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Karsten Staehr*

Austerity in the Baltic States During the Global Financial Crisis

The Baltic states were arguably the countries most severely affected by the global financial crisis. This article discusses the boom preceding the crisis, the ensuing austerity policies and the economic effects of these policies. All three countries maintained fixed exchange rates, but the degree of fiscal austerity varied across the countries, with Estonia undertaking the strongest fiscal consolidation in 2009. The downturn was so swift and deep that expansionary policies were unlikely to affect short-term outcomes. Growth returned towards the end of 2009, largely driven by exports. The export performance cannot be directly linked to the austerity policies. The main lesson from the Baltics is that increased macroeconomic stability must be attained by avoiding overheating and unsustainable financial exposure. The challenge for the future is to ensure that austerity policies are implemented during economic booms.

The global financial crisis and the subsequent sovereign debt crisis in Europe spurred an intense debate about which policy measures to apply in order to bring the affected countries out of the crisis and restore stability. Central to this debate has been the question of whether austerity measures are beneficial or detrimental to growth. A number of papers discussing austerity measures in crisis countries in Western Europe were published in a Forum in *Intereconomics* earlier this year.¹ The Baltic states were not included, even though they arguably implemented far more sweeping austerity measures than any Western country after the outbreak of the global financial crisis.

The global financial crisis hit the Baltic states much harder than other countries in the EU. The cumulative output loss in 2008 and 2009 was 18.3 per cent in Estonia, 21.0 per cent in Latvia and 11.9 per cent in Lithuania. The unemployment rate shot up, and substantial emigration followed. The austerity measures implemented in the Baltic

states rested on two pillars: the countries retained their fixed exchange rate policies and embarked on substantial fiscal consolidations for 2009, which included tax increases and spending cuts, comprising inter alia reductions in public sector wages.

The three countries, and in particular Estonia and Latvia, have been hailed by some as successful austerity policy cases. Others have questioned this assertion and argue that a more expansionary policy mix would have benefited the countries.² This article discusses austerity in the Baltic states after the outbreak of the global financial crisis. It argues that the crisis and the austerity measures should be seen in light of the preceding boom, which made the countries particularly vulnerable to sentiment shifts and financial instability. The effects of the austerity measures are difficult to ascertain, but the article seeks to draw lessons from the timing and intensity of the economic downturn.

The pre-crisis boom

The Baltic states regained independence from the Soviet Union in 1991 and established market-based economies. In order to combat high inflation and to facilitate international trade, the countries established fixed exchange rate systems at an early stage; Estonia and Lithuania opted for a currency board, while Latvia chose a conventional but

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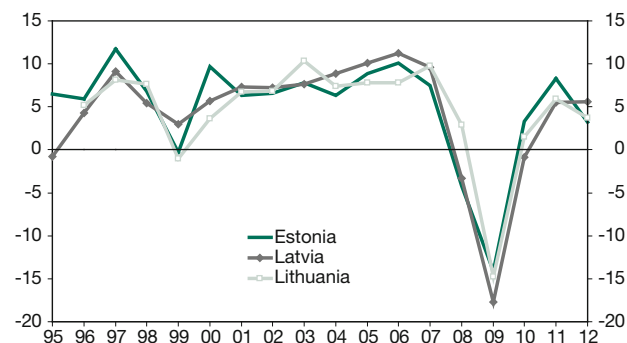
1 Austerity Measures in Crisis Countries – Results and Impact on Mid-term Development, in: *Intereconomics*, Vol. 48, No. 1, 2013, pp. 4-32.

2 An overview of the debate is provided in R. Kattel, R. Raudla: The Baltic Republics and the Crisis of 2008-2011, in: *Europe-Asia Studies*, Vol. 65, No. 3, 2013, pp. 426-449.

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Figure 1
Annual GDP growth, 1995-2012

in %



Source: Eurostat.

tight peg. The countries privatised most enterprises and cut spending to reduce the size of the public sector. All three countries have flat income tax systems.

Economic growth has been uneven but has exhibited substantial synchronisation across the three countries (see Figure 1). After the initial post-transition recessions, growth was restored in the mid-1990s, interrupted only by the Russian economic crisis in 1998-99. In the eight-year period from 2000 to 2007, average growth rates in the three economies hovered around eight per cent per year, by far the highest in the enlarged EU. During the same period, consumption and investment expanded and unemployment fell, earning the countries the nickname “the Baltic tigers”.³

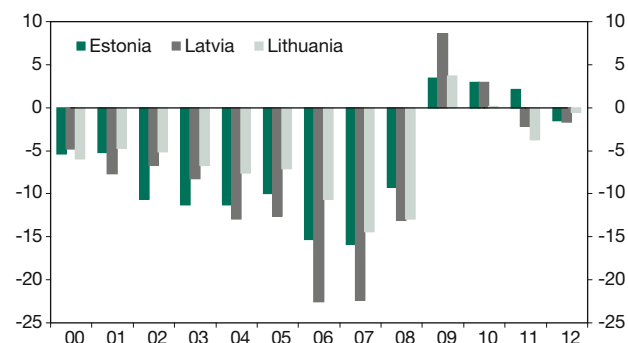
The strong growth performance in the period 2000-07 was accompanied by rapid changes across the economy. Consumption and investment increased quickly, aided by rapid credit growth and extremely low or even negative real interest rates. The construction sector boomed as real estate prices skyrocketed. Eventually, high rates of wage growth and inflation ensued. These developments culminated in 2006-07, with signs of overheating becoming increasingly evident.

The economic boom in the period leading up to the global financial crisis was in large part driven by favourable international financing conditions, as large amounts of capital flowed into the Baltic states and other countries in

3 A discussion of the boom in the Baltics is available in M. Reiner: Boom and Bust in the Baltic Countries – Lessons to be Learnt, in: *Intereconomics*, Vol. 45, No. 4, 2010, pp. 220-226.

Figure 2
Current account balance, 2000-2012

in % of GDP



Source: Eurostat.

the European periphery.⁴ The inflow of capital increased throughout the 2000-07 period, as illustrated by the development of the current account balance (see Figure 2). The current account deficit reached unprecedented levels of around 22 per cent of GDP in Latvia during 2006-07 but was also very large in the two other countries. Net foreign liabilities grew rapidly, and by the end of 2007 they reached 72 per cent of GDP in Estonia, 75 per cent in Latvia and 56 per cent in Lithuania.⁵

The capital inflows were the result of both supply and demand factors. An important supply factor was the global savings glut, which helped drive down yields in the US and Western Europe while enticing investors to search for higher yields in emerging markets. The EU negotiations and the eventual membership in 2004 improved confidence in the investment climate. The results were lower risk premia and improved access to external financing for enterprises, banks and other financial institutions. On the demand side, firms and households became increasingly optimistic about future growth prospects and borrowed in order to increase consumption and investment. The commitment to fixed exchange rates facilitated loans denominated in euros or other non-domestic currencies, which reduced borrowing costs and increased demand for credit.

The positive demand impulses meant that production levels gradually diverged from potential output, leaving an increasingly large positive output gap. Estimating output gaps is notoriously difficult, and the estimates are often

4 Z. Brixiova, L. Vartiab, A. Wörgötterb: Capital flows and the boom-bust cycle: the case of Estonia, *Economic Systems*, Vol. 34, No. 1, 2010, pp. 55-72.

5 Eurostat, 2013.

revised substantially as new data become available. This has also been the case for the pre-crisis output gap in the Baltic states, where the estimates have been revised upwards. The European Commission estimated in mid-2013 that the output gap in 2007 amounted to 12.0 per cent of potential output in Estonia, 11.5 per cent in Latvia and 9.8 per cent in Lithuania.⁶ The output gap may be taken as a proxy for the expected output decline in the absence of extraordinary demand impulses.

The Lithuanian economy appears to have been less overheated than the Estonian and Latvian ones. This conclusion is supported by estimates of the output gap. In 2000-07 the increase in growth rates in Lithuania appears to have lagged behind the increases in Estonia and Latvia by a year or so. This is also consistent with the relatively smaller current account deficits in Lithuania. A factor contributing to these differences was the switching of the Lithuanian peg from the dollar to the euro in 2002, which led to an effective appreciation of the Lithuanian litas in the following years as the euro appreciated relative to the dollar.

All three countries implemented measures to restrain credit growth from around 2005. In Estonia the weighting of housing loans used in the calculation of capital adequacy was increased, and bank reserve requirements were raised to a very high level. In Latvia the steering rate was raised several times, an option unavailable to the two other Baltic countries due to their currency boards. In 2007 Latvia introduced a tax on capital gains from real estate transactions, a maximum loan-to-value limit of 90 per cent on housing loans and stricter requirements for the verification of borrower incomes. In Lithuania reserve requirements were increased at an early stage, the calculation of capital adequacy was made more stringent, a ceiling was introduced on deductions of mortgage interest rate payments and the real estate register started to publish a house price index in order to enhance transparency.

The authorities in the Baltic states also used moral persuasion and sought to enter agreements with individual banks requesting lower lending growth and stable funding. The measures were not effective in the sense that credit growth and large current account deficits continued until shortly before the outbreak of the global financial crisis. It may be argued, however, that the measures made the banks more solid and reduced overall risks in the financial sector.

⁶ AMECO database, available at http://ec.europa.eu/economy_finance/db_indicators/ameco/.

Fiscal policy did not restrain unsustainable borrowing and excessive demand. The automatic stabilisers are weak in the Baltic states due to the small public sectors and flat income tax systems. There was also a discretionary loosening of fiscal policy. Abundant tax revenues allowed policy makers to cut taxes and increase spending while at the same time retaining budget surpluses in Estonia and roughly balanced budgets in Latvia and Lithuania. Supplementary budgets contributed to the somewhat expansionary fiscal stance.

There are several explanations for the lack of decisive counter-cyclical measures in the face of mounting financial and economic imbalances during the boom. It was difficult to argue for fiscal restraint when budgets were largely in balance or even showing surpluses. EU membership in 2004 also opened up additional job opportunities in Sweden, Ireland and the United Kingdom, and higher real wages following the boom were seen as a means for stemming emigration. Policy makers retained their commitment to small government and took the opportunity to lower taxes.

There are also more benign explanations for the lack of measures.⁷ First, the rapid development of the economic situation made it difficult to attain – in real time – a comprehensive picture on which to base macroeconomic policy decisions. Second, it was at the time unclear whether the large current account deficits and corresponding credit growth were merely temporary phenomena essentially representing an adjustment to a new level of financial depth made possible by EU membership and enhanced perspectives for long-term growth. Third, policy makers became increasingly convinced that the economic boom was sustainable. Estimates of the “natural” or long-term growth rate were continually revised upwards, suggesting that the observed rates of economic growth could be maintained over a long time span. The Baltic states were compared to the Asian tigers, which had maintained growth rates of five to ten per cent per year over extended periods of time.

In the first half of 2008, all three Baltic states found themselves in a vulnerable position with rapid credit growth, excessive capital inflows, large net foreign liabilities, property booms, and increasing wage and price inflation. At the same time, GDP started to decline. The question was not whether there would be an adjustment, but whether it would take the form of a gradual “soft landing” or a “hard

⁷ See e.g. A. Dabusinskas, M. Randveer: The financial crisis and the Baltic countries, in: M. Beblavy, D. Cobham, L. Odor (eds.): The Euro Area and the Financial Crisis, Cambridge 2011, pp. 97-128, Cambridge University Press.

landing” entailing large output losses. The advent of the global financial crisis made a hard landing inevitable.

The crisis

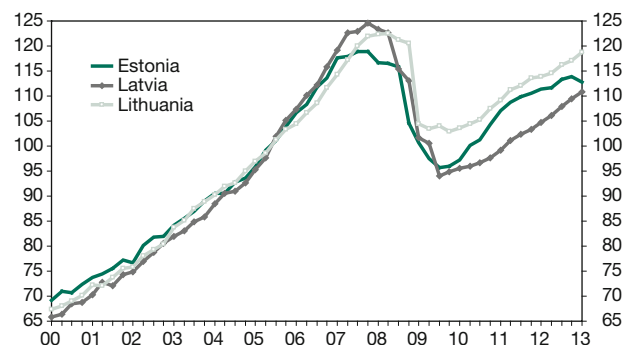
The crisis unfolding in the aftermath of the Lehman Brothers bankruptcy in September 2008 entailed several disruptions that affected European economies in various ways.⁸ The immediate consequence was a *flight to quality* and consequently a *sudden stop* of capital flows to the Baltic states (see the pronounced current account reversal from 2007 to 2009 in Figure 2). Export demand collapsed, which affected the Baltic states disproportionately, as their economies are very open and have large export sectors integrated into Western European supply chains. The crisis also impaired sentiment among households and firms, leading to lower consumption and investment demand. The situation was exacerbated by the disruption of financial markets, which spurred banks to tighten credit standards and made stock markets illiquid, in turn making it difficult for many enterprises to access working capital.

The collapse in demand and the disruption of financial markets led to large output contractions in the Baltic states. In the early stages of the crisis, the sectors most severely affected were construction, manufacturing and retail sales. Seasonally adjusted GDP for Estonia fell 13.1 per cent from the third quarter of 2008 to the first quarter of 2009, as shown in Figure 3. The corresponding decline was 11.9 per cent for Latvia and 13.9 per cent for Lithuania.

Although overall developments were similar across the three countries, a closer inspection reveals some important differences. Quarterly GDP growth slowed at different points in time, i.e. the beginning of 2007 in Estonia, the middle of 2007 in Latvia and the beginning of 2008 in Lithuania.⁹ Output declines following the bankruptcy of Lehman Brothers were similarly staggered. Estonia endured a marked decline as early as the fourth quarter of 2008, followed by another one in the first quarter of 2009. Latvia and Lithuania only saw rapid economic declines in the first quarter of 2009. Whereas output continued to decline in the following quarters in Latvia, it stabilised beginning in the second quarter of 2008 in Lithuania. Overall, the crisis appeared to hit Estonia first and Latvia the hard-

Figure 3
GDP, 2000-2013

index 2005 = 100



Note: Quarterly data adjusted for seasonality and working days.

Source: Eurostat.

est, while Lithuania had only a short-lived contraction of output.

The astonishing magnitude and pace of the output declines in the Baltic states after the outbreak of the global financial crisis were in large part a reflection of pre-existing vulnerabilities. Empirical studies have found that countries that had a large foreign debt stock, large current account deficits and a high share of exports before the crisis suffered the largest output declines after the outbreak of the global financial crisis. This seems to hold both for emerging market economies and for the EU.¹⁰ The fact that Estonia and Latvia experienced larger output declines than Lithuania is consistent with these findings.

The rapid decline in production was followed by increasing unemployment. The output decline particularly affected labour-intensive sectors such as construction, manufacturing and retail services. This effect was initially dampened somewhat, as some companies kept excess staff on the payroll until the depth of the crisis became evident. In the fourth quarter of 2009, the unemployment rate among 15-74 year-olds had risen to 18.2 per cent in Estonia, 21.3 per cent in Latvia and 17.4 per cent in Lithuania (see Figure 4).

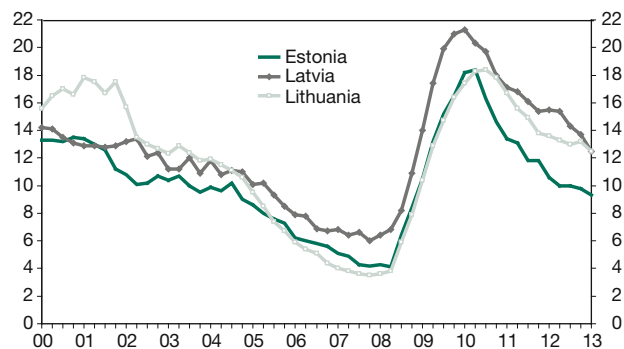
8 C. Purfield, C.B. Rosenberg: Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-09, IMF Working Paper, No. 10/213, 2010.

9 The downturn in Estonia from the second half of 2007 might also have been related to measures taken by Russia due to political disagreements, which led to reduced transit trade and the severance of other economic ties.

10 O. Blanchard, M. Das, H. Faruqee: The initial impact of the crisis on emerging market countries, Brookings Papers on Economic Activity, Spring 2010, pp. 263-323; and K. Kondor, K. Staehr: The impact of the global financial crisis on output performance across the European Union: vulnerability and resilience, in: L. Lacina, P. Rozmahel, A. Rusek (eds.): Financial and Economic Crisis: Causes, Consequences and the Future, Bučovice 2011, pp. 128-158, Martin Stříž Publishing.

Figure 4
Unemployment rates (ages 15-74), 2000-2013

in % of labour force



Note: Quarterly data adjusted for seasonality.

Source: Eurostat LFS.

Unemployment began to decline in early 2010. This partly reflected the upturn in the Baltic economies, which had already started in 2009, but it also reflected increasing emigration, particularly from Latvia and Lithuania. From 2007 to 2011, the official annual gross emigration rate increased from 0.3 per cent of the total population to 0.5 per cent in Estonia, from 0.2 per cent to 1.5 per cent for Latvia, and from 0.4 per cent to 1.8 per cent for Lithuania.¹¹ Emigration was clearly one way in which people in the Baltic states coped with the consequences of the crisis.

Policy measures

The abrupt spread of the global financial crisis after the bankruptcy of Lehman Brothers on 15 September 2008 came as a surprise. Policy makers in each of the Baltic states faced different decisions as the rapidly worsening economic situation fostered substantial uncertainty.

Public finances deteriorated markedly from the fourth quarter of 2008 as tax revenues fell and social spending increased somewhat due to negative GDP growth and rising unemployment.

The banking sectors in the three countries came under pressure; the wholesale funding of the banks was impeded by illiquidity in the funding markets in Western Europe. Estonia had almost entirely foreign-owned banks, while Latvia and Lithuania had both domestic and foreign banks. To avoid bank failures and excessive contraction of lending volumes, the governments worked to entice foreign owners to stay in the Baltic markets.

¹¹ Eurostat, 2013.

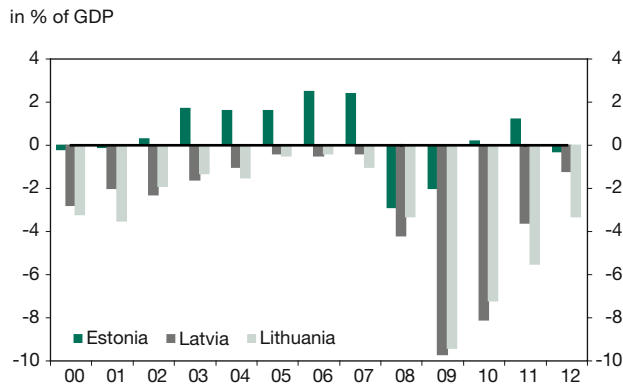
The situation was further complicated in Latvia, where the second largest bank, Parex Bank, faced severe problems in autumn 2008. The Latvian government intervened by nationalising and recapitalising the bank, but the result was still greater uncertainty about the health of the Latvian financial system. Given the extremely illiquid international and domestic capital markets, the government was unable to borrow in private markets and had to seek help from public lenders. In December 2008, Latvia signed an agreement with the IMF, the EU and a number of neighbouring countries, which agreed to make 7.5 billion euros available to Latvia. The agreement stipulated a number of conditionalities, including tight limits on future budget deficits.

The cornerstone of the policy response to the crisis in all three Baltic states was to maintain their fixed exchange rates towards the euro. This came in spite of numerous calls from foreign commentators and policy advisors to devalue the national currencies or let the exchange rates float and depreciate. The argument was that a depreciation of the nominal exchange rate would provide a badly needed demand stimulus by improving external competitiveness and helping exports and import-competing sectors.

The choice to retain the fixed exchange rates was based on economic and political arguments. A devaluation or float could have proven difficult to manage when financial markets were illiquid and unpredictable. The result could have been extreme exchange rate instability, which may have then led to further uncertainty and loss of confidence. Furthermore, if the result were a substantial depreciation of the exchange rate, those households and companies that had borrowed in euros or other foreign currencies would have seen higher debt servicing costs with knock-on effects on domestic demand and the real estate sector. Another, partly political, argument was that a large depreciation of the currency could be seen as expropriation or unjustified redistribution of resources. Finally, the countries were striving to join the euro area and therefore had joined the Exchange Rate Mechanism (ERM2), which required that the exchange rate with the euro remain within a ± 15 per cent band. A devaluation or float of the currencies would have jeopardised membership in the ERM2 and thus the prospects of joining the euro area.

In fiscal policy, the response to the crisis differed across the three countries. Until 2007 the budget in Estonia was balanced or had small surpluses, while the budgets in Latvia and Lithuania exhibited small deficits (see Figure 5). This picture changed markedly after the onset of the global financial crisis. In 2008 all three countries had

Figure 5
Annual budget balance, 2000-2012
in % of GDP



Source: Eurostat.

deficits of three to four per cent of GDP due to the downturn.

Despite a large output contraction in 2009, followed by a period of subdued economic growth, Estonia managed to keep the budget deficit at two per cent of GDP in 2009, and the budget remained roughly in balance in the following years. Latvia had a budget deficit of almost ten per cent of GDP in 2009 despite some budgetary consolidation in line with the requirements in the IMF-led lending package.¹² By 2012 the deficit was down to 1.2 per cent of GDP, well below the three per cent threshold stipulated in the Maastricht Treaty and the Stability and Growth Pact. Lithuania also exhibited a budget deficit of close to ten per cent in 2009, but the consolidation was more gradual than in Latvia, and in 2012 the deficit was still above three per cent of GDP.

It is difficult to provide quantitative estimates of budget consolidations, as there are numerous conceptual and methodological challenges. Data from the European Commission show the cyclically adjusted budget balance in 2009 to have been 0.8 per cent of GDP in Estonia, -5.9 per cent in Latvia and -6.2 per cent in Lithuania.¹³ This represents an improvement in the cyclically adjusted balance from the previous year of around five percentage points of GDP in Estonia, while the changes were small in Latvia and Lithuania. A study from 2010 suggests that the discretionary fiscal consolidation in 2009 was around seven per cent of GDP in Estonia, three per cent in Latvia

¹² The budgetary impact of the rescue of Parex Bank was around 0.9 percentage points of GDP in 2009, 1.7 percentage points in 2010, 0.2 percentage points in 2011 and 0.5 percentage points in 2012, see Bank of Latvia.

¹³ AMECO database, op. cit.

and one per cent in Lithuania.¹⁴ The OECD also calculates a net budget consolidation for Estonia in 2009 of around seven percentage points of GDP but stresses the uncertainties involved and the numerous ways such measures can be calculated.¹⁵

Overall, Estonia stands out for its remarkable fiscal consolidation in 2009, while Latvia and Lithuania adopted more gradual approaches to fiscal austerity.¹⁶ This is also noticeable from the tax measures undertaken in 2009. In Estonia the value added tax, social security contributions and excise taxes were increased, and a part of the private pension payments was diverted to the government budget. In Latvia the value added and excise taxes were increased, but the income tax rate was reduced. In Lithuania the income tax rate was similarly reduced, while the corporate, the value added and excise taxes were hiked. The bulk of the adjustment came from the expenditure side and comprised substantial cuts in employment and wages in the public sector, cuts in social programmes, postponement of investment, and structural reforms, e.g. mergers of hospitals and schools. In addition, a number of extraordinary revenue measures were taken, particularly in Estonia, where extra dividends from some state-owned companies and the sale of land brought in additional revenue.

The dynamics of the fiscal austerity in the Baltic states can be traced in more detail if the quarterly budget balance is considered (see Figure 6). The large deficits in the fourth quarter of 2008 and the first quarter of 2009 bear witness to the substantial downturns experienced in all three countries. The large Estonian budget surplus in the fourth quarter of 2009 stands out. This was mainly the result of large transfers to the budget from state-owned companies, but the return of economic growth at the end of the year also played a role.

Due to its strong fiscal consolidation in 2009 and the subsequent maintenance of a balanced budget, Estonia is the foremost exponent of austerity among the Baltic states. This raises the question as to how such strong fiscal consolidation was possible without public protests or

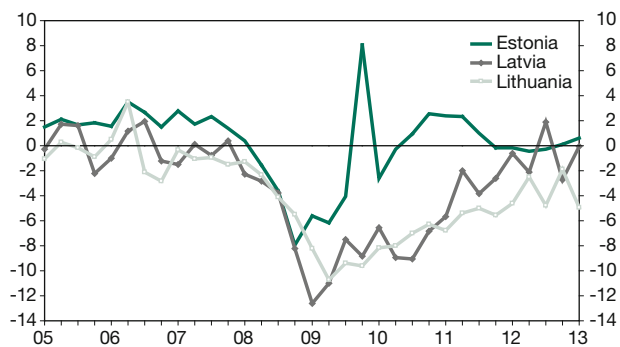
¹⁴ K. Staehr: The global financial crisis and public finances in the new EU countries in Central and Eastern Europe: developments and challenges, in: *Public Finance and Management*, Vol. 10, No. 4, 2010, pp. 671-712.

¹⁵ OECD Economic Surveys: Estonia 2011, pp. 53-55. C. Purfield, C.B. Rosenberg, op. cit., present data that suggest that the fiscal consolidation in 2009 was quite similar across the three Baltic states, but this appears unlikely given the size of the eventual budget deficits in Latvia and Lithuania.

¹⁶ See C. Purfield and C.B. Rosenberg, op. cit. and European Commission: *Economic Policy Challenges in the Baltics, Cross-Country Study*, in: *Occasional Papers*, Vol. 58, 2010.

Figure 6
Budget balance, 2005-2013

in % of GDP



Note: Quarterly data adjusted for seasonality. Data for Lithuania seasonally adjusted by the author using additive X12.

Source: Eurostat.

a political backlash.¹⁷ The question is particularly relevant given the problems faced by policy makers in other crisis countries seeking to implement austerity policies.

It is important to note that the fiscal consolidation undertaken in Estonia in 2009 was not a direct reaction to the economic downturn or rising unemployment. After joining the EU, the Estonian authorities sought to get their country into the euro area as soon as possible. The objective remained out of reach during the boom, as high inflation meant that Estonia did not comply with the price stability criterion of the Maastricht Treaty, but policy makers decided at the end of 2008 to use the opportunity afforded by the reduced inflationary pressure during the downturn to seek membership in the euro area by 2011. While the financial crisis eased the inflationary pressure, it brought compliance with the fiscal criterion into question, as the Maastricht Treaty stipulates that the budget deficit cannot exceed three per cent of GDP. Thus, fiscal austerity measures were taken to ensure that this was satisfied in 2009.

The fiscal consolidation in Estonia in 2009 was aided by a number of factors. The budget balance was strengthened through a number of measures with little immediate impact on everyday life. Among these were the revenues from extra dividends from state-owned companies and the sale of land. The diversion of pension payments into the budget instead of private funds had no immediate effect on household budgets.¹⁸ Moreover, the European

17 R. Raudla, R. Kattel: Why did Estonia choose fiscal retrenchment after the 2008 crisis?, in: *Journal of Public Policy*, Vol. 31, No. 2, 2011, pp. 163-186.

18 OECD, op. cit., p. 54, estimates that a little less than half of the discretionary budget improvement came from such measures.

Union accelerated the distribution of payments from the structural and social funds. Some of the budget cuts were in areas where spending had been committed during the boom period but activities had not yet been implemented.

In almost all the years since regaining independence, Estonia had kept its budget balanced or in surplus. This meant that Estonia had essentially no (gross) public debt at the outbreak of the crisis and had never issued government bonds. Financing substantial deficits would have been complicated given the lack of a domestic bond market.¹⁹

There were no manifestations of popular discontent in Estonia, and the government responsible for the austerity measures was re-elected with a strengthened mandate in a general election in March 2011. The public acceptance of fiscal austerity may have been because the budget in Estonia was usually in balance and people had come to expect this outcome at all times. The public might also have supported the goal of using the downturn as an opportunity to join the euro area and the fact that the government signalled commitment and a clear direction of policy.

The effects of austerity

It is not easy to assess the effects of the austerity measures taken in the three Baltic states and even more difficult to assess the effects of alternative measures such as expansionary policies. At the outset, the austerity measures were not based on any clear conception of the management of the crisis, but after a while the policies became linked to the concept of *internal devaluation* as a means of restoring economic growth.²⁰

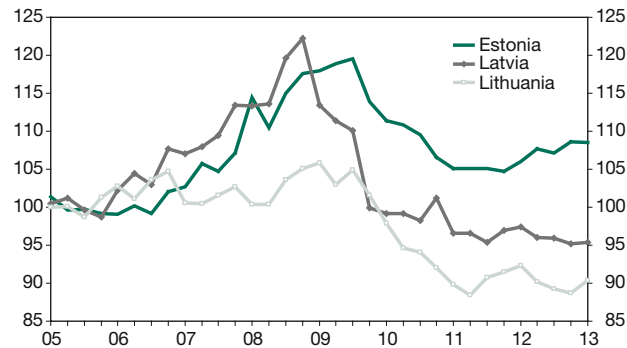
The austerity policies were successful in the sense that the Baltic states managed both to retain their fixed exchange rate systems and consolidate their government budgets. The countries remained in the ERM2, allowing Estonia to adopt the euro in 2011 and Latvia in 2014. The banking sectors held up relatively well, partly due to support from foreign ownership. Non-performing loans generally remained manageable and the number of personal bankruptcies stayed within reasonable bounds. A Lithuanian bank went under in 2011, taking its Latvian subsidi-

19 The government had accumulated stabilisation reserves of 2.5 per cent of GDP by the end of 2007 and also had a substantially larger liquidity reserve fund available. The reserves facilitated liquidity management and might also have given the authorities a stronger position when negotiating credit lines with lenders.

20 C. Purfield, C.B. Rosenberg, op. cit.

Figure 7
Real effective exchange rate based on unit labour costs, 2005-2013

index 2005 = 100



Note: Quarterly data adjusted for seasonality and working days.

Source: Eurostat.

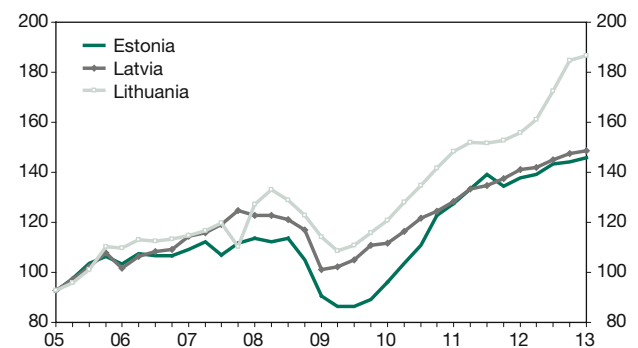
ary with it, but the event did not lead to wider financial instability.

As regards the development of output, an obvious observation relates to the timing of events. The bulk of the output decline occurred in the fourth quarter of 2008 and the first quarter of 2009, and it is unlikely that any currency depreciation in late 2008 or early 2009 would have been able to reverse the initial GDP decline, since the trade balance typically reacts with a substantial delay (the j-curve effect). A more expansionary fiscal policy might similarly have had a muted effect due to implementation lags and sluggish effects. It is also worth noting the magnitudes involved. Annual data show the accumulated output loss in 2008-09 to have been between 12 and 21 per cent in the Baltic states. Even in a hypothetical best-case scenario, expansionary fiscal policy would only have had a small impact on such output declines, as the deficits would otherwise have become extremely large and impossible to finance.

The conclusion is that no realistic policy prescription would have been able to substantially avert the output decline in 2008-09. The decline was in large part the result of the vulnerable position of the Baltic states before the crisis, when large positive output gaps had opened up after years of demand-driven growth facilitated by capital inflows. This conclusion still leaves the question of the appropriate policy mix after the immediate effects of the global financial crisis had vanished. Were austerity policies effective in stimulating GDP growth and employment, or would expansionary policies have been more appropriate?

Figure 8
Commodity and service export, 2005-2013

volume index 2005 = 100



Note: Quarterly data adjusted for seasonality and working days.

Source: Eurostat.

The Baltic states improved their international price competitiveness from 2009 as real unit labour costs declined (see Figure 7). Before the crisis, real unit labour costs had increased rapidly in Estonia and Latvia but had been more stable in Lithuania, where the pre-crisis boom was less extreme. As the crisis unfolded, the decline in real unit labour costs was largest and fastest in Latvia, while the declines were more gradual in Estonia and Lithuania. The substantial decline in real unit labour costs can be seen as a realisation of an internal devaluation in which competitiveness was improved through wage and productivity adjustments and without nominal depreciation.

There is no simple causal link from the austerity policies to the improved competitiveness. The deep downturns meant that the least productive workers were laid off and high unemployment restrained wage pressures. The dramatic reversals of capital flows are also likely to have contributed to improved competitiveness.²¹ It cannot be ruled out, however, that the austerity policies, and in particular the lowering of public wages, might have contributed to a lowering of wages in the whole economy and hence improved competitiveness.

Output reached its lowest level in the third quarter of 2009 in Estonia and Latvia and as early as the first quarter of 2009 in Lithuania. In all cases, the return to growth was driven by strong export performance, with export vol-

²¹ H. Gabrisch and K. Staehr: The Euro Plus Pact: competitiveness and external capital flows in the EU countries, IOS Regensburg Working Paper, No. 324, 2012.

umes up by 40 per cent or more from 2009 to 2013 (see Figure 8).²²

The striking increase in exports cannot, however, be taken as an indication of the success of austerity and internal devaluations in the Baltic States. First, the rapid export growth in 2009 took place against the background of an extraordinarily deep contraction in exports, thus some rebound was to be expected. Second, exports picked up while unit labour costs were still at or above their 2007 level. Empirical studies typically find that short-term export price elasticities are relatively small and subject to time lags (the j-curve effect). Finally, the sudden decline in domestic demand may have led to excess capacity and compelled producers to increase exports; a study on Portuguese export dynamics suggests that domestic demand has substantial explanatory power.²³ In short, although exports have played a major role in the return to growth in the Baltic states since 2010, it is difficult to establish a link between austerity policies and export performance.

The question remains as to whether more expansionary policies could have brought about a stronger growth performance from 2009 and, in turn, dampened the rise in unemployment and emigration. The countries had negative output gaps of around ten per cent of GDP in 2009 and only slightly less in 2010, suggesting substantial slack in the economies. Given the staunch political commitment to fixed exchange rates in the Baltic states, it is most relevant to consider fiscal measures. No studies investigating the effect of fiscal policy measures on output in the Baltic states have been published. A study of expansionary fiscal policy in other European transition countries indicates that the effect, though varying across countries, remains modest or non-existent.²⁴ Another study finds non-Keynesian effects of fiscal policy for a panel of ten EU countries from Central and Eastern Europe, but the results are not very robust and depend on the composition of the fiscal policy measures.²⁵ More empirical research analysing the effect of fiscal policy measures in the Baltic states is warranted.

22 The very strong export performance in Lithuania in 2012 can partly be attributed to a very good harvest and larger exports from the Mazieki-ai oil refinery.

23 P.S. Esteves, A. Rua: Is there a role for domestic demand pressure on export performance?, Banco de Portugal Working Papers, No. 03/2013, 2013.

24 R. Mirdala: Effects of fiscal policy shocks in the European transition economies, in: Journal of Applied Research in Finance, Vol. 1, No. 2, 2009, pp. 141-155.

25 P. Borys, P. Cizkowicz, A. Rzonca: Panel data evidence on effects of fiscal impulses in the EU New Member States, Munich Personal RePEc Archive, 2011, available at <http://mpra.ub.uni-muenchen.de/48243/>.

The size of the fiscal multiplier has been subject to much discussion since the outbreak of the global financial crisis.²⁶ It has been argued that the multiplier might be large during the crisis as low interest rates reduce the risk of crowding out. In autumn 2012 the IMF presented estimates of the fiscal multiplier during the crisis based on growth revisions in a sample of 28 advanced economies.²⁷ The result was an upward revision of the multiplier from about 0.5 to between 0.9 and 1.7. It is unclear to what extent these higher estimates of the fiscal multiplier apply to the Baltic states, as their economies are smaller and more open than those in the sample. In any case, a substantial fiscal expansion is possible only if the resulting deficit can be financed at a reasonable interest rate and at least without leading to a fiscal crisis. It remains uncertain whether the Baltic states would have been able to finance substantial budget deficits.

Discussion

The Baltic states embraced austerity after the eruption of the global financial crisis in 2008 by retaining their exchange rate pegs and consolidating public finances. Austerity policies have subsequently become the subject of heated debates in academic and policy-oriented circles. Proponents argue that austerity restored stability and confidence and facilitated an internal devaluation that restored competitiveness, thus forming the basis for a quick return to growth. Critics point to the social costs of subdued income levels and continued high unemployment five years after the outbreak of the crisis and argue that exchange rate depreciation and expansionary fiscal policies would have been beneficial. The debate on austerity in the Baltics is in many ways a debate on whether the glass is half full or half empty.

This paper argues that the vulnerabilities caused by the pre-crisis economic boom played a major role for the subsequent developments. The demand-driven boom had become unsustainable by 2008, as is illustrated by the rapidly increasing net foreign liabilities and large positive output gaps. The sudden stop that accompanied the global financial crisis made deep downturns unavoidable. Due to the speed and intensity of the downturn, the immediate policy stance was arguably of little importance in the short term. Possible longer-term effects of more expansionary policies are difficult to assess, in part due to a lack of empirical studies.

26 G.J. Müller: Fiscal austerity and the multiplier in times of crisis, German Economic Review, forthcoming.

27 IMF: World Economic Outlook, 2012.

The upshot is that most of the downturn after the outbreak of the global financial crisis was a consequence of pre-crisis overheating and financial exposure in the Baltic states. In this respect, the austerity measures came too late. This suggests that the Baltic states, in line with most other European countries, should not shy away from austerity measures, including contractionary fiscal policy, but such policies should preferably be applied during booms.

The Baltic states are small and open economies seeking to catch up with their Western European neighbours. Since the countries have adopted the euro or are committed to adopting it, an independent monetary policy is not a part of the macroeconomic toolbox. The challenge is to ensure that the cycle of booms and busts of the last 20 years does not recur during the remainder of the catching-up process.

It is important that the catching-up process is sustained by a high growth rate of potential output rather than by demand growth that leaves the countries vulnerable. The countries must raise medium-term productivity growth (and hence the “speed limit”) by continuing structural reforms within education, infrastructure, social policy, public administration and governance.

The Baltic states will remain vulnerable to developments in financial markets, as changes in capital inflows, credit and sentiments will affect demand and economic activity. This underscores the importance of measures that discourage financial imbalances and the accumulation of excessive liabilities. Such measures could target the supply of credit through macroprudential regulation and discretionary measures aimed at the financial sector, but they could also target the demand for credit through changes in taxation, down-payment rules, borrowing requirements and stamp duties. It is also important for fiscal policy to become clearly counter-cyclical, which implies that automatic stabilisers must be allowed to operate and that general tax cuts and discretionary spending increases should be avoided during upturns. Preparedness might also be enhanced by the erection or expansion of government reserve funds.

The global financial crisis and its reverberations have fundamentally altered the economic landscape in the Baltic states. The depth of the crisis was a reflection of unsustainable pre-crisis booms, and the subsequent economic policies might have been of lesser importance. The challenge is to take steps to ensure that unsustainable booms do not develop and that austerity measures are implemented if such booms appear anyway. In this respect, the Baltic states do indeed share many features and challenges with the rest of the countries in the European Union.