Lithuania leads Baltic economic slump

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Economies in the Baltic region are set to suffer steep declines in output this year. On July 28, Lithuania released economic figures for the second quarter of 2009, revealing a year-on-year contraction of 22.4 percent of GDP. The data suggests that of the 27 EU members, Lithuania will face the worst economic contraction this year, surpassing Latvia, which recorded an 18 percent slide in the first quarter.

Lithuania's first quarter figures showed a decline in GDP of 13.3 percent. For 2009 overall, the Lithuanian economy is anticipated to contract 19.3 percent.

The figures confounded the hopes of some economists, who suggested that Lithuania's economy was better placed to withstand the global turmoil compared to neighbouring Latvia. Now many have been forced to admit that Vilnius will be compelled to seek assistance from the International Monetary Fund and may have to abandon its currency peg with the euro. This could trigger similar moves in Riga, Latvia, and in Estonia, where GDP fell by over 15 percent in the first quarter.

Domestic economic difficulties have been exacerbated by deepening problems across eastern Europe. The Baltic countries' main export markets include Russia, Belarus and Ukraine, all of which have suffered in the global downturn. Belarus and Ukraine have both been forced to turn to the IMF for support.

Responding to the bleak figures, Lithuanian President Dalia Grybauskaite indicated that IMF help was likely. The finance ministry would have "one more shot" at raising capital in the international markets before turning to the fund for support. In June, €500 million were raised through issuing government bonds.

The decision not to immediately seek IMF assistance has provoked criticism in ruling circles, with some pointing out that the government is borrowing money on the international markets at a higher interest rate than the IMF would charge. Rimvydas Valatka, an analyst from Lithuania's *Lietuvos Rytas* newspaper, commented that it was "unacceptable" that the government issued a €500 million bond in June with an annual interest rate of 9 percent when it could have turned to the IMF instead.

Such criticisms ignore the devastating consequences for the population that would result from IMF involvement. In every country that has turned to the IMF, and in which the fund has become involved, it has presented demands for savage cuts in government budgets, designed to promote "economic stability." Its prescriptions invariably impose the burden of economic crisis onto the backs of working people.

Nonetheless, with the economy worsening so dramatically, the government is now preparing for IMF support. It announced sharp budget cuts at the end of July, including an across-the-board public sector pay cut of 5 percent, the second such announcement of the year. Value Added Tax, which falls disproportionately on the worst off sections of society, was increased from 19 percent to 21 percent. This follows on from government spending cutbacks in the first six months of the year amounting to 7 percent of GDP.

Government finances are deteriorating, with projections of a budget deficit of over 8 percent this year. The European Union commission stated in June that Lithuania must return its budget deficit to below 3 percent of GDP by 2011, in order to comply with EU regulations. Grybauskaite has insisted that this was the motivation behind the budget cuts, and that they were not linked to a planned approach to the IMF. Recent examples suggest otherwise.

In neighbouring Latvia, IMF help was sought last December after the country's second largest bank, Parex banka, was bailed out by the government. The final loan agreement, totalling €7.5 billion, imposed strict conditions on Riga. Cuts of €1 billion euro in government spending for 2009 and 2010 were adopted, including a reduction in public sector pay by a third, the removal of pensions for some and the cutting of spending on social services.

While Latvia's 18 percent GDP contraction for the first quarter was widely reported, economic figures from every sector showed even steeper declines. Industrial output has declined year on year by 19 percent, imports by 40 percent, foreign trade by 38 percent and retail sales are down by 24 percent.

As with Iceland, which saw the virtual collapse of its financial system last October, many outstanding loans in Latvia and neighbouring states are in foreign currency, mainly euros. As a result, the decision of the governments in Riga and Vilnius to cut wages has led to an increasing number of people being unable to meet the costs of repayment. This problem would only be compounded by any future move to remove the currency peg with the euro and would spell bankruptcy for thousands.

The level of Latvian unemployment stands officially at 11.8 percent, although in actuality it is believed to be over 16 percent. With unemployment benefits only lasting nine months, it is feared that conditions will deteriorate rapidly in the autumn when those who lost their jobs at the beginning of the year will be left with no support from the state.

Working people have responded to the cutbacks with growing protest action. In January, the previous Latvian government was forced out following street protests in Riga involving thousands. Organised action by workers has emerged in opposition to the government's budget cuts, prompting Prime Minister Valdis Dombrovskis to state that his main aim will be to "preserve the social peace."

Neighbouring Estonia has received less coverage since its economic decline has not been quite as sharp as its neighbours. But on top of a GDP contraction of over 15 percent in the first quarter, unemployment currently stands at 15 percent. In the aftermath of the announcement of Lithuania's grim economic data, Estonia's Finance Minister Jürgen Ligi said that a contraction of more than 15 percent in the second quarter was likely.

During the years of economic boom, when Latvia and Estonia were the fastest growing economies in the EU between 2004 and 2006, the Baltic states relied on a constant stream of cheap credit. The main source of this was Sweden, with Swedbank representing the largest lender in Estonia and Latvia, while SEB dominated the market in Lithuania. Earlier this year, reports estimated that, in total, Swedish banks had extended loans of over 500 billion kronor (€60 billion) to the Baltic region.

Such a high level of exposure is threatening these banks with substantial losses. SEB and Swedbank posted large second quarter losses, even as other financial institutions saw their figures improve. Swedbank has reported that 54 percent of its property loans in Latvia are now under water, i.e., the property is now worth less than the loan extended.

The danger of the Swedish banks being unable to deal with losses of this size prompted the government in Stockholm to strengthen its currency reserves in June, with Finance Minister Anders Borg admonishing the banks' irresponsible actions.

Beyond Sweden, Baltic economic difficulties have the potential to destabilise the euro. A decision by any one of the Baltic states to abandon its currency peg with the euro would inevitably force the other two to take similar action. Such moves would force other Eastern European countries, such as Bulgaria, to consider devaluation.

As Gideon Rachman wrote in the *Financial Times*, "Despite the region's small size, the intensifying crisis in the Baltics cannot be treated as a freakish local squall of little concern to outsiders. Bank failures or plunging currencies in the three Baltic nations—Latvia, Lithuania and Estonia—could threaten the fragile prospect of recovery in the rest of Europe. These countries also sit on one of the world's most sensitive political fault-lines. They are the European Union's frontier states, bordering Russia."