance according to EDP (% potential GDP)



Source: DG ECFIN and calculations of NBS.
The 2007 and 2008 data are a prediction of DG ECFIN.
EDP – excessive deficit procedure.

Chart 33 Output gap (% potential GDP)



Source: DG ECFIN and calculations of NBS.
The 2007 and 2008 data are a prediction of DG ECFIN.

could reach positive values of 0.1 – 1.2 % GDP in Lithuania and Estonia[5].

3. In the coming period, the Baltic economies will be affected by adjustments in direct and indirect taxes. Estonia decreased the personal income tax as early as in 2006, Lithuania plans a similar measure in January 2008. As for indirect taxes, their level is quite low in these countries, whereas they are obliged to reach the minimum requirements in line with EU directives not later than by 2010. This primarily applies to excise taxes on tobacco products, which are supposed to be increased in 2007 and more considerably in 2008 (Estonia and Latvia). Harmonization should also affect other indirect taxes, particularly the VAT (value-added-tax). While decreases in income taxes can have a stimulating influence on the already strong consumption demand, changes in the indirect taxes usually have a direct effect on prices and could contribute to a further acceleration of inflation.

4. The public sector could influence these economies also through wages. The growth of labour cost in administration, defense and compulsory social security accelerated to 9-19% in 2006 (it reached 4-9% in real terms in 2005). Al-

though the labour cost growth in the public sector is lagging behind some other branches, in 2006, this sector "outrunned" in labour costs dynamics the real estate sector, hotels and restaurants or financial intermediation. This could have a certain signalling influence on wage increases in these branches.

5. A more concrete upward risk to inflation from the fiscal policy is associated with (proceeding and planned) adjustments to the regulated prices of distributed heat and of gas (more on the extent of deregulations in the Baltic region in Box 2).

The influence on macroeconomic stability which fiscal policy ultimately exerted and still exerts in the Baltic region gives, from several perspectives, a caution also to our economy:

1. The fiscal policy in these countries might not have been sufficiently tight taking into account the opening of a positive output gap in recent years, even despite low budget deficits (Lithuania, Latvia) or surpluses (Estonia).

2. The warning is all the more serious when considering the effect of drawing EU funds by the new member countries next to the fiscal impulse itself (an adjusted impulse to our economy could reach around -0.5 to 0.3% of GDP).

3. Among policies, still available after euro area accession, fiscal policy will become a key instrument. The importance of fiscal policy will increase with the "expiry" of the nominal exchange rate against the euro and the necessity of an anti-cyclical stance of the fiscal policy will increase, so that it does not bring additional impulses to the fast growing economy. Due to the positive impulse that the euro adoption could entail, including further FDI inflows, the fiscal policy should be necessarily set in a sufficiently tight manner. Hence, also the importance and impact of structural policies will increase.

7. Conclusions

Individual parts of the article deal with the development in the converging Baltic economies which currently resulted into both internal and external imbalances. Some problems associated with the opening of a positive output gap may result from the chosen fixed exchange rate regime which these economies have operated for more than a decade. However, specific problems, beyond the responsibility of the exchange rate policy, have also become more pronounced in the region.

What is the information from the experience of the Baltic countries relevant for our economy? On the one hand, we can learn about some warnings from their development. These regard, above all, consequences of the loss of a floating exchange rate against the euro which will definitely happen with the euro area accession.

Pass-through of the NEER appreciation of the koruna seemed to have, at least a moderate, dampening effect on Slovak prices of non-energy industrial goods and food prices. Because the NEERs have gradually stabilized in the case of the Baltic currencies, we can expect to lose the NEER appreciation also in the case of koruna. At the same time, with the euro area accession the independent monetary policy will cease to exist. Hence, fiscal policy will gain on importance and will become virtually the only active instrument to influence stability. Should it be inadequately loose, the resulting impulses would pose a threat for the healthy development of the economy.

With a certain abstraction, a lesson can be also drawn from other aspects of Baltic development, above all from the labour market and the credit development. A more detailed comparison with our economy, however, shows that these problems could occur in Slovakia just to a much lesser extent.

On the other hand, this article points out some advantages resulting for Slovakia from a comparison with the Baltic region. It is obvious that the Slovak economy has, in many aspects, passed a much more balanced development than, for example, the Baltic region. Importantly, the price convergence was well balanced with the catching up in terms of GDP; also, the real convergence has been continuously passed through into real appreciation.

We also perceive a difference in the timing of fixation the exchange rate of koruna against the euro. Slovakia will accede to the euro area reaching a significantly higher level of convergence than was that of the Baltic countries at the time of their exchange rate fixation to the euro. In terms of GDP per capita, (in purchasing power standards), Lithuania reached about 38% of the EU-15 average in 2002 and Latvia around 40% in 2004. Slovakia reached 56% of the EU-15 average as early as in 2006. Moreover, the "fixation" of the koruna to the euro will be a kind of secondary effect of euro area accession and not any stabilization instrument in the form of a nominal exchange rate anchor.

We expect that the membership in the euro area will help a further convergence of the economy through closer trade ties and a further inflow of foreign direct investments. Accession of Slovakia to the euro area at the time of euro area expansion could help a closer synchronization of economic cycles; this would limit an eventual inflation impulse of a loosened policy of the ECB. Nevertheless, we can expect a certain impulse to inflation resulting from the euro area accession with a high probability. Fiscal policy, adequately set, should help to absorb it.

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