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Baltic Austerity—the New False Hope

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June 12, 2012

Ireland was at one time the poster child for fiscal austerity, but that country's disappointing economic performance of late has left austerity apologists searching for a new model—and the Baltic economies appear to be next in line. But Estonia, Latvia, and Lithuania are as unsuited to stand as successful models of expansionary fiscal contraction and "internal devaluation" as their Irish predecessor. Paul Krugman recently drew the ire of the Estonian president by questioning the impressiveness of the Baltic recovery, noting that the data show a huge downturn followed by positive but modest growth—essentially an incomplete recovery. But even if you put aside this debate over the relative impressiveness of the growth rates, the key policy question here is whether the Baltic economic recoveries can serve as models for the struggling eurozone periphery to emulate. To the extent that Estonia, Latvia, and Lithuania have had even limited success climbing out of a very deep economic hole, this has been due to factors that are unique to the Baltic situation—and largely unrelated to domestic austerity policies.

After joining the European Union (EU), the Baltic economies enjoyed unprecedented economic booms. But having developed unsustainable bubble economies that were largely fueled by cheap credit provided by foreign-owned banks, the Baltics were hit hard by the financial crisis and resulting credit contraction. The peak-to-trough collapses in GDP were among the most dramatic in the world—at 20 percent (Estonia), 25 percent (Latvia), and 17 percent (Lithuania). Unemployment rates skyrocketed in equally eye-opening fashion, to 19.8 percent in Estonia, 20.5 percent in Latvia, and 18.3 percent in Lithuania. In 2009 and 2010, all three governments enacted fiscal austerity measures as part of a strategy of internal devaluation (essentially an attempt to reduce real wages in order to regain competitiveness). By 2011, GDP growth came in at 7.6 percent, 5.5 percent, and 5.9 percent, respectively.

So should the Baltic economies be held up as examples of the success of internal devaluation? The first problem with this story is that little actual devaluation (or "adjustment") took place in these countries. Considering how overheated their economies had become prior to the crisis, the downward adjustment of prices and wages in the Baltics was relatively modest. None of the three countries actually experienced any significant deflation, and in fact, in 2010 and 2011, inflation resumed an upward trajectory. The peak-to-trough reduction of real wages was about 15 percent in all three. By the end of 2009, real effective exchange rates had fallen by three to five percentage points from their boom-time peaks.

To what, then, can we attribute the return to growth (incomplete as it may be)? The Baltics essentially "outsourced" their recovery. First, they relied (and still rely) on a massive use of EU fiscal funds—20 percent of Estonia's 2012 budget is made up of EU transfers. Second, Baltic export sectors are deeply integrated with neighboring Scandinavia and Poland, whose economies either recovered quickly from the crisis or, in the case of Poland, did not experience a crisis at all. These unique circumstances account for a great deal of the modest growth enjoyed by the Baltic economies—but they have little to do with domestic policies.

All three economies also feature flexible labor markets, which, as noted above, have been accompanied by high levels of unemployment. And while unemployment has been trending downward lately, this is partly due to uniquely elevated levels of emigration in the Baltics, the pace of which has increased since the crisis broke. Lithuania and Latvia experienced particularly large population decreases in 2011. The Baltic states have relatively quiescent civil societies, which makes it less likely that imposing austerity will provoke instability and unrest. But for an increasing number of people in Estonia, Latvia, and Lithuania, the preferred alternative is simply to leave the country.

Even if countries in the troubled eurozone periphery were politically able to enforce austerity and "adjustment" without generating significant popular unrest, they still could not replicate the unique economic factors that account for the recovery in the Baltics. Moreover, that outsourced Baltic recovery is unlikely to be sustainable. EU funds run out by 2015, and there is a great deal of uncertainty as to whether and in what amounts they might continue. And while Baltic exports have bounced back to precrisis levels, they are not nearly high enough to make up for the lack of foreign financing that was used to fuel growth in the mid-2000s.

The search for the austerian exemplar continues.

A more detailed discussion of this topic can be found at
www.levyinstitute.org/pubs/pn_12_05.pdf

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