The Baltic States and the Crisis of 2008-2011

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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.

1. Introduction

Europe, and the rest of the developed world along with it, seems to be mired in a debate over whether austerity brings growth or not. While there seem to be less and less candidates for actual European cases where fiscal retrenchment resulted in economic recovery and growth, the Baltic states persistently attempt to claim that austerity works. All three countries were painfully hit by the global financial crisis in 2008-2009 and topped the global charts in GDP contraction; all three responded to the crisis by adopting a series of austerity measures. In 2010, the Baltic states 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 the policy circles both inside the Baltic states but also internationally to draw a causal conclusion and to claim that it was the austerity that led to growth. This has led to well publicized spats in the media; so, for instance, Paul Krugman drew the ire of the Estonian president by questioning the impressiveness of the Baltic recovery, noting that the data show a huge downturn followed by positive but modest growth.[2] This was preceded by a high level conference in Riga, Latvia where IMF's Christine Lagarde and others praised

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[2] The debate between Krugman and President Ilves took place in blog posts and twitter tweets, mostly in June 2012, a brief summary can be found here: http://www.washingtonpost.com/blogs/reliable-source/post/estonian-president-hammers-paul-krugman-on-twitter/2012/06/07/gJQApU0zLV_blog.html-. See also Grennes 2012.

the austerity measures applied there and in the rest of the Baltics.[3] Most of these debates have been rhetorically charged leaving little room for reflection and details. However, the question of whether austerity works or not, and whether the Baltics managed indeed to recover with the help of fiscal measures, remains highly relevant and deserves careful consideration, especially if their model of “crisis resolution” via 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 the Baltic crisis management and its impact on the economy. While our approach is clearly informed by economic heterodoxy, we follow what can be called historical institutionalist perspective in which “temporal sequences, durations, paths, and cycles are important explanatory factors” (Pollitt 2012, 39), and thus we concentrate our discussion on institutional and policy processes and on their description.

Specifically, this paper sets out to explore the following questions: First, how did the Baltic states 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 neoliberal 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 neoliberal policy paradigm characteristic to the region since early 1990s, but that the crisis in fact radicalized 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.” (2010, 101; see also Åslund 2009 and 2012) We will argue that there are a number of unique features in all three Baltic countries’ political economies that made such a radicalization possible. However, these unique features make it almost impossible for the Baltic experience to be replicable anywhere else in Europe.

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

The paper is structured as follows. We will first give a brief overview about the origins of the crisis and proceed to the discussion of policy responses. We will then examine how the societies reacted to the governments' anti-crisis measures and inquire into factors that help to understand 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.

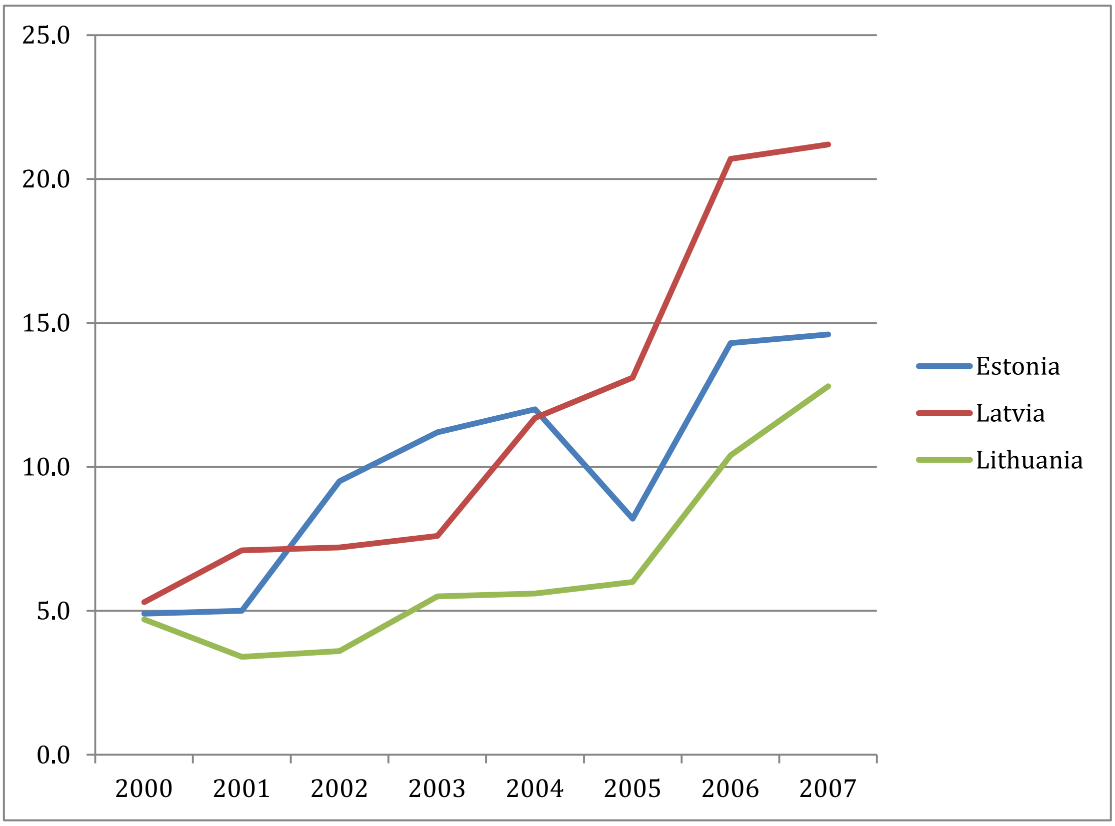
2. Origins of the Crisis

Since regaining independence, the Baltic countries have stood out among the transition countries in the CEE region as radical pro-market reformers. In early 1990s, all three countries adopted a mix of policies advocated by the Washington consensus: currency boards with fixed pegs (acting as nominal anchors for securing stabilization), fiscal discipline, liberalization of prices and trade, and wide-ranging privatization. The economic environments created as a result of such neoliberal policy choices appeared to have put the Baltic countries on an impressive growth track, only interrupted by the Russian crisis at the end of 1990s. After accession to the EU, all three economies witnessed an unprecedented boom; between 2004 and 2007, the Baltic countries stood out among the EU 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, like double-digit inflation, a housing boom,[4] appreciating real exchange rates, accelerating wage growth (that exceeded productivity growth, especially in Latvia and Estonia, 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 (referring to aggregate spending in the economy, minus net exports), and were channeled into real estate, construction, financial services and private consumption. Figure 1 depicts financial account dynamics in all Baltic economic during the boom years 2000-2007. All three economies were rapidly building up debt towards the rest of the world. Thus, during the last boom year, 2007,

[4] Between 2003 and 2007 Latvia witnessed more than tripling and Estonia and Lithuania more than doubling of the real estate prices (European Commission 2010, 26).

the current account deficits 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; European Commission 2010).[5]

Figure 1. Financial account developments in the Baltic countries, 2000-2007 (as % of GDP).



Source: Eurostat.[6]

Beneath such massive growth of imbalances all Baltic economies experienced rapid wage growth with slow gains in productivity. Figures 2 and 3 show the evolution of nominal wage costs and labor productivity (as measured against Germany's productivity) in Baltic economies in 2000s. As we can see, all Baltic economies were rapidly losing competitiveness in addition to becoming massively indebted.

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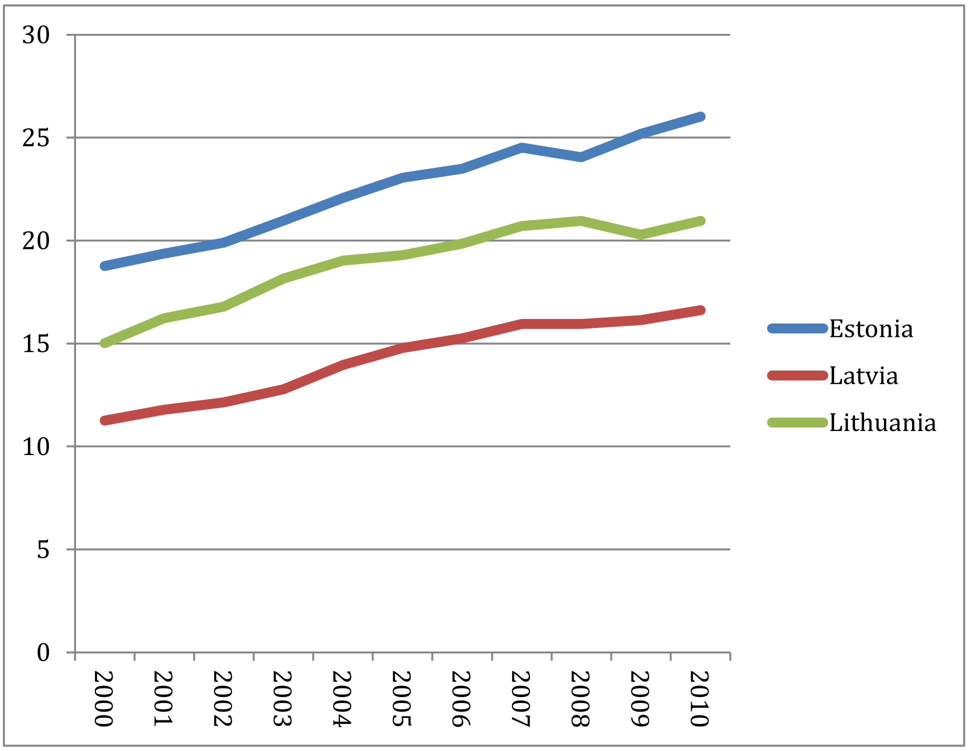
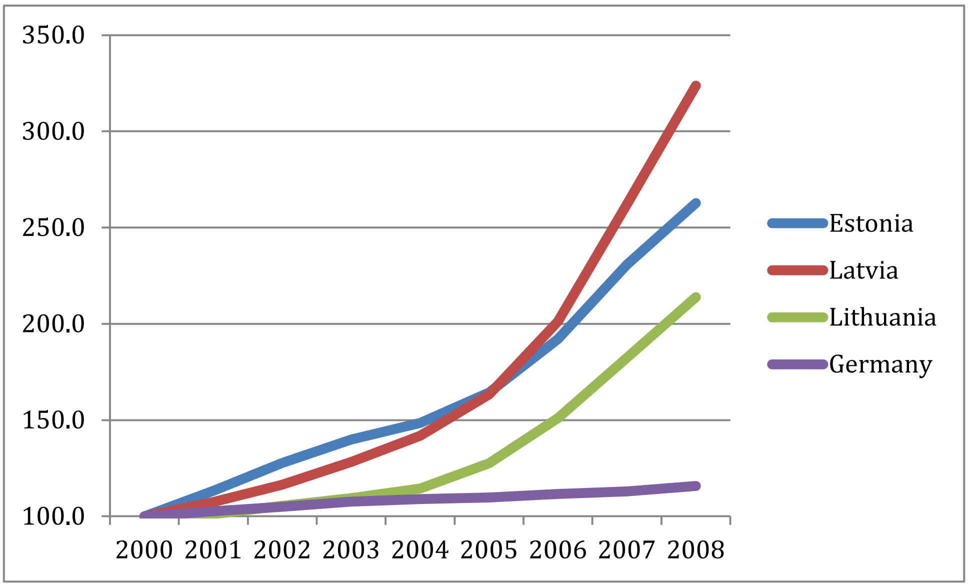
[5] European Commission (2010, 46) notes that the growth rates of *mortgage loans* were especially high in the Baltics – with growth rates "among the highest recorded in emerging economies in recent times". See Herzberg (2010) for a more detailed discussion on the private sector debt overhang in the Baltics.
[6] All references to Eurostat refer to the statistics database available at http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database.

Figure 2. Real labor productivity in the Baltics (as % of German labour productivity), 2000-2010 (Euro per hour worked).



Source: Eurostat; calculations by the authors.

Figure 3. Labour cost index in the Baltics and Germany, 2000-2008 (2000=100).



Source: Eurostat.

Latvia came to be the most overheated of the three and Lithuania the least: Latvia had the highest wage growth and the lowest productivity growth (Figures 2 and 3); it 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 kind of a “lulling effect”, which made the political elites oblivious to the few warning signals (pointing to increasing external imbalances) that managed to break through. Furthermore, the governments even added to the overheating of the economies via cyclically loose fiscal policies (including the spending of boom-generated windfall revenues via supplementary budgets adopted in the course of the fiscal year) – although more so in Latvia and Lithuania than in Estonia (where the budget surpluses were accumulated into a rainy-day fund, called stabilization fund in the organic budget law) (Purfield and Rosenberg 2010; Deroose et al. 2010).[7] At the backdrop of such optimistic oblivion, the magnitude of the economic downturn certainly came as a surprise to the local policy-makers. However, also in academic circles critical analyses of the Baltic boom were rare.

The crisis hit all Baltic countries quickly and painfully. The domestic bubbles burst in early 2008, when the credit supply decelerated, as the 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 the 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 (25.9%), followed by 15.8% in Latvia and 14.6% in Lithuania.

Purfield and Rosenberg (2010, 8) note that the decline in the real sector was driven by two factors: shrinking exports and the fall in domestic demand; the deterioration of the private sector demand, resulting from credit squeeze and plunging consumer confidence, was further aggravated by reduced public sector spending.

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

Table 1: Selected economic indicators for the Baltic states, 2007-2010.

	2007	2008	2009	2010	2011
Real GDP growth (% change)					
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
Inflation (HICP) (annual % change)					
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) (EU 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 wages and salaries (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

Source: Eurostat (data retrieved in July, 2012)

Given such massive drops 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, all three countries, the unemployment rates were almost 3-4 times higher at the end of 2009 than they had been in 2007 (Masso and Krillo 2011, 9).

3. Responses to the Crisis: Changes in Policies and Institutions

As the crisis gathered steam in 2008, most countries entertained, and many also implemented, some forms of Keynesian stimulus packages. As John Cassidy quipped, "We were all Keynesian, and we all knew it – for about five minutes." (Cassidy 2011) The Baltic states did not experience those five minutes. While the basic response in all Baltic countries to the crisis was very similar – undertaking fiscal retrenchment, combined with maintaining the fixed pegs and not engaging in expansionary monetary policies – then the details in political economy, external environment and political cycle made the nature of responses and their fiscal, economic and political success different but only in details within the same broader paradigm. In the following, we will describe the policy responses and institutional changes undertaken by the Baltic governments in 2008-2010.

3.1. Fiscal Consolidation

As can be seen from Table 2, all three Baltic countries implemented sizable fiscal consolidations in 2008-2010. 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 were around 8-9% of GDP (Convergence programmes of Estonia, Latvia and Lithuania 2009-2010).

Table 2. Scope of fiscal consolidation (as % of GDP) in the Baltic countries, 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

Source: OECD 2011, Convergence programmes of Estonia, Latvia and Lithuania.

3.1.1. Why Was Fiscal Consolidation Chosen?

Broadly speaking, in order to deal with the crisis, the Baltic countries all opted for internal devaluation (instead of external devaluation), which implied the downward adjustment of nominal wages throughout the economy and fiscal contraction. The obvious question to ask here is: 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 while a number of foreign analysts advocated external devaluation as an adjustment strategy for the three Baltic countries (*inter alia*, Krugman, Rogoff and Roubini), then domestically, this option was, for post part, not even given serious consideration (see also Raudla and Kattel 2011a,b). The Baltic states' governments were heavily 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,[8] external devaluation would have imposed large costs on significant parts of the population and reduced private sector net worth (and potentially led to a surge in loan defaults, with contagion effects to the rest of the economy) (see also Purfield and Rosenberg 2010; Raudla and Kattel 2011a). Kuokstis and Vilpisauskas (2010) note that among the local policy-makers and experts, the prevalent causal belief was that devaluation of the currency would have been "clearly wrong and potentially disastrous".[9] It was felt that by devaluing the currencies, the governments would lose an important focal point for action. In addition, none of the Baltic countries had had experience with alternative exchange

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

[9] As Hansen (2010) put it, "In all Baltic countries 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".

rate regimes and hence no existing competencies to manage “non-automatic” systems (see Raudla and Kattel 2011a). Internal devaluation as an adjustment strategy was also supported by the European Union, who 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 and Vilpisauskas 2010; Åslund 2010).[10] In addition, when explaining the decision of all three Baltic governments to opt for internal devaluation, instead of external devaluation, the (national) symbolic importance that 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 early 1990s had coincided with the restoring of independence, democratization 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 the confidence in the peg and to aid internal devaluation, the Baltic governments also hoped that fiscal retrenchment would act as a signaling device, restore the confidence of the markets and secure the return of foreign investments (which were perceived to be paramount for bringing the countries back to the growth path) (see, for example, Raudla and Kattel 2011a,b for a detailed analysis of the austerity discourse in Estonia).

3.1.2. The content of austerity measures

Fiscal consolidation in all three countries entailed both expenditure and revenue measures (see Table 3).[11] The relative importance of the measures *shifted in time* though 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 earlier phase of adjustment than later on. In Estonia, the

[10] The IMF, in contrast, initially advocated external devaluation.
[11] Detailed discussion of the austerity measures undertaken in all three Baltic countries is provided in Raudla and Kattel (2012).

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 side 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: OECD 2011, Convergence Programmes

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 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 and Krillo 2011).[12] Salary 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 2010b). The staff expenditure (the remuneration fund) decreased by 17% in Lithuania (between 2008 and 2011) (Nakrošis et al. 2012). It can be observed that the wage cuts were more "progressive" (with higher wages taking a larger hit) in Lithuania than in Estonia and especially Latvia. In Lithuania, the salary cuts varied

[12] These numbers reflect annual wage changes in the entire public administration (including also the local governments) (Masso and Krillo 2010).

from 8% to 36%, depending on how high their previous wages had been, with the highest earners taking the largest hits (Nakrošis et al. 2012).[13] In Estonia, teachers were subjected to a lower wage cut than the rest of the public sector employees (Jõgiste et al. 2012). In Latvia, in contrast, the education and health care sectors were particularly hard hit by the wage cuts; for example, in the fall of 2009, teachers' gross monthly wages were reduced from 494 euros to 358 euros.

With regard to social benefit outlays, pensions and sickness benefits took the first hit. Sickness benefits were curtailed in all three countries (either in the form of cutting the benefits for the first days of sick leave, like in Estonia, or in the form of reducing the payments that exceeded a certain threshold by 50% like in Latvia). In Estonia, the pensions were increased by 5% instead of following the indexing formula that would have foreseen a 14% increase; in Latvia and Lithuania, the old-age pensions were cut, but in both countries the cuts were contested by judicial review and were found unconstitutional.[14] In Estonia the foreseen increase in unemployment insurance benefits was postponed; at the same time, those parts of the new employment contracts law that made redundancies and layoffs easier, were still enacted (in other words, from the "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 pillar to the public PAYG pillar.[15]

With regard to changes to tax codes, then instead of increasing *one* particular tax significantly, the governments opted to spread the tax increases across a large number of different taxes, both direct and indirect. Besides increases in nominal tax *rates*, the option of broadening tax *bases* was extensively utilized by the Baltic governments

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[13] In 2009 the wages of politicians, judges and public servants were reduced by an average of 10%; the wages of employees of budgetary institutions and organizations were reduced by 8% on average and the salaries of teachers and employees in the social sector and culture were cut by 5%. Though the salary reductions were meant to be temporary in 2009, these were extended in 2010.

[14] According to the constitutional court ruling in Latvia the government had to cancel the pension cut and compensate the unpaid parts of the pensions. Still, the indexation of pensions was frozen by the end of 2013. In Lithuania "progressive" cuts to pensions were undertaken in 2010, with the beneficiaries of larger pensions facing larger cuts.

[15] In Estonia, the state-financed contributions to the second pillar were stopped from 1 July 2009 until 31 December 2010.[15] 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).[15] The savings from this measure were considerable, ranging between 0.5% and 1% of GDP per year.

(especially in Latvia and to a lesser extent in Lithuania). Value added tax and excise taxes (on cigarettes, alcohol and fuel) were increased in all three countries. [16] With regard to the personal income tax, all three countries broadened the tax *base* by reducing the number of deductibles. The income tax *rates* themselves also saw some changes. In Estonia, the planned reduction of income tax rate was postponed. In Latvia, the income tax rate was subject to fluctuations: PIT was first decreased from 25% to 23% in 2009, then increased again to 26% in 2010, followed by lowering it to 25% in 2011. In Lithuania the 2009 increase in CIT rate (from 15% to 20%) was subsequently reversed in 2010. In Estonia, the unemployment insurance contributions were increased from 0.9% to 4.2% of gross wages. In Latvia, the employee's social contribution rate was increased from 9% to 11% in 2011. Latvia also introduced progressive real estate tax (with higher rates applying to buildings with higher value) in 2009 and doubled the tax rates in 2011; Lithuania introduced the 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*, then in Lithuania the picture is more complex: besides tax increases, there were also some decreases (e.g. the reduction of PIT rates and adding exemptions to excise duties). In the fall 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 (like taking out dividends from state-owned enterprises and selling the shares of the Estonian Telecom (on a condition that additional dividends would be paid out in 2009 and 2010) (Raudla 2011).[17]

3.1.3. Similar Austerity Measures, Different Fiscal Outcomes?

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

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[16] 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.
[17]The revenue generated by additional dividends amounted to 0.78% of GDP in 2009 and 0.31% of GDP in 2010.

Table 4: Fiscal indicators for the Baltic countries, 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.

Indeed, although all three Baltic countries implemented sizable fiscal adjustments in 2009-2011, there was, both within the Baltic states as well as without, a rather strong perception that Estonia was significantly "more successful" with fiscal consolidation than other Baltic countries. Such diverging fiscal performance of the three Baltic countries was especially visible 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, with Lithuania somewhere in between. How to account for such diverging fiscal outcomes? Altogether, the Estonian "success" can be attributed to a combination of political, institutional and economic factors.

First – timing. The Estonian government started consolidating the budget already in 2008, whereas the other two governments still foresaw significant expenditure increases for the original budgets of 2009. Indeed, in terms of timing, the three Baltic economies have 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 has led the way, with Lithuania being in many cases the last to adopt certain reforms.[18] This is also true of growth dynamics (GDP growth, exports, etc) where Estonia usually leads and Lithuania is the last of the pack. True to the pattern, Estonia's economy showed already in early 2008 clear signs of slowing down and this gave Estonia's policy makers something of an advantage. Latvia and Lithuania remained particularly optimistic and engaged in expansionary fiscal policies still in 2008 (e.g. by increasing social expenditures), whereas Estonia started to roll back expenditures already in 2008. (Purfield and Rosenberg 2010, 16; Deroose et al. 2010, 6) Indeed, 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.[19]

Second – the availability or lack of reserves. While the fiscal policies in all three countries had been pro-cyclical in the run-up to the crisis, leading to underlying fiscal unbalances in cyclically adjusted terms, they had been the least pro-cyclical in Estonia, where the government had accumulated significant reserves by channeling the windfall revenues into a rainy day fund, which amounted to as much as 9% of GDP in the wake of the crisis (see, e.g. Klyviene and 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 percent of GDP in Latvia and Lithuania (Purfield and Rosenberg 2010).

Third – the ownership structure of banks. Figure 4 shows the structure of Baltic financial sectors by ownership. As can be see, the asset share of foreign owned banks was almost 99% in Estonia, while amounting to just above 60% in Latvia. Given the need to bail out the Parex Bank in the absence of fiscal reserves, the Latvian government had to ask for international support from the IMF, the EU and Nordic countries in November 2008.[20] The package that was approved in December/January

[18] For example, Lithuania explicitly waited in early 1990s to see how currency board works in Estonia (Hanke 2009).

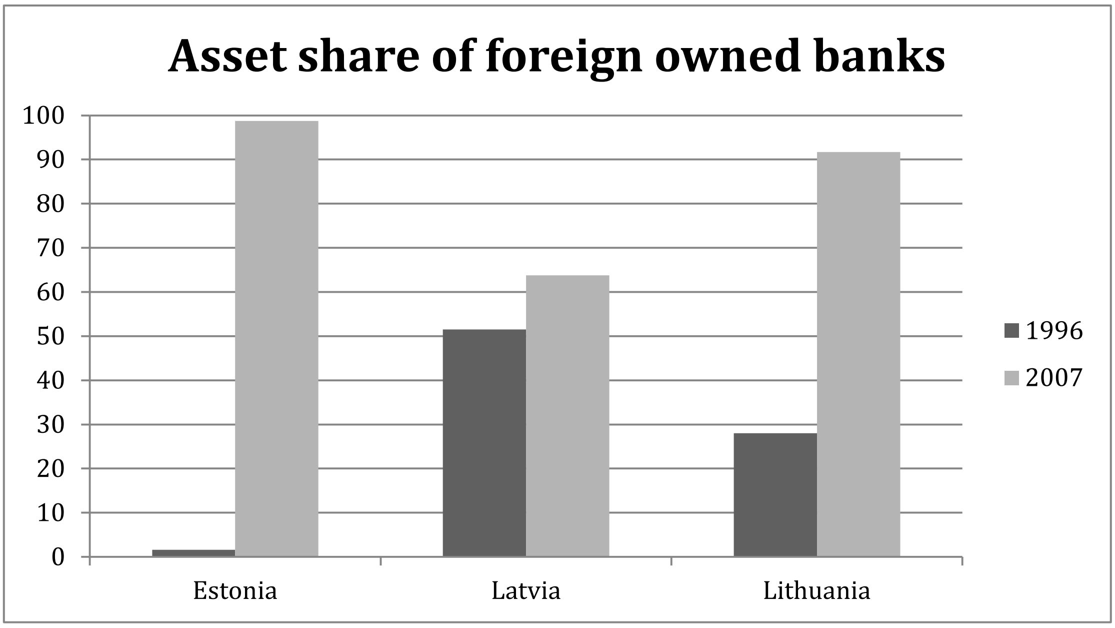
[19] Proceeding from the assumption that the GDP growth for year 2008 would be 3.7% (instead of the projection of 7% growth that had been the basis for adopting the initial budget for 2008), the supplementary budget reduced the revenues by 6.1 billion kroons and expenditures by 3.2 billion kroons, which meant a 3% cut in appropriations. Of those cutbacks, 683 million came from investments, 2.28 billion from transfers and 177 million from operating costs.

[20] Parex had at the time ca 20% of domestic banking market (Purfield and Rosenberg 2010).

helped to avoid the spillover of the liquidity crisis to the other Baltic economies as well (Purfield and Rosenberg 2010).[21] The lack of domestic banks gave Estonian (and Lithuanian) government significantly more fiscal space as bailing out banks was essentially 'outsourced' to the Swedish central bank.

Fourth, the electoral cycle in Estonia favoured swifter adjustment (starting already in 2008). At the height of the crisis in 2009, Estonia was in the middle of the electoral cycle, with next general elections in 2011. Both Latvia and Lithuania were in a somewhat different situation, with Latvia having general elections in 2010, and Lithuania facing general elections in 2008 and presidential elections in 2009.[22] (Kuokstis and Vilpisauskas 2010) 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.

Figure 6. Structure of financial sector by ownership in the Baltic countries.



Source: Kattel 2010, 46.

[21] In fact, Estonia was able to participate in this support action with 100 MEUR. This lent considerable political support both domestically and internationally to the Estonian government. Furthermore, the 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.

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

Finally, while in Latvia and Lithuania, the crisis brought about a dramatic fall in tax revenues, then in Estonia the revenue shock was significantly smaller; this divergence has been attributed to better tax compliance and tax administration in Estonia (Purfield and Rosenberg 2010; Nakrosis et al. 2012).

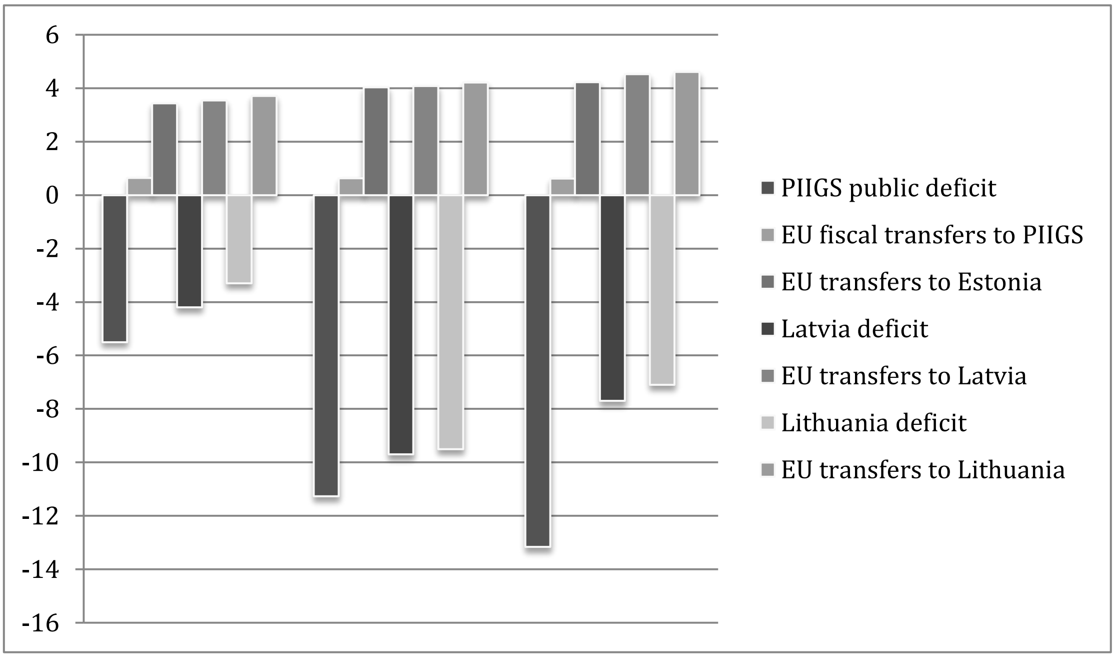
In sum, the coincidence of these four factors gave Estonia a considerable advantage in dealing with the crisis as it offered a great opportunity to unify all efforts behind one single goal: entrance into the euro zone. This option, and the added strain of election cycles, was not available anymore to Latvia and Lithuania, mainly because these countries did not fulfill the inflation criteria at the eve of the crisis, while the slowing growth was rapidly decreasing inflation in Estonia. More importantly, in Estonia's case fulfilling deficit and debt criteria was rather realistic (Latvia had lost out on the deficit criteria with one single act: bailing out the Parex bank): it was feasible to fulfill 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, coming as it did again last in the Baltic flying geese pattern, had a much shorter window of opportunity for the eurozone entrance and it had negative experience from 2005 when Lithuania missed out on the eurozone entrance by 0.2% margin on the inflation criteria (calculation for which oddly includes also non-eurozone economies such as Sweden). As Estonia's next general elections were to be in 2011, this gave the government also realistic hopes that with eurozone entrance it would be able to generate enough political capital domestically to survive the crisis. Thus, the initial conditions made it possible for Estonia to have a straightforward realistic goal how to deal with the crisis that the other two Baltic countries lacked.

3.2. 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 R&D and technology projects. In both set of measures, the availability and use of EU's structural funding played a crucial role.

Figure 7 shows the level of EU's structural funds in Baltic economies in comparison to PIIGS (Portugal, Ireland, Italy, Greece and Spain).

Figure 7. Public deficit and EU fiscal transfers (cohesion funds), as % of GPD, in the Baltics, 2008-2010.



Source: Eurostat and European Commission; calculations by the authors.[23]

Finally, all Baltic countries undertook quite significant actions in the labor market – especially in the second part of 2009 and early 2010. Lithuania and Estonia introduced in 2009 reforms to labor laws in an attempt to make the labor markets more flexible;[24] similar measures were enacted in Latvia in spring 2010. Latvia increased the duration of unemployment benefits to 9 months, relaxed eligibility conditions and introduced a minimum floor (Purfield and Rosenberg 2010, 25). Latvia is also the only country to have raised minimum wage during the crisis (Zazova 2011, 12). All three countries increased their spending on labour market policies, both in

[23] 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 is available at http://ec.europa.eu/budget/biblio/documents/fin_fwk0713/fin_fwk0713_en.cfm#alloc.

[24] 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, the constraints on using fixed-term contracts were lifted. In Lithuania, the regulations concerning flexible work arrangements (like temporary and part-time employment) were relaxed, but at the same time, additional security for workers under fixed-term contracts was stipulated. (Masso and Krillo 2011)

terms of absolute sums and as a fraction of GDP (Masso and Krillo 2011).[25] Again, all three countries made extensive use of EU funds for the employment support measures. In the second half of 2009, the Estonian government introduced an action plan (foreseeing 45 million euros for creating 5000 jobs), entailing a range of different measures, including business start-up support and broadening the conditions for wage subsidies (Masso and Krillo 2011, p. 44).[26] In 2010, a training voucher 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) have also been offered; further plans entail 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 and Rosenberg 2010).[27]

3.3. Institutional Changes

On the level of *institutions*, Estonia had structurally the fewest changes during the crisis, Lithuania some (mostly still in implementation phase) and Latvia rather dramatic. First, in Latvia the government became a significant actor in the banking sector. Second, more than half of government agencies were closed. (Latvia's Convergence Programme 2010) Third, in particular in education and health sector, there were significant changes as the number of schools and hospital decreased dramatically. Latvia closed 24 of 49 hospitals; (Åslund 2010, 37; Latvia's Convergence Programme 2010) and the number of general education institutions was reduced from 982 to 873, and vocational education institutions from 67 to 58 (Latvia's Convergence Programme 2010). Lithuania also initiated radical reforms in higher education and health care – under the general heading of "optimization" – which are yet to be fully implemented. (Åslund 2010, 41; Jankauskiene 2010)

[25] 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 and Krillo 2011, p. 43).
[26] For example, for start-up subsidies, the available sum was doubled, eligibility conditions relaxed and self-financing rate decreased; the ceiling of the subsidized loan available for start-ups was doubled. (Masso and Krillo 2011).
[27] For a more detailed overview of the labour market measures adopted in the Baltics, see Masso and Krillo (2011, Appendix 1).

In terms of *institutional capacities*, the crisis management brought two discernable changes in all three countries. First, the crisis led to politicization 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 centralized. This strengthened the position of the executive relative to legislatures, and within the executive branch, ministries of finance, already important because of the role of EU structural funding management issues, became even more pivotal in policy making.[28] The planned changes to the budget process (e.g. in the form of Fiscal Discipline Law in Latvia) are likely to increase the power of the ministries of finances vis-à-vis the line ministries even further. Second, while already during the accession to the EU and later with the usages of structural funds, the EU had become a highly important institutional factor for the Baltic economies (see Suurna and Kattel 2010 for a case study), the crisis reinforced and strengthened such institutional patterns. In the Latvian case, the EU and the IMF, as the largest donors in the 7.5 billion euro rescue package, were in direct dialogue with Latvian officials and in a position to raise direct demands. Seemingly it was the IMF that at least initially was open to more diverse solutions (including external devaluation) and the EU more the hardliner in terms of fiscal policy. (Lütz and Kranke 2010) In Estonian and Lithuanian cases, the IMF's potential role and even more so its image from 1990s structural adjustments programs, made the IMF a warning factor within domestic debates, which reinforced 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, the entrance into the eurozone was an important source of policy discipline. Indeed, it can be argued that for all three Baltic policy makers, the EU has become the key policy and epistemic peer community, source of key policy ideas and their positive feedback.[29]

Another key aspect on institutional level was the re-enforcement of path dependencies in policy capacities. Since regaining independence, fiscal retrenchment had worked in every major crisis the Baltic countries had faced: after 1992, after Russian crisis in 1999, and also now it became particularly clear with Estonia's entrance into the

[28] For a discussion on the evolution of budgetary institutions in Estonia, see Raudla (2010a,b).
[29] See also Ikstens (2010, 1056) for discussions on the role Commissioner Alumina played in the introduction of tax increases and progressive real estate tax in Latvia in 2009.

eurozone. (Raudla and Kattel 2011a,b; Åslund 2010, 40)[30] While the year 2009 could have, in principle, offered a window of opportunity for a critical juncture in economic policy making – switching from rather passive government role in economy towards more active macro-management of the economy by the state – the policy choices made during the crisis imply the continuation of already existing policy and administrative capacities. Furthermore, both in Estonia and Latvia there have been discussions on establishing the principles of fiscal discipline in their respective constitutions.[31]

4. Reactions to the Austerity Measures

In the light of the public protests against austerity measures in Greece and other European countries, one is likely to wonder how the public reacted to the fiscal consolidation packages in the Baltic countries. All in all, the population in Estonia accepted the austerity measures quietly (or even supportively),[32] while there were some protests in Latvia and Lithuania. Indeed, while Estonia avoided completely any street riots,[33] in Latvia and Lithuania the brief one-day riots in January 2009 seem to have had much more political than economic background, at least in the case of Latvia. (Ikstens 2010, 1055 on Latvia; Woolfson 2010, 496 on Lithuania) There were muted and sporadic protests organized by various trade unions and citizen interest

[30] In fact, Andrius Kubilius, Lithuanian prime minister since 2008, was also in office during the aftermath of Russian crisis in Lithuania in 1999-2000; a fact that supported his credibility in the current crisis. (See also Brozaitis 2005)

[31] In Estonia, the Pro Patria and Res Publica union campaigned for introducing a balanced budget rule in the run-up to 2011 parliamentary elections. In Latvia, a set of fiscal rules pertaining to budget balance, debt level and countercyclical fiscal policy are being planned.

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

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

groups throughout 2009 in all three countries.[34] Their impact remained limited, however.

Only in Lithuania did the trade union protests manage to make their voices heard: although initially, when devising the austerity measures at the end of 2008, the government totally avoided social dialogue, it was forced to engage in it – at least to a certain extent – in the course of 2009. [35] (Masso and Krillo 2011, 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; according to the "national agreement" the trade unions promised to suspend social protests in exchange for government's promise to protect the living standards and to engage in social dialogue (Woolfson 2010, 504-505).[36]

In accounting for such mild reactions to the governments' measures, one has to look at different levels of explanations. 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 (the discourse pointed to three major elements: we cannot abandon the peg, we have to adopt the euro; hence we have to adjust the budget) (for more detailed discussions, see Raudla and Kattel 2011a,b).

Though one would have expected some more protests once the "pain" induced by the austerity measures was felt, a number (political) cultural and social factors prevented them. First, the Baltic states have been characterized by "patience culture" (whereby the society is willing to endure short-term pain for a long-term gain in the form of

[34] As Woolfson (2010, p. 502) notes, the trade unions in Lithuania were somewhat reluctant to organize another wide-spread protest action since they did not want to be made responsible for provoking social unrest and violence.

[35] For example, in summer 2009 the Lithuanian trade union confederation protested against the government plan to cut basic monthly salary in the public sector (which would have primarily affected the lowest paid employees) by organizing a hunger strike in front of the parliament. As a result of the protest, the government amended the plan and introduced more progressive salary cuts, whereby higher cuts were imposed on the better paid employees (Masso and Krillo 2011, Appendix 3).

[36] As Woolfson (2010, 504-505) notes, though, the pact still entailed cuts to wages, pensions and parental benefits.

independence, freedom and economic prosperity), which emerged in late 1980s and early 1990s but lingered on, even after the initial phase of transition was over (see Greskovits 1998; Kuokstis and Vilpisauskas 2010). As Purfield and Rosenberg (2010, 4) rightly note, during the previous crises (in early 1990s and at 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 (see also Raudla and Kattel 2011a,b). Thus, the hope that the short-term pain would give rise to a long-term gain is likely to have made the 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 pains inflicted by contractionary policies (see also Kuokstis and Vilpisauskas 2010).[37] Second, the civil society in Baltic countries at large is underdeveloped and hence unable to mobilize significant protests. Third, the industrial relations in all three countries are "highly individualized and dominated by employers" (Gonser 2011, 409) and the trade union density is the lowest in Europe,[38] which has meant that the trade unions have not been able to organize wide-ranging actions.[39]

5. Discussion: From Nationalist to Pragmatic Neoliberalism

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

Embedded neoliberalism denotes a specific form of capitalism that has developed in Eastern Europe after the demise of Soviet Union. (See van Apeldoorn 2009; for a discussion of this concept in the context of the crisis, see Bideleux 2011) van Apeldoorn and others take their inspiration from Karl Polany's classic concept of embedded capitalism in which the state functions, via social protection mechanisms, as a curtailer of capitalist free market excesses (Polany 1957). In Eastern European

[37] In 2009, the net migration did not change in Estonia, whereas it increased to 2% in Latvia and to almost 5% in Lithuania (Eurostat).
[38] In 2009, trade union density was 7.6% in Estonia and 10% in Latvia and Lithuania (Gonser 2011).
[39] As Gonser (2011, 412) points out, although a number of times collective agreements were changed and wage cuts or freezes were undertaken without consulting with the unions, employees accepted these changes without protests.

case, it is the idea of self-regulating markets that is, in reversing the original Polany idea (whichlater become epitomized in the European welfare state) that better functioning markets bring also social well-being. One of the key features that has enabled this construct to work in real polities is the instrumentalization of the idea of nation and nationalism as a substitute for social well-being. That is, in the context of especially Baltic countries, 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 neoliberalism where the embedding agent is nationalism, reflects developments in the entire Eastern European region and specifically the Baltic case as well, it is Estonia where it has evolved perhaps into its purest form. (See also Thorallsson and Kattel 2012)

This nationalist neoliberalism is reflected in very open economy with governments looking for further avenues to liberalize and deregulate; low income tax for persons and companies; relatively flexible labour markets (see also Zazova 2011; Masso and Krillo 2011); high level of foreign direct investments; relatively stable governments (Estonia's prime minister is in office since 2007; leading coalition party, the Reform Party, has been in the government since 1999); increasing importance of the core executive (Drechlser et al 2003) with weak to non-existing social partnerships; increasing importance of external ideas and policies in the sphere of economic policies (Karo and Kattel 2010); and language and cultural policies favoring respective majority nations (both Estonia and Latvia have in difference to Lithuania sizable Russian-speaking minorities) (on Estonian minority politics, see Aidarov and Drechsler 2011). Ironically, in economic policies the Baltics do not exhibit almost any nationalist elements (that would mean some form of domestic market protection); rather it is the functioning of the markets that is seen to deliver also 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, etc) play little role in actual policy-making. Key policy-making capacity in simple polities is communication towards wider population. This is juxtaposed to 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 and Kattel 2011a,b)

While constitutionally and historically (from the so-called first period of independence in the interwar area) the Baltic countries had a potentiality for both forms of polities, the above described nationalist neoliberalism has led to emergence of decidedly simple polities in all Baltic countries. (See also Woolfson 2010) This has led to two phenomena: first, the evolution of specific institutional interactions and policy capacities; and second, implicit politicization of the executive branch in terms of ideology and skills tacitly expected from new employees, i.e the adherence to the basic tenets of nationalist neoliberalism (see Peters and Pierre 2004 on forms of politicization). This has resulted in specific elite building with rather discernable esprit de corps, visible perhaps in 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 entrance into the EU, NATO) played a crucial role in mobilizing the emerging elite and justifying its beliefs and value systems reflected in nationalist neoliberalism. Reaching these goals became perhaps the key measure of efficiency and it also opened channels of communications especially towards 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 the 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 have 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, 409, 412) argues, the crisis has led to “a deinstitutionalization of collective bargaining system” and has further weakened the trade unions (due to membership losses resulting from redundancies), implying further “simplification” of the polities in all three countries.

The crisis management enforced the basic values of nationalist neoliberalism, but it became more pragmatic during the course of the crisis. (See also Åslund 2010, 7, 32)

Indeed, it is remarkable that both Estonia and Latvia have returned in 2011 into office the governments responsible for heavy budget cuts under very high levels of unemployment. Lithuania elected a president that favored the hard-line neoliberal agenda of the government and brought with her also important changes in the government towards such pragmatic austerity. (Krupavicius 2010, 1062, 1066) Indeed, both Latvia and Lithuania had been crippled by the power of domestic oligarchs and the crisis intensified attempts to curb this. (See Woolfson 2010, 508)

Specifically, the pragmatism comes via one policy goal: entrance into the eurozone. As argued above, this gave particularly for Estonia, and upon her success also to Latvia and Lithuania (and until the entrance into to eurozone, keeping the currency pegs), a policy goal that unified the need to consolidate budget, enforce more neoliberal structural and administrative reforms, and economic reforms that should enable export-led growth. (See also Lütz and Kranke 2010 for interviews with the IMF staff) As shown above, Lithuania in fact created in 2009 a national agreement, signed by government and largest trade unions and several other social partners that expressed exactly this: how various policy goals (fiscal deficit reduction) are subsumed under the eurozone entrance. (Krupavicius 2010, 1071; also Woolfson 2010, 505)

Eurozone entrance as a general goal also engendered other specific goals that could be easily communicated to the public and that could be easily measured (the Maastricht criteria). As the eurozone entrance was realistic in Estonia, it also generated much stronger trust in government and generally legitimized retrenchment. And this enforced a much more pragmatic approach to policy as it subordinates also the nationalistic goals to the eurozone entrance. 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).[40]

6. Did the Internal Devaluation Work?

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

With year 2009 the worst seems to have been over for the Baltics. 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 current Baltic recovery has not resulted from the 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 was from peak to trough about 15-20% in all countries.[41] (Table 1; see also Krugman 2011; Knibbe 2011) By the end of 2009, the real effective exchange rates had fallen by 10-20 percentage points from their boom-time peaks (Table 1). However, in the light of the preceding boom, the internal devaluation was rather moderate and cannot fully account for recovery witnessed in the Baltics since 2010. (See also Grennes 2012)

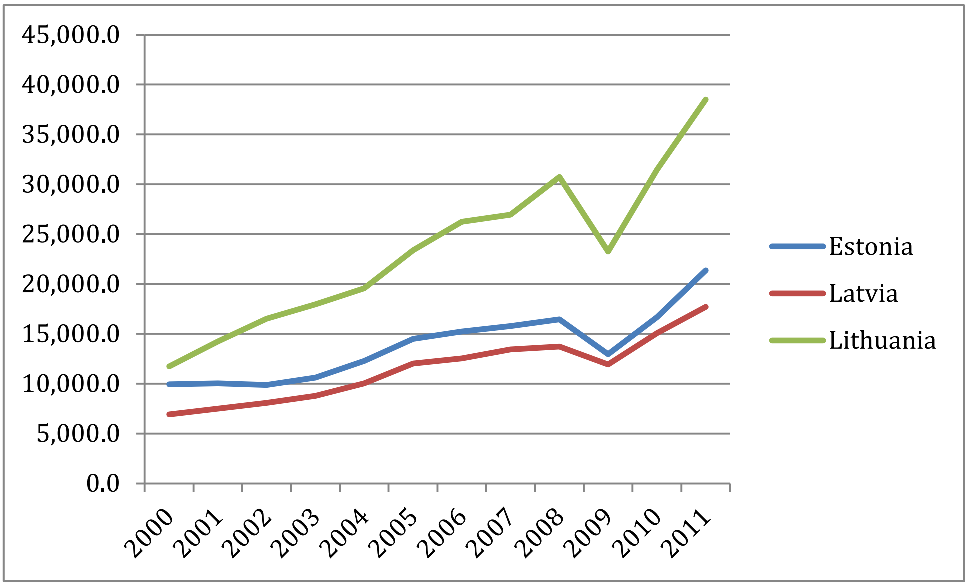
If not internal devaluations, then what is behind the Baltic recovery in 2011? There are three key factors: massive use of European funds, flexible labor markets and integration of export sectors into key European production networks. Flexible labor markets have had two consequences, first persistently high unemployment, which did not lead to higher social expenditure (automatic stabilizers are relatively unimportant as benefits are low and brief (see also European Commission 2010, 64), and active labor market measures are financed largely by EU structural funds); second, while particularly in Lithuania emigration was high already before the crisis, the latter seems to have fastened emigration in all Baltic states (Lithuania's and Latvia's census in 2011 showed dramatic drop on population numbers; Estonia's census in 2012 showed more moderate reduction in population; see also IMF 2011, 14). As Baltic states are strongly simple polities, voice does not seem to be an option for many and

[41] In 2009, in nominal wage adjustments the private sector outpaced the public sector in Lithuania, they followed a relatively similar pattern in Estonia, whereas in Latvia the public sector led by a wide margin (see, for example, Table 4 in Purfield and Rosenberg 2010).

thus exit becomes the preferred choice for increasing number of people. (See also Kuokstis and Vilpisauskas 2010) However, both high unemployment and exit are forms of future costs in terms of future social issues and lack of workforce. Thus, while during the crisis the costs of external devaluation were argued to be higher than internal devaluation (or adjustment, as it is mostly referred to in Baltic debates), it remains to be seen whether this is really so given persistently high levels of unemployment and emigration.

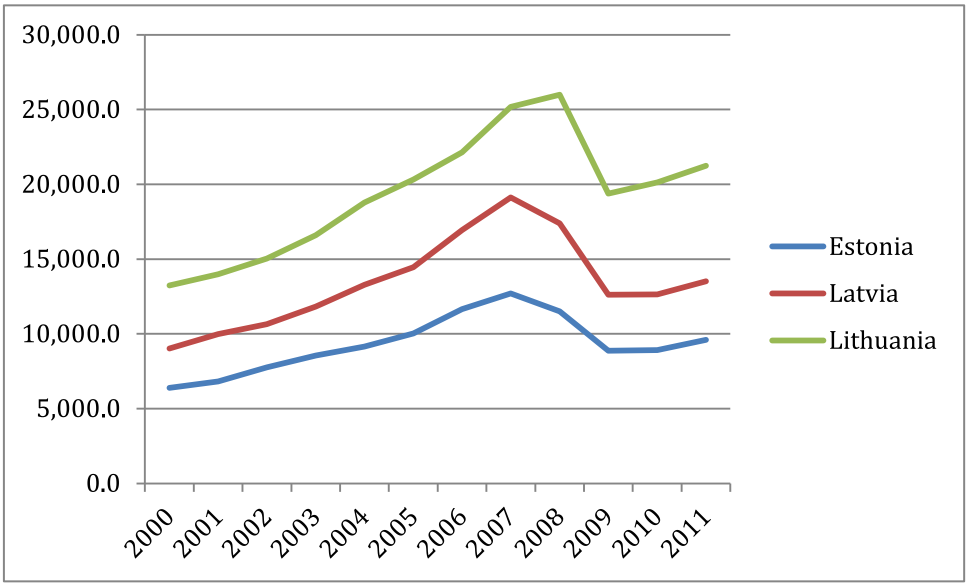
Integration into European networks by few dozen leading exporters is another key factor explaining the Baltic recovery. Figures 6 and 7 show the changes in exports and domestic demand. As it is clearly visible from the figures, exports picked right up in 2010 and reached in fact record levels in 2011.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

Figure 6. Exports of goods and services from the Baltics, in millions of PPS, 2000-2011.



Source: Eurostat.

Figure 7. Domestic demand in the Baltic countries, in millions of euro, chain-linked volumes, reference year 2000 (at 2000 exchange rates), 2000-2011.



Source: Eurostat.

One can argue that these developments have had relatively little to do with domestic conditions or policy actions, however. Rather, it is rather an increasingly important symptom of the Baltic blend of capitalism: enclave industries. It has been recognized for quite some time that one the key problems faced by Eastern European companies is the low embeddedness of foreign owned exporting companies, which is reflected in low level of linkages with domestic suppliers and partners, and with higher education and research institutions. For instance, one of the key electronics exporters from Estonia, Elcoteq, uses currently up to 200 suppliers, none of them are domestic. (See also Tiits and Kalvet 2012) While Baltic exports have bounced back to the pre-crisis levels, the problem of linkages and feedbacks remains. In addition, the pre-crisis level of exports are by far not enough to make up for the lack of foreign financing that used to fuel Baltic growth in mid-2000s. In sum, while the crisis has hardened the Baltic neoliberal resolve, the responses to the crisis have not so far brought substantial changes to Baltic economic structure and consequently the underlying fragility remains unresolved. However, as the Baltic economies are very open and small, their recovery and future growth depends heavily also on European recovery. As the latter seems likely to be slow and sluggish for some years to come, it is also difficult to foresee that the Baltic economies will experience growth rates similar to mid-2000s any time soon.

In sum, almost all of the above factors make the Baltic cases unique and irreproducible in the EU context. (See also Grennes 2012) First, most EU countries, especially in the troubled periphery, are already in the eurozone, so they cannot justify short-term austerity measures and eurozone entry as a crisis exit strategy; second, very few EU countries have civil societies as weak as those in the Baltic countries, and thus austerity breeds visible unrest and instability; and third, few if any EU countries have such narrow and detached policy elites—elites that have become accustomed to satisfying their European policy peers rather than their domestic partners.

Yet, even if the EU periphery could somehow manage to replicate the aforementioned political conditions − by weakening civil society, retrenching the welfare state, and relaxing labor regulations − they still would not have similar economic factors. There are a number of economic and structural factors that make the Baltics relatively unique, including high levels of economic globalization (both in exporting and in the financial sector) and strong dependence on larger neighboring economies − Scandinavia and Poland − in terms of trade and (in the case of Scandinavia) technology transfer. Both of these economies either recovered quickly (Scandinavia) or did not experience any crisis at all (Poland). Thus, while the EU is 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 have dealt best with such fiscal policies is of very little use to other troubled EU members.

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