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The Baltic Republics and the Crisis of 2008–2011

RAINER KATTEL & RINGA RAUDLA

Abstract

This essay explores how the Baltic republics responded to the crisis of 2008–2011. We argue that while there are significant differences in how the Baltic economies responded to the crisis, these responses not only remain within the neo-liberal policy paradigm characteristic of the region from the early 1990s, but that the crisis radicalised Baltic economies and particularly their fiscal stance. We show that there are a number of unique features in all three Baltic republics' political economies that made such a radicalisation possible. However, these unique features make it almost impossible for the Baltic experience to be replicable anywhere else in Europe.

EUROPE, AND THE REST OF THE DEVELOPED WORLD, SEEMS to be mired in a debate over whether austerity brings growth or not. While there seem to be fewer candidates for actual European cases where fiscal retrenchment resulted in economic recovery and growth, the Baltic republics persistently attempt to claim that austerity works. All three countries were affected painfully by the global financial crisis in 2008–2009 and experienced one of the highest levels of GDP contraction globally. All three responded to the crisis by adopting a series of austerity measures. In 2010, the Baltic republics started to recover and recorded GDP growth between 5.5% and 7.6% in 2011. In the light of such temporal sequences of events, there has been a temptation in policy circles, both inside the Baltic republics and internationally, to draw a causal conclusion and to claim that it was the austerity that led to growth. This has led to well-publicised arguments in the media with, for instance, Paul Krugman arousing 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.[1] This was preceded by a high-level conference in Riga, Latvia where the IMF's Christine Lagarde and others praised the austerity measures applied there and in the rest of the Baltic countries.[2] Most of these debates

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[1]The debate between Krugman and President Ilves took place in blog posts and twitter tweets, mostly in June 2012. A brief summary is available at: http://www.washingtonpost.com/blogs/reliable-source/post/estonian-president-hammers-paul-krugman-on-twitter/2012/06/07/gJQApU0zLV_blog.html, accessed 6 August 2012. See also Grennes (2012).

[2]Dani Rodrik offers a measured discussion of the conference in his blog entry, available at: http://rodrik.typepad.com/dani_rodriks_weblog/2012/06/what-i-learned-in-latvia.html, accessed 6 August 2012.

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were rhetorically charged leaving little room for reflection and details. However, the question of whether austerity is effective or not, and whether the Baltic republics managed to recover with the help of fiscal measures, remains highly relevant and deserves careful consideration, especially if their model of 'crisis resolution' by fiscal adjustment is to be held up as an example to be emulated in the ailing European periphery. In what follows, we attempt to dissect in some detail the story of Baltic crisis management and its impact on the economy. While our approach is clearly informed by economic heterodoxy, we follow a historical institutionalist perspective in which 'temporal sequences, durations, paths, and cycles are important explanatory factors' (Pollitt 2012, p. 39). We thereby concentrate our discussion on institutional and policy processes and on their description.

Specifically, this essay sets out to explore the following questions: first, how did the Baltic republics respond to the crisis? Second, to what extent did the responses across the three countries differ and to what extent were they similar? Third, how can these differences and similarities be explained? Fourth, did the austerity measures work and is the Baltic experience replicable in other countries of the European Union as well?

As we will show, policy responses in all three Baltic economies exhibit a similar pattern of hardening the neo-liberal paradigm. Indeed, while there are significant differences in how the Baltic economies responded to the crisis, we will argue below that these responses not only remain within the neo-liberal policy paradigm characteristic of the region since the early 1990s, but that the crisis in fact radicalised the Baltic economies and particularly the fiscal stance. Indeed, as Åslund argues, 'the East Europeans have emerged as the successful pioneers of a new, more liberal, and fiscally responsible all-European economic system' (Åslund 2010, p. 101).[3] We will argue that there were a number of unique features in all three Baltic republics' political economies that made such a radicalisation possible. However, these unique features make it almost impossible for the Baltic experience to be replicable anywhere else in Europe.

The essay is structured as follows. We first give a brief overview of the origins of the crisis and proceed to a discussion of policy responses. We then examine how the societies reacted to the governments' anti-crisis measures and inquire into factors that help to explain the policy responses by the Baltic governments. We conclude with a brief examination of the impacts of the internal devaluation strategy adopted by all three states and discuss whether the Baltic 'model' of crisis resolution could be replicable in other European countries.

Origins of the crisis

Since regaining independence, the Baltic republics have stood out among the European transition countries as radical pro-market reformers. In the early 1990s, all three countries adopted a mix of policies advocated by the Washington consensus, including currency boards with fixed pegs (acting as nominal anchors for securing stabilisation), fiscal discipline, liberalisation of prices and trade, and wide-ranging privatisation. The economic environments created as a result of such neo-liberal policy choices appeared to have put the Baltic republics on an impressive growth track, only interrupted by the Russian crisis at the end of the 1990s. After accession to the EU, all three economies witnessed an unprecedented boom. Between 2004 and 2007 the Baltic republics stood out among the EU

[3]See also Åslund (2009, 2012).

countries for their high growth rates: the average annual growth rates for this period were 10.3% in Latvia, 8.5% in Estonia and 8.2% in Lithuania. These remarkable figures were, however, accompanied by signs of overheating, including double-digit inflation, a housing boom,[4] appreciating real exchange rates, accelerating wage growth—that exceeded productivity growth, especially in Latvia and Estonia and, to a lesser extent, in Lithuania—a fast accumulation of net foreign liabilities and soaring current account deficits. To a significant extent, the growth was fuelled by cheap credits, available through foreign-owned banks, which drove up domestic demand and which were channelled into real estate, construction, financial services and private consumption. Figure 1 depicts financial account dynamics in the Baltic republics during the boom years of 2000–2007. All three economies were rapidly building up debt towards the rest of the world. Thus, during 2007, the last boom year, the current account deficit exceeded 20% of GDP in Latvia and 15% in Estonia and Lithuania; credit to non-financial corporations and households exceeded 75% of GDP in Lithuania and 100% in Latvia and Estonia (Deroose *et al.* 2010; EC 2010).[5]

This massive growth of imbalances coincided with rapid wage growth and slow gains in productivity. Figures 2 and 3 show the evolution of nominal wage costs and labour

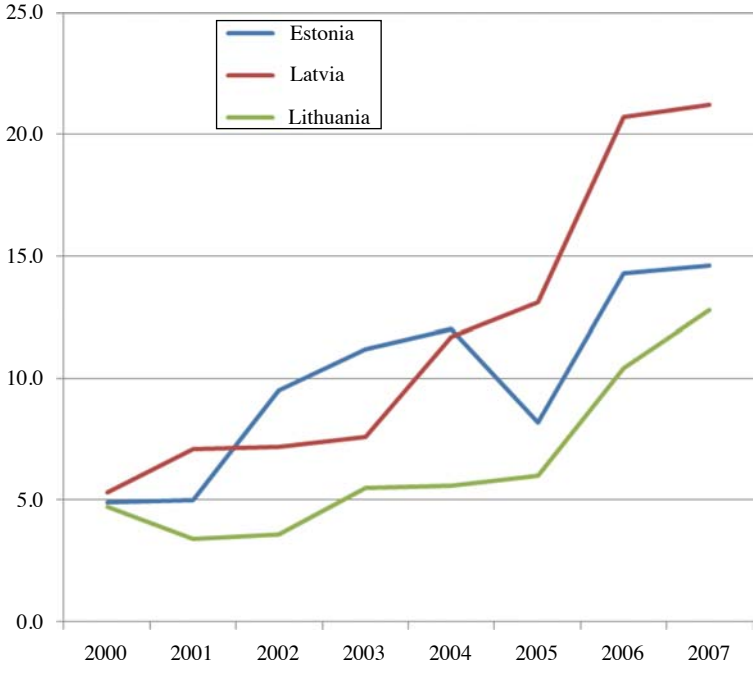

FIGURE 1. FINANCIAL DCCOUNT DEVELOPMENTS IN THE BALTIC REPUBLICS, 2000–2007 (% OF GDP).
Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012.

[4]Between 2003 and 2007 Latvia witnessed more than a tripling and Estonia and Lithuania more than a doubling of real-estate prices (EC 2010, p. 26).

[5]The European Commission (2010, p. 46) noted that the growth rates of mortgage loans were especially high in the Baltic republics, with growth rates 'among the highest recorded in emerging economies in recent times'. See Herzberg (2010) for a more detailed discussion on the private sector debt overhang.

productivity, measured against Germany's productivity, in Baltic economies in the 2000s. As we can see, all Baltic economies were rapidly losing competitiveness in addition to becoming massively indebted. Latvia, with the highest wage growth and the lowest productivity growth (Figures 2 and 3), became the most overheated of the three and Lithuania the least. Latvia also recorded the highest current account deficit, the highest GDP growth rate and the highest rate of inflation (see Table 1).

The high growth rates induced a lulling effect, leaving the political elites oblivious to the few warning signals that pointed to increasing external imbalances. Furthermore, the governments even added to the overheating of the economies by loose fiscal policies, including the spending of boom-generated windfall revenues from supplementary budgets adopted in the course of the fiscal year. This was more pronounced in Latvia and Lithuania than in Estonia, where the budget surpluses were accumulated into a rainy-day fund, referred to in the budget as the Stabilisation Fund (Purfield & Rosenberg 2010; Deroose *et al.* 2010).[6] Against the backdrop of such oblivious optimism, the magnitude of the economic downturn came as a surprise to the local policy makers. However, in academic circles critical analyses of the Baltic boom were also rare.

The crisis hit all Baltic republics quickly and painfully. The domestic bubbles burst in early 2008, when the credit supply decelerated and banks started tightening credit conditions. The downturn was further exacerbated by negative developments in the external economic environment after the Lehman Brothers' bankruptcy. As can be seen from Table 1, in 2009 GDP fell by 14.3% in Estonia, 14.8% in Lithuania and 17.7% in Latvia. The decline in industrial production in 2009 was the largest in Estonia at 25.9%, followed by 15.8% in Latvia and 14.6% in Lithuania. Purfield and Rosenberg (2010, p. 8) note that the decline in the real sector was driven by two factors: shrinking exports and the fall in domestic demand. The deterioration in private sector demand, resulting from the credit squeeze and plunging consumer confidence, was further exacerbated by reduced public sector spending.

Given such massive falls in both domestic demand and exports in 2008 and 2009, unemployment figures soared, rising most rapidly in Latvia—from the 2007 level of 6.0% to 18.7%, making it the largest increase in the EU—but closely followed by Estonia (from 4.7% to 16.9%) and Lithuania (from 4.3% to 17.8%) (see Table 1). In other words, in all three countries, unemployment rates at least trebled from 2007 to 2009 (Masso & Krillo 2011, p. 9).

Responses to the crisis: changes in policies and institutions

As the crisis deepened in 2008 most countries entertained, and many also implemented, some forms of Keynesian stimulus packages. The basic response in the Baltic republics amounted to fiscal retrenchment, combined with maintaining the fixed pegs and not engaging in expansionary monetary policies. The nature of the responses and their fiscal, economic and political success differed only in details within the same broader paradigm. In the following,

[6]With respect to financial markets, the Baltic governments did adopt some steps to cool the bubble, such as increasing reserve requirements and tightening the formula for calculating capital adequacy ratios, but these measures came either too late or were insufficient, given the largely foreign-owned banking sector which would have called for swifter and tighter cross-border cooperation between the authorities (Deroose *et al.* 2010, p. 5).

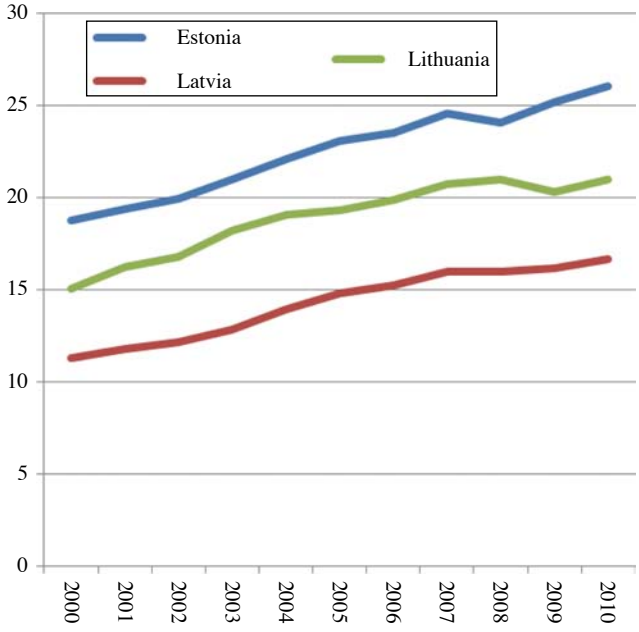

FIGURE 2. REAL LABOUR PRODUCTIVITY IN THE BALTIC REPUBLICS (% OF GERMAN LABOUR PRODUCTIVITY), 2000–2010 (EURO PER HOUR WORKED).

Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012. calculations by the authors.

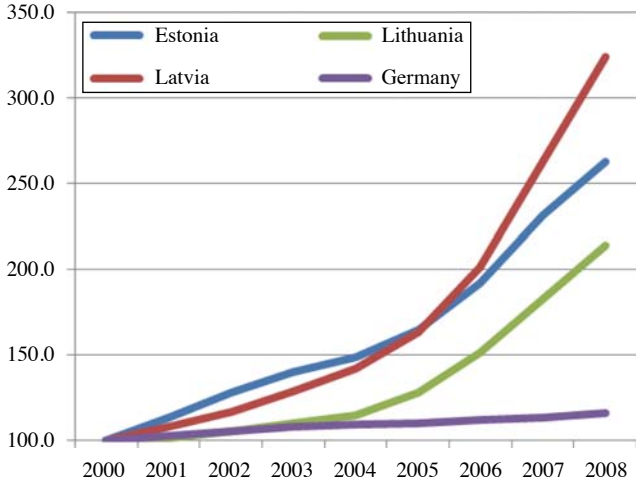

FIGURE 3. LABOUR COST INDEX IN THE BALTIC REPUBLICS AND GERMANY, 2000–2008 (2000 = 100).

Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012.

TABLE 1
SELECTED ECONOMIC INDICATORS FOR THE BALTIC REPUBLICS, 2007–2010

	2007	2008	2009	2010	2011
Real GDP growth %					
Estonia	7.5	−3.7	−14.3	2.3	7.6
Latvia	9.6	−3.3	−17.7	−0.3	5.5
Lithuania	9.8	2.9	−14.8	1.4	5.9
Current account, % of GDP					
Estonia	−15.9	−9.7	3.7	3.6	3.2
Latvia	−22.4	−13.1	8.6	3.0	−1.2
Lithuania	−14.4	−12.9	4.4	1.5	−1.6
Annual inflation, %					
Estonia	6.7	10.6	0.2	2.7	5.1
Latvia	10.1	15.3	3.3	−1.2	4.2
Lithuania	5.8	11.1	4.2	1.2	4.1
*Unemployment rate (% of labour force) (European Union Labour Force Survey)**					
Estonia	4.7	5.5	13.8	16.9	12.5
Latvia	6.5	8.0	18.2	19.8	16.2
Lithuania	4.3	5.8	13.7	17.8	15.4
Gross pay (euro per inhabitant)					
Estonia	4200	4600	4000	3800	4100
Latvia	3700	4400	3300	3100	3400
Lithuania	2900	3300	2800	2700	3000
Real labour productivity growth per person employed (% change on previous period)					
Estonia	6.6	−3.8	−4.7	7.4	0.6
Latvia	5.8	−4.2	−5.3	4.7	14.8
Lithuania	6.8	3.6	−8.6	6.9	3.8
Real effective exchange rate (index 1999 = 100)					
Estonia	139.16	152.38	152.69	142.05	142.93
Latvia	142.97	165.30	150.30	132.59	134.41
Lithuania	128.09	134.79	132.51	121.20	120.99

Note: *European Union Labour Force Survey, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/microdata/lfs, accessed 5 February 2013.
Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012.

we will describe the policy responses and institutional changes undertaken by the Baltic governments in 2008–2011.

Fiscal consolidation

As can be seen from Table 2, all three Baltic republics implemented sizable fiscal consolidations in 2008–2010.[7] The fiscal adjustment was the largest in Latvia, adding up to around 14% of GDP between 2008 and 2011; the largest adjustment took place in 2009 when the consolidation measures constituted 9.5% of GDP. The 2009 consolidation figures for Estonia and Lithuania, quoted in those countries' convergence programmes, were around 8–9% of GDP.[8]

[7]By fiscal consolidation we mean the improvement of government's budget-deficit-to-GDP ratio via discretionary changes in fiscal policy (i.e. by expenditure cuts and/or revenue increases).

[8]Convergence programmes were required for new EU member states and contained commitments to policies and set timetables aimed at achieving compliance with the EU's Growth and Stability Pact which set the conditions for membership of the eurozone. All countries' convergence programmes are available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm, accessed 1 September 2012.

TABLE 2
SCOPE OF FISCAL CONSOLIDATION (% OF GDP) IN THE BALTIC REPUBLICS, 2008–2010.

	Estonia	*Latvia*	*Lithuania*
2008 fiscal consolidation measures	2	0.5	0
2009 fiscal consolidation measures	8.9	9.5	8
2010 fiscal consolidation measures	2.9	4	3.7

Note: The size of fiscal consolidation for any given year is measured by adding up the changes in expenditures and revenues following the various deliberate consolidation measures undertaken by the government to improve the fiscal balance for that particular year.
Source: 'Restoring Public Finances', *OECD Journal on Budgeting*, 2011, no. 2, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm, accessed 1 September 2012.

Why was fiscal consolidation chosen?

Broadly speaking, in order to deal with the crisis, the Baltic republics all opted for internal devaluation, instead of external devaluation, which implied the downward adjustment of nominal wages throughout the economy and fiscal contraction. Why did the Baltic governments prefer internal devaluation? As Kuokstis and Vilpisauskas (2010) argue, the choice of internal devaluation was 'anchored in the domestic consensus of policy makers and expert communities'. They point out that, although a number of foreign analysts, including Krugman, Rogoff and Roubini, advocated external devaluation as an adjustment strategy for the three Baltic republics, this option was, for the most part, not even given serious consideration.[9] The Baltic republics' governments strongly objected to external devaluation of the domestic currencies for a number of reasons, ranging from practical to symbolic.

Importantly, nominal exchange rate adjustment would have precluded joining the eurozone as an exit strategy from the crisis. Furthermore, given that a large proportion of loans in these countries had been denominated in euros,[10] external devaluation would have imposed large costs on significant parts of the population and reduced private sector net worth, potentially leading to a surge in loan defaults, with contagion effects for the rest of the economy.[11] Kuokstis and Vilpisauskas (2010) note that among local policy makers and experts, the prevalent belief was that devaluation of the currency would have been 'clearly wrong and potentially disastrous'.[12] It was felt that by devaluing the currencies, governments would lose an important focal point for action. In addition, none of the Baltic republics had had experience with alternative exchange rate regimes and hence no existing competencies to manage non-automatic systems (Raudla & Kattel 2011a).

Internal devaluation as an adjustment strategy was also supported by the European Union, which was afraid that devaluation of the Baltic currencies would cause havoc in the financial markets and, potentially, lead to spillovers to other Central and Eastern European countries, inducing capital flight from this region (Kuokstis & Vilpisauskas 2010; Åslund 2010).[13]

[9]See also Raudla and Kattel (2011a, 2011b).

[10]As of 2008, 88% of Latvia's private debt was in euros, followed by Estonia (with 85%) and Lithuania (with 64%).

[11]See also Purfield and Rosenberg (2010) and Raudla and Kattel (2011a).

[12]As Hansen (2010) put it, 'In all Baltic Republics devaluation, rightly or wrongly, is seen as Pandora's Box size XXXL and rapid euro introduction is seen, again rightly or wrongly, as an entry ticket to monetary Nirvana'.

[13]The IMF, in contrast, initially advocated external devaluation.

In addition, when explaining the decision of all three Baltic governments to opt for internal devaluation, instead of external devaluation, the national-symbolic importance of the currencies and the corresponding exchange rates has to be kept in mind. As the creation of the new currencies and the corresponding exchange rate regimes in the early 1990s had coincided with the restoration of independence, democratisation and nation-building, the currencies acquired strong national-symbolic values and devaluing currencies came to be equated with devaluing the self-identity, sovereignty and statehood of these countries.

In addition to undertaking fiscal adjustment in order to maintain confidence in the peg and to aid internal devaluation, the Baltic governments also hoped that fiscal retrenchment would act as a signalling device, restoring the confidence of the markets and securing the return of foreign investment, which was seen as paramount for bringing the countries back to the growth path.[14]

The content of austerity measures

Fiscal consolidation in all three countries entailed both expenditure and revenue measures (see Table 3).[15] However, the relative importance of the measures shifted in time and followed somewhat different dynamics in the three countries. In Latvia, for example, the consolidation efforts were driven by spending cuts in 2009, but shifted more towards the revenue side in 2010. In Lithuania, the adjustment in 2009–2011 was driven by the expenditure side measures and the government was more willing to increase taxes at an earlier phase of adjustment than later on. In Estonia, the fiscal adjustment in 2008 and 2009 focused more on the expenditure side, whereas in 2010 the austerity measures were almost equally divided between the expenditure and revenue sides.

TABLE 3
CONSOLIDATION MEASURES TAKEN ON EXPENDITURE AND REVENUE SIDES OF THE BUDGET (% OF GDP)

		Expenditure side	*Revenue side*
Estonia	2008	2	0
	2009	6.2	2.7
	2010	1.6	1.3
Latvia	2008	0.5	0
	2009	6.7	2.8
	2010	1.9	2.1
Lithuania	2009	5.8	1.6
	2010	3.7	?

Source: 'Restoring Public Finances', *OECD Journal on Budgeting*, 2011, no. 2, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm, accessed 1 September 2012.

Cuts were applied to all expenditure categories, though operating expenses and transfers took a larger hit than investments. In all three countries, the governments curtailed those parts of capital budgets that were not financed from EU funds and accelerated spending on

[14]See, for example, Raudla and Kattel (2011a, 2011b) for a detailed analysis of the austerity discourse in Estonia.

[15]Detailed discussion of the austerity measures undertaken in all three Baltic republics is provided in Raudla and Kattel (2012).

EU-financed investments, facilitated by the new EU rules that allowed the governments to front-load the disbursements. The expenditure measures combined across-the-board cuts with targeted reductions. Among across-the-board measures, the cuts to operating expenses of the public sector—especially salary reductions—were the most prominent. Following a 'cheese-slicing' strategy, cuts in operating expenses took place in several rounds via negative supplementary budgets. In 2009, the largest wage cut took place in Latvia (by 18%), followed by Lithuania (10%) and Estonia (8%) (Masso & Krillo 2011).[16] Pay cuts continued in 2010 and 2011, especially in Latvia, although they were somewhat less dramatic than in 2009. Altogether, public sector employees faced the largest cut in Latvia: the salaries of central government officials, for example, were cut by 30% between 2009 and 2011 (IMF 2011). The wage bill expenditure decreased by 17% in Lithuania between 2008 and 2011 (Nakrošis *et al.* 2012). Pay cuts were less progressive in Estonia and Latvia than in Lithuania where cuts varied from 8% to 36%, depending on how high the previous level had been, with the highest earners taking the largest hits (Nakrošis *et al.* 2012).[17] In Estonia, teachers were subjected to a lower pay cut than the rest of the public sector (Jõgiste *et al.* 2012). In Latvia, in contrast, the education and health care sectors were particularly hard hit by cuts so that, for example, teachers' gross monthly pay was reduced from €494 to €358.

Among social benefits, pensions and sickness benefits took the first hit. Sickness benefits were curtailed in all three countries, either by cutting the benefits for the first days of sick leave, as in Estonia, or by reducing the payments that exceeded a certain threshold by 50%, as in Latvia. In Estonia, pensions were increased by 5% instead of following the indexing formula that would have led to a 14% increase. In Latvia and Lithuania, old-age pensions were cut, but in both countries the cuts were contested by judicial review and were found to be unconstitutional.[18] In Estonia a planned increase in unemployment benefits was postponed while those parts of the new employment law that made redundancies and layoffs easier were still enacted. In other words, from the so-called 'flexicurity' package, the flexibility aspects were introduced, while the security elements were postponed. In all three countries, significant savings were attained by diverting all or part of the contributions to the compulsory private funded pension pillar to the 'public pay as you go' pillar.[19]

Instead of increasing one particular tax significantly, the governments opted to spread increases across a large number of different taxes, both direct and indirect. Apart from increases in nominal tax rates, there was also extensive broadening of tax bases, especially in Latvia and to a lesser extent in Lithuania. Value added tax and excise duties on cigarettes,

[16]These numbers reflect annual wage changes in the entire public administration, including the local governments (Masso & Krillo 2010).

[17]In 2009 the pay of politicians, judges and civil servants was reduced by an average of 10%; the pay of employees in institutions and organisations supported by the state budget institutions was reduced by 8% on average and the pay of teachers and employees in the social sector and culture was cut by 5%. Although pay reductions were meant to be temporary in 2009, they were extended in 2010.

[18]Following a constitutional court ruling in Latvia, the government had to cancel the pension cut and compensate for the unpaid parts of the pensions. Nevertheless, the indexation of pensions was frozen from the end of 2013. In Lithuania, progressive cuts to pensions were implemented in 2010, with larger pensions facing larger cuts.

[19]In Estonia, the state-financed contributions to the second pillar were stopped from 1 July 2009 until 31 December 2010. In both Latvia and Lithuania, the part of the social insurance contributions transferred to the funded pillar was reduced (from 5.5% to 2% in Lithuania and from 6% to 2% in Latvia). The savings from this measure were considerable, ranging between 0.5% and 1% of GDP per year.

alcohol and fuel were increased in all three countries.[20] They all also broadened the base for personal income tax by reducing the number of allowances. Income tax rates also saw some changes. In Estonia, a planned reduction was postponed. In Latvia, the income tax rate was subject to fluctuations, first decreasing from 25% to 23% in 2009, then increasing again to 26% in 2010, followed by a reduction to 25% in 2011. In Lithuania, the 2009 increase in corporate income tax rate, from 15% to 20%, was reversed in 2010. In Estonia, unemployment insurance contributions were increased from 0.9% to 4.2% of gross wages. In Latvia, the employee's social insurance contribution rate was increased from 9% to 11% in 2011. Latvia also introduced a progressive real-estate tax, with higher rates applying to buildings with higher value, in 2009 and doubled the tax rates in 2011. Lithuania introduced a real-estate tax in 2011. No new taxes were introduced in Estonia during the crisis.

It is worth noting that, while in Estonia and Latvia the governments primarily imposed tax increases, in Lithuania the picture is more complex, with some reductions alongside increases, as exemplified by the reduction in personal income tax rates and the addition of exemptions to excise duties. In the autumn of 2009, in order to secure adherence to the Maastricht deficit criterion, the Estonian government also resorted to a number of one-off revenue-generation measures, such as taking dividends from state-owned enterprises and selling the shares of Estonian Telecom, with the condition that additional dividends would be paid out in 2009 and 2010 (Raudla 2011).[21]

Similar austerity measures, different fiscal outcomes?

In the light of their similar policy reactions—that of fiscal consolidation—in order to manage fiscal stress during dramatic economic decline, it may seem somewhat puzzling that fiscal performance, if measured in debt and deficit figures, was significantly better in Estonia than in Latvia and Lithuania (see Table 4).

Indeed, although all three Baltic republics implemented sizable fiscal adjustments in 2009–2011, there was, both within and outside the Baltic republics, a strong perception that Estonia was significantly more successful with fiscal consolidation than the others. Diverging fiscal performances were especially clear in 2009 (see Table 4), in the light of which Estonia came to be perceived as a shining poster-boy of crisis management, Latvia still looking troubled, while Lithuania lay somewhere in between. Estonia's apparent success can be attributed to a combination of political, institutional and economic factors.

First was timing. The Estonian government started consolidating the budget in 2008, whereas the other two governments still foresaw significant expenditure increases in planned budgets for 2009. Indeed, in terms of timing, the three Baltic economies had formed, since 1992, a peculiar kind of flying geese pattern of policy transfer and learning, and of growth, in the sense that in most policy reforms as well as growth dynamics, Estonia led the way, with Lithuania being in many cases the last to adopt certain reforms.[22] This is also true of growth

[20]In Latvia, the standard VAT rate was increased from 18% to 21% in 2009 and then to 22% in 2011. The VAT increases were from 18% to 21% in Lithuania and from 18% to 20% in Estonia. In addition, the lists of goods with favourable VAT rates were shortened and the favourable rates were increased.

[21]The revenue generated by additional dividends amounted to 0.78% of GDP in 2009 and 0.31% of GDP in 2010.

[22]For example, Lithuania explicitly waited in the early 1990s to see how the Currency Board would work in Estonia (Hanke 2009).

TABLE 4
FISCAL INDICATORS FOR THE BALTIC REPUBLICS, 2007–2010.

	2007	2008	2009	2010	2011
General government deficit/surplus (% of GDP)					
Estonia	2.4	−2.9	−2.0	0.2	1.0
Latvia	−0.4	−4.2	−9.8	−8.2	−3.5
Lithuania	−1.0	−3.3	−9.4	−7.2	−5.5
General government gross debt (% of GDP)					
Estonia	3.7	4.5	7.2	6.7	6.0
Latvia	9.0	19.8	36.7	44.7	42.6
Lithuania	16.8	15.5	29.4	38.0	38.5
Total government expenditures (% of GDP)					
Estonia	34.0	39.5	45.2	40.6	38.2
Latvia	35.9	39.1	44.2	44.4	39.1
Lithuania	34.6	37.2	43.8	40.9	37.5
Total government revenues (% of GDP)					
Estonia	36.4	36.5	43.2	40.9	39.2
Latvia	35.6	34.9	34.6	36.1	35.6
Lithuania	33.6	33.9	34.3	33.8	32.0

Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012.

dynamics, notably of GDP and exports, where Estonia usually led and Lithuania was the last of the pack. True to the pattern, Estonia's economy was already showing clear signs of slowing down in early 2008 and this gave its policy makers something of an advantage. Latvia and Lithuania remained particularly optimistic and engaged in expansionary fiscal policies through 2008 (for example by increasing social expenditures), when Estonia was already reducing spending (Purfield & Rosenberg 2010, p. 16; Deroose *et al.* 2010, p. 6). The Estonian government adopted a negative supplementary budget as early as June 2008, when it became clear that the initial budget for 2008 had been adopted on the basis of unrealistic growth projections.[23]

Second was the availability or lack of reserves. While fiscal policies in all three countries had been pro-cyclical in the run-up to the crisis, leading to underlying fiscal imbalances in cyclically adjusted terms, they had been the least pro-cyclical in Estonia. There the government had accumulated significant reserves by channelling the windfall revenues into a rainy-day fund, which amounted to as much as 9% of GDP in the wake of the crisis (Klyviene & Rasmussen 2010; Brixiova *et al.* 2010). Thus, the resulting spending overhang was the largest in Latvia and the smallest in Estonia. In essence, with unchanged policies, the deficit for 2009 would have been around 10% of GDP for Estonia and 16–18% of GDP in Latvia and Lithuania (Purfield & Rosenberg 2010).

Third was the ownership structure of banks, as shown in Figure 4. As can be seen, the asset share of foreign-owned banks was almost 99% in Estonia, while amounting to just over 60% in Latvia. Given the need to bail out the Parex Bank in the absence of fiscal reserves, the

[23]Proceeding from the assumption that the GDP growth for 2008 would be 3.7% (instead of the projection of 7% growth that had been the basis for adopting the initial budget for 2008), the supplementary budget reduced projected revenues by €390 million (with the lower than originally projected GDP growth leading to lower tax revenues) and expenditures by €205 million (implying an expenditure cut of 3% compared to the originally planned budget and amounting to about 1% of GDP). Of those cutbacks, €44 million came from investments, €145 million from transfers and €11 million from operating costs.

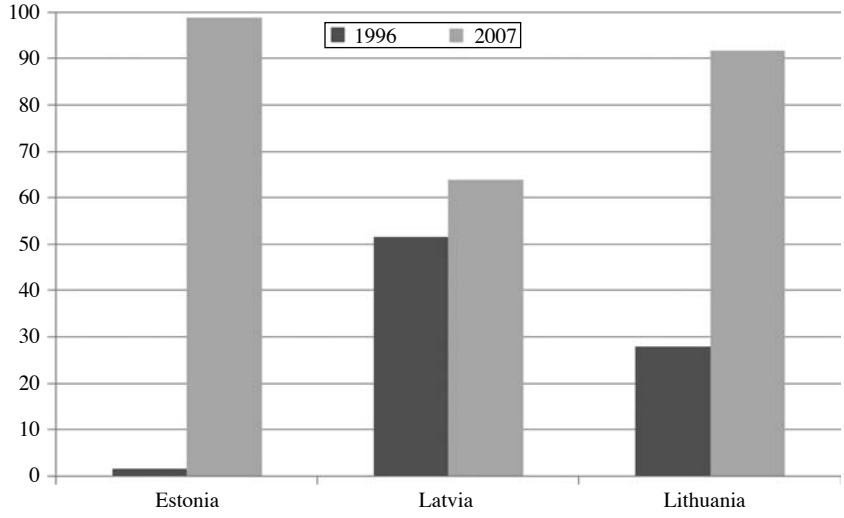

FIGURE 4. STRUCTURE OF FINANCIAL SECTOR BY OWNERSHIP IN THE BALTIC REPUBLICS: ASSET SHARE OF FOREIGN-OWNED BANKS (%).

Source: Kattel (2010, p. 46).

Latvian government had to ask for international support from the IMF, the EU and Nordic countries in November 2008.[24] The package that was approved in December/January helped to avoid the spillover of the liquidity crisis to the other Baltic economies as well (Purfield & Rosenberg 2010).[25] The lack of domestic banks gave Estonian and Lithuanian governments significantly more fiscal space as bailing out banks was essentially 'outsourced' to the Swedish central bank.

Fourth, the electoral cycle in Estonia favoured starting adjustment as early as 2008. At the height of the crisis in 2009, Estonia was in the middle of the electoral cycle, with the next general elections due in 2011. Both Latvia and Lithuania were in a somewhat different situation, with Latvia facing parliamentary elections in 2010, and Lithuania facing parliamentary elections in 2008 and presidential elections in 2009 (Kuokstis & Vilpisauskas 2010).[26] This meant that in both Latvia and Lithuania growth in public expenditure, and further promises of the same, was more recent and looming elections made the debates more difficult while Estonia had a relatively less fierce political climate. Finally, while in Latvia and Lithuania, the crisis brought about a dramatic fall in tax revenues, in Estonia the revenue shock was significantly smaller; this divergence has been attributed to better tax compliance and tax administration in Estonia (Purfield & Rosenberg 2010; Nakrošis *et al.* 2012).

[24]Parex held at the time about 20% of the domestic banking market (Purfield & Rosenberg 2010).

[25]In fact, Estonia was able to participate in this support action with €100 million. This lent considerable political support both domestically and internationally to the Estonian government. Furthermore, government reserves gave the Estonian government significantly more room in terms of building the case for fiscal retrenchment as international financial support with respective conditionalities was depicted as a loss of sovereignty: the politicians could argue that Estonia still needed to hold on to the accumulated reserves, in order to avoid a situation similar to Latvia's, which in turn necessitated fiscal retrenchment, rather than spending the entire rainy-day fund.

[26]Elections to the European Parliament were held in all three countries in 2009.

In sum, the coincidence of these five factors gave Estonia a considerable advantage in dealing with the crisis as it offered a great opportunity to unify all efforts behind one single goal: entrance into the eurozone. This option was not available to Latvia and Lithuania, mainly because these countries did not fulfil the inflation criteria on the eve of the crisis, while slowing growth was rapidly reducing inflation in Estonia. More importantly, in Estonia's case fulfilling deficit and debt criteria was realistic, while Latvia had lost out on the deficit criteria with one single act: bailing out the Parex Bank. It was feasible to fulfil all Maastricht criteria in 2009 and 2010 as the cuts started the earliest in Estonia and inflation was slowing because of the first signs of crisis. Lithuania had a much shorter window of opportunity for eurozone entry and it had a negative experience from 2005 when it missed by a 0.2% margin on the inflation criterion. As Estonia's next parliamentary elections were to be in 2011, the government had realistic hopes that it would be able to generate enough political capital domestically with eurozone entry to survive the crisis. Thus, the initial conditions made it possible for Estonia to have a straightforward realistic goal that the other two Baltic republics lacked.

Beyond fiscal consolidation: other policy measures adopted in response to the crisis

Besides fiscal consolidation, the second set of measures adopted during the crisis concerned the strengthening of (mostly already existing) policy measures for export-oriented activities, mostly via additional credit guarantees for exporters, but also shifting funding towards enterprise research and development and technology projects. In both sets of measures, the availability and use of EU Structural Funding played a crucial role. Figure 5 shows the level of EU Structural Funds in Baltic economies in comparison to Portugal, Ireland, Italy, Greece and Spain.

Finally, all Baltic republics undertook quite significant actions in the labour market, especially in the second part of 2009 and early 2010. Lithuania and Estonia introduced reforms to labour laws in 2009 in an attempt to make the labour markets more flexible.[27] Similar measures were enacted in Latvia in spring 2010. Latvia increased the duration of unemployment benefits to nine months, relaxed eligibility conditions and introduced a minimum floor (Purfield & Rosenberg 2010, p. 25). Latvia is also the only country to have raised the minimum wage during the crisis (Zazova 2011, p. 12). All three countries increased their spending on labour market policies, both in terms of absolute sums and as a fraction of GDP (Masso & Krillo 2011).[28] Again, all three countries made extensive use of EU funds for employment support measures. In the second half of 2009, the Estonian government introduced an action plan, foreseeing €45 million for creating 5,000 jobs and entailing a range of different measures, including business start-up support and broadening the conditions for wage subsidies (Masso & Krillo 2011, p. 44).[29] In 2010, a training voucher

[27]The new Employment Contracts Law in Estonia, enacted in July 2009, relaxed provisions pertaining to regular labour contracts, notice periods for redundancies were shortened, severance payments were curtailed and constraints on using fixed-term contracts were lifted. In Lithuania, the regulations concerning flexible work arrangements, such as temporary and part-time employment, were relaxed, but additional security for workers under fixed-term contracts was stipulated at the same time (Masso & Krillo 2011).

[28]Comparing 2008 and 2009, the expenditures on labour market policies increased from 0.2% to 1% of GDP in Estonia and from 0.4% to 0.9% of GDP in Lithuania (Masso & Krillo 2011, p. 43).

[29]For example, for start-up subsidies, the available sum was doubled, eligibility conditions relaxed and the self-financing rate decreased. The ceiling for subsidised loans available for start-ups was doubled (Masso & Krillo 2011).

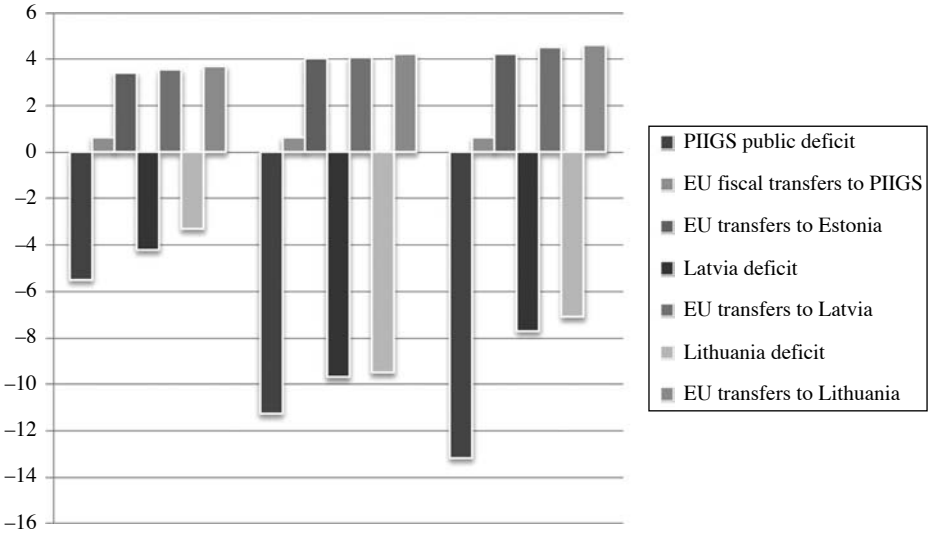

FIGURE 5. PUBLIC DEFICIT AND EU FISCAL TRANSFERS (COHESION FUNDS), AS % OF GPD, THE BALTIC REPUBLICS, 2008–2010.

Note: Fiscal transfers from the European Union are annual transfers through the Structural Funds. Here, the EU fiscal transfers include funds from three main sources: Cohesion, Rural Development, and Fisheries Fund. Data are available at: http://ec.europa.eu/budget/biblio/documents/fin_fwk0713/fin_fwk0713_en.cfm#alloc, accessed 6 August 2012.

Sources: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/, accessed 5 February 2013; and European Commission, Cohesion Funds, available at: http://ec.europa.eu/regional_policy/thefunds/funding/index_en.cfm, accessed 5 February 2013; calculations by the authors.

scheme was introduced in Estonia, enabling small firms to purchase training from an established list of institutions. In Latvia, the government created a public works programme in 2011. Training programmes, including on starting a small business, were also offered. Other plans included training vouchers, wage subsidies and special support measures for young people. In Lithuania, a larger scale programme entailing a number of job support instruments was adopted in 2010 (Purfield & Rosenberg 2010).[30]

Institutional changes

On the level of institutions, Estonia changed the least during the crisis. Lithuania undertook some changes, mostly still in the implementation phase, but Latvia's response was rather dramatic. First, in Latvia the government became a significant actor in the banking sector. Second, more than half of government agencies were closed, as reported in the 2010 Convergence Programme.[31] Third, in particular in education and the health sector, there were significant changes and the Convergence Programme showed the numbers of schools and hospitals decreasing dramatically, including the closure of 24 out of 49 hospitals

[30]For a more detailed overview of the labour market measures adopted in the Baltic republics, see Masso and Krillo (2011, Appendix 1).

[31]See http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm, accessed 2 September 2012.

(Åslund 2010, p. 37). The number of general education institutions was reduced from 982 to 873, and vocational education institutions from 67 to 58.[32] Lithuania also initiated radical reforms in higher education and health care—under the general heading of 'optimisation'—which were still to be fully implemented in 2012 (Åslund 2010, p. 41; Jankauskiene 2010).

In terms of institutional capacities, crisis management brought two discernible changes in all three countries. First, the crisis led to politicisation of decision-making processes as decisions needed to be made in a relatively short time period, which meant that both analytical and consultative processes remained brief and highly centralised. This strengthened the position of executives relative to legislatures and, within the executive branch, ministries of finance, which were already important because of the role of EU Structural Funding management issues, became even more pivotal in policy making.[33] The planned changes to the budget process, for example in the form of the Fiscal Discipline Law in Latvia, are likely to further increase the power of the ministries of finance relative to that of line ministries. Second, the crisis further reinforced and strengthened the position of the EU as an institutional factor, which had already been substantial during the process of accession to the EU and later with the use of Structural Funds.[34] In the Latvian case, the EU and the IMF, as the largest donors in the €7.5 billion rescue package, were in direct dialogue with Latvian officials and in a position to raise demands directly. The IMF, at least initially, appeared open to more diverse solutions, including external devaluation, and the EU was more the hardliner in terms of fiscal policy (Lütz & Kranke 2010). In the Estonian and Lithuanian cases, the IMF's potential role, and even more its image from 1990s structural adjustment programmes, made the IMF a warning factor within domestic debates, which reinforced the EU's role as the key external advisor. The EU had two key advantages; first, as the source of Structural Funding, it had a lever to push for reallocation of resources within policy measures and to heighten the pace of funds' usage; and second, entry into the eurozone was an important source of policy discipline. Indeed, it can be argued that for all three Baltic policy makers, the EU became the key policy and epistemic peer community, the source of key policy ideas and of their positive feedback.[35]

Another key aspect on the institutional level was the reinforcement of path dependencies in policy capacities. Since regaining independence, fiscal retrenchment had worked in every major crisis the Baltic republics had faced: after 1992, after the Russian crisis in 1999, and particularly after Estonia's entrance into the eurozone (Raudla & Kattel 2011a, 2011b; Åslund 2010, p. 40).[36] While 2009 could in principle have offered a window of opportunity for a critical juncture in economic policy making—switching from a rather passive government role in the economy towards more active macro-management of the economy by the state—the policy choices made during the crisis imply the continuation of pre-existing policy and administrative capacities. Furthermore, both in Estonia and Latvia there

[32]See http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm, accessed 2 September 2012.

[33]For a discussion on the evolution of budgetary institutions in Estonia, see Raudla (2010a, 2010b).

[34]See Suurna and Kattel (2010) for a case study.

[35]See also Ikstens (2010, p. 1056) for discussions on the role Commissioner Alumina played in the introduction of tax increases and the progressive real-estate tax in Latvia in 2009.

[36]In fact, Andrius Kubilius, Lithuanian Prime Minister from 2008, was also in office during the aftermath of the Russian crisis in Lithuania in 1999–2000, a fact that supported his credibility in the post-2008 crisis (see also Brozaitis 2005).

were discussions on establishing the principles of fiscal discipline in their respective constitutions.[37]

Reactions to the austerity measures

In marked contrast to the public protests in Greece and other European countries, the population of Estonia broadly accepted the austerity measures quietly, or even supportively,[38] and there were no street riots.[39] There were some protests in Latvia and Lithuania, but brief one-day riots in January 2009 seem to have had political rather than economic causes, at least in the case of Latvia.[40] There were muted and sporadic protests by various trade unions and citizen interest groups throughout 2009 in all three countries,[41] but their impact remained limited.

Only in Lithuania was the voice of trade union protests heard. The government had totally avoided social dialogue when preparing austerity measures at the end of 2008, but it was forced to engage in consultations—at least to a certain extent—in the course of 2009[42] (Masso & Krillo 2011, p. 48). In the autumn of 2009, a social pact, or a national agreement, was concluded in Lithuania, endorsed by the trade union confederations, employers' unions and the government. The trade unions thereby promised to suspend protests in exchange for a government promise to protect living standards and to engage in social dialogue (Woolfson 2010, pp. 504–5).[43]

These mild reactions to the governments' measures can be explained in terms of immediate policy issues and of deeper political and historical factors. Importantly, the majority of the populations in these three countries were in favour of keeping the currency pegs, which made it easier for the government to sell the measures necessary for internal devaluation. In Estonia, the government was particularly successful in constructing a communicative crisis discourse that was simple, coherent and persuasive. It was built on three major elements: we cannot abandon the peg; we have to adopt the euro; we therefore have to adjust the budget.[44]

Although more protests could have been expected once the pain induced by the austerity measures was felt, a number of cultural and social factors prevented this. First, the Baltic

[37]In Estonia, the Union of *Pro Patria* and *Res Publica* (*Isamaa ja Res Publica Liit*), a conservative political party, campaigned for a balanced budget rule in the run-up to 2011 parliamentary elections. In Latvia, a set of fiscal rules on budget balance, debt level and countercyclical fiscal policy were being planned.

[38]As Kuokstis and Vilpisauskas (2010) point out, in Estonia public trust in the government actually increased at the height of the crisis in 2009: while in spring 2009, 38% of the population trusted the national government, the figure increased to 47% by the autumn of 2009, after three austerity packages had been adopted.

[39]In Estonia mass protests as a means of expressing discontent had been stigmatised in spring 2007, when Russian-speaking youths reacted with riots and looting to the relocating of the Bronze Soldier statue commemorating the Soviet victory over Nazi Germany from the city centre of Tallinn. Thus, as argued by Kattel (2010), the Estonian public feared that mass protests against the government's austerity measures would be likened to the rioters and looters during the Bronze Soldier events.

[40]See Ikstens (2010, p. 1055) on Latvia and Woolfson (2010, p. 496) on Lithuania.

[41]As Woolfson (2010, p. 502) notes, trade unions in Lithuania were reluctant to organise another major protest action as they did not want to be made responsible for provoking social unrest and violence.

[42]For example, in summer 2009 the Lithuanian trade union confederation protested against the government plan to cut basic monthly salaries in the public sector, which would have primarily affected the lowest paid employees, by organising a hunger strike in front of parliament. As a result of the protest, the government amended the plan and introduced more progressive pay cuts (Masso & Krillo 2011, Appendix 3).

[43]As Woolfson (2010, pp. 504–5) notes, the pact still entailed cuts to wages, pensions and parental benefits.

[44]For more detailed discussions, see Raudla and Kattel (2011a, 2011b).

republics were characterised by a patience culture, whereby society was willing to endure short-term pain for long-term gain in the form of independence, freedom and economic prosperity. This emerged in the late 1980s and early 1990s, but lingered on, even after the initial phase of transition was over (Greskovits 1998; Kuokstis & Vilpisauskas 2010). As Purfield and Rosenberg (2010, p. 4) rightly note, during the previous crises, in the early 1990s and then in 1998–1999, the populations of these countries had witnessed that the imposition of painful measures by the government, in the form of fiscal contractions, had paid off and led the countries back to a growth path.[45] Thus, the hope that the short-term pain would give rise to a long-term gain is likely to have made society more willing to accept the austerity measures in 2008–2010, although more so in Estonia than in Latvia and Lithuania, where a significant number of people chose to emigrate, rather than to stay and put up with the pain inflicted by contractionary policies.[46] Second, civil society in the Baltic republics was underdeveloped and therefore unable to mobilise significant protests. Third, the industrial relations in all three countries were 'highly individualised and dominated by employers' (Gonser 2011, p. 409) with trade union density the lowest in Europe,[47] meaning that trade unions could not stage significant protests.[48]

Discussion: from nationalist to pragmatic neo-liberalism

There are two constructs that help to understand the Baltic economies and their responses to the crisis: first, the idea of embedded neo-liberalism and its evolution in the region; and second, the concept of simple polity and its application to the Baltic republics.

Embedded neo-liberalism denotes a specific form of capitalism that developed in Eastern Europe after the demise of the Soviet Union.[49] This takes inspiration from Karl Polanyi's classic concept of embedded capitalism in which the state functions, by means of social protection mechanisms, as a curtailer of capitalist free market excesses (Polanyi 1957). In the Eastern European case, in a reversal of Polanyi's original idea which was epitomised in the European welfare state, self-regulating markets are seen as bringing social well-being.

One of the key features that enabled this construct to work in real polities is the instrumentalisation of the idea of nation and nationalism as a substitute for social well-being. That is, in the context especially of the Baltic republics, what capitalism can deliver is not so much a socially more balanced society, but rather the survival of the nation. While the notion of embedded neo-liberalism, where the embedding agent is nationalism, reflects developments in the entire Eastern European region and especially the Baltic republics, it is Estonia where it has evolved into perhaps its purest form.[50]

This nationalist neo-liberalism is reflected in a very open economy with governments looking for further avenues to liberalise and deregulate: low income tax for persons and

[45]See also Raudla and Kattel (2011a, 2011b).

[46]See also Kuokstis and Vilpisauskas (2010). In 2009, net migration from Estonia remained unchanged, but increased to 2% of the population from Latvia and to almost 5% from Lithuania (Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012).

[47]In 2009, trade union density was 7.6% in Estonia and 10% in Latvia and Lithuania (Gonser 2011).

[48]As Gonser (2011, p. 412) points out, although on a number of occasions collective agreements were changed and pay cuts or freezes implemented without consultation with unions, employees accepted the changes without protests.

[49]See van Apeldoorn (2009); for a discussion of this concept in the context of the crisis, see Bideleux (2011).

[50]See also Thorhallsson and Kattel (2012).

companies; relatively flexible labour markets (Zazova 2011; Masso & Krillo 2011); high levels of foreign direct investment; relatively stable governments;[51] increasing importance of the core executive (Drechsler *et al.* 2003) with weak to non-existent social partnerships; increasing importance of external ideas and policies in the sphere of economic policies (Karo & Kattel 2010); and language and cultural policies favouring the respective majority nations. This is significant for Estonia and Latvia which, unlike Lithuania, have sizable Russian-speaking minorities.[52] Ironically, in economic policies the Baltic republics exhibited practically no nationalist elements, for example eschewing domestic market protection. It is rather the functioning of the market that is seen as ensuring the survival of the nation.

The concept of simple polities denotes polities where social partnerships, constitutional veto players and corporatist structures—employers' unions, industry associations—play little role in actual policy making. The key policy-making capacity in simple polities is direct communication with the wider population. This can be contrasted with compound polities where social partnerships, veto players and/or corporatist structures play a pivotal role in decision making and where accordingly key capacities evolve around deliberation and consultation (Schmidt 2008, 2010; Raudla & Kattel 2011a, 2011b).

While constitutionally and historically, from the so-called first period of independence in the interwar period, the Baltic republics had a potential for both forms of polities, the nationalist neo-liberalism described above led to the emergence of decidedly simple polities in all Baltic republics.[53] This led to two phenomena. First, the evolution of specific institutional interactions and policy capacities; and second, implicit politicisation of the executive branch in terms of ideology and skills tacitly expected from new employees, meaning their adherence to the basic tenets of nationalist neo-liberalism.[54] This resulted in specific elite building with a discernible *esprit de corps*, visible in perhaps its purest form again in Estonia because of stable governments. In this setting, wide policy goals based on some form of implicit social consensus, such as entry into the EU and NATO, played a crucial role in mobilising the emerging elite and justifying the beliefs and value systems reflected in nationalist neo-liberalism. Reaching these goals became perhaps the key measure of efficiency and also opened channels of communication with the EU and its institutions. Indeed, for the emerging policy elites, these channels became key sources of ideas and positive feedback.

At the same time, domestically, the role of social partners in policy coordination remained undeveloped. The degree of insulation of the policy-making elites from social partners varies somewhat in the three countries, Estonia being the most detached and Lithuania the least. In Estonia, for example, although both the employers' union and trade unions made policy proposals about how to deal with the recession and reacted to the measures proposed by the government, they did not have sufficient power to force the government to amend its plans. Furthermore, as Gonser (2011, pp. 409, 412) argues, the crisis led to 'a deinstitutionalization of the collective bargaining system' and further weakened the trade unions, due to membership losses resulting from redundancies, implying further simplification of the polities in all three countries.

[51]Estonia's prime minister in 2012 had been in office since 2007; the leading coalition party, the Reform Party (*Reformierakond*), had been in the government since 1999.

[52]On Estonian minority politics, see Aidarov and Drechsler (2011).

[53]See also Woolfson (2010).

[54]See Peters and Pierre (2004) on forms of politicisation.

Crisis management enforced the basic values of nationalist neo-liberalism, but it became more pragmatic during the course of the crisis.[55] Indeed, it is remarkable that both Estonia and Latvia returned to office in 2011 the governments responsible for heavy budget cuts under very high levels of unemployment. Lithuania elected a president who favoured the hard-line neo-liberal agenda of the government and brought with her also important changes in the government towards such pragmatic austerity (Krupavicius 2010, pp. 1062, 1066). Indeed, both Latvia and Lithuania had been crippled by the power of domestic oligarchs and the crisis intensified attempts to curb this (Woolfson 2010, p. 508).

This pragmatism is associated with one policy goal, entry into the eurozone. As argued above, this gave, particularly for Estonia, and after that country's success also to Latvia and Lithuania, a policy goal that unified the need to consolidate the budget, enforce more neo-liberal structural and administrative reforms, and implement economic reforms intended to support export-led growth.[56] Indeed, the Lithuanian government, the largest trade unions and several other social partners signed a national agreement in 2009 that expressed exactly this, subsuming policy goals, notably fiscal deficit reduction, under the aim of entry to the eurozone (Krupavicius 2010, p. 1071; Woolfson 2010, p. 505).

Eurozone entry as a general goal also engendered other specific goals that could be easily communicated to the public and that could be easily measured, following from the Maastricht criteria. As eurozone entry was realistic for Estonia, it also generated much stronger trust in the government and generally legitimised retrenchment. This enforced a much more pragmatic approach to policy as it subordinated the nationalistic goals to eurozone entry. Kuokstis and Vilpisauskas (2010) show how general levels of government trust remained significantly higher in Estonia than in Latvia and Lithuania, and this in turn translated into higher tax returns.[57]

Did the internal devaluation work?

After 2009 the worst seemed to be over for the Baltic republics. The economies returned to growth and in the second half of 2010 employment started picking up again. Exports followed a growth trend and current accounts turned into surplus. In the light of these developments, can we say that internal devaluation really worked?

The uniquely Baltic economic factors listed above indicate that the 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 in the light of how overheated the 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 in all three countries resumed an upward trajectory. The reduction of real wages from peak to trough was about 15–20% in all countries.[58] By the end of 2009, the real

[55]See also Åslund (2010, pp. 7, 32).

[56]See also Lütz and Kranke (2010) for interviews with the IMF staff.

[57]While in 2009 tax revenues fell by about 30% in Latvia and Lithuania, they declined by less than 5%, year on year, in Estonia (see also Staehr 2010).

[58]See Table 1; see also Krugman (2011) and Knibbe (2011). In 2009, the private sector outpaced the public sector in Lithuania in nominal pay adjustments. The pattern was similar in Estonia, while in Latvia the public sector led by a wide margin (see, for example, Table 4 in Purfield and Rosenberg (2010)).

effective exchange rates had fallen by 10–20% from their boom-time peaks (Table 1). However, in the light of the preceding boom, the internal devaluation was rather modest and cannot fully explain the recovery in the Baltic republics from 2010.[59]

If not internal devaluations, then what was behind the Baltic recovery in 2011? There are three key factors: massive use of European funds; flexible labour markets; and integration of export sectors into key European production networks. Flexible labour markets have had two consequences. The first was persistently high unemployment, but this did not lead to higher social expenditure: automatic stabilisers were relatively unimportant, due to low levels of benefits and short periods of entitlement.[60] Moreover, active labour market measures were financed largely from EU Structural Funds. The second was accelerated emigration from all Baltic republics. The level had already been high in Lithuania before the crisis and Lithuania's and Latvia's censuses in 2011 showed dramatic falls in population numbers. Estonia's census in 2012 showed a more modest reduction in population (IMF 2011, p. 14). As the Baltic republics were simple polities, voice did not seem to be an option for many and exit became the preferred choice for increasing numbers of people (Kuokstis & Vilpisauskas 2010). However, both high unemployment and exit are forms of future costs in terms of future social issues and lack of a workforce. Thus, while during the crisis the costs of external devaluation were argued to be higher than internal devaluation—or adjustment, as it was mostly referred to in Baltic debates—it remains to be seen whether this is really so, given persistently high levels of unemployment and emigration.

Integration into European networks by a few dozen leading exporters is another key factor explaining the Baltic recovery. Figures 6 and 7 show the changes in exports and domestic demand. As is clearly visible from the figures, exports picked up in 2010, reaching record levels in 2011. In all three economies, however, domestic demand remained anaemic, hovering around the levels of 2004.

These developments had relatively little to do with domestic conditions or policy actions. Rather, they are an increasingly important symptom of the Baltic blend of capitalism, namely enclave industries. It has been recognised for some time that one of the key problems faced by Eastern European companies is the low embeddedness of foreign-owned exporting companies, reflected in the low level of linkages with domestic suppliers, partners, higher education and research institutions. For instance, one of the key electronics exporters from Estonia, Elcoteq, used up to 200 suppliers in 2012, none of which were domestic (Tiits & Kalvet 2012). While Baltic exports bounced back to their pre-crisis levels, the problem of linkages and feedbacks remained. In addition, the pre-crisis levels of exports were not enough to make up for the lack of foreign financing that fuelled Baltic growth in the mid-2000s. In sum, while the crisis hardened the Baltic neo-liberal resolve, the responses to the crisis did not bring substantial changes to Baltic economic structures and consequently their underlying fragility remained unresolved. However, as the Baltic economies are very open and small, their recovery and future growth depended heavily on European recovery. As the latter seemed likely to be slow and sluggish for some years, there is no reason to expect growth rates similar to those of the mid-2000s for some time to come.

The above factors made the Baltic cases unique. Their experience could not be reproduced in older EU members for three reasons (Grennes 2012). First, most EU countries, especially

[59]See also Grennes (2012).

[60]See also European Commission (2010, p. 64).

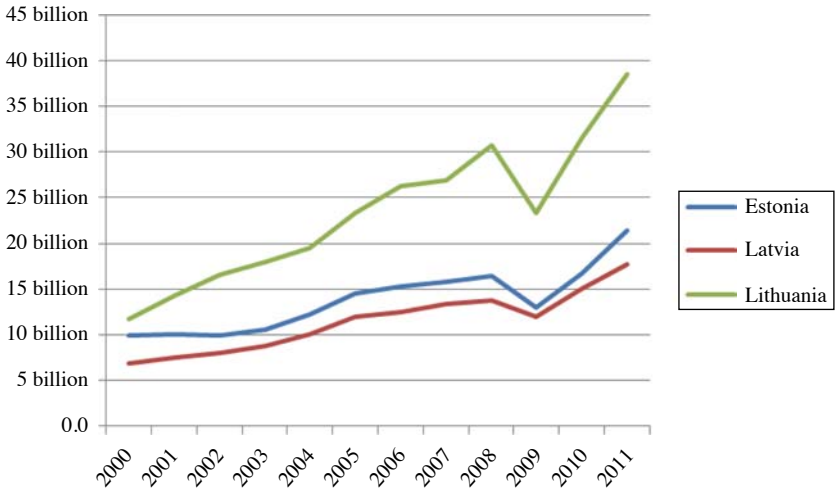

FIGURE 6. EXPORTS OF GOODS AND SERVICES FROM THE BALTIC REPUBLICS, MILLIONS OF PURCHASING POWER STANDARD, 2000–2011.

Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012.

in the troubled periphery, were already in the eurozone and therefore could not present short-term austerity measures and eurozone entry as a crisis exit strategy. Second, very few EU countries had civil societies as weak as those in the Baltic republics, and thus austerity bred visible unrest and instability. Third, few if any EU countries had such narrow and detached

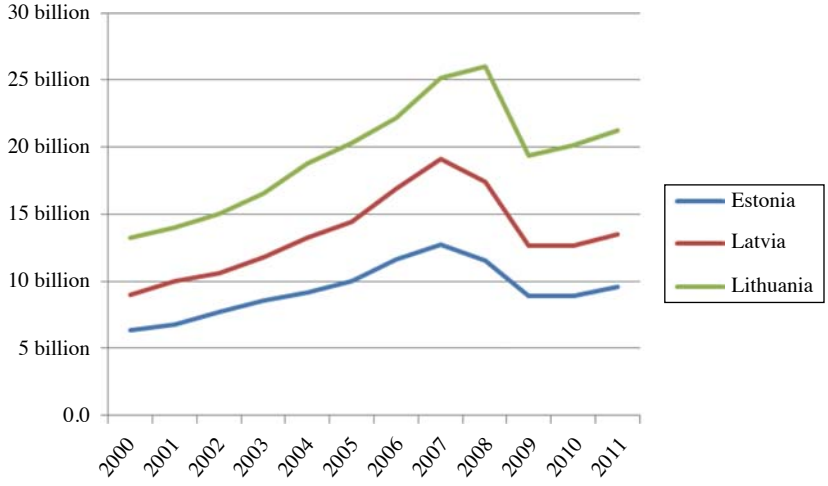

FIGURE 7. DOMESTIC DEMAND IN THE BALTIC REPUBLICS, MILLIONS OF EURO, CHAIN-LINKED VOLUMES, REFERENCE YEAR 2000, 2000 EXCHANGE RATES, 2000–2011.

Source: Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, accessed 6 August 2012.

policy elites, accustomed to satisfying their European policy peers rather than their domestic partners.

Even if countries of the EU periphery could somehow replicate the aforementioned political conditions—by weakening civil society, retrenching the welfare state and relaxing labour regulations—they would still not face the same economic conditions. A number of economic and structural factors made the Baltic republics unique, including high levels of economic globalisation, both in terms of exports and in their financial sectors, and strong dependence on larger neighbouring economies, Scandinavia and Poland, for trade and, in the case of Scandinavia, technology transfer. Scandinavian economies recovered quickly, while Poland experienced no fall in GDP at all. Thus, while the EU was behaving more and more as if it were a small open economy where budget discipline was important for convincing investors and markets (Münchau 2011), the experience of the small open economies that dealt best with such fiscal policies is of very little use to other troubled EU members.

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