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THE BALTIC TIGERS: PAST, PRESENT AND FUTURE

WHY HAVE THE BALTIC TIGERS BEEN SO SUCCESSFUL?

ANDERS ÅSLUND*

In August 1991, the three Baltic nations, Estonia, Latvia and Lithuania, suddenly regained the independence lost in 1940, thanks to the failed coup by Soviet hardliners in Moscow. Their economic situation was desperate. They were major importers of energy and other raw materials, and their Soviet manufactured goods were of substandard quality. Soviet public finances collapsed in every regard, which also hit the Baltic states. All three managed to limit their inflation to about 1,000 percent in 1992, but their output was in free fall. In 1992 Latvia's GDP officially fell by 35 percent. The Baltic countries did not return to economic growth until 1995. Their economies grew soundly from 1996 to 1998, but the Russian financial crash of 1998 wiped out their growth once again (Åslund 2013).

From 2000 onwards, however, the three Baltic economies started growing extraordinarily at an average of 8–9 percent a year. Latvia even recorded average growth of 10 percent for the three years from 2005 to 2007. Alas, this was overheating. The three Baltic countries were hit hard by the liquidity freeze that followed the bankruptcy of Lehman Brothers in September 2008. In 2009, output in all three countries plummeted at a double digit rate. All three reacted as they had done in the early 1990s, with radical and front-loaded fiscal adjustment accompanied by structural reforms; and they succeeded once again.

Since 2012 the three Baltic countries have recorded the highest growth rates in the EU. Their growth is no longer as high as it was during the golden years of the early 2000s. The global credit boom is over, and growth rate in the neighbourhood has declined. Yet during the four years from 2011 to 2014 the three

Baltic countries had an average annual growth rate of 4.1 percent compared with only 0.7 percent for the EU as a whole (Figure 1). The Baltic economies have converged significantly with EU economies as a result.

The aim of this paper is firstly to analyse how the Baltic countries managed to accomplish their success. Its second aim is to assess where they are now. What are their achievements, lingering concerns and new rising worries? The paper will conclude by considering the broader implications of the Baltic experience.

How the Balts reformed

Looking back at the situation of the Baltic states in autumn 1991, it is truly remarkable that they managed to get their economies back on track. None of them had been independent since 1940. They lacked nearly all relevant national institutions, including central banks and ministries of finance. All three had large ethnic minorities, mainly Russians, and they harboured around 200,000 Soviet soldiers and major military installations. Their economies were in a state of complete collapse.

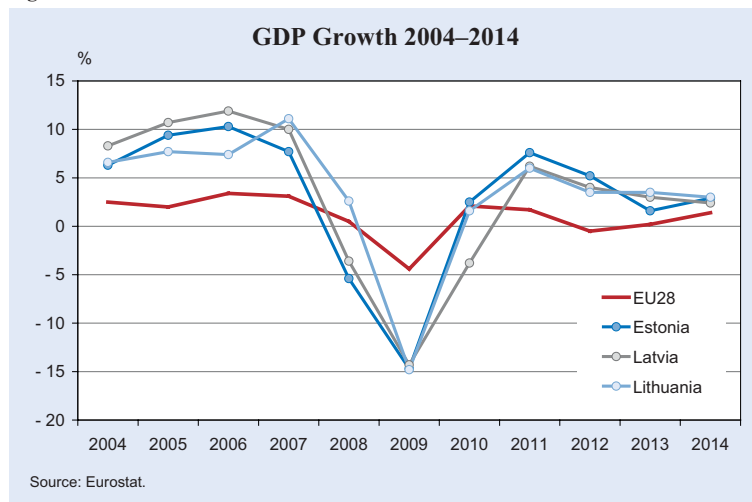
They did, however, have four favourable preconditions. Firstly, all three developed strong national fronts in the late 1980s that aroused a strong sense of national community in each of the Baltic countries. Secondly, these national fronts won the republican parliamentary elections in early 1990 and were allowed to form national governments, although these governments had minimal powers. Thirdly, their renewed independence in August 1991 was not contested, but recognised by Russian President Boris Yeltsin. The world welcomed the Baltic countries to all international institutions and no violence erupted. Fourthly, they had friendly and wealthy western neighbours who welcomed them.

All three Baltic republics are small and vulnerable. Each is ethnically and linguistically distinct, unable to understand one another's languages. Yet in their reforms they acted very similarly, sharing ideas and experiences. Estonia tended to take the lead with ei-



* Atlantic Council, Washington DC. In this paper I draw on three of my books: Åslund (2002); Åslund (2013); and Åslund and Dombrovskis (2011).

Figure 1



ther Latvia or Lithuania following suit. It is therefore natural to focus on Estonia as the pioneer, whose ideas quickly travelled to and were embraced by Latvia and Lithuania, where they were frequently adopted with minor adjustments. The main reform government in Estonia was led by Prime Minister Mart Laar, 1992–94 (Laar 2002). After achieving little in 1991, key reforms were implemented in 1992. Intense reforms continued in 1993 and 1994.

The central goal of the early Baltic reforms was to secure national independence. Being small and having been occupied for half a century, the Baltic nations never took independence for granted. While other bigger former Soviet republics asked Russia for assistance, the Baltic states preferred independence and never even considered joining the post-Soviet Commonwealth of Independent States. Their urge to gain independence was fundamental to their economic policy. They shared central Europe's two slogans 'we want a normal society' and a 'return to Europe', which meant the EU, embracing early radical reforms. Democracy and freedom were self-evident.

The first economic policy needed was a radical and early deregulation of trade and prices, which was pioneered by Estonia, with Lithuania quickly following suit. Estonia abolished all foreign trade tariffs and quotas, becoming the only truly free-trading country in Europe. This radical and early deregulation of foreign trade and prices wiped out criminal gangs of metal traders that had taken hold in 1990 and 1991. Lithuania did not go quite as far in its foreign trade liberalization, and Latvia waited for one year before deregulating its foreign trade, creating a thriving oil transit trade from Russia through the Latvian port of

Ventspils. Its mayor Aivars Lembergs became the country's richest man and remains so to this day. Latvia started corruption proceedings against him in 2006, but the case is ongoing and there is no real end in sight. Latvian politics became dominated by three oligarchs, who each controlled one political party. These three groupings dominated Latvian politics until 2010, showing how dangerous the quick entrenchment of rent seeking interests are – see Murphy, Shleifer and Vishny (1992 and 1993).

All three countries carried out rigorous macroeconomic stabilisation in 1992, introducing their own currencies in the summer of 1992: first Estonia, next Latvia and finally Lithuania. The Estonians argued that a national currency was the best wall against Russia. Their currency reforms were unilateral without any consultation with Russia or other members of the rouble zone, cutting them off from otherwise ample Russia central bank credits. Estonia and Lithuania established formal currency boards with fixed exchange rates in 1992, while Latvia pursued a similar policy. All three have been firm fiscal conservatives, regardless of political party in power, carrying out radical expenditure cuts aimed at a balanced budget. Tax reforms took a slightly longer time to implement. In 1994, Estonia minimised its taxes and introduced a flat income tax, initially of 26 percent. Latvia and Lithuania quickly adopted flat income taxes too, and rates were reduced as far as public finances allowed them to be. At present, Lithuania has the lowest flat income tax rate of 15 percent. Corporate profit taxes have fallen in line with personal income tax.

The Baltic countries carried out early and fast privatization, doing almost as well as the Central European countries. All three countries insisted on the restitution of agricultural land and housing to a far greater extent than other countries. Estonia adopted the East German model of privatization through sales *via* a strong privatization agency, while Lithuania pursued far-reaching voucher privatization, and Latvia adopted a mixed model, which led to a slightly slower privatization rate. Thanks to early and fast deregulation and privatisation, all three Baltic countries have at-

tracted a large and steady stream of foreign direct investment.

None of the post-communist countries implemented a more radical transformation of its public sector than Estonia. The Laar government laid off all government employees, reorganised state institutions and invited both former employees and outsiders to apply for new jobs. Together with the other reforms, this helped to give Estonia the best governance of all post-communist countries. Latvia and Lithuania reformed the government less radically in the early transition, but caught up to a large extent through rigorous restructuring during the financial crisis in 2009. Importantly, all three Baltic states rebuilt their military and security services after regaining independence, which left them free of poor Soviet governance. As a result, Transparency International ranks Estonia No. 26, Lithuania 39 and Latvia 43 out of 175 countries on its Corruption Perception Index for 2014. Eight EU members rank below Latvia (Transparency International 2014).

These achievements were possible because the Balts received the international support that they needed. They swiftly joined the International Monetary Fund and the World Bank. To facilitate their initial financial stabilization, the IMF, the World Bank, the EU and individual countries provided loans totalling 1 billion US dollars for the three countries in 1992. The EU concluded free trade agreements and opened up its markets early on, which made it possible for the Balts to raise the share of their exports to the EU to two-thirds. In June 1995, the EU signed European Association Agreements with the Baltic nations, opening up the perspective of EU membership. Thus, the EU legal and democratic standards as inscribed in the *acquis communautaire* applied to the Baltic states. In 2004, they finally become EU members. At the same time the Balts applied for membership of the North Atlantic Treaty Organization, and became fully members of NATO in 2004 (Åslund 2013).

In 2008, however, the Baltic countries experienced a serious shock when the European Central Bank (ECB) did not provide them with any liquidity at all, as the three countries faced a nearly complete liquidity freeze. But aware of their weakness, they abstained from criticising the ECB and instead attempted to qualify for adoption of the euro as quickly as possible. In 2011, Estonia adopted the euro, followed by Latvia in 2014 and Lithuania in 2015. In any future liquidity crisis, they will all have access to ECB funding.

The current state of affairs

Overall, the three Baltic economies are currently in good shape economically. They have achieved most of what one could have hoped for in post-communist transformation, although a few problems remain. The most obvious achievement of the Baltic states is that they established a high and steady growth rate after the 2008/9 crisis of about 4 percent a year, which is much higher than that of the rest of the EU. Their convergence with the rest of the EU is therefore likely to continue after the hiatus of 2009 (Figure 1). Their main advantages compared to other EU economies lie in the fiscal sphere. Their public finances are in perfect order, with low and flat tax rates and simpler tax systems than anywhere else in Europe.

The Baltic economies are all close to fiscal balance, especially Estonia, after running large deficits during the crisis years of 2008 to 2010.¹ As a result of good fiscal discipline, the Baltic countries have limited public debt. At the end of 2014, Estonia's public debt was tiny at a mere 10.4 percent of GDP, while Latvia and Lithuania had a public debt of just over 40 percent of GDP, compared with the far higher average EU debt of 87 percent of GDP.² The Baltic states have achieved these excellent fiscal results by cutting public expenditure rather than raising taxes. In 2014, the average public expenditure of EU countries amounted to 48 percent of GDP, compared to 38.8 percent, 36.9 percent and 34.9 percent in Estonia, Latvia and Lithuania, respectively. Thus, the Baltic countries on average spend as much as 11 percent of GDP less on public expenditure than the EU.³

Correspondingly, they enjoy far greater economic freedom, lower taxes and more stimulating incentives. The flat income tax and corporate profit tax rates continue to fall. At present, Estonia has a flat personal income tax rate of 20 percent compared to 23 percent in Latvia, and just 15 percent in Lithuania, which took the lead in terms of both low public expenditure and low taxes after the global financial crisis. Privatisation was carried out early and well, especially in terms of the restitution of land and housing. As

¹ Eurostat, 'General government deficit (-) and surplus (+) - annual data', <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina200&plugin=1>.

² Eurostat, 'General government deficit (-) and surplus (+) - annual data', <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina225&plugin=1>.

³ Eurostat, 'General government expenditure in the EU', News Release, 7 July 2015, <http://ec.europa.eu/eurostat/documents/2995521/6899478/2-07072015-AP-EN.pdf/797f4af9-c37f-4631-8211-5dd0b32fcb31>.

Table 1

**Population in the three Baltic countries
(in million people)**

	1989	2014	Change (%)
Estonia	1.6	1.3	-17
Latvia	2.7	2	-25
Lithuania	3.7	2.9	-21
Total	8	6.2	

Source: Eurostat.

everywhere, some privatisations were controversial and there were some failures to privatise, but few post-communist countries have experienced less controversy over privatisations than the Baltic states. In addition, the Balts excel in programmatic deregulation, as prescribed by the World Bank Ease of Doing Business Index. Estonia ranks No. 16 in the world out of 189 countries, Lithuania No. 20 and Latvia No. 22. Only five EU countries beat Estonia in this measure.⁴

The Balts nevertheless still suffer from some lingering problems of their Soviet legacy. The most obvious ills pertain to demography. Their total population fell from 8.0 million in 1989 to 6.2 million in 2014, a decline of slightly over a fifth (Table 1). The decline was mainly due to low birth rates and emigration. EU membership facilitated emigration to European countries. Birth rates are low, but not lower than elsewhere in Europe at around 1.55 net births per woman, which is the current EU average.⁵

Health statistics offer a mixed picture, with Estonia standing out as a star. A primary measure is life expectancy at birth, which was much lower in the former Soviet Union than anywhere in Europe. After independence, Estonia performed very well, raising its life expectancy from 69.9 years in 1990 to 77.6 in 2013, almost catching up with the EU average of 80. Latvia and Lithuania, by contrast, have underperformed (Table 2). Estonia appears to have succeeded in making its health care system one of the best in Europe. Its infant mortality at birth has fallen to the second lowest in the EU at 2.1 deaths out of 1,000 live births. Only neighbouring Finland has a lower rate, while the EU average is 3.7. Latvia and Lithuania have also done well, with slightly higher but still respectable figures of 4.4 and 3.7.⁶ All three Baltic states have man-

⁴ World Bank Group, 'Ease of Doing Business Rankings 2015', <http://www.doingbusiness.org/rankings>.

⁵ Eurostat, 'Total fertility rate, 1960-2013 (live births per woman)', [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Total_fertility_rate,_1960%E2%80%932013_\(live_births_per_woman\)_YB15.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Total_fertility_rate,_1960%E2%80%932013_(live_births_per_woman)_YB15.png).

⁶ Eurostat, 'Infant mortality rate', <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tps00027&plug-in=1>.

Table 2

Life expectancy at birth in the three Baltic countries

	1990	2013	Change
Estonia	69.9	77.5	7.6
Latvia	..	74.3	..
Lithuania	71.5	74.1	2.6
EU28	..	80.6	..

Source: Eurostat.

aged to catch up with the EU as a whole in something as complex as health care, and Estonia has even reached the top.⁷

Yet geography is fate. The Baltic nations cannot escape the vicinity of Russia. Their trade with Russia contracted sharply during their early independence, but their transportation systems have been formed spokes in a wheel with Moscow as the hub. Every construction project of a road, railroad or pipeline has aroused an argument over whether a project should link the three Baltic countries or continue to go to Moscow.

Gas trade with Russia has caused the greatest problems. Russia's Gazprom interrupted its supplies repeatedly in the early 1990s, and Gazprom bought large shares in the gas companies in all three countries, becoming a monopolist in these markets. The Baltic countries have only been able to escape from Gazprom's monopolistic grasp over their gas markets in recent years by forcing Gazprom to sell its shares in the Baltic pipeline companies thanks to their implementation of the EU third energy package of 2009. The Baltic countries are also developing LNG imports and they have decided to build a gas pipeline from Poland. Russian counter sanctions against the EU were disproportionately directed against the Baltic states, since the latter exported a great deal of food to Russia.

Education usually takes a long time to develop, but the Baltic countries have made very speedy progress in this field too. Every third year, the Program for International Student Assessment (PISA) of the Organisation for Economic Cooperation and Development (OECD) carries out a major survey of the skills of half a million students aged 15-16 years. In 2012, the newest survey to date, Estonia caused a shock outcome by ranking second among the EU countries after the Netherlands in mathematics, while Latvia end-

⁷ See *Estonian Human Development Report 2011: Baltic Way(s) of Human Development: Twenty Years On, 2010/2011*, Tallinn: Eestil Koostöö Kogu.

ed up in the middle and Lithuania significantly below the middle (OECD 2014). All three beat the EU average with regard to share of youth completing higher education, with Lithuania leading the pack,⁸ though the quality of Baltic universities leaves a lot to be desired.

The ultimate question is whether the Baltic States can catch up with the United States in high-tech development. Arguably, Estonia can do so as it boasts the high-tech company Skype. Estonia's high-tech industry took off as an off-shoot to Finland's Nokia, but has also suffered with the telephony giant's decline. Latvia and Lithuania have not reached the same level as Estonia.

What can we learn from the Baltic successes?

The success of the Baltic states since regaining independence is stunning by any standards and has been multifaceted. They did well in every relevant regard: financial stabilisation, deregulation, privatisation, economic growth, social developments, democracy and good governance. They underscore that all good developments go together, rather than being subject to any trade-off, as so many argued in the early post-communist transformation.

It is often argued that the Baltic countries are 'special' in one way or another and therefore more virtuous: small and fearful of losing their independence once again, accustomed to major drama after the collapse of the Soviet Union, characterised by very open economies, etc. Yet, the point is that they chose the best policies and that these policies were supported by a broad popular and political consensus. The Baltic approach boils down to: why do anything worse than the best, when the best option is feasible?

The experiences of the Baltic nations show that it is best to target as radical and early a break from an old bad system as is politically possible. All three countries broke away from the rouble zone as early as they were able to do so in 1992 and thus escaped the rouble zone's hyperinflation of 1993. Estonia carried out the earliest and most radical deregulation of prices and foreign, and thereby managed both to stimulate its early economic growth and improve its governance the most, with Latvia doing the worst in both respects,

and Lithuania ending up somewhere in the middle. The speed of privatisation was staggered in the same fashion, which also contributed to growth and good governance. No post-communist country carried out as radical a lustration as Estonia, and none has achieved such good governance standards. Estonia's results in health care and education in particular are outstanding, while those of Latvia and Lithuania are highly respectable (Åslund 2013). Since many reforms were carried out in parallel, it is virtually impossible to distinguish the specific weight of each reform, but the pattern is overwhelmingly clear.

Interestingly, none of the Baltic countries maintained government stability. On average, the Baltic governments lasted for one year during their first decade of independence, illustrating that the importance of government stability is highly exaggerated. If major reform is required and corruption is a central concern, government stability is hardly desirable, as any government becomes complacent over time, and these small and vulnerable nations could not afford complacency at the time.

During the banking crisis in the mid-1990s after stabilisation had taken hold, the Baltic countries acted in a similarly rigorous fashion. Estonia reacted to the first banking crisis by quickly closing down the country's three biggest banks without any compensation for their former owners (Hansson and Tombak 1999). Latvia and Lithuania acted in the same way, thus minimising the cost of bank crises. During the global financial crisis in 2008/9, the Baltic countries acted in a similarly radical fashion once again by putting their house in order as fast as possible. In 2009, all three carried out fiscal adjustments of around 8–10 percent of GDP (Åslund and Dombrovskis 2011). Their quick cures had many advantages: they managed to keep their public debts limited and their market interest rates swiftly fell to a very low level. The radical fiscal adjustments prompted great structural reforms especially in Latvia and Lithuania, which had implemented far fewer reforms than Estonia. All three returned to economic growth after only two years of recession and have persistently maintained a much higher growth rate than the rest of the EU ever since.

The Baltic states have been the poster boys of the Washington consensus, showing that the latter works when it is sensibly and firmly applied. This does not mean that the Baltic countries have obeyed the IMF and the EU. In several major cases, they have chosen

⁸ Eurostat, 'Mortality and life expectancy statistics, EU28', http://ec.europa.eu/eurostat/statistics-explained/index.php/Educational_attainment_statistics.

policies opposed by these two organisations, but the Baltic governments have usually proven right.

From the outset of their independence, these nations wanted to become members of both the EU and NATO, a notion that most European governments perceived as fanciful at best; but eventually the Baltic countries were unanimously accepted.

In 1992, the IMF took a firm stand in favour of preserving the rouble zone, but all the three Baltic states broke out, and wisely so, thus escaping the zone's hyperinflation. By May 1993, the IMF had learned its lesson and helped Kyrgyzstan to break out of the common currency zone.

Estonia adopted a currency board in June 1992, which the IMF considered an obsolete and excessively rigid arrangement at the time, but Estonia was so successful that the IMF changed its policy in favour of currency boards in similar cases.

Estonia opted for completely free trade, going further than the EU favoured, while the IMF considered import tariffs an attractive source of revenue. Undoubtedly, this far-reaching liberalisation facilitated swift restructuring and thus early growth in Estonia.

Estonia carried out the greatest lustration of all, which the Council of Europe opposed as undemocratic (Laar 2002). However, that is a major cause of Estonia having less corruption than any other post-communist country.

During the renewed financial crisis in 2008/9, the dominant IMF advice was that all three countries needed to devalue their currencies, especially Latvia. This was a view strongly held by opinionated Anglo-American macroeconomists, and particularly by Paul Krugman. The Balts, however, insisted on not devaluing and that turned out to be the best solution. In order to resist devaluation, they pursued more radical and front-loaded fiscal adjustments than the parochial Anglo-American macroeconomists considered possible (Åslund and Dombrovskis 2011).

Many other examples could be presented, but the broader point is that the policy elite in the Baltic countries adopted the philosophy of the Washington consensus, and applied it in a pragmatic fashion to the existing conditions. There were, of course, some negative implications. The worst example was probably eco-

nomic overheating, especially in Latvia in the years between 2005 and 2007, when the Latvian government publicly advocated a policy of 'pedal to the metal'. After having faced the consequences of this flawed policy, however, the Latvians returned to their standard orthodox fiscal policies.

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