

Transition from Command Economy to Macroeconomic Populism: the Baltic case

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Abstract:

According to Kornai's research on transition economies, the paper analyze the path of post-Soviet Baltic economies. The focus is on whether these economies transited into a cycle of macroeconomic populism from command economy which can be uncovered in the current account imbalance and not in the text book macroeconomic indicators. The economic story of emerging Baltic countries seemed to be a success before 2007. The region has seemed to be very disciplined in fiscal and monetary sense since there independence, besides, produced a boosting economic growth and significant real convergence to the higher developed EU members. But these countries with balanced policies suffered sudden stop in 2007. If fiscal balance, debt sustainability and fixed exchange rate is secured, what else can undermine the growth potential?

The hypothesis is that the process of income growth and quick catching-up of Baltic economies were established on external financing. Baltic countries can be complied to the political economy model of macroeconomic populism.

Theory and methodology: The analysis is based on the transition economics by Kornai, the macroeconomics of the Feldstein-Horioka puzzle and the reverse Balassa-Samuelson effect. The paper examines terms of trade, NEER, REER, ULC, current account imbalance, inflation and savings to conclude on reasons sudden stop in the Baltic region. Through the Baltic example, the paper enlightens on a structural problem of the European transition economies. The assumption of the paper is that the Baltic current account imbalance is based on the appreciation of real effective exchange rate (REER). The study explains and proves correlation between the REER appreciation and the current account deficit in Baltic relevance.

Keywords: Baltic states, external imbalance, macroeconomic populism, reverse Balassa-Samuelson effect, transition

JEL: F32, F36, F41, G01, H60

1. Introduction

The economic story of emerging Baltic countries seemed to be a success up to 2007. They were small, open economies with sustainable and low public debt, and a five to eleven percent permanent annual GDP growth rate; they became member states of the EU, and got rid of the Soviet economic heritage. According to Kornai (1994), we know that the transition economies had to cancel the laws of shortage economy, and create market economy by privatization, capital assets, fiscal and external balancing, and reforming of the social services. Nevertheless, he saw and showed that those reforms are limited by political factors as the redistribution actually means the cost and benefit position of interest-groups. (Kornai 1992a, Kornai et al. 2001) Moreover, he clearly demonstrated the weaknesses of the democracy and the political system of transition economies. (Kornai 1992b) The region seemed to be very disciplined in a fiscal and monetary sense from the very start of their independence. In the first half of 2000s they even produced a robust economic growth and significant real convergence as compared to the more developed EU members. The region has proved to be attractive for capital investment. However, economic analyses have projected some structural problems in their external (im)balance. These countries, characterized by balanced policies, suffered sudden stop in 2007, which was further exacerbated by the global crisis. If fiscal balance, debt sustainability and fixed exchange rate is secured, then what else can undermine the growth potential? Behind the fine indicators that were considered to be important, the external imbalance of the Baltics showed increasing deficit each year. Finally, the external indebtedness problem undermined sustainable growth. Besides, the Baltic convergence also signaled the imperfection of the Baltic economic success. The currency board-based economic policy produced more than excellent public finance and debt numbers which were directly under the influence of policy makers. However, inflation, as an indirect indicator of policies, brought about a series of failures in monetary integration. The focus is on the origins of sudden economic stop and the failure in price stability aspirations. External imbalance caused by passive macroeconomic populism gets under test now in view of Baltic economies.

The study examines the political economy of current account imbalance in the Baltic countries, where the public finances have seemed to meet the mainstream economics, and the pegged exchange rate has proved to be sustainable. The origin of the problem is assumed to be macroeconomic populism. The Baltic states show a weird form of populism, called passive kind in the study. In market economies without significant rent seeking opportunities from commodity resources, the private sector provides most of the income sources. This way, the populist politicians will not be generous spenders, but undisciplined delayers of restrictions. What is common in the active generous spender the passive delayer is that they wish to favor electoral groups in the society by securing a higher income, and none of them worry about long-term inflation undermining the sustainability of growth.

The hypothesis is that the process of income growth and quick catching-up of Baltic economies were established on external financing. Baltic countries can be complied to the political economy model of macroeconomic populism. The analysis is based on the macroeconomics of the Feldstein-Horioka puzzle and the reverse Balassa-Samuelson effect. The paper examines terms of trade, NEER, REER, ULC, current account imbalance, inflation and savings to conclude on reasons sudden stop in the Baltic region. Through the Baltic example, the paper enlightens on a structural problem of the European integration. The assumption of the paper is that the Baltic current account imbalance is based on the appreciation of real effective exchange rate (REER). The study explains and proves correlation between the REER appreciation and the current account deficit in Baltic relevance.

2. Political economy of external indebtedness

In the single European market, the individual external balance of member states became neglected aspect. In the catching-up member states with inflation beyond the average, the single central bank rate proved to be too low in the sense that credit was very cheap and it was preferable to spend when it was available instead of saving income for the future. This counter-selection of the single monetary policy is an important factor, as the Baltic states' current account deficit was accumulated through foreign currency (euro) credits. Thus, it was not the national, but the single central bank rate that mattered to the market. Meanwhile, the Baltic way of monetary convergence with a strictly pegged foreign exchange caused non-adjustable real appreciation, since it worked as a peg toward the core countries with a single currency within the EU. This characteristic ruined the Baltic wage competitiveness by increasing wage demand caused by higher inflation. The additional inflation and the increasing wages originated in external credit money through additional demand. The relatively cheap credit – which *a priori* originated in non-local sources – financed mostly the consumption of imported products and services. This could be maintained only up until any one of the global financial actors were willing to seek risky emerging market items. The Baltic recession situation – originating in the external indebtedness – reveals the trap of those periphery countries in the eurozone which wasted the single currency advantages to finance the cheap import from foreign private credit. The currency board countries cannot neither devalue their currency to improve the current account, nor have the public debt depreciate through inflation without damage of monetary and fiscal credibility. (Kutasi, 2012:717-718)

In the Baltic case, where euroization of the credit market was supported by policy makers, thus significantly influencing monetary processes to become lost, the Baltic private debtors calculated with the euro rates. The multi-country inflation with a single interest rate of ECB has preferred the countries with higher inflation level which was a counter-selection in the loan market, but for their fate, this also has discouraged the private savings in these countries. By looking at the time series of effective exchange rate and unit labour cost, it gets clear that there has been real appreciation in the member states with high inflation in comparison to ones with low inflation in the single currency zone without any local monetary intervention. Calculation is used to show the real appreciation problem of Baltic countries against the lower-inflation ones, in the single currency zone without any effective monetary intervention in a currency board regime. This reverse Balassa-Samuelson impact would have been motivation for excessive intra-community import in externally indebted countries. The survey on decreasingly competitive price and wage of countries suffering from real appreciation is an explanation for loss of competitiveness in their export and for relative cheapness of import.

Macroeconomic populism

As Kornai (1992a:449) explains, the fiscal reforms in the post-communist, transition countries are limited by political factors. According to Latin American observations, Dornbusch and Edwards (1989:2-5 and 1991:7) understood the macroeconomic populism as the heterodoxy of economic policy making. Namely, when the economy gets wind for a while, the policy makers start policy actions which make them popular in short term. But it does not mean simply spending money. The paradigm of macroeconomic populism results in an interim increase in living standards through macroeconomic stimuli, just like excessive fiscal and credit policy and overvalued currency. The core element of the paradigm is the redistribution of attaining development without experiencing social conflicts. Meanwhile, populists neglect the importance of the risk of inflation, the risk from deficit financing, the external constraints and the reaction of global market actors on non-market-like policies. This approach can result in a short term growth and recovery period. Nevertheless, policy makers ignore the fiscal and external constraints, and these bottlenecks cause recession and crisis in the medium term, as the constraints make the heterodoxy unsustainable. Finally, the long term outcome of

macroeconomic populism will be the '*plummeting of real wages*', '*severe*' difficulties in balance of payment, '*galloping inflation*', crisis and the '*collapse of economic system*'. These "developments" will enforce austerity and demand for external (IMF) aid. (Dornbusch and Edwards;1991:7-8) The macroeconomic populism is built on the citizens' demand for social and economic security. Kornai (1996) indicated that the citizens in the post-communist, transition economies has aspired to social benefits and security. This characteristic was strengthened by the communist regimes in the Eastern European societies, as the promise of the regime was the economic and income security, as Kornai (1992a: 332) wrote about it. This phenomenon strengthened the demand of the societies in the transition economies for the economic security. And as Benczes (2016) explains, it the Latin-American type of macroeconomic populism is not unprecedented in the post-communist European Economies.

Based on the observations by Darvas and Szapáry (2008) describing the economic trends and risks in the Eastern EU member states, Csaba (2008) discovered a similar but different kind of macroeconomic populism in the EU10 region. Neményi and Oblath (2012: 596) established that not only those countries got into trouble which have been under excessive deficit procedure of the Community. The Baltic sudden stop in 2007 or the Slovenian indebtedness problems in 2012 appeared in countries with sustainable budget balance. Divergence in inflation, competitiveness and relative wage cost was already observable among the eurozone countries. Unlike Latin American active populist policy, Csaba (2009: 111-112) determines the '*new kind*' of macroeconomic populism as a passive policy making by delaying reforms and unleashing private demand financed by loan. Unlike, again, the Latin American heterodoxy, Csaba (2008:602) establishes, that the new kind correctly follows the simplified models of '*elementary economic textbooks*'. This characteristic originates in the European economic circumstances, where typically there are no significant opportunities for rent seeking in public finances from natural raw material resources. That is why, the European version of populism can mostly affect passively on living standards by not levying more taxes in the revenue channel or not blocking the private consumption in the regulation channel. This will result in a short term '*boom driven by the private sector and personal consumption*'. Csaba (2008:603)

Both Dornbusch and Edwards (1989) and Csaba (2008) established about the two types of macroeconomic populism, that the mix of populist policy, external world economy, and macroeconomic contexts result in an unsustainable economy where several elements get uncontrollable by policy makers. Control can be lost over inflation, current account deficit, public debt, crediting, money supply and monetary processes.

To implement the paradigm of populism to the case of Baltic states, the passive kind of macroeconomic populism model can be implemented. In Darvas and Szapáry's (2008) view, the Baltic countries accumulated high annual current account deficit, their pegged foreign exchange strengthened the price convergence, and in 2007 they got into recession with high inflation beside the high speed of growth of 2000-2006. It was also recognized that the euroization of their credit market (52-77%) became significant. (Darvas & Szapáry, 2008:847) This characteristic severely reduced the influence of monetary policy on monetization; at the same time, it proves the passivity of the populist policy. The euro credit got so popular, as it was based on the EURIBOR rate, much below the Baltic rates. It also had positive economic results in form of an interest rate convergence that could verify the policy makers' passivity.

Exchange rate policy aspects

The Baltic internal economic balances originated in the primacy of monetary policy which targeted exchange rate stability first of all. In case of Estonia and Lithuania, the currency

board system has been applied, and the Latvian monetary policy also targeted pegged rate with some adjustment cases. The purpose of the currency board is to copy the price stability of the reference (key currency) country/region. The Baltic monetary policies hoped to adjust the national price stability to the one in eurozone by pegging. The currency board is in a quasi single currency position, as there is no exchange rate volatility at all (toward the euro), and actually the monetary policy is very strictly bounded without room for non-harmonized maneuver by the exchange rate target. The national currency is pegged rigidly to the key currency and the peg becomes the anchor of economic policy as a primary target. Price stability will be a necessity to keep the relative purchasing power of the national currency. Basically the currency board is credible if the national inflation keeps pace with the reference region. Of course, the economic policy instruments are also usable for exchange rate stability. Namely, the higher central bank rate, via the interest rate parity, can strengthen the demand for the national currency, or the public budget surplus can reduce the commodity market demand through the purchasing power parity, on the one hand, and the inflation, on the other, to keep the foreign exchange peg. (The peg has been 15.6466 EEK and 3.4528 LTL to 1 EUR.¹) It is concluded from the interest rate parity model that the policy on interest rate and money supply must be subordinated to the rigid target of foreign exchange. Moreover, for the financial market equilibrium depending on GDP and real interest rate, the equilibrium of money demand and supply must be controlled by the fiscal revenue and spending items. In case of emerging countries, like the Baltics, the inflationary impact from Balassa-Samuelson effect should be buffered in the way of public distraction from private demand.

The full pegging can be advantageous only beside credible economic policy, but even fundamentals are correct, the peg still can endanger the economic growth. In case of overvaluation, the wage competitiveness of the economy using currency board deteriorates badly in the international trade. This can result fall in export revenue. Meanwhile, the local households perceive increasing real income since the overvaluation and start to increase their import consumption. Thus, pegging can cause contraction after a temporary economic boost. Both the South-East Asian currency crisis in 1997 (Krugman & Obstfeld 2002) and the Baltic recession in 2006-2008 (IBRD 2007) gives empirics to this thesis. In both cases, strong deterioration of external balance and sharp slow-down of economic growth were observable. Because of danger on competitiveness, the countries with peg find themselves on the horns of a dilemma: Namely, do they want to reserve their monetary credibility by insisting on the peg, or devaluate to improve the competitiveness and thus the external balance.

As Baltic countries use strict pegging, their case has been very similar to the single currency zone members in sense of external adjustment without revaluation of foreign exchange. When it comes to examine the intra-community movement of products, services and transfers in a quasi single currency situation, the object of study is a quasi homogeneous money market. The latter eurozone accession² was just a technical shift for Baltic countries into the real single currency zone, since they were successful in sustaining the currency board.

Recession model of external imbalance

It is worth emphasizing that savings and investments can correlate very weakly to each other in an open economy, unlike in a closed economy assumed by Keynes where savings and investments assumed to be equal. Obstfeld and Rogoff (1996), in their ‘new open economy

¹ The Latvian pegging was very close to the currency board. Since 2005, Latvia participated in the ERM II system, with a special individual unilateral commitment, namely that the Bank of Latvia guaranteed a +/-1 percent floating margin. The central peg haven't been changed since 2005, it is 0.702804 LVL to 1 EUR and the volatility was kept in the guaranteed margin. source: www.ecb.int, www.bank.lv

² Estonia in 2011, Latvia in 2014, Lithuania in 2015.

model', emphasized the phenomenon of free international movement of national savings, thus, the free international financing of investments, which is referred to as the Feldstein-Horioka puzzle (see Feldstein & Horioka 1980). Regarding the Feldstein-Horioka puzzle, Afonso and Rault (2008) state that if savings and investments are not correlated, the budget deficit and the current account deficit "*tend to move jointly*".

As there has been neither an individual devaluation nor a federal bail-out mechanism, the unsolved external imbalance can result divergence, regression and degradation of externally indebted countries. This is the so called *reverse Balassa-Samuelson effect*. (see Grafe & Wyplosz 1997; Jakab & Kovács 2000:144). The original Balassa-Samuelson effect derives the higher inflation of catching-up countries from the development of productivity in the catching-up tradable sector, which causes a wage increase and thus inflation pressure in the non-tradable sector. (Balassa 1964) The reverse Balassa-Samuelson effect, however, claims that the relative change of price leads to divergence of productivity in the following way: In the eurozone, the quick convergence of interest rate imposed an overheating in consumption in periphery economies of the eurozone. The expectations of households based on sharply decreasing interest rate were unfounded, and resulted in a quick private indebtedness particularly through the consumption of non-tradable services. This latter impact raised the wage demands in the local non-tradable sector that spilled over to the tradable (export) sector. Thus, the export competitiveness deteriorated, meanwhile the local inflation rose by the higher wage cost. (Mongelli & Wyplosz 2008; Neményi & Oblath 2012)

3. Empirical signs of macroeconomic populism

Minimal state with fiscal discipline

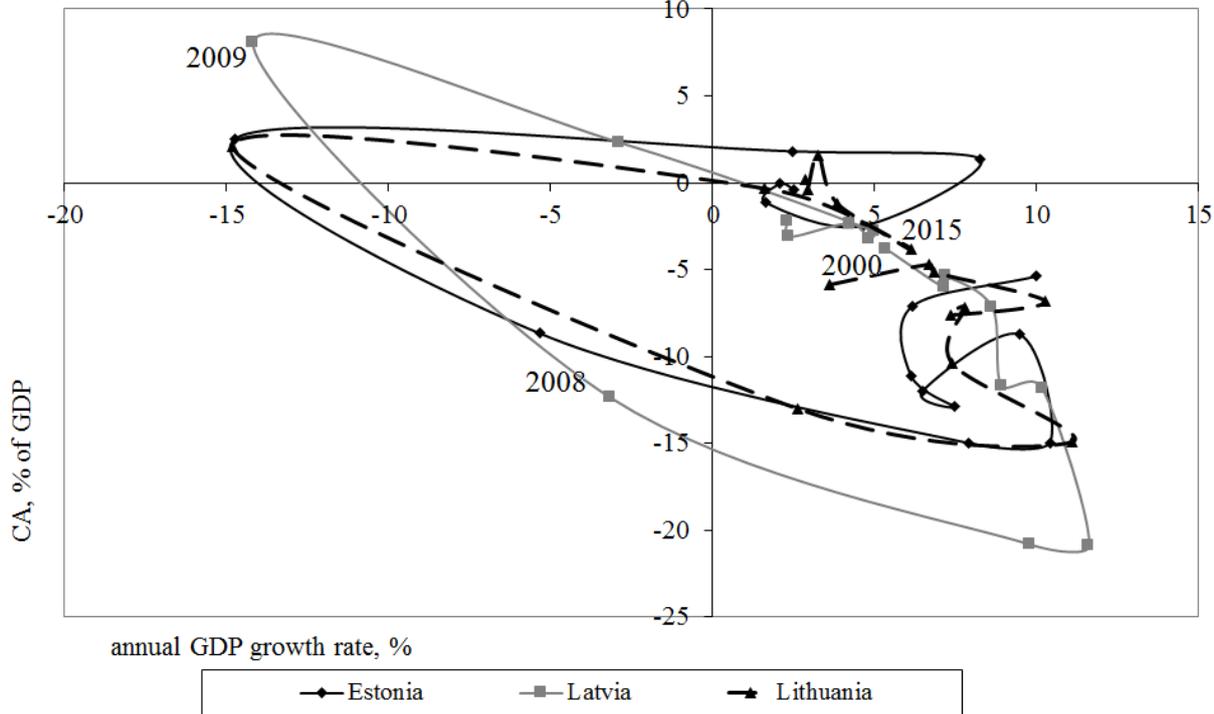
After the collapse of the Soviet Union, one of the few advantageous heritages of Baltic countries was the very low level of public debt, around 5 percent of the GDP. This could have created a robust room for maneuver for fiscal populism, however, the Baltic governments avoided to use it to the fiscal easing and political populism. This opportunity was utilized to reform the system of social services and shift the Baltic society and economy toward a liberal (Anglo-Saxon) social model with private financing.³ Economic growth and the welfare were based on influx of foreign direct investments and other capital sources. Nevertheless, the public balance and the monetary stability were not enough to bring along a quick success in the monetary integration, as they did not have enough impact on inflation. Since companies and households have accessed to cheap foreign loan, none of the budget surpluses and central bank rates could control and restrict the national consumption and investment and their impact on inflation. Constantly missing the inflation target criterion, the Baltic monetary integration slowed down. Meanwhile, their euroization reached high level through loans. In the end of 2006, the financial euroization of loan market was approximately 52 percent in Lithuania, 76 percent in Latvia and 79 percent in Estonia. (Chitu, 2012:chart1) These data strengthens the thesis that monetary transmission has been very weak in the Baltics.

Figure 1 shows the connection between income growth and current account of Baltic economies. Between 2000 and 2006/2007 these countries had regionally outstanding growth, beside an extremely negative and deteriorating current account balance. Only the GDP contraction shock could have the Baltic economies to break the deteriorating trend of external imbalance. The global shortage of credit money enforced the three economies to give up the import financed from debt. However, after the annual flow surpluses of contraction years, namely 2009-2010, as economic growth returned to the region, current account turned into a moderate deficit, again. The thesis, i.e., that these economies were overheated by foreign

³ About liberal social model see: Sapir (2005)

money can be verified by output gap data. The Baltic output gap was massively positive (beyond the potential) before the global crisis. (see table 1)

Figure 1 Baltic GDP growth rates and the balance of current accounts (% of GDP), 2000-2015



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
EE	-0.3	1.2	1.8	3.0	3.3	6.3	10.7	13.9	5.2	-9.6	-7.0	-0.7	2.2	1.6	1.3	1.0
LV	-1.4	-1.4	-0.6	1.4	2.9	5.3	9.1	11.3	3.2	-10.9	-11.6	-6.3	-2.2	0.7	1.4	1.4
LT	-4.5	-3.7	-3.2	0.6	1.9	3.8	5.1	9.1	6.4	-10.1	-8.6	-3.7	-1.2	0.2	0.6	0.4

Source: IMF World Economic Outlook, 2015 April, download 09.07.2015., 2013 and later years are IMF estimation

Table 1 Gap between actual and potential gross domestic product at 2010 reference levels

source: DG-ECFIN AMECO database, download 09.07.2015., 2015 forecasted

The overheated economy was only particularly based on external loans, as well as on tax cut competition among the Baltic fiscal policies. Furthermore, the business cycle strongly synchronized with the Russian economy which boosted by the oil price boom of 2002-2007.

The global financial crisis hid a default risk from the foreign exchange rate originating in the pegged rate and currency board regimes. The peg motivates market actors to become indebted in euro with lower reference rate. Nevertheless, it is clear, that the financial sector was the main channel of foreign credit promotion, as most of capital import was composed from foreign credit channeled in by monetary financial institutions (namely banks) and financial corporations.

Escaping from the menace of currency crisis, Estonia successfully ran forward into the eurozone accession in 2010, Latvia demanded 7.5 billion euro credit from IMF and EU, and Lithuania has tried to follow Estonian footsteps. Finally, Latvia became eurozone member in 2014, while Lithuania managed to do it in 2015.

Up until 1999, each transition country in CEE had to undergo considerable fiscal adjustment programs either because of internal tensions in their public finances systems or because of international financial crises. The Baltic states typically exemplified as an aftermath of the Russian financial crisis 1998. (Benczes 2008) Fiscal adjustments under transition period created a stable starting point for Baltic countries. In case of the striving Baltics, the typical characteristics have been stable fiscal positions, relatively low public debt ratios compared to GDP, and low government spending.

Basically, some risks have been evident regarding price stability, but mostly on the back of global economy developments and convergence. On the one hand, energy prices were rising very dynamically in the first years of the 21st century, and on the other hand there is a serious lag behind EU15 prices and wages – with the exception of Slovenia – but economic convergence inevitably calls for rises in these scopes, too. Evidently, successful convergence requires an economic policy mixture to ensure monetary convergence for the CEE countries. (Festič and Bekő, 2006, page 82). This is the reason for a large number of criticisms and suggestions on the part of international organisations (the IBRD, the OECD) regarding the fiscal policies of the Baltic States, as price levels are partially subject to the structure of government consumption as well as to the taxation and subsidy system which influences consumption and investment decisions of corporations and households.

In the Baltic states, one of the components of the legacy from the disintegrating Soviet Union was an extremely low level of public debt – roughly 5 % of GDP, which would have meant almost limitless fiscal opportunities in the foreseeable horizon for policy decision makers. However, the governments of the Baltic states used this chance not to opt for fiscal laxity or vote-generating subsidies but to restructure their finance system of social benefits and to accumulate primary budget surplus. Economic growth and welfare improvement are based on FDI influx in their case. They had the largest manoeuvring room in their budgets among the EU member countries in terms of fiscal balance and public debt. However, all this was ruined with external imbalance. International reports – such as the ones issued by the IBRD (2007), Deutsche Bank (2006a), the IMF, the EBRD, and the European Commission – already underlined external imbalance as the main risk factor.

In Latvia and Lithuania, the economic crisis shock of 2009-2010 could be treated only by sharp public indebtedness, as these two countries doubled their public debt what is not anymore covered by national savings. In this sense, the Baltic troika split. Estonia remained fiscally stable, and fiscal demand for debt financing has not caused significant crowding-out of private debtors from national savings. Meanwhile, Latvia and Lithuania deteriorated their fiscal room for maneuver.⁴

In case of inflation analysis, it is clear that basically the currency board or narrow pegging does not automatically “import” the inflation rate of the reference zone. In the pre-crisis period, only Lithuania could perform below the eurozone average. (See Table 2.) This proves that Estonia and Latvia did not put all efforts into keeping the purchasing value of national currencies up to the power of euro. Although the global crisis years created deflation impacts, only Estonia could use it for quick monetary integration. As it was mentioned before, the stimulus ruined the fiscal indicators of the other two countries. Returning to the pre-crisis deviation from average, some kind of additional inflation can be observed. In case of high growth rate years of the Baltics, it would be easy to say, that this was because of a normal

⁴ See IMF World Economic Outlook data on gross national savings and general government gross debt. Estonian savings moved between 20-25 % of GDP while debt did among 3-8% of the GDP between 2000 and 2012, meanwhile Latvian and Lithuanian government debt exceeded the national savings since 2010 by 15-25 % of the GDP.

Balassa-Samuelson effect originated in some sort of catching up procedure and its impact on wages in tradable and non-tradable sector. However, this would be a hasty conclusion to draw.

Table 2 Baltic deviation from eurozone average inflation (= national inflation – eurozone inflation), percentage point, eurozone = current members in a year, percentage point

	2004	2005	2006	2007	2008	2009	2010	2011	2012
EE	0.9	1.9	2.2	4.6	7.3	-0.1	1.1	2.4	1.7
LV	3.2	2.8	2.2	3.4	4.7	3.1	-3.9	-0.9	-1.9
LT	-5.0	-4.2	-2.8	-4.3	-4.2	0.9	2.4	-0.1	0.9

Notice! This is not the Maastricht criterion on price stability.

Note: EE – Estonia, LV – Latvia, LT – Lithuania

Source Eurostat database, 2013. Feb. 16.

4. Baltic external imbalance – proof on passive macroeconomic populism

The model and data

Analyzing the processes of nominal effective exchange rate (NEER), real effective exchange rate (REER), nominal unit labour cost (ULC) by country in database of Eurostat and DG-ECFIN AMECO, it is clear that the growth period of Baltic EU membership of 2004-2007 resulted in a measurable relative appreciation of Baltic prices and production costs. According to the NEER and REER data, the pegged rates has been very unfavourable and disadvantageous for the Baltic region in medium term. Especially, in 2007, the REER appreciated sharply, reflecting a price and/or wage increase, which meant deteriorating competitiveness in trade and inflowing FDI. (See DG-ECFIN Price and Cost Competitiveness statistics.) The crisis years made change in the process which created imbalance. All Baltic states' NEER and REER indices have made a turn, particularly because of adjustment in public finances, nominal wages, consumption, investment and crediting. However, the monthly REER based on HICP deflator still has reserved the trend of appreciation in comparison to period of 2007 and before. The same is true for REER based on ULC – except Lithuania. The turn was established, also, in case of the analysis on current account imbalance, nevertheless, the rebalancing is far from balanced relations.

The productivity can be used as a control indicator of real appreciation. The relative productivity deteriorated in the Baltics when the sudden stop appeared in the economic performance. In case of Estonia, the relative productivity per worker significantly declined during 2007 and 2008, and the one per hour had also a slight decline in 2007. Lithuania, also, showed deterioration in 2009, meanwhile the Lithuanian relative productivity per worker had only a short stagnation in period of 2007-2008. These periods correlate with peaks of ULC based REER. This is logic, as lower productivity increases the relative wage and this way the wage based exchange rate. (See Eurostat productivity per worker and per hour statistics.)

In the following, the analysis is concentrating on panel regression on current account and effective exchange rate. According to De Santis and Lührmann (2006) and Gavilán et al. (2011) the current account is determined by the following factors:

- The demography impact on the structure of consumption and savings. (Ando & Modigliani, 1963)
- Real GDP growth and its impact on savings (Modigliani, 1970) or on consumption based on future income (Tobin, 1967; Farrell, 1970)
- International competitiveness based on REER.
- Stages of development, as there is a U-shape relation assumption between CA balance and relative per capita income.

- Positive correlation between money stocks to GDP and savings. (Edwards, 1996; Chinn & Prasad, 2003)
- The continuity/smoothness of growth of labor productivity. (Glick & Rogoff, 1995)
- The inherited debt, called “original sin”.
- The effect of transparency on lower risk.
- Restrictions on current account and capital account, for example capital control.
- Deviation from uncovered interest rate parity.
- Portfolio impact, namely, sometimes the investors sell their low risk bonds with high yield to counterweight their loss on risky bonds, thus rebalance their portfolio. (Bohn & Tesar 1996)
- Market valuation impact, namely, how are the investment products overvalued according to P/E and fundamental value ratio.
- Effect of size of a company or a country. (Banz, 1981; Asness et al., 1997; Bekaert et al., 1997) The less capitalized country pays higher return.
- The investment and capital demand of national industries.
- The external financing demand and crowding-out impact of the public finances.
- The impact of crisis through GDP contraction, negative wealth shock on saving assets, increasing public spending and the end of plenty of international credit money.

The hypothesis is that the effective exchange rate determines the CA balance of the Baltic countries beside a fixed rate of (quasi) single currency zone. In the following, we will focus on the REER and NEER impact. In case of REER, the calculation can be based on consumer price index (CPI) calculated by deflating with HICP, nominal unit labour cost (ULC), nominal unit wage cost of manufacturing (UWC), price deflator of GDP, price deflator of export of goods and services. Besides, hypothesis is tested with NEER, too. All predicting exchange rate variables tested both for eurozone (EA18) and for the EU (EU28). The analysis is a two variable, linear, panel regression about the three Baltic counties. The regression functions applied in this study are the followings:

$$CA = \beta_0 + \beta_1 REER + \varepsilon_i \quad (1)$$

$$CA = \beta_0 + \beta_1 NEER + \varepsilon_i \quad (2)$$

The REER and NEER data are from the European Commission, DG-ECFIN Price and Cost Competitiveness statistics, the CA data are from the Eurostat. All data are in quarterly breakdown. The time period of the data is 2000Q1 – 2014Q4.⁵

Theoretically, the relative development and productivity level of countries are included in the REER, as their price and wage competitiveness is the base of REER calculation. (see Lauro and Schmitz, 2012; Turner and Dack, 1993) Thus, the evaluation or devaluation of high and low developed member states do not distort the relative competitiveness included in REER.

Analysis and results

The analysis on fifteen years of integration period of Baltic countries showed assessable correlation between CA and REER. It can be established that the passive macroeconomic populism by pegging is measurable in the catching-up Baltic countries since the fix exchange rate has ignored the inflation differences. The REER based on HICP deflator explains the development of current account strongly and significantly in all of the three Baltic countries. The REERs based on price deflators are also significant predictors of CA. (In Latvian case, only the price deflator for export of goods and services, in Lithuanian case only the GDP price deflator has significance.)

⁵ CA of Lithuania is since 2005Q1.

The labour cost indicators are rather ambivalent and precarious. The Estonian CA is significantly explained by REER based on ULC and UWC in direct correlation. This seems to be logic, since higher wage indices result in less export and more import through cost competitiveness. Meanwhile, the Latvian case show no significant relations, moreover, the Lithuanian correlation is significant but inversely. The Lithuanian significant negative betas occurred beside almost stagnating ULC and UWC REER indices what highlights something deeper, structural problem of the national economy. Especially in case of Lithuanian beta of REER based on UWC of manufacturing calculated toward EU28 group shows that slight repression on wages cannot prevent the drop of competitiveness and the deterioration of CA.

Testing the NEER indices, there is no assessable result about the relation to the eurozone (EA18), but the tests on NEER as a predictor calculated vs. EU28 confirms the REER results with significance in case of Estonia and Lithuania.

Table 3 Results of two-variable regression analyses (standardized Beta, significance and adjusted R^2)

	EE	LV	LT
REER, HICP-deflator, EA18	0.607*** (0.358)	0.548*** (0.288)	0.657*** (0.417)
REER, HICP-deflator, EU28	0.610*** (0.361)	0.557*** (0.299)	0.689*** (0.461)
REER, nominal ULC, EA18	0.516*** (0.254)	0.006 (-0.017)	-0.483*** (0.213)
REER, nominal ULC, EU28	0.533*** (0.272)	0.070 (-0.012)	-0.276* (0.052)
REER, nom UWC of manufacturing, EA18	0.269** (0.056)	0.103 (-0.006)	-0.876*** (0.761)
REER, nom UWC of manufacturing, EU28	0.344*** (0.103)	0.188 (0.019)	-0.838*** (0.695)
REER, Price deflator GDP, market prices, EA18	0.531*** (0.269)	0,121 (-0.002)	0.436*** (0.169)
REER, Price deflator GDP, market prices, EU28	0.534*** (0.273)	0.151 (0.006)	0.506*** (0.237)
REER, Price deflator, exports of goods and services, EA18	0,532*** (0,270)	0.257** (0.050)	0.239 (0.032)
REER, Price deflator, exports of goods and services, EU28	0.528*** (0.267)	0.276** (0.060)	0.263* (0.045)
NEER, EA18	0.105 (-0.006)	0.041 (-0.016)	-0.362** (0.108)
NEER, EU28	0.517*** (0.255)	0.166 (0.011)	0.781*** (0.600)
number of observations	60	60	40

Standardized Beta, (adjusted R-square)⁶, statistical significance is indicated by * at 10%, ** at 5%, *** at 1%.

source: author's calculation from Eurostat and DG-EECFIN data

⁶ Adjusted R-squared is computed using the formula $1 - [(1 - R^2)(N - 1) / (N - k - 1)]$ where k is the number of predictors.

5. Conclusions

In this study, the political economy model of macroeconomic populism was represented through the case study of Baltic countries. The model was supported with the economics theories of Feldstein-Horioka puzzle and the reverse Balassa-Samuelson effect.

As results confirmed, the process of income growth and quick catching-up of the Baltic economies were established on external financing. This phenomenon heated non-tradable inflation, as foreign savings were mostly channeled through credits and loans toward the household and corporate sectors. Finally, the external credibility of the region exhausted independently from the global recession, but not independently from the global credit money shortage. This turn caused a sudden stop, which demanded a quick and radical public and/or private adjustment in all of the surveyed countries.

It can be established, that even an impressively catching-up economy with internal balance and without heavy burden of public crowding out can fall into a recession or depression. The reasons of disappearance of economic growth are many, such as the political motivation to heat the economy by leaving more room for private sector to spend, the appreciation of real wage due to the fixed foreign exchange rate, the increasing inflation from sharply growing income, and the permanently growing external imbalance.

For all three Baltic countries, the signs and effects of passive macroeconomic populism can be detected, such as the balanced budget before sudden stop, the pegged foreign exchange rate and the deteriorating external imbalance during the impressive growth period. It was also concluded that before the sudden stop, the public indebtedness was low and stable, meanwhile private sector indebtedness was multiplied by the economic growth results. The inflation risk increased – except for Lithuania. The risk was increased by the external indebtedness and the share of foreign currency in total debt. Many indicators of export competitiveness showed deterioration before the sudden stop. The NEER and the REERs indicated an appreciation of costs and prices of the Baltic production. Namely, the economic indicators of the Baltics strengthened the assumption, that the national economic policies postponed those actions which could have sustained the export competitiveness and the relative cost of regional workforce and production, even though, the public finance and monetary indicators were kept in balance. This way, the inflation of prices and wage cost gradually terminated the attractiveness of Baltic investment opportunities and export products. Meanwhile, the sharply increasing income and creditworthiness of Baltic households had negative impact on current account by increasing import and on wage competitiveness by pushing the wages up first in the non-tradable, then later on in the tradable sectors.

To prove the hypothesis, the analysis used panel regression analysis about the correlation between current account and REER, NEER of the three Baltic countries. The regression analysis confirmed that some REER and NEER indices strongly and significantly have determined the current account of Baltic countries. In practice, it means that the fixed exchange rate and later the adoption of single currency caused overvaluation of Baltic prices and wages, thus, deterioration of competitiveness both in the eurozone and in the whole EU. Finally, the lost competitiveness kept on raising the current account deficit which enforced an austerity in welfare and income policies, namely, in the GDP, in the end.

This study focused on the Baltic region, however, the passive macroeconomic populism as an explanatory factor can be extended to many emerging countries which build their growth on

secondary and tertiary export and foreign direct investment among Eastern Europe and South-East Asia, which have suffered from sudden stop during dynamic economic expansion.

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