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PART 2

ECONOMIC MIRACLE IN THE BALTIC STATES: AN EXEMPLARY WAY TO GROWTH?

by Kristina Maslauskaitė and Liva Zorgenfreiņa

INTRODUCTION

In the recent years, marked by economic and financial turmoil, Estonia, Latvia and Lithuania have been in the international spotlight on more than one occasion. The three Baltic states were hit early and hard experiencing double-digit recessions already in 2009, which in terms of output loss could only be compared to the ones that took place when the Soviet Union collapsed. For a number of reasons, the governments in all three countries quickly and decidedly chose to respond to the crisis by following the route of internal devaluation instead of devaluing their national currencies – a policy option so longed-for by the Southern EMU members today. This strategy has worked remarkably well: today the Baltic tigers start roaring again, though in a more sustainable manner, as the three countries are among the fastest growing in the EU. In addition, Estonia (joined on 1 January 2011) and Latvia (has been invited to join on 1 January 2014) have been rewarded with their much sought-after prize of joining the Euro Area.

As a result, the way the Baltic states dealt with the crisis and the near-miraculous current economic recovery invites the austerity-supporters to proclaim the countries as an example, in particular for the Southern EMU member states caught in protracted recessions. However, even though austerity has played a role in economic recovery in the Baltic states, it is important to recognise that on the one hand, the factors that determined the relatively successful recovery were specific to the region and the countries. On the other hand, the current economic recovery hides a number of social issues that might surface later on and hinder the future development of the economies. The medicine

taken by the Baltic states has thus to be prescribed to the other sick men of Europe with caution – making sure to recognise the differences among the individual symptoms.

The paper starts out by shedding some light on economic developments in the Baltic states after the collapse of the Soviet Union and explaining the factors that contributed to the pre-crisis build-up of macroeconomic imbalances. It then proceeds by presenting the specificities of the great recession and analyses the policy response taken in each of the three countries. The subsequent section looks at the context-specific reasons that played to the advantage of the Baltics as well as the social cost that has emerged as a consequence of the crisis. The last section concludes and provides some policy implications.

1. Developments before the Economic Crisis

1.1. Emergence of the Baltic Tigers

The Baltic economies emerged from communism as examples of quick and efficient transition countries even though the transition period was marked by numerous challenges. First of all, the three states were the only ones of the current Central and Eastern European (CEE) EU member states which had been fully incorporated in the Soviet Union and hence had been deprived of any autonomous institutions needed to run the state. Secondly, all existing economic activity was marked by the Soviet era and trade was geared towards the East. To give an idea, in the years preceding the independence, Estonia had only 34 rather small private companies¹ and 90% of its exports went to the Soviet Union². Finally, the transition was made more difficult by hyperinflation in the rouble-area, with inflation rates peaking at around 1000% in all the three Baltic states in 1992³. National wealth was declining below the Soviet-era

1. Erixon Fredrick, "Baltic Economic Reforms: A Crisis Review of Baltic Economic Policy", *ECIPE Working Paper*, 2010, p. 9.

2. *Ibid.* p. 10.

3. Ståhr Karsten, "Economic Development in the Baltic States: Success and New Challenges", *Monetary Review 4th quarter 2007*, Denmark's Nationalbank, 2007.

levels: GDP levels in 1992 fell by more than 20% in Estonia and Lithuania and by more than 30% in Latvia. Therefore, after regaining independence in the beginning of 1990s the three countries lived through an extremely difficult period of reorganisation, reconstruction and economic turmoil.

The Baltic states chose to distance themselves from the Russian influence and direct their policies westwards, largely following the liberal prescriptions of the Washington consensus to become open market economies. So much so that Estonia had to re-regulate its tariffs with the view of entering the WTO and the EU⁴. In addition, after several years of hyperinflation, all three states chose to peg their currencies⁵. The policies in general were geared towards ensuring macroeconomic stability, attracting foreign investment and, finally, entering the prestigious clubs of Western countries, most prominently the EU and the NATO.

Thanks to strong political will and public support the reforms in the fields of institution building, privatisation and trade liberalisation were largely successful as evidenced by the astonishing economic performance. In the mid-2000s, the three Baltic tigers had a golden age. The economies were growing at the spectacular pace of 8-9% per year on average in real terms, and the levels of national real wealth more than doubled in the period of 2000-2008 (*Figure 1*). The countries possessed “ample room for restructuring”⁶ due to an extremely well qualified labour force and low capital endowment, which made them attractive for entrepreneurs. Moreover, the institutional convergence was the fastest one among the post-communist countries as shown by standard governance indicators⁷. Pegged exchange rates and EU membership in 2004 provided the required credibility. As a result, large capital inflows followed, for example, FDI peaked at 20% of GDP in Estonia, 8.5% in Latvia and 6% in Lithuania in the pre-crisis years. Unemployment rates dropped from 14-16% in 2000 to approximately 4% in Estonia and Lithuania and 6% in Latvia in 2007 (*Figure 2*).

4. Estonia essentially applied near 0% tariffs on its imports until 1995 when it began harmonising its Most Favoured Nation (MFN) tariff rates towards the EU's Common External Tariff (CET). See “Enhancing market openness, intellectual property rights, and compliance through regulatory reform in Estonia”, *OECD Report*, 2011, p. 11.

5. The exchange rate arrangements have not been the same in all three countries, but in their essence they have all included a currency peg.

6. Deroose Servaas, Flores Elena, Giudice Gabriele and Turrini Alessandro, “The tale of the Baltics: experiences, challenges ahead and main lessons”, *ECFIN Economic Briefs*, Issue10, July 2010.

7. *Ibid.*

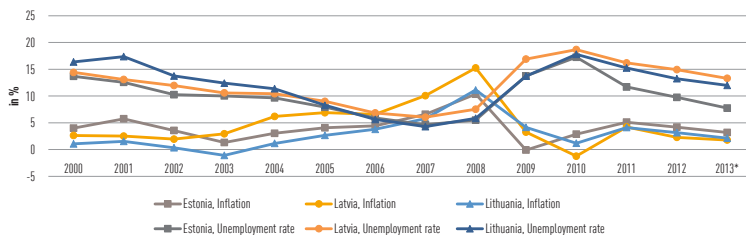
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FIGURE 1 ▶ Real GDP per capita, levels (RHS) and growth (RHS)



Source: International Monetary Fund, World Economic Outlook Database, April 2013

FIGURE 2 ▶ Unemployment and Inflation Rates



Source: International Monetary Fund, World Economic Outlook Database, April 2013

1.2. Build-up of Macroeconomic Imbalances

However, the positive developments were accompanied by a significant build-up of macroeconomic imbalances, housing booms and arguably international competitiveness losses in terms of labour costs. In addition, even before the outburst of the crisis, there were growing concerns about overheating in

the Baltics about which the countries have been warned. The IMF⁸, the EU⁹ and the World Bank¹⁰, all had doubts about the long-term sustainability of the economy. Indeed, Figure 2 illustrates that during the peak year of 2008, the inflation rates in the three states were largely above 10%.

The causes of rising imbalances were several. Firstly, the financial sector was completely liberalised and almost entirely overtaken by the Nordic banks in all three countries, which fuelled capital inflows and credit expansion. In Latvia more than 60% and in Lithuania and Estonia more than 90% of the financial sector became foreign-owned¹¹. Competing for market shares within the region and enjoying ample liquidity in the global markets, the Scandinavian banks offered very low interest rates to the Baltic populations. Such conditions, coupled with overly optimistic expectations about the future economic convergence within the EU, fuelled a real explosion of private sector debt. As shown in Figure 3, private sector debt more than tripled in all three states in the period 2000-2008. The great majority of loans were invested in real estate, which subsequently led to a housing bubble. To quote one example of the magnitude of the boom: the real estate prices in Riga in two years (2005-2007) increased by 385%¹².

8. See for example: IMF, "Republic of Latvia: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia", *IMF Country Report*, No. 06/353, October 2006. The second text reads: "More recently, however, when overheating pressures emerged and credit growth accelerated, fund policy advice had less resonance", p. 7.

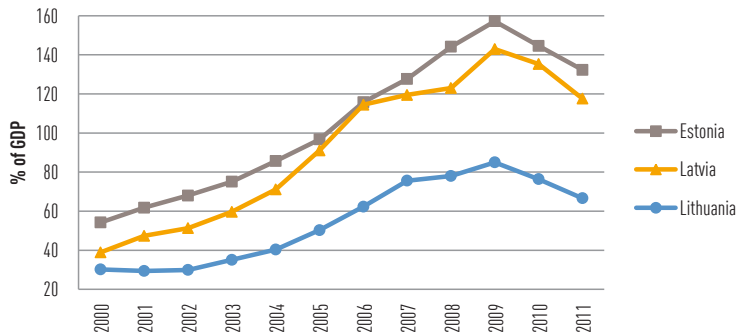
9. European Central Bank, "Convergence Report", May 2006 reads: "Over the reference period, Lithuania achieved a 12-month average rate of HICP inflation of 2.7%, which is just above the reference value stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise gradually in the coming months".

10. World Bank, "EU8+2 Regular Economic Report", January 2007 reads: "An excessive growth rate of credit in some countries is contributing to overheating and large external imbalances, especially in the Baltic States".

11. Kattel Rainer, "Financial and Economic Crisis in Eastern Europe", *Journal of Post-Keynesian Economics*, vol. 33, issue 1, 2010, p. 46.

12. Blanchard Olivier, Das Mitati, Faruquee Hamid, "The initial impact of the crisis on emerging market countries", *Brookings Papers on Economic Activity*, 1 January 2010.

FIGURE 3 ▶ Private Sector Debt



Source: Eurostat

Secondly, as discussed above, the Baltic states quickly became very attractive destinations for foreign investment. However, most of the incoming international investment was directed towards the non-tradable goods sector, namely real estate, retail distribution and the financial sector. Such investment added to the consumption boom, but did not produce the expected productivity gains in the tradable sector. It inflated the profits and wages in the non-tradable sectors, “causing labour and capital to be reallocated from more competitive sectors towards non-tradable ones and playing a key role in inflating internal demand”¹³.

Thirdly, wage growth outpaced productivity gains. In the three years preceding the crisis (2006-2008), unit labour costs¹⁴ grew at rates of around 20% in Latvia, 15% in Estonia and 10% in Lithuania¹⁵, suggesting that wage increases were not matched by equally rapid productivity growth. There are several reasons that can explain such a wage boom. Firstly, wages grew because the

13. European Commission, DG ECFIN, “European Economy: EU Balance-of-Payments assistance for Latvia. Foundations of success”, Occasional Paper 120, November 2012, see Di Comite et al., Chapter 2 – The evolution of the Latvian external sector: imbalances, competitiveness and adjustment, p. 40.

14. Unit labour costs (ULC) measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs to real output. In broad terms, unit labour costs show how much output an economy receives relative to wages, or labour cost per unit of output.

15. OECD Statistics Database.

governments of all three Baltic states (especially Latvia and Lithuania) were pursuing expansionary fiscal policies even during the peak boom years¹⁶. Secondly, after the EU adhesion, wages experienced upward pressure as a result of mass emigration of labour. And finally, the aforementioned capital inflows in the non-tradables sector not only raised the wages in this sector, but also exerted pressure for the wages in the tradables sector to grow faster than productivity.

The surging wages and prices are often said to have resulted in a loss of competitiveness, reflected in the real effective exchange rate (REER) developments. As shown in Figure 4, ULC-adjusted REER¹⁷ experienced significant appreciation in all three Baltic states. However, one has to note that, the REER has a number of flaws as a measure of competitiveness¹⁸, and such a comparison misses the convergence process for catching-up countries. Furthermore, the REERs calculated by Eurostat do not include Russia, which is a key trade partner of the Baltic states.

Indeed, contrary to the usual economic logic, the export shares of the three Baltic states did not decline, up until the crisis even as their REERs appreciated (*Figures 4 and 5*). This can be explained by the improvements in the non-price factors – the changes in the export structure, consumer tastes, and product quality. If these are taken into account, Latvia's pure price-competitiveness, for example, has been shown to have somewhat worsened over the boom years, although less than suggested by the REER¹⁹. The non-price competitiveness has been improving since 1999, with the most significant improvement observed during the crisis and post-crisis years.

16. Fiscal stimulus has inflationary effect if it is increasing labour demand while the labour supply remains fixed (if the workers that are employed as a result of fiscal stimulus are the ones that had a job anyway).

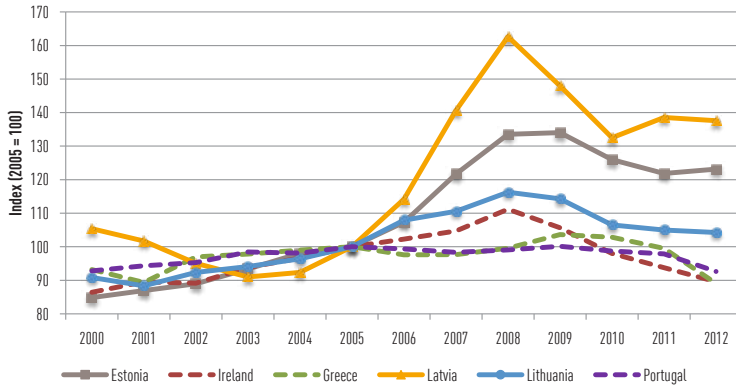
17. The REER (or Relative price and cost indicators) aim to assess a country's price or cost competitiveness relative to its principal competitors in international markets. Changes in cost and price competitiveness depend not only on exchange rate movements but also on cost and price trends. Calculated against 36 trading partners, excluding Russia. (definition taken from Eurostat) Given the high share Russia has in the exports of the Baltic states, the Baltic states' REERs might not be a good measure of their competitiveness.

18. It is a poor proxy for exporting activities, ignores structural differences of competitors, and, perhaps most importantly, focuses solely on price competitiveness. Source: *Op. cit.* "European Economy: EU Balance-of-Payments assistance for Latvia Foundations of success", see Benkovskis, K., "Chapter 3 – Evaluation of non-price competitiveness of exports from Latvia", p. 67.

19. *Op. cit.*

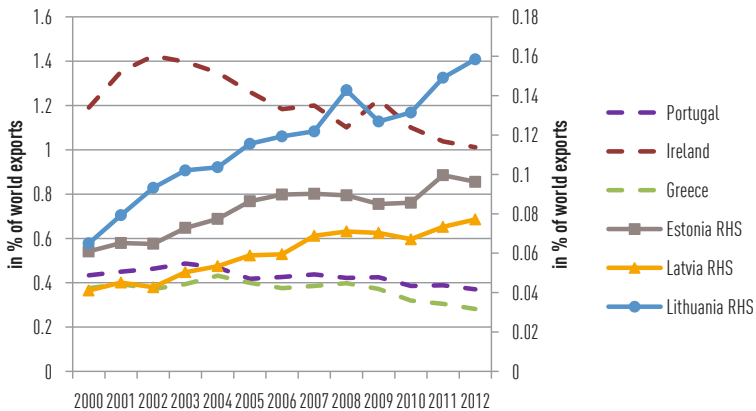
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FIGURE 4 ▶ ULC-adjusted²⁰ REER



Source: Eurostat

FIGURE 5 ▶ Export shares in world exports



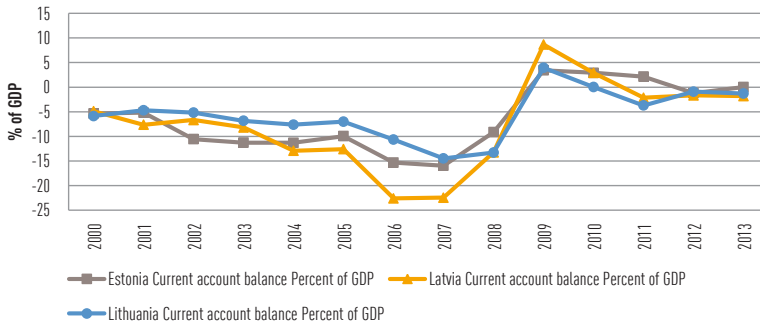
Source: Eurostat

²⁰. Deflated by nominal unit labour costs of the total economy.

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These developments, coupled with the fixed exchange rate policy, resulted in large current account deficits that mostly occurred due to increased import demand. Consequently, the three countries accumulated large current account deficits from almost 15% in Lithuania to more than 20% in Latvia (*Figure 6*).

FIGURE 6 ► Current Account Balance



Source: International Monetary Fund, World Economic Outlook Database, April 2013

2. Difficult Years and Difficult Policies

2.1. The Crash

The recession did not exactly come as a total surprise because macroeconomic imbalances had to be corrected even in the absence of the global financial crisis; however, the magnitude of it did. No one predicted the output losses in one year to be as high as the observed 18%, 15% and 14% in 2009 for Latvia, Lithuania and Estonia respectively²¹. The cumulative output losses were even more dramatic – 21% for Latvia (2007-2010) and 18% for Estonia (2007-2009)²². To emphasise the size of the loss, a comparison with the hardest-hit eurozone periphery economy is useful: the IMF projects that it is only this year (2013) that the Greek output will have contracted by 23% as compared to the peak reached in 2007²³.

As previously explained, there were a number of warnings pertaining to the imbalances accumulated during the boom years, which largely went unheard by the governments, especially the Latvian and Lithuanian ones. The recession in Latvia and Estonia started in the first half of 2008, whilst Lithuania only saw a slowdown in activity at the time (*Figure 1*). Despite the general lack of a timely and sufficient response to the overheating, almost up until the Lehman Brothers' bankruptcy some still hoped to achieve a "soft landing"²⁴.

The driving force of the remarkable GDP growth had been domestic demand that was fuelled by credit growth, which in turn occurred due to the large capital inflows. In 2007 the governments adopted certain measures to reign in the credit growth and combat inflation, but it could be described as "too little, too late"²⁵. In light of the growing awareness of credit risk in the region, banks reassessed their exposure to the Baltic states and tightened lending standards. Consequently the credit supply decelerated which led to a slowdown

21. GDP constant prices, own calculations, see IMF, "World Economic Outlook Database", April 2013

22. Own calculations, see IMF, "World Economic Outlook Database", April 2013.

23. *Ibid.*

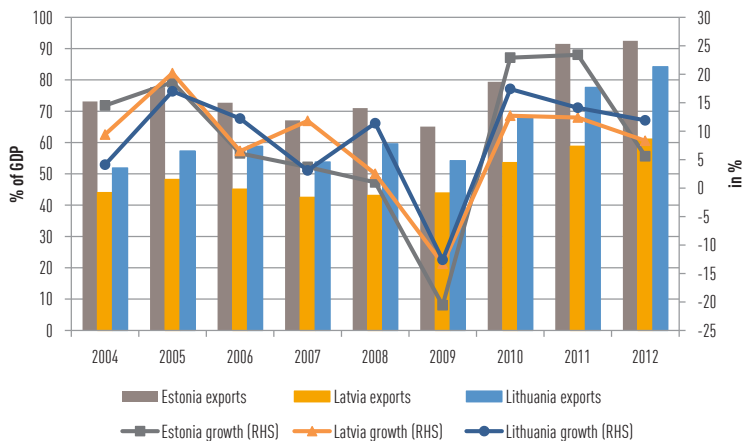
24. See Grajewski M., "Lithuania set for soft landing, euro in 2010-11 – PM", Reuters, November 2007; Swedbank, *The Baltic Outlook: Over Troubled Water*, January 2008; Swedbank, "The Baltic Outlook: Watch out for the Rocks", July 2008.

25. Peach, G., "Latvia finally tends to runaway economy, but measures may be 'too little too late'", *The Baltic Times*, 14 March 2007.

in the housing market, affecting house prices and decreasing liquidity to the detriment of the value of household equity. The mortgage loan to value ratios increased leading to deteriorating credit quality which in turn raised the credit risks in the Baltic countries, validating the pessimistic conjectures that initiated the downward spiral in the first place.

On the demand side, the irrationally buoyant expectations about the ever-increasing incomes that prevailed during the boom years abated. The imports started falling significantly in 2008 in Latvia and Estonia, and in 2009 in Lithuania, which helped in adjusting the current account balance. The external situation, however, was still relatively favourable until autumn 2008 and the export growth continued (*Figure 7*). This relatively mild recessionary phase lasted until the September 2008 global financial crash, which removed any glimmer of hope that a full-blown recession can be avoided.

FIGURE 7 ➤ Exports²⁶ (LHS) and Export Growth (RHS)²⁷



Source: Eurostat, own calculation

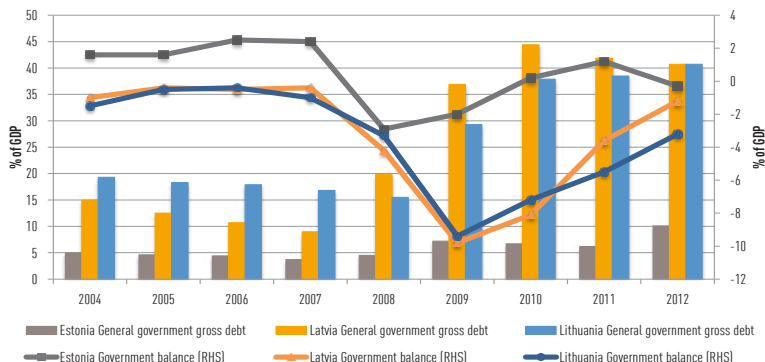
26. In current prices.

27. In volumes.

The period from autumn 2008 onwards saw a sharp reversal in capital flows due to the intensification of the aforementioned downward spiral as well as the global liquidity crisis. Elevated risk aversion prevailed globally, and the most vulnerable economies, including the Baltics, were hit hard. Additionally, the exports no longer provided a positive contribution to the economies, since the foreign demand of trade partners fell considerably. In 2009 the huge current account deficits turned to surpluses (Lithuania 3.9%, Latvia 8.7%, Estonia 3.4% of GDP in 2009, *Figure 6*)²⁸. All these factors led to a contraction of domestic demand.

Since the public expenditures were in line with the optimistic projections for 2008, whilst the revenue growth slowed considerably; the general government balances deteriorated²⁹. The trait was less pronounced in Estonia which maintained surpluses before the crisis (*Box 1*), a little more so in Lithuania, with the worst development seen in Latvia (*Figure 8*).

FIGURE 8 ➤ Government Gross Debt (Maastricht Debt³⁰, LHS) and Deficit (as considered under the EDP³¹, RHS)³²



Source: Eurostat

28. IMF, "World Economic Outlook Database", April 2013

29. Due to credit rating downgrades it had become very expensive for the Baltic states to borrow in the international markets; the balance of payments financing gap increased, especially so in Latvia, where in addition to the aforementioned effects, the government had to recapitalise the largest domestic bank.

30. Consolidated general government gross debt of the whole general government sector at nominal value, outstanding at the end of the year.

31. The difference between government revenue and expenditure relevant for the Excessive Deficit Procedure.

32. Eurostat database.

BOX 1 ► Fiscal stability and rainy day funds³³

Rainy day funds allow countries to set aside excess revenue, earned during times of economic expansion, for use in times of unexpected revenue shortfall or budget deficit. The Estonians were the only ones among the Baltic states to appreciate the significance of such an approach to fiscal policy and to accumulate some fiscal buffers during the peak boom years. They started out by targeting a balanced medium-term position. However, in 2006, seeing the pace of economic growth (overheating), the government decided to switch to targeting a nominal surplus which they succeeded at, even outperforming the targets. Nevertheless the rule did not entirely prevent fiscal loosening during the years of high growth, since mid-year supplementary budgets increasing expenditure targets were adopted every year.

Even though the general government balanced budget rule in Estonia was not legally formalised and non-compliance with it did not automatically trigger any punitive action, the rule was observed up until the crisis. That is why already in 2008, after seeing that the actual revenues were likely to underperform, the Estonian government and Parliament adopted a supplementary restrictive budget that initiated a series of consolidation measures in 2009³⁴. As a result of the comparatively prudent approach, Estonians could rely on the accumulated reserve when the crisis hit. Therefore, an important lesson for the Baltic states as well as for other countries can be learnt from the Estonian experience: in order to ensure fiscal stability, the country has to work towards the goal at the times of both unfavourable and favourable economic environment.

While Lithuania had set some rules on central government net borrowing and balanced budget rules for local governments, these did not prevent the implementation of procyclical fiscal policy in the boom years. There were no binding fiscal rules for the central government in Latvia at all.

2.2. Austerity as an Exit Strategy

There were two ways of dealing with the crisis – either through external (currency) or internal devaluation. The supporters of the former approach included such prominent names in academic world as Krugman³⁵, Roubini³⁶ and Rogoff³⁷ who argued that, in the Latvian case, the cuts required in public spending would be unsustainable and that eventual devaluation was unavoidable.

33. Based on: European Commission, DG ECFIN, "Fiscal frameworks across Member States: Commission services country fiches from the 2011 EPC peer review", *Occasional Papers 91*, February 2012.

34. European Commission, DG ECFIN, "European Economic Forecast – autumn 2009", *European Economy 10*, 2009, p. 86.

35. Krugman Paul, "Latvia is the New Argentina", *New York Times Blog*, 23 December 2008.

36. Roubini, N., "Latvia's Currency Crisis is a Rerun of Argentina's", *The Financial Times*, 10 June 2009.

37. Magnusson, N., "Rogoff Says Latvia Should Devalue Its Currency, Direkt Reports", *Bloomberg*, 29 June 2009.

However, the Baltic central banks, governments and the EU rejected devaluation as a policy option³⁸. Devaluation in one of the Baltic countries could have caused contagion in the other two and would have been a threat to the stability of the whole region. In addition, domestically, the high share of euro-denominated loans (in 2008, more than 80% of loans in Latvia and Estonia and more than 60% in Lithuania were foreign currency-denominated³⁹) meant that the solvency of households and corporates would come under serious pressure, resulting in a sharp deterioration in the asset quality of banks. The global downturn cast a doubt on the potential magnitude of a devaluation-fuelled rebound in exports, while the competitiveness gains associated with devaluation would not have lasted long since exports had a high import content. Due to the weight of imports in the economy, the consumer price inflation would have sky-rocketed. Devaluation would have also meant that the goal of joining the Euro Area, viewed by most as the main crisis exit strategy, had to be forgotten. Finally, it was of great importance that the public and the governments understood that there were structural problems in the economy that needed to be addressed in any case in order to regain market confidence and put the economies on a more sustainable path.

As a result of the above considerations, the Baltic states opted for internal devaluation that consisted of both expenditure cuts and revenue increases. In addition, there were several types of external help provided, amongst these were: medium-term financial assistance to Latvia⁴⁰; adherence to the “Vienna initiative”⁴¹; EU’s frontloading of structural and cohesion funds⁴²; the central bank currency swap agreements between Denmark and Sweden on one side and Latvia or Estonia on the other⁴³; the expansion of EBRD activities; and policy advice from such institutions as the European Commission (EC), the IMF and the World Bank.

38. European Commission, DG ECFIN, “European Economy: EU Balance-of-Payments assistance for Latvia Foundations of success”, *Occasional Paper 120*, November 2012.

39. European Commission, DG ECFIN, “Cross-country study: Economic policy challenges in the Baltics. Rebalancing in an uncertain environment”, *Occasional Papers 58*, February 2010, p. 47.

40. Under the EU medium-term financial assistance facility for non-euro-area EU countries. The EU Balance-of-Payments assistance programme amounted to EUR 3.1bn. There were also loans provided by the IMF, the World Bank, regional neighbours and the EBRD (a total of EUR 7.5bn of which Latvia used only EUR 4.5bn).

41. The European Bank Coordination “Vienna” Initiative, created in January 2009, was a coordinated effort by the public and private sector to secure financial sector stability in the CEE countries with substantial foreign bank ownership.

42. Although the allocation of structural and cohesion funds to support the EU’s poorer regions and infrastructure improvements is not related to the crisis, frontloading of disbursement was decided in response to the crisis.

43. Darvas, Z. “The EU’s Role in Supporting Crisis-hit Countries in Central and Eastern Europe”, *Bruegel Policy contribution*, Issue 2009/17, December 2009, p. 5.

The three countries differed in terms of the severity of the crisis, but followed a similar process when dealing with it. Primarily due to the need to bail out the largest domestic bank (Parex Bank), the Latvian fiscal situation was the worst among the three. In November 2008 the Latvian authorities applied for a balance of payments support from the IMF, the EU and regional neighbours. The country took drastic measures in a short period of time – the cumulative fiscal adjustment from 2008 to 2011 was estimated to be at 17% of GDP (6.8% on the revenue side, 10.2% on the expenditure side)⁴⁴. In comparison, it is only this year that the Greek cumulative fiscal correction is expected to surpass the Latvian one. As a part of structural reforms, state institutions saw important changes: half of the state agencies were closed, support functions were centralised, and the average size of a ministry was reduced by one third⁴⁵. Hospitals, especially the small ones, schools, and vocational education institutions were closed. The financial sector saw a division and a restructuring of the bailed-out bank. Even though the consolidation measures (*Table 1*) brought changes to taxes, the National Reform Programme states that the tax burden against the GDP did not increase⁴⁶. To avoid similar crises in the future, a Fiscal Discipline Law that provides for a balanced budget in the economic cycle came into force in March 2013.

The realised measures have been effective in stabilising the Latvian budgetary situation; the budget deficit in 2012 was only 1.2% of GDP (*Figure 8*). Latvia returned to the international capital markets very successfully in June 2011, issuing USD-denominated bonds⁴⁷. The balance-of-payments assistance programme was concluded in January 2012. Not only did Latvia use just EUR 4.5bn out of the EUR 7.5bn loan, but also it repaid the part owed to the IMF early – at the end of 2012. The GDP growth, led by exports, resumed in 2011 (5.5%), and in 2012 (5.6%) it was the fastest growing country in the EU. Perhaps the most important development is the country's recent bid to join the Euro Area. Latvia fulfils the Maastricht criteria, and on the 9th of July 2013 the Council invited the country to join the EMU.

44. European Commission, "Convergence Programme of the Republic of Latvia 2012-2015", Riga, April 2012, p. 27.

45. Working group for the development of the National reform programme of Latvia, "National Reform Programme of Latvia for the Implementation of the "Europe 2020" strategy", Riga, April 2011, p. 9

46. *Ibid.*

47. *Op. cit.*, European Commission, *Occasional Paper 120*, p. 10.

Lithuania was hit later, had no systemically important domestic banks to save, adopted significant austerity measures and saw rebound quicker than Latvia; the year-on-year growth turned positive in the second quarter of 2010, chiefly due to exports. The Excessive Deficit Procedure (EDP) that was started in July 2009, together with the tough existing financing conditions at the time, provided the necessary push for a serious response to the crisis. In 2009, consolidation measures amounted to around 8% of the GDP⁴⁸ and were focused mainly on the expenditure side, involving public sector wage cuts, as well as cuts in social benefits (*Table 1*). Lithuania initiated radical health care and education reforms, but all in all the institutional changes were less drastic than those seen in Latvia. Furthermore, alongside the consolidation measures, Lithuanians introduced comparatively more stimulus measures than the other two Baltic states. For instance, the personal income tax was reduced by 9 percentage points to 15% and exemptions were added to excise duties⁴⁹. The measures granted the needed credibility and put the economy on a more sustainable path. The export-driven GDP growth reached 5.9% in 2011 – in the EU, second only to Estonia's 8.3%. According to the recent opinion of the EC on Lithuania's National Reform Programme, the 2012 level of general government deficit (3.2%) can be considered sufficient for abrogation of the decision on the existence of excessive deficit⁵⁰. The Lithuanian authorities have also declared their willingness to introduce the euro in 2015⁵¹.

Estonia, having been the most prudent one during the boom years (*Box 1*), embarked on fiscal consolidation early in 2008 because it aimed to fulfil the Maastricht criteria in the near future, which was out of reach for both Latvia and Lithuania. Similarly to the other two countries, public sector wages were slashed and benefits were cut, but unlike the neighbours, Estonia changed little on the institutional level⁵². The country also introduced several one-off measures aimed at improving the budget balance in order to qualify for the introduction of euro. In addition to the consolidation measures, the Estonian government attempted to further liberalise the economy. The country's approach was successful and the developments in main trade partners were

48. European Commission, "Assessment of the Action Taken by Lithuania and Romania", Communication to the Council, 2010, p. 5.

49. Bagi, A. and Mezo, J., "Crisis management in the Baltic States" *Munich Personal RePEc Archive*, No. 40366, August 2012, p. 435.

50. European Commission, "Recommendation for a Council Recommendation on Lithuania's 2013 national reform programme", Brussels, 29 May 2013, p. 3.

51. Lithuanian Finance Ministry's affirmation to adopt the euro in 2015.

52. Kattel, R. and Raudla, R., "The Baltic Republics and the Crisis of 2008–2011", *Europe-Asia Studies*, 65 (3), p. 439, 2013.

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favourable. Estonia resumed growth in the second quarter of 2010, primarily due to increasing exports, and by 2011 it had already joined the Euro Area. In 2011 it was the only EMU country with a budget surplus.

TABLE 1 ► Budgetary Adjustment in the Baltic States

	Consolidation	Expenditure	Revenue
LITHUANIA	Examples of measures	<ul style="list-style-type: none"> Cuts of public sector operating expenses by 10% in 2009.⁵³ The cuts were progressive, from 8-36%, and highest earners took larger hits. Sickness benefits curtailed; old-age pensions cut⁵⁴; the part of the social insurance contributions to the compulsory private funded pension pillar were reduced from 5.5% to 2%. 	<ul style="list-style-type: none"> VAT increase from 18-21% (2009); corporate income tax rate 15-20% (2009)⁵⁵; increase in excise duties. Broadening of the base for VAT, by reducing the number of goods with favorable rates, and increasing the favorable rates. Introduction of a real-estate tax.
	as % of GDP	2009: 5.8%, 2010: 3.7%	2009: 1.6%
LATVIA	Examples of measures	<ul style="list-style-type: none"> Cuts of public sector operating expenses by 18% in 2009 and continued later. Central government officials saw cuts of 30% between 2009-2011, while public wages were cut by 25%. Sickness benefits that exceeded a threshold were cut by 50%; old-age pensions cut⁵⁴; the part of the social insurance contributions to the compulsory private funded pension pillar were reduced from 6%-2%. Increase in retirement age to 65 (2012). 	<ul style="list-style-type: none"> Increase in the rate of personal income tax 23-26% (2010)⁵⁷; employee social contribution rate 9-11% (2011); VAT increase from 18-21% (2009) and then to 22% (2011); increase the excise duties on alcohol, tobacco and energy; increase in vehicle taxes. Broadening of the base for personal income tax and VAT. Introduction of a progressive real-estate tax in 2009 that was doubled in 2011.
	as % of GDP	2008: 0.5%, 2009: 6.7%, 2010: 1.9%, 2011: 0.7%, 2012: 0.4% ⁵⁸	2008: 0%, 2009: 2.8%, 2010: 2.1%, 2011: 1.6%, 2012: 0.3%

53. Masso, J., Krillo, K., *Labour Markets in the Baltic States During the Crisis 2008-2009: The Effect on Different Labour Market Groups* (2011), University of Tartu, Faculty of Economics and Business Administration, 2009.

54. Progressive – larger pensions facing larger cuts. The cuts were contested by judicial review and were found to be unconstitutional. Reversed in 2010.

56. The cuts were contested by judicial review and were found to be unconstitutional. The government had to cancel the cut and compensate the pensioners.

57. Reduced again to 25% in 2011.

58. European Commission, *Convergence Programme of the Republic of Latvia 2012-2015*, Riga, April 2012, p. 27.

THE BALTIC STATES IN THE EU: YESTERDAY, TODAY AND TOMORROW

ESTONIA	Examples of measures	<ul style="list-style-type: none"> • Cuts to public sector operating expenses by 8% in 2009. Some groups, like teachers, were subjected to a lower pay cut than others. • Sickness benefits for the first days of leave were cut; pensions were not indexed by the planned 14%, but rather by 5%; state-financed contributions to the second pillar were stopped (July 2009 - December 2011). Retirement age to be raised from 2017. 	<ul style="list-style-type: none"> • Planned income tax rate reduction was postponed; Unemployment insurance contributions increased from 0.9-4.2% of gross wages; VAT increase from 18-20%; • Broadening of the base for VAT, by reducing the number of goods with favorable rates, and increasing the favorable rates. • No new taxes introduced • One-off measures: taking dividends from SOEs (2009); selling shares of Estonian Telecom (2009); sold "Kyoto Units".
	as % of GDP	2009: 6.2%, 2010: 1.6% ⁵⁹	2009: 2.7%, 2010: 1.3%

59. OECD, "Restoring Public Finances", *Journal on Budgeting*, vol. 11, no. 2, 2011, p. 101.

3. Why has Austerity Worked for the Baltics and at What Price?

3.1. Specific Economic and Political Context

There were several contextual factors that helped the countries deal with the crisis and that, in a way, set them apart from the hard-hit Southern Euro Area member states.

3.1.1. Low Levels of Debt

The Baltic states did not go through a sovereign-debt crisis. The countries started out with low and stable debt-to-GDP ratios that did increase sharply during the crisis due to falling GDPs and increasing budget deficits, in Latvia's case, particularly due to the support given to the banking sector. The government debt has since stabilised thanks to effective consolidation measures and revived growth. The low level of government debt in the three Baltic states (*Figure 8*) was of paramount importance for the successful recovery from the crisis. For example, when Latvia entered the balance-of-payments assistance programme, its debt was negligible compared to that of Greece (9% of GDP for Latvia vs. 107% for Greece in 2007⁶⁰). Public debt in the three countries was therefore used to absorb the shock of the collapse in economic activity. The 2012 debt ratios of around 40% of GDP for Lithuania and Latvia and 10% for Estonia⁶¹ are considerably higher than before the crisis, but are still well below those seen in Europe. The fiscal consolidation was needed to offset the gap in the budget, rather than to bring down excessive public debt-to-GDP ratios as it is in most countries that are under pressure from markets to act today. The comparatively low level of debt increases the credibility in the eyes of the markets and implies a brighter outlook for the future, since there is less fiscal retrenchment required going forward as compared to the highly-indebted countries.

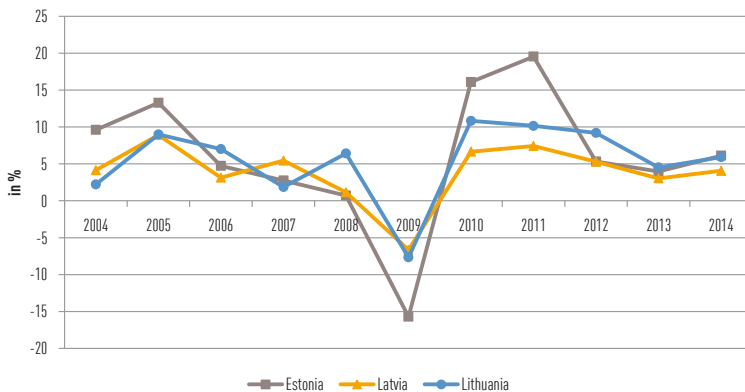
⁶⁰. Source: Eurostat.

⁶¹. The debt increased sharply (by 3.9pp) in 2012. The main reasons for the government debt increasing were an increase in loans issued by the European Financial Stability Fund (EFSF) and the use of the credit from the European Investment Bank to co-finance structural funds. Source: Ministry of Finance of Estonia, *Stability Programme 2013*, 2013, p. 39.

3.1.2. Export-Led Recovery

Common to all three Baltic states was their export-led recovery. The Baltic economies are very open and the exports as a percentage of GDP are as high as 60% for Latvia, above 80% for Lithuania and above 90% for Estonia (*Figure 7*). For Greece and Portugal in 2012, for example, the exports constituted only around 25% and 37% of the GDP respectively⁶². Therefore it is not surprising that the main driver for the revival of the GDP in the post crisis period in the Baltics was exports (*Figure 9*).

FIGURE 9 ➤ Contribution of Exports to GDP Growth



Source: Eurostat, own calculations

The reasons for exceptional export growth were generally twofold. Firstly, it is important to recognise that the countries' main export partners (*Table 2*) managed to survive the crisis comparatively well (Poland) or recover quickly (Scandinavian countries, Russia, and all three Baltic states, who are among each other's main trading partners). This is reflected in the sharp rebound of the foreign demand⁶³ at the beginning of 2010 (*Figure 10*)⁶⁴. The import

⁶². Source: Eurostat.

⁶³. Foreign demand is the import demand of a country.

⁶⁴. The weighted change in foreign demand of the five largest trading partners. Rather than sticking to the weights observed at an arbitrary point in time, a time series of trade weights was determined in order to capture the potential changes in the importance of each of the trading partners.

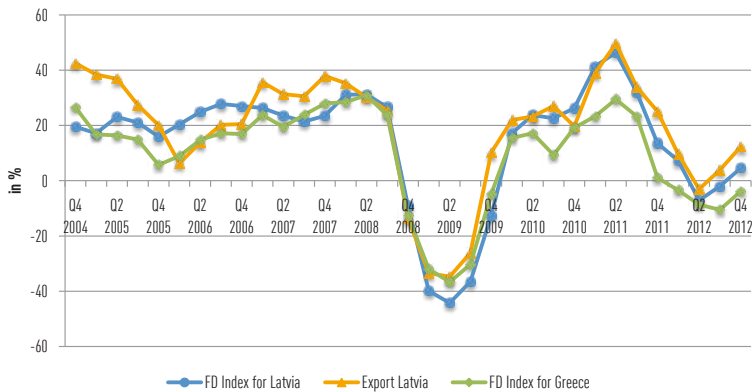
developments in the main trading partners of the Southern Euro Area periphery countries were different and the foreign demand growth they were facing was not as steep as that experienced by the three Baltic states. This leads to a conclusion that the external environment was relatively beneficial and, what is more, the countries, by the virtue of being much more open than the Southern Euro Area states, were well disposed to profit from that.

TABLE 2 ► The Largest Export Partners in 2012

ESTONIA		LATVIA		LITHUANIA	
Country	Average GDP growth 2010-2012	Country	Average GDP growth 2010-2012	Country	Average GDP growth 2010-2012
SWEDEN	3.7	RUSSIA	4.1	RUSSIA	4.1
FINLAND	2.0	LITHUANIA	3.7	LATVIA	3.4
RUSSIA	4.1	ESTONIA	4.9	ESTONIA	4.9
LATVIA	3.4	GERMANY	2.7	GERMANY	2.7
LITHUANIA	3.7	POLAND	3.4	UNITED KINGDOM	1.0

Source: Eurostat, ComExt, IMF World Economic Outlook

FIGURE 10 ▶ Foreign Demand Growth and Export Growth for Latvia⁶⁵
and Foreign Demand Growth for Greece



Source: Datastream, IMF DOTS, own elaboration

Secondly, the developments in the external competitiveness are of key importance for the export performance. The boom years in the Baltics had seen wages grow significantly faster than productivity, impacting competitiveness. In the aftermath of the crisis the countries experienced gains in competitiveness. The REER fell sharply, whilst the export market shares increased (*Figures 4 and 5*). The comparison with the hardest-hit Southern EMU periphery countries shows that, according to the REERs, they too saw increasing competitiveness in the post-crisis years, whilst their export market shares have been deteriorating since the early 2000s. The continuing decline in export shares of the Southern Euro Area countries might suggest that these have not managed to undertake the reforms necessary to sufficiently boost their competitiveness.

To some extent, the significant improvement in the Baltic states' competitiveness was achieved through internal devaluation. Even though none of the countries experienced significant deflation (*Figure 2*), there was a sizeable reduction in real wages coupled with important labour productivity gains. In Lithuania,

⁶⁵ The foreign demand growth indices for Estonia and Lithuania are very similar to that of Latvia due to the similarities in their main exports partners.

and to a smaller extent in Estonia, private sector nominal wages decreased by more than public sector ones, while in Latvia public sector employees experienced the sharpest declines⁶⁶.

The improvement in relative cost and price indicators might have also been aided by sectoral re-orientation of the economy from construction and real estate back to manufacturing. Before the crisis the reverse shift took place, as the economy was shifting towards the non-tradables. These changes might have an impact on the economy-wide ULCs, but are generally not taken into account when calculating those. The ULCs are calculated simply by dividing the aggregate labour costs by GDP, without adjusting for the structural changes. Using this approach, the aggregate ULC index might show deterioration even though the individual indices at the sector level do not⁶⁷. Similarly, now after the crisis, the observed ULC improvement and the resulting ULC-adjusted REER depreciation could be simply reflecting the structural shift thereby overestimating the impact of the austerity measures.

3.1.3. Flexible Labour Markets

Another important factor for successful internal devaluation in the Baltic states was their labour market flexibility. Indeed, labour markets are more flexible in the Baltic states than they are in the Southern Europe on several dimensions. For example, strictness of employment protection in Estonia is lower than in Portugal and Greece⁶⁸. In addition, workers representation is extremely weak in all three Baltic states as trade union density and collective bargaining coverage are (among) the lowest in the EU⁶⁹. Finally, the generosity of unemployment benefits is also below the EU average in all three Baltic states whereas they are higher than EU average in Portugal and Ireland⁷⁰. Against such background, employee bargaining power in the Baltic states remains extremely limited enabling employers to adjust their production decisions quickly and often unilaterally.

66. Kattel, R. and Raudla, R., "The Baltic Republics and the Crisis of 2008–2011", *Europe-Asia Studies*, 65 (3), p. 444, 2013; Darvas, Z. "A Tale of three countries: Recovery after banking crises", *Bruegel Policy contribution*, Issue 2011/19, December 2011, p. 6.

67. European Commission, DG ECFIN, "European Economy: EU Balance-of-Payments assistance for Latvia Foundations of success", *Occasional Paper 120*, November 2012, p. 45.

68. As measured by OECD "Strictness of Employment Protection" indicator.

69. Quantitative estimations available at http://fr.worker-participation.eu/content/download/4283/58937/file/EPI_2_0_data.xls

70. Stovicek, Clara and Turrini, Alessandro, "Benchmarking Unemployment Benefit Systems", *European Economic Papers Nr. 545*, European Commission, May 2012, p. 19.

3.1.4. The Societal Ethos

A key factor that made the chosen policies work is related to the existent ethos of the Baltic societies. The overall economic adjustment process in the Baltic states could be (and often is) regarded as an example of swift and efficient political action. In both Estonia and Latvia, austerity governments have been re-elected and seem to have solved J. C. Juncker's conundrum of how to adopt politically unpopular reforms and get re-elected afterwards⁷¹. Whilst the austerity government in Lithuania lost in recent polls, it entered into history as the first government after independence to have served its full term.

The absence of common action aimed at denouncing austerity policies in response to the social consequences of the economic recession does not mean that the societies did not suffer (*see the following section (3.2) on Social cost of adjustment*). One could claim that no significant protests were observed because, even though the recent crisis has brought about an economic "collapse that is comparable to that at the beginning of the 1990s, right after independence"⁷² in terms of proportional GDP loss, the real GDP levels have remained as high as in 2006 (or shortly before the break-out of the crisis, *Figure 1*).

However, there were other more important reasons that made the fiscal adjustment story a success. First of all, because the time span has been relatively short and the generation shift has not yet taken place, the national memory of real economic hardship of the 1990s was undoubtedly instrumental in facilitating the swallowing of the bitter pill of austerity in the context of a deep recession. Secondly, due to heavy historical heritage, civil societies in the Baltic states are still rather immature and common action in general is extremely rare when compared to the "older" democracies. As a consequence, rather than engaging in political action, significant parts of Baltic societies "voted with their feet" by choosing the path of emigration. Thirdly, there was a deep-running national consensus on both the political and the societal level on the

71. "We all know what to do, but we don't know how to get re-elected once we have done it." Jean-Claude Juncker, Prime Minister of Luxembourg and President of the Eurogroup, see "*The Quest for Prosperity*", *The Economist*, 15 March 2007.

72. Hoen Herman, "*Crisis in Eastern Europe: The Downside of a Market Economy Revealed?*", *European Review*, Cambridge University Press, Vol. 19(1), 15 April 2011, p. 38.

need for austerity and economic rebalancing, which made the governments' job in explaining the drastic approach easier.

3.2. Social Cost of Adjustment

The fact that austerity measures have not been accompanied with any significant public action geared against them might lead towards a simplified conclusion that these policies have not been extremely painful in social terms. However, in certain dimensions the social situation has deteriorated much more in Latvia, Lithuania and Estonia than it has in Portugal or even Greece, which is usually seen as the most striking case. Not only are these social consequences dramatic in their own right as relatively poor (parts of) populations became poorer, but they could also have significant negative repercussions on the future growth prospects of the three Baltic states.

As emphasised in the latest Commission's assessments of all three National Reform Programmes⁷³, the most acute social problems, namely poverty and social exclusion, have been getting more serious. Figure 11 illustrates that more than a third of the population in Latvia and Lithuania are at risk of poverty and social exclusion⁷⁴. The trends are also similar for severe material deprivation⁷⁵, which has increased significantly in the last several years. The levels of these two indicators today are lower than in 2005 (when almost a half of population in Latvia were at risk of poverty and social exclusion), yet they remain among the highest in the EU. Of the "programme" countries, only Greece is approaching comparable levels, which nonetheless remain below those of

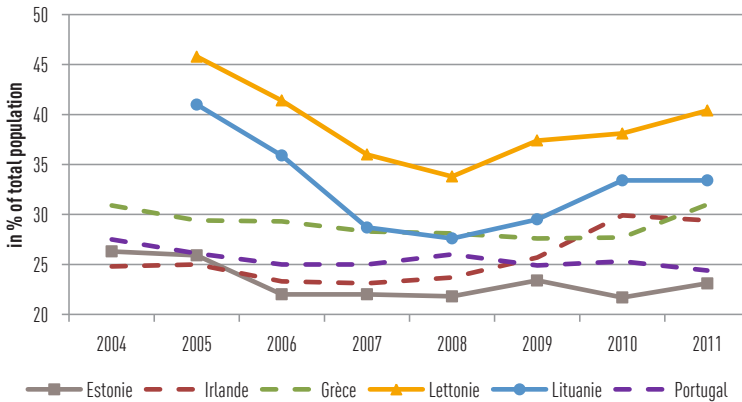
73. European Commission, Staff Working Document, "Assessment of the 2013 national reform programme and stability programme for Estonia" Accompanying the document "Recommendation for a Council Recommendation on Estonia's 2012 national reform programme and delivering a Council Opinion on Estonia's updated stability programme for 2012-2016", Brussels, COM(2013) 364 final, 29 May 2013. Same for Latvia and Lithuania.

74. At risk of poverty or social exclusion (AROPE) indicator is defined as the share of the population in at least one of the following three conditions: 1) at risk of poverty, meaning below the poverty threshold, 2) in a situation of severe material deprivation, 3) living in a household with very low work intensity.

75. Material deprivation refers to a state of economic strain and durable, defined as the enforced inability (rather than the choice not to do so) to pay unexpected expenses, afford a one-week annual holiday away from home, a meal involving meat, chicken or fish every second day, the adequate heating of a dwelling, durable goods like a washing machine, colour television, telephone or car, being confronted with payment arrears (mortgage or rent, utility bills, hire purchase instalments or other loan payments). The material deprivation rate is an indicator in EU-SILC that expresses the inability to afford some items considered by most people to be desirable or even necessary to lead an adequate life. The indicator distinguishes between individuals who cannot afford a certain good or service, and those who do not have this good or service for another reason, e.g. because they do not want or do not need it.

Latvia and Lithuania. The situation in Estonia is somewhat better. However, the Commission notes that “the targets set for reduction of poverty and social exclusion will pose a serious challenge” as “the poverty risk of children in job-less households is starting to increase, while the number of children needing social assistance has more than doubled over the last five years”.⁷⁶ Worryingly, these social indicators continued to deteriorate in all three Baltic states in 2011, even though economies were recovering already.

FIGURE 11 ► People at Risk of Poverty or Social Exclusion



Source: Eurostat

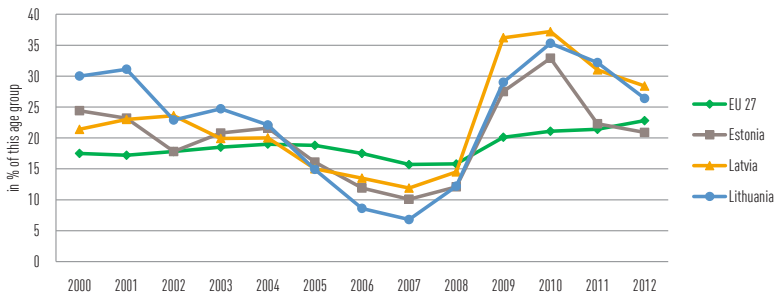
Currently, worse-than-expected developments on the labour market are undoubtedly one of the most important reasons of increasing poverty. Overall unemployment rates in all three Baltic states are still higher than the below-natural pre-crisis levels and will remain so in 2013 (around 8% in Estonia and above 10% in both Latvia and Lithuania, *Figure 2*). The figures are more alarming for more vulnerable social groups, in particular the young and the long-term unemployed. In the period 2010-2012, long term unemployment has reached decade's highs and remains well above the EU average⁷⁷. In addition, in 2012,

⁷⁶. European Commission, *op.cit.*, p.13.

⁷⁷. Eurostat Database.

more than 25% of young people were unemployed in Latvia and Lithuania, whilst Estonia has managed to achieve below EU average levels (*Figure 12*).

FIGURE 12 ► Youth Unemployment Rate (25 years old and younger)



Source: Eurostat

These figures might not seem as dramatic as in Spain and in Greece, where youth unemployment is above 50%, yet it is obvious that they are very much deflated by another mass phenomenon in the three Baltic states, namely labour force emigration. Generally speaking, in less than a decade of EU membership (2004-2013), Latvia and Lithuania have lost 13-14%⁷⁸ of their total population whereas the size of the Estonian population remained more or less stable. In order to get a sense of magnitude, if Spain and Italy would have lost the same proportion of their population as Latvia and Lithuania in the past 5 years, it would represent a total of 11 million people⁷⁹.

Even though populations of the Baltic states are naturally ageing, net emigration accounted for more than three fourths of the total population loss in the last decade⁸⁰. Figure 13 illustrates that the extent of declared year-on-year emigration since the three countries joined the EU has been impressive. Official emigration numbers peaked in the year 2010 in Lithuania (more than 3.5% of

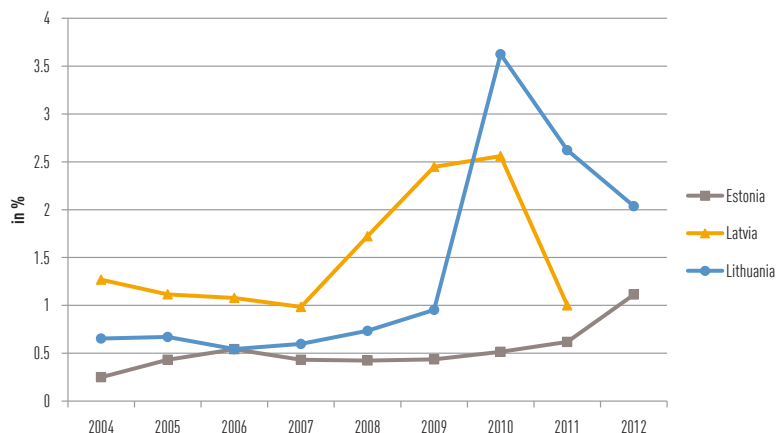
78. Eurostat Database.

79. Wolf Martin, "Why the Baltic states are no model", *Financial Times*, 30 April 2013.

80. Hazans Mihails, "The changing face of Latvian emigration... and the changing face of Latvia", AmCham Outlook on demographics, University of Latvia, Institute for the study of labour (Iza Bonn), 1 March 2012.

its working age population)⁸¹ and in Latvia (2.5%), the year when unemployment rate also reached its heights in both countries. More worryingly still, actual emigration numbers are even higher than these estimations. For example, OECD study quotes that “undeclared emigration accounted, on average, for more than a half of total outflows in the period 2001-10”.⁸²

FIGURE 13 ➤ Official Emigration as % of Working Age Population (15-65)



Source: own elaboration, national statistics departments for emigration flows and Eurostat for working age (15-65) population, for Latvia data available until 2011 only

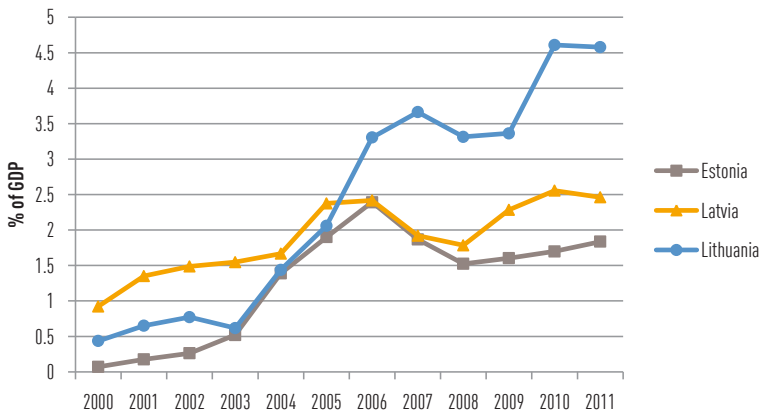
In some respects emigration has positive effects. Indeed, as suggested by the Optimal Currency Area theory, labour mobility is instrumental in cushioning asymmetric economic shocks and benefit the whole monetary union as workers from a badly hit country go to work in other better-off member states. In this way, Latvia and Lithuania are spared from paying unemployment benefits with obvious positive effects for public finances whereas better-off countries such as Finland or Germany get a much needed labour inflow. In addition, in the case of the Baltic states, remittances represent a non-negligible part

81. The peak in Lithuania was also influenced by a change in national laws whereby declaring departure became compulsory; otherwise, the emigrant would have to continue paying national social insurance contributions.

82. OECD, “Country notes: recent changes in migration movements and policies: Lithuania”, *International migration outlook 2012*, 2012.

of national wealth (*Figure 14*). For example, in Lithuania, more than 4.5% of national GDP came as transfers from Baltic workers living abroad in 2010 and 2011. These transfers stimulate national demand and potentially serve as a “safety net” against poverty for a number of households.

FIGURE 14 ▶ Remittances



Source: World Bank

Despite all these benefits, massive emigration represents several serious challenges for such small nation states both in the short and in the long term. In the shorter term, gains in public finances accruing from savings on unemployment payments might be largely offset by missing budgetary revenues as potential tax payers are paying their taxes abroad. But the main problem is that emigration concerns not only the unemployed, but also people in employment who are looking for a higher pay abroad. As a consequence, a significant proportion of young, flexible and highly skilled segments of labour force might be lost as the “brain drain” materialises. For example, in Lithuania more than 50% (more than 80% in Latvia⁸³) of emigrants are between 20 and 35 years old and 75%

83. *Op. cit.*, Hazans Michailis.

of emigrants have post-secondary education⁸⁴. This aggravates existing skilled labour shortages and makes labour matching much more difficult⁸⁵.

In the longer term, and in the absence of compensatory (re)immigration, emigration might result in a demographic gap whereby a significant part of working-age population goes missing in the national demographic pyramid. As a result, population ageing accelerates with all its negative consequences; threats for public finance sustainability, especially in what regards pension and healthcare systems, lack of economic dynamism, and labour shortages, among others. All these threats are even more credible as the surveys suggest that out of current emigrants only 8% plan to return to their homelands within 6 months and just about 20% within next 5 years⁸⁶.

84. "Migracija Lietuvoje: Faktai ir Skaiciai".

85. As discussed in the three assessments of the NRP, EC, *Op. cit.*

86. *Op. cit.*, Hazans Michails.

4. Conclusions and Lessons for the Future

From the collapse of the Soviet Union up until the global financial crisis the Baltic states were largely considered a success story. However, their rapid development and fast GDP growth took place concurrently with a build-up of massive economic imbalances. The most problematic development in the pre-crisis period was the excesses of internal demand and consequently, the soaring imports. These occurred due to the capital inflows that made credit amply available and the investment that went largely into the non-tradable sectors fuelling asset price bubbles. The wages grew faster than productivity, impacting competitiveness; however, the extent of the pre-crisis competitiveness losses is usually exaggerated. At the end of the boom years, the worsening outlook caused a slow-down in the lending activities, which were entirely stopped after the Lehman Brothers bankruptcy.

In the second half of 2008 the three countries experienced a sharp reversal of capital flows, and the general government balances swiftly deteriorated. Despite the comparatively low levels of government debt, it became very expensive to borrow on international markets. Furthermore, Latvians, unlike the other two neighbouring governments, had to save a systemically important domestic bank. There were two ways out of the crisis: external (currency) or internal devaluation, out of which the second policy option was chosen. Therefore, the countries' response to the crisis was to front-load harsh austerity measures. The Baltic states saw drastic cuts in public spending; wage deflation; institutional changes; and a drop in domestic demand that translated into a huge fall in imports helping to correct the current account imbalances.

However, before the austerity supporters can attribute the Baltic recovery to a strict adherence to austerity, and prescribe the approach to all the crisis-hit countries, it has to be pointed out that the unique economic and societal model of the small open economies has worked to their advantage when dealing with the crisis. The government debt issue, so pressing in the rest of Europe, is not a key concern in the Baltics, due to their low debt levels. Exports, the main driver of the revival of GDP, rose quickly partly because of competitiveness increases

and partly because of the favourable developments in the main export partners. Whilst the rising competitiveness was austerity-facilitated, the post-crisis structural shift back from the construction and real estate sectors to manufacturing could have played a role. Flexible labour markets, weakness of trade unions and the comparatively low social demands – the opposite of what is seen in Southern Europe – fostered successful implementation of the austerity policies.

Perhaps most importantly, another reason for the success of the austerity policies in dealing with the crisis was the ethos of the Baltic population. The people are not prone to voicing their concerns through public action in the form of demonstrations, protests or strikes. The civil society in general is weak. Furthermore, the memories of the post-Soviet economic collapse are still alive, therefore, the recent crisis did not come as great a shock to the Baltics as to the Southern European states, who prior to the crisis had enjoyed a much longer period of prosperity and economic growth. Finally, the public understood that reforms were needed and that the previous growth streak was not sustainable.

Contrary to what the lack of protests might suggest, the populations are paying a high price for the austerity policies. The most acute social problems, namely poverty and social exclusion, have been getting more serious. Unemployment figures are down from the crisis readings, but are still relatively high. The extremely high emigration, especially in Latvia and Lithuania, flatters the official statistics in terms of national unemployment and even poverty levels. However, the emigration trend has a number of negative consequences, including “brain-drain” and the creation of a demographic gap that will threaten the sustainability of the future public finances.

In conclusion, the Baltic states’ near-miraculous recovery from the crisis was a result of many factors, not least of them being the strict adherence to austerity policies. However, one has to be careful not to overestimate the importance of austerity measures in reviving economic growth, or underestimate their impact on the wellbeing of the three societies. Currently the social situation is slowly improving, but some trends are a threat to sustainable development of the three Baltic states. The extent to which other crisis-hit countries can learn from the experience of the Baltics is limited due to the specificities of the three. Therefore, perhaps the most valuable lesson is to be learnt by the tiny Baltic countries themselves for their own future policies.