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AUSTERITY THAT NEVER WAS? THE BALTIC STATES AND THE CRISIS

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The commonly cited example of the successful application of "internal" devaluation as a strategy for economic recovery is that of the Baltic economies. In this Policy Note, we discuss whether the Baltic austerity plan worked, how it was designed to work, and, most important, whether it can be replicated anywhere else.[1] We argue that the recent Baltic recovery has unique features that do not relate to domestic austerity policies, nor are they replicable elsewhere.

As widely reported in the economic press, the impression is that austerity worked in the Baltic economies of Estonia, Latvia, and Lithuania. The *Wall Street Journal* said so; *Der Spiegel* said so. In 2009, hit with the deepest GDP declines in the world—with peak-to-trough reductions in GDP as high as 20 percent, 25 percent, and 17 percent, respectively, over the course of the crisis—all three Baltic states adopted austerity measures amounting to 8–9 percent of GDP, with an additional 3–4 percent in 2010. By 2011, the Baltics were again, as in the mid-2000s, topping European GDP growth charts, with rates of 7.6 percent (Estonia), 5.9 percent (Lithuania), and 5.5 percent (Latvia). Estonia's prime minister was rewarded with a personal invitation to dine with German Chancellor Angela Merkel.

The problem with this recovery story is that, as with so many other things in the past 20 years, the Baltics "outsourced" their recovery, and they did it very well. Namely, behind the Baltic recovery are two phenomena: the massive (and partially ahead of schedule) use of European Union (EU) fiscal funds (e.g., 20 percent of Estonia's 2012 budget is made up of EU transfers), and

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extreme integration of the export sector with Scandinavian producers. These sources of growth are unlikely to be sustainable. The problem with EU funds is that they run out by 2015, and nobody knows if and in what amounts they might continue. The problem with the export sector is that it tends to be an enclave: for instance, Elcoteq Tallinn, until February 2012 a subsidiary of the now-bankrupt Finnish-owned mobile components manufacturer Elcoteq SE and for the past decade a key exporter in Estonia, uses around 200 suppliers in its manufacturing production—none of them based in Estonia.

Since regaining independence, the Baltic states have stood out among the transition countries in Central and Eastern Europe as radical pro-market reformers. In the early 1990s, all three countries adopted a mix of policies advocated by the Washington Consensus: currency boards with fixed pegs (acting as nominal anchors for securing stabilization), fiscal discipline, price and trade liberalization, and wide-ranging privatization. Indeed, in many ways they became neoliberal transition icons, with thin governments, a high penetration of Internet service, and very open economies. After accession to the EU, all three economies witnessed an unprecedented boom; between 2004 and 2007, the Baltics stood out among EU member-states for their high growth rates, which averaged 10.3 percent in Latvia, 8.5 percent in Estonia, and 8.2 percent in Lithuania. However, this remarkable growth was accompanied by signs of overheating, like double-digit inflation, a housing boom, sharply appreciating real exchange rates, accelerating wage growth (which exceeded productivity growth, especially in Latvia and Estonia), rapid accumulation of net foreign liabilities, and soaring current account deficits. To a significant extent, the growth was fueled by cheap credit (available through foreign-owned banks; Baltic banking sectors are overwhelmingly Swedish owned), which drove up domestic demand and were channeled into real estate, construction, financial services, and private consumption. All three economies were rapidly building up debt with the rest of the world. During 2007—the last boom year—the current account deficit exceeded 20 percent of GDP in Latvia and 15 percent in Estonia and Lithuania. Even without the global financial crisis, the Baltics were Ponzi schemes in spe.

Thus, it comes as no real surprise that the crisis hit all of the Baltics quickly and painfully. The domestic bubbles burst in early 2008 (when the credit supply decelerated, as banks tightened credit), and the downturn was further exacerbated by negative developments in the external economic environment after the Lehman Brothers bankruptcy. In 2009, GDP fell by 14.3 percent in Estonia, 14.8 percent in Lithuania, and 17.7 percent in Latvia. Following massive drops in both domestic demand and exports, unemployment figures soared, rising most rapidly in Latvia (from a low of 5.3 percent to 20.5 percent, making it the largest such increase in the EU) but closely followed by Estonia (from 4.1 percent to 19.8 percent) and Lithuania (from 4.5 percent to 18.3 percent). In all three countries, the unemployment rates were almost four times higher at the end of 2009 than they had been in 2007.

In response to the crisis, the Baltics opted for internal, as opposed to external, devaluation of the domestic currency, which implied the downward adjustment of nominal wages and fiscal contraction (instead of countercyclical policy measures). The Baltic state governments heavily objected to external devaluation for a number of reasons, ranging from the practical to the symbolic. Perhaps most important, nominal exchange rate adjustment would have precluded their joining the eurozone as a crisis exit strategy. Furthermore, given that a large proportion of the loans in these countries had been denominated in euros, external devaluation would have imposed heavy costs on large segments of the population and reduced private sector net worth (and potentially led to a surge in loan defaults, with knock-on effects for the rest of the economy). Significantly, none of the Baltic countries had had experience with alternative exchange rate regimes and hence lacked competencies in managing "nonautomatic" systems; policymakers had indeed deeply internalized Washington Consensus policy prescriptions. Internal devaluation as an adjustment strategy was also supported by the EU, which was afraid that devaluation of the Baltic currencies would cause havoc in the financial markets and potentially lead to contagion of other Central and Eastern European economies, inducing capital flight from this region.

The choice of internal devaluation, in turn, implied the need for fiscal consolidation, which all three governments implemented in 2009 and 2010. They also relied heavily on EU structural support funding, which exceeded 4 percent of GDP in these years. Under EU structural support regulations, countries can access funds earmarked for later use; all of the Baltic economies took advantage of this opportunity.

The combination of minimal public reserves and troubled domestic banks put Latvia in the most difficult situation of the three by the fall of 2008. Given the need to bail out the Parex bank in the absence of fiscal reserves, the Latvian government had to ask for support from the International Monetary Fund, the EU, and Nordic countries in November 2008. The package that was ultimately approved in January 2009 helped to avoid the spillover of the liquidity crisis to the other Baltic economies. In fact, Estonia was able to participate in this support action by pledging 100 MEUR (Latvia did not exercise this option, since it did not need as much money as donors offered); this lent considerable political support, both domestically and internationally, to the Estonian government. Furthermore, its reserves (around 9 percent of GDP) gave the government significantly more room in terms of building the case for fiscal retrenchment, since conditional outside financial support was depicted as a loss of sovereignty: the politicians could argue that Estonia still needed to hold on to its accumulated reserves in order to avoid a situation similar to Latvia's (which necessitated fiscal retrenchment) rather than spending the entire rainy-day fund. The lack of domestic banks also gave the Estonian government significantly more fiscal space, since bank bailouts were "outsourced" to the Swedish central bank. (The latter, in fact, took out a loan from the European Central Bank in the amount of three billion euros.) All three Baltic countries thus averted a banking crisis.

Estonia had a considerable advantage compared to the rest of the Baltics, since it could unify all efforts behind a single goal: entry into the eurozone. This option was no longer available to Latvia and Lithuania, mainly because these countries did not fulfill the inflation criteria on the eve of the crisis, while slowing growth was rapidly decreasing inflation in Estonia. In Estonia's case, fulfilling all of the Maastricht debt and deficit criteria in 2009 and 2010 was feasible, since it was the first to impose budget cuts and inflation was slowing in the wake of the crisis. (Latvia had failed to meet the deficit criteria because of a single act: the Parex bank bailout.) Lithuania had a much narrower window of opportunity for joining the eurozone and had had a negative experience in 2005, when it missed eurozone entry by a 0.2 percent margin on the inflation criteria (calculation for which also includes, oddly, noneurozone economies such as Sweden).

Estonia's next general elections were scheduled for 2011, giving the government realistic hopes that entrance to the eurozone would generate enough political capital domestically to enable it to survive the crisis. Thus, the initial conditions made it possible for Estonia to have a straightforward, realistic goal for dealing with the crisis that the other two Baltic countries lacked.

By the close of 2009, the worst seemed to be over for the Baltics. Their economies returned to growth, and in the second half of 2010 employment started picking up again. Exports followed a growth trend, and their current accounts turned toward surplus. In light of these developments, can we say that austerity and internal devaluation really worked?

In fact, a closer look shows that the current Baltic recovery did not result from internal devaluation but rather from other factors not under the control of the Baltic governments. While many analysts hasten to call the internal devaluation successful, the downward adjustment of prices and wages in the Baltics was relatively modest, especially considering how overheated these economies had become by the end of the boom. None of the three countries actually experienced any significant deflation; in fact, in 2010 and 2011, inflation resumed an upward trajectory in each case, and the peak-to-trough reduction of real wages was about 15 percent in all countries. By the end of 2009, real effective exchange rates had fallen by three to five percentage points from their boom-time peaks.

If not internal devaluations, then what was behind the Baltic recovery in 2011? There are three key factors: massive use of European funds, flexible labor markets, and the integration of export sectors into key European production networks. Flexible labor markets have had two consequences: persistently high unemployment, which did not lead to significantly higher social expenditure (automatic stabilizers are relatively unimportant as benefits are low and brief, and active labor market measures are financed largely by EU structural funds); and higher emigration. While emigration was already high in the mid-2000s, particularly in Lithuania, the crisis seems to have hastened emigration in all of the Baltic states: censuses in Lithuania and Latvia in 2011 showed a dramatic drop in population numbers, and Estonia's census of 2012 shows a marked decrease in population over the last decade. Since the Baltic states are "simple polities," reflected, inter alia, in low levels of popular unrest and restrained civic dialogue, having a voice in government does not seem to be an option for many; thus, emigration becomes the preferred choice for an increasing number of people. However, both high unemployment and emigration have future costs in terms of social stratification and a smaller workforce. Thus, while during the crisis the costs of external devaluation were argued to be higher than internal devaluation (or "adjustment," as it is mostly referred to in Baltic debates), it remains to be seen whether this is really so, given the persistently high levels of unemployment and emigration.

Integration into European networks by a few dozen leading exporters is another key factor in explaining the Baltic recovery. However, this has hardly anything to do with domestic conditions or policy actions. It is, rather, an increasingly important symptom of the Baltic brand of capitalism: enclave industries. One of the key problems faced by Eastern European companies is the low embeddedness of foreign-owned exporting firms, which is reflected in the low level of linkages with domestic suppliers and partners, and with higher education and research institutions. While Baltic exports have bounced back to precrisis levels, the problem of linkages remains. In addition, the precrisis level of exports is not nearly high enough to make up for the lack of foreign financing that was used to fuel Baltic growth in the mid-2000s. In sum, while the crisis has hardened the Baltic neoliberal resolve, the responses to the crisis have not so far brought substantial changes to Baltic economic structures; consequently, the underlying fragility remains unresolved. However, since the Baltic economies are very open and small, their recovery and future growth also heavily depend on a broader European recovery. As the latter seems likely to be slow and sluggish for some years to come, it is difficult to foresee that the Baltics will experience growth rates similar to those in the mid-2000s anytime soon.

In sum, almost all of the above factors make the Baltic cases unique and irreproducible in the EU context. First, most EU countries, especially in the troubled periphery, are already in the eurozone, so they cannot justify short-term austerity measures and eurozone entry as a crisis exit strategy; second, very few EU countries have civil societies as weak as those in the Baltic countries, and thus austerity breeds visible unrest and instability; and third, few if any EU countries have such narrow and detached policy elites—elites that have become accustomed to satisfying their European policy peers rather than their domestic partners.

Yet, even if the EU periphery could somehow manage to replicate the aforementioned political conditions—by weakening civil society, retrenching the welfare state, and relaxing labor regulations—they still would not have similar economic factors. There are a number of economic and structural factors that make the Baltics relatively unique, including high levels of economic globalization (both in exporting and in the financial sector) and strong dependence on larger neighboring economies—Scandinavia and Poland—in terms of trade and (in the case of Scandinavia) technology transfer. Both of these economies either recovered quickly (Scandinavia) or did not experience any crisis at all (Poland). Thus, as Wolfgang Münchau argues, while the EU is behaving more and more as if it were a small open economy where budget discipline was important for convincing investors and markets, the experience of the small open economies that have dealt best with such fiscal policies is of very little use to other troubled EU members.

Note

1. An earlier version of this note appeared as a post on the Triple Crisis Blog, **http://triplecrisis.com/can-austerity-bring-growth/**. We would like to thank Jan Kregel and Ken Shadlen for their help and comments.