

## ERM Blues

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Andrew Bosomworth  
Executive Vice President,  
Head of Portfolio Management,  
Munich

Remember September 1992? Earlier rate hikes in Germany triggered a reversal of capital flows from surrounding countries, wreaking havoc on the European Exchange Rate Mechanism (ERM) that fixed currencies to the deutschemark. Italy and Spain devalued, Sweden's Riksbank hiked interest rates to 500% and the British pound was unceremoniously ejected from the ERM altogether. Fast forward to 2009 and you would be excused for thinking more volatility is brewing.

This time, Lithuania, Latvia and Estonia are in the ERM and the financial earthquake is the global credit crisis that cut off private capital to fund these countries' current account deficits. Latvia's current account deficit topped 20% of gross domestic product (GDP) in 2006 and 2007. Thanks in part to small illiquid markets, speculative attacks of the sort witnessed in 1992 have not befallen the Baltic states. And public authorities there have shown steadfast commitment to maintaining fixed exchange rates despite enormous economic upheaval. In this European Perspectives, we ask if the political systems in the Baltic states will keep their commitments to the pegs, and what the consequences are if they don't.

### Two Roads, One Destination

Real GDP is set to shrink by 19.4% in Lithuania, 24.9% in Latvia and 19.2% in Estonia in the four years spanning 2007 to 2010, according to the IMF's

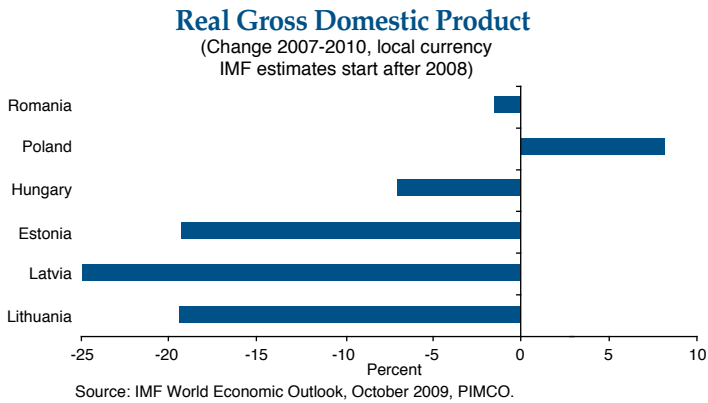


Chart 1

October forecasts. Unemployment has risen to 13.7%<sup>1</sup> in Lithuania, 18.3% in Latvia and 13.3%<sup>1</sup> in Estonia. Only Spain has a higher unemployment rate in the European Union (EU). Other countries in Central and Eastern Europe with floating exchange rates have experienced less severe adjustments. While these countries also had different initial conditions, real GDP in Hungary, Poland and Romania will change by -7%, 8.2% and -1.5% respectively between 2007 and 2010, according to the same IMF projections (see Chart 1). Their unemployment rates are a more manageable 9.6%, 8.0% and 6.4%<sup>1</sup> respectively.

Judged by those simple metrics alone, there clearly are different costs associated with fixed and floating exchange rates when adapting to external shocks. Contrast how the Irish and

British economies are adjusting to the financial crisis. The United Kingdom's floating exchange rate has helped cushion its economy relative to Ireland, which is experiencing a sharp contraction in GDP under its fixed exchange rate to the euro.

Fixed exchange rates to the euro did not cause today's problems in the Baltic states, but they certainly abetted them. Interest rates were too low relative to the strength of domestic demand in the years leading up to 2007, because they imported the European Central Bank's (ECB) monetary policy. Nor was fiscal policy tight enough during the boom years to compensate for the lack of an independent monetary lever. Today, right when stimulus is needed, the opposite conditions prevail. Local interest rates have soared for fear of devaluation, and deep cuts in fiscal expenditure are being made to offset a collapse in tax revenue. So fixed exchange rates are exacerbating the recession, but what's the real problem?

The real problem is that the Baltic states lost international competitiveness because of high domestic inflation alongside fixed nominal exchange rates, making their products uncompetitive in international markets. This is particularly relevant for Lithuania and Latvia, less so

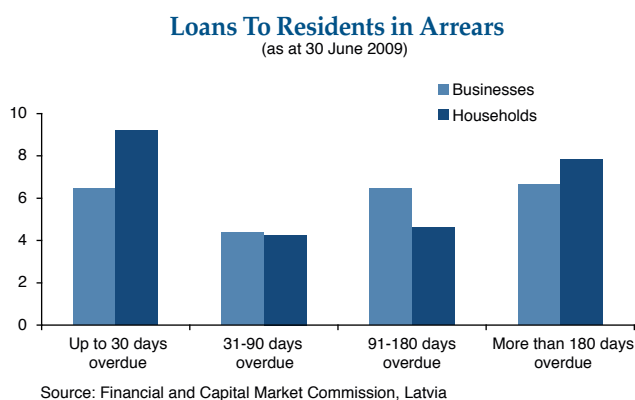


Chart 2

in Estonia. The rate of both consumer and wage inflation in Lithuania and Latvia rose faster than the prices and wages of their trading partners, causing their real effective exchange rates to appreciate. Faced with that situation, there are two roads a country can choose between to regain competitiveness; both, however, end at the same destination. Either engineer a lower rate of change in domestic prices and wages relative to trading partners, or devalue the nominal exchange rate. The Baltic states are successfully pursuing the first route. The problem is that when your trading partner has no inflation – inflation in the euro area is currently negative – you need deflation to regain competitiveness.

Both routes, internal deflation or external devaluation, end up at the same destination of rising non-performing loans (see Chart 2). In the first case, falling incomes and rising

unemployment gradually erode borrowers' ability to honour their debts. In the second case, currency devaluation immediately raises the cost of repaying foreign currency debt. And because foreign currency debt, especially euro-denominated debt, is widespread in Central and Eastern Europe, an external devaluation poses problems.

If they both result in the same thing, shouldn't one be indifferent to the choice between internal deflation or external devaluation? Yes, if they both maximise social welfare. But do they? Look at efficiency and the distribution of welfare and you will see that the cost of the fixed exchange rate might well exceed that of a floating exchange rate. Let's start with efficiency and examine Latvia in particular, since it is the region's potential catalyst.

## Efficiency and Welfare

Latvia's authorities are doing all the right things to engineer internal deflation. Budget cuts have slashed public sector wages by 36%. Lower wages for the civil service are spilling over to the private sector. Deep cuts in fiscal expenditure plus structural reforms of the way government operates in health and education are helping lower domestic prices and wages relative to trading partners. By freeing up

human and capital resources in the non-tradable sectors, mainly government, property and construction, the aim is that market forces will redirect them to the tradable sectors. Indeed, government wants to support businesses in five sectors: forestry, food processing, chemicals, optical devices and metals.

When a fixed exchange rate is misaligned through overvaluation of the real exchange rate, transferring resources from the non-tradable to the tradable sectors can be achieved more efficiently by devaluing. The longer it takes to redirect resources from non-tradable to tradable sectors, the higher the risk those resources become redundant in the process. Idle factories depreciate in value and idle workers lose their skills or emigrate.

Proponents of maintaining the fixed exchange rate say devaluation won't help exports because most of them are assembled from imported components; i.e., exports are just a margins business. For a pure import-export margins business, like importing crude oil, refining it and exporting gasoline, the exchange rate level does not matter. Since structural reforms help make the economy more efficient, why not implement structural reforms and devalue at the same time? That

will help other fledgling export sectors grow. Forestry and furniture, for example, are home-grown products. Foreign companies will also be more willing to invest once devaluation risk has gone. So from a resource allocation perspective, the peg is inefficient. What about the distribution of welfare?

The peg protects a relatively small number of households and large institutions who borrowed foreign currency against devaluation. But the rest of society pays a high price for that via falling income and rising unemployment. The data in Chart 3 show 87.1% of loans to residents are denominated in euros (2.9% are denominated in US dollars and other foreign currencies, while 9.9% are in lats). At first sight that implies it would be crazy to devalue. But consider the following: There were 154,760 mortgages outstanding at the end of the second quarter, according to Latvia's Financial and Capital Markets Commission, and there were 868,000 households at the end of 2007 and 2.26 million people living in Latvia at the beginning of 2009, according to Eurostat. If we assume each homebuyer constitutes one household with one mortgage and that 90% of home loans are denominated in foreign currency, then only 16% of households and

### Latvian Banking Sector Loans

(thousands of lats, as at 30 June 2009)

<b>Total loans</b>	<b>Lats 15,993,351</b>	<b>% of loans to residents</b>
Loans to residents	14,226,537	
Loans to non-residents	1,766,814	
Residents' loans by currency:		
In LVL	1,414,194	9.9%
In EUR	12,393,021	87.1%
In USD & other currency	419,321	2.9%
Residents' loans by sector:		
Households	6,226,591	43.8%
Financial institutions	676,046	4.8%
Private non-financial companies	6,759,624	47.5%
Central & local government + public non-financial companies	541,552	3.8%
Non-profit institutions + transit loans	22,724	0.2%
Loans by loan category:*		
Mortgages	8,616,914	53.9%
Commercial credit	2,946,097	18.4%
Industrial credit	2,177,346	13.6%
Consumer credit	507,467	3.2%
Settlement card credit	239,787	1.5%
Others	1,344,552	8.4%

\*Excluding loans to central/local government and transit loans, as percent of total loans

Source: Financial and Capital Market Commission, Latvia

#### Chart 3

6% of the population actually have a foreign currency mortgage. Yet the rest of society is affected by government's tight fiscal policy supporting the peg. Government sacked many teachers from the civil service, cut family benefits and pension outlays 10% and pensions of working pensioners by 70%.

Households, workers and entrepreneurs without direct foreign currency liabilities may of course have indirect exposure to devaluation via the corporate sector. 52.3% of all loans were taken

out by private resident corporations. If devaluation causes them to default, more jobs will be at risk. But what type of companies took those loans? Classified by loan category, 54% of loans are mortgages while just 32% are commercial and industrial credit. So it looks like banks lent quite a lot to the commercial real estate and property development sectors. While devaluation will hurt these companies, they operate precisely where resources need to shrink. Other companies in the tradable sector have

some insulation from devaluation due to their foreign currency earnings.

So a large part of society without direct exposure to foreign currency debt – the young, old and companies in the tradable sector – is paying a high price to support those who borrowed foreign currency. Further cuts to the 2010 budget are looming. From the perspective of welfare, the cost of deflation associated with maintaining the fixed exchange rate suggests it is not an optimal position. In a democracy, the political system usually delivers what the public ultimately wants. As the welfare cost to society of maintaining the peg grows, public support for it will wane. Why then do the EU and IMF support it?

### **International Support**

The international community, led by the EU and IMF, agreed to lend Latvia €7.5 billion, a relatively small sum compared to the G-20 countries' fiscal measures but a whopping 33% of Latvia's GDP. Even neighbouring Estonia chipped in. By lavishing support on Latvia, they hope to prevent a domino effect whereby devaluation of the lat might trigger capital outflows and a run on domestic currency deposits in the other fixed exchange rate regimes in the region: Lithuania, Estonia and Bulgaria.

Why should we care? Well, it could get worse. If Latvia were to devalue, you can count on residents in Lithuania and Estonia converting their local currency savings into euros. Many already have. Foreign currency debt is high in the Ukraine, Hungary, Romania and Poland, so demand for euros could rise there too. The Swedish and Austrian banking sectors, which financed much of the foreign currency debt in Central and Eastern Europe, will come under pressure, as will the Swedish krona and Swedish and Austrian government bonds. If that scenario were to play out, the final cost of financial support to Central and Eastern Europe could well exceed the sum so far extended to the region today.

Where there is a clear case of a real exchange rate misalignment, however, and where there are efficiency and equality reasons to change the exchange rate regime in order to regain international competitiveness, devaluing is always an option. Done convincingly, with support from the ECB, EU and IMF, the shock wave across Central and Eastern Europe described above need not occur. And if joining Europe's Economic and Monetary Union (EMU) is Latvia's eventual prize for EU membership, then it is not clear how devaluing now would delay that goal, because at this juncture

Latvia is not meeting any of the other Maastricht entry criteria required to adopt the euro.

Very small and illiquid local markets also mean there is little in the way of short-term portfolio flows in the Baltic states speculating on devaluation. The relatively more liquid markets in Sweden, Poland, Hungary and Austria already discount some risk of banking system recapitalisation. Central banks in Sweden and Hungary have more than once proved willing to raise interest rates to defend their currencies. While some Swedish and Austrian banks are particularly vulnerable to loan losses in Central and Eastern Europe, irrespective of whether they are caused by deflation or devaluation, the size looks manageable. Based on our worst-case scenarios, even the most exposed Swedish and Austrian banks should be able to weather the storm with a lot of shareholder and a bit of state support. So if Latvia's authorities were to choose devaluation, expect that to cause some volatility in interconnected markets, but not systemic risk.

What about the benefits of maintaining the peg, and are there other policy options? Maintaining the peg and enduring internal deflation is precisely what Germany experienced after joining the EMU and what other euro area countries with large current account deficits are experienc-

ing today. Regaining international competitiveness can be done. It just requires a lot of wage restraint, fiscal austerity and time. The benefit of EMU for Spain and Ireland today is lower borrowing costs. Latvia will eventually achieve that too under its fixed exchange rate once the economy adjusts.

One policy option the Latvian and international authorities might want to consider is full or partial mandatory conversion of foreign currency debt to lats, followed by devaluation. While that would transfer the cost of devaluation from borrowers to lenders, Latvia's international loan and, heaven forbid, more taxpayers' money from the EU could be used to help recapitalise the banks.

There is no shortage of uncertainty. As investors, we care about uncertainty and contagion risks. The sooner real and nominal exchange rates in Lithuania and Latvia are realigned, the less uncertainty there will be about eventual loan losses and the sooner private capital will flow back to the region. Until that happens, the ERM is set to replay the Blues.

Andrew Bosomworth  
Executive Vice President

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# P I M C O

Sydney

PIMCO Australia Pty Ltd

ABN 54 084 280 508

AFS Licence 246862

Level 19, 363 George Street

Sydney, NSW 2000

Australia

612-9279-1771