Forbes

The Triumph Of Good Economics: 'Austere' Baltic States Outgrow Their European Neighbors

By: Doug Bandow – April 15, 2013

The Eurozone crisis continues, like the rerun of a bad soap opera. The only constants are bail-outs and rosy scenarios. Maybe Greece will hang onto the Euro at the cost of its economy. Maybe Italy will find political stability through another election. Maybe Great Britain won't leave the European Union. Maybe Germany will bail out all of its profligate neighbors—forever.

And maybe Latvia will join the Euro.

The latter suggests rats racing aboard a sinking ship. Questions about the judgment of Prime Minister Valdis Dombrovskis aside, however, his determination to have Riga join the currency union reflects his nation's surprisingly strong economic performance. GDP growth in 2012 hit five percent and, reported the *Wall Street Journal*: "Latvia plans to pay off loans from the International Monetary Fund and the European Commission by 2014."

Also highly rated are the fellow Baltic States of Estonia and Lithuania. All three faced enormous economic difficulties just a couple of years ago but, noted Anders Aslund of the Peterson Institute for International Economics, "Crisis resolution in these countries was decisive and successful."

In short, at a time when the question seems to be which European nation won't require a bail-out, the Baltic Three have demonstrated the art of economic reform. Fiscal prudence delivers economic growth. This experience offers a reform model for the rest of the continent and beyond.

Estonia, Latvia, and Lithuania have not had an easy time. They were, wrote economists Catriona Purfield and Christoph Rosenberg, "early and avid reformers" after escaping the unwanted bonds of the Soviet Union. But they were careless after the good times arrived. Observed my Cato colleague Dan Mitchell, "They allowed spending to rise too rapidly in the middle of last decade—an average of nearly 17 percent per year between 2002 and 2008." Then the global financial crisis and recession hit.

However, they turned to reform and restraint, really cutting government spending—not just slowing the upward rise which, in Washington, counts as a savage "cut." Explained Purfield and Rosenberg: In all cases "The adjustment strategies were expenditure-led, for 2009 "ranging from about half of the total in Estonia and Latvia to more than three-quarters in Lithuania."

After escaping the Soviet embrace Estonia made liberalization a priority. But Estonia did not escape the global economic crisis and found itself with a shrinking economy in the

late 2000s. Rather than borrow money for a lavish "stimulus" program, Tallinn emphasized fiscal responsibility. Estonian President Toomas Hendrik Ilves observed: "Growth policy" essentially means doing "more of what we're already doing wrong, which is borrowing money to pay for things."

When asked how Tallinn responded to the economic challenge, Peeter Koppel of SEB Bank responded: "I can answer in one word: austerity. Austerity, austerity, austerity." Spending was restrained, debts did not balloon. Explained Economy Minister Juhan Parts: "Everybody had to give a little bit."

Moreover, the government attempted to further liberalize the economy. For instance, a recent study for the Institute for the Study of Labor explained that Estonian employment markets were "more rigid than in other Central European countries or the OECD average" until 2009. Then the government adopted a program "which facilitates overall mobility and job search."

Unlike the frustrated Greeks, Estonians didn't riot. Rather, they reelected their government. "In normal times cutting the salaries of civil servants, of policemen etc. is extremely unpopular, but I think the people showed a good understanding that if you do not have revenues, you have to cut costs," added Parts.

The economy grew 7.6 percent in 2011, five times the Eurozone average. Economists forecast that Estonia's economy is back at its 2008 level. Net foreign investment fell into 2009 before beginning a dramatic rebound. By 2011 FDI had increased six times. Unemployment began to drop in 2011 and has been falling steadily.

The national debt is just six percent of GDP, compared to 81 percent for Germany and 165 percent for Greece (and 100 percent for the U.S.). Four years ago Estonia was ranked as the third riskiest member of the EU. Now it trails only Finland and Germany as a safe bet. Estonia also is the only Eurozone nation to run a budget surplus. With the improved economy the government intends to lower the income tax rate in 2015, which should further boost growth.

Of course, the country is not without problems. *New York Times* economist Paul Krugman criticized Estonia's "incomplete" recovery, earning a rebuke from Estonian President Ilves. Anders Aslund was equally blunt: Krugman "praises the fiscally irresponsible and scolds the virtuous, denigrating the Baltic achievements while trying to explain away miserable failures, such as Greece."

My Cato Institute colleague Dan Mitchell offered a more detailed response, observing that Krugman's "own chart shows that the economy hit the skids in 2008—a year in which government spending in Estonia soared by nearly 18 percent." After economic bad times hit, "Estonians realize that they needed to cut spending. And now that spending has been curtailed, it's worth noting that growth has resumed."

Nevertheless, further reforms are necessary. For example, the Institute for the Study of Labor concluded: "The Estonian labor markets would also benefit from reduction of high tax wedge on wages as well as from keeping increases of the minimum wage in line with changes in labor productivity."

Latvia had a similar experience to Estonia, turning to the market from Soviet communism and instituting a flat income tax. Although not quite as tight-fisted as Estonia, Riga still avoided the European disease.

Latvia enjoyed an average economic growth rate of ten percent a year from 2005 to 2007, but suffered a crash in 2008. Since Riga pegged its currency to the Euro, explained the Associated Press, "Latvia had to accomplish what many Eurozone countries such as Greece and Spain are being asked to do—restore competitiveness through austerity measures, such as public sector wage cuts, and not a currency devaluation." However, Latvia played to its strengths.

The country had low public debt and its earlier boom had prepared the public for the risk of a bust. Said IMF head Christine Lagarde: "At a very basic level, everybody knew what needed to be done. They understood that the huge spike in spending in the years leading up to the crisis could not be sustained."

Joerg Asmussen, a member of the Executive Board of the European Central Bank, observed: "With a budget consolidation of around nine percent of GDP in 2009 alone, Latvia's effort is unparalleled in Europe." Riga sharply cut public sector wages after the crunch hit. Moreover, added Asmussen, "Education, health care, central administration: hardly any public sector category was spared by the reforms."

Latvian Prime Minister Valdis Dombrovskis emphasized the importance of speedy fiscal adjustment: "Restoration of financial stability is a precondition for economic growth, because once you restore financial stability, banks start lending, people stop worrying, businesses stop worrying, capital is not fleeing the country, probably capital is starting to flow into the country again, so all the process is helping to enable to return to growth."

Even skeptical economist Dani Rodrik did not gainsay the benefits: "growth has returned faster than most anticipated, exports are up, unemployment has come down, and the political system appears more stable than it has been for some time." Equally complimentary was Asmussen: "the speed of the economic rebound is as extraordinary as the depth of the recession."

Latvia's economy now is one of the fastest growing in the EU. Per capita GDP is heading back to its peak in 2007. Unemployment started to fall in 2010 and net foreign direct investment has strongly recovered from its 2008 crash. Overall, wrote Olivier Blanchard, the IMF's chief economist: "Latvia has one of the highest growth rates in Europe, the peg has held, and the fiscal and current accounts are close to balance."

In September Latvia made a sizable early repayment of its debt. The IMF's Lagarde opined that Riga should serve as an inspiration for other European nations struggling to resolve the Euro crisis: "We see the success of the program as a real achievement, a real tour de force."

Latvia enjoyed not just economic success but political stability and social peace. Asmussen cited "the degree of national ownership of the adjustment program—not only by national policy-makers but also by the population itself." He also noted that "Despite harsh austerity measures the Prime Minister managed to get re-elected twice."

Nevertheless, Riga's work is not done. Latvia scored lowest of the three Baltic states in the *2012 Index of Economic Freedom*. Particularly problematic was "worsened

management of public finance" and "perceived corruption exacerbated by a relatively inefficient judicial system."

Lithuania has the largest economy of the three Baltic States and suffered a substantial GDP drop in 2008 and 2009. The recovery program was grounded in genuine austerity, including spending, which rose in many other European nations which choose to hike taxes. In 2011 the IMF lauded Vilnius for reducing its fiscal deficit "substantially since 2009, mostly reflecting expenditure restraint." According to Aslund, "Four-fifths of the fiscal adjustment consisted of expenditure cuts," far different than other European countries.

Benefits for social services had risen 44 percent in real terms between 2006 and 2008, forcing the government to advance "structural expenditure reforms in social security, health care, and education sectors." The sharp outlay reductions caused total spending to fall even with higher debt service payments. In reviewing the record of Prime Minister Andrius Kubilius, reported the *Economist*: "After coming to power in 2008, he cut public spending by 30 percent, slashed pensions by 11 percent and even took a pay cut of 45 percent himself."

The result has been a notable success. Its economic slowdown was less severe than its neighbors and its rebound was quicker, with economic growth of 1.4 percent in 2010. Per capita GDP growth began to rise again the same year. Net foreign direct investment began to recover in 2009. Although public debt rose, it remained low as a share of GDP compared to the rest of Europe.

Reported the IMF, the country has enjoyed "one of the strongest recoveries in Europe." Corporate profits improved and unemployment fell, along with "strong labor productivity growth." Nominal wage reductions "restored competitiveness" while the economic upturn has "lowered unemployment and stabilized wages."

Of course, policy challenges remain. The IMF pointed to reforming pensions, health care, and state-owned enterprises, improving tax compliance and budget practices, dealing with potential problem banks, improving labor flexibility, and streamlining business regulation. The 2012 Index of Economic Freedom cited the need for judicial and legislative reform, as well as addressing corruption "still perceived as significant."

However, not all Baltic voters reward success at election time. In October 2012 the Lithuanian people, apparently tired of austerity, ousted the ruling Christian Democrats. The new government promised to increase public spending, threatening the country's long-term economic future. SEB banka economist Dainis Gaspuitis even cited the elections as a potential risk factor for the country.

The Baltic States demonstrate that someone in Europe is doing something right. Observed Anders Aslund: "Amid the carnage of the European financial crisis, the Baltic countries, by and large, are doing quite well. Estonia, Latvia, and Lithuania are booming. In 2011, their growth rates reached 7.6 percent, 5.5 percent, and 5.9 percent, respectively. The turnaround, driven largely by manufacturing exports, has been one of the most remarkable and promising stories of the crisis."

This experience offers obvious lessons for the rest of Europe.

Don't run up big debts. It is a lot easier to manage when things go bad if you aren't overextended to start. Observed Rosenberg: "Estonia's experience shows that prudent policies during the boom may not avoid a bust, but they can put the country into a better position to deal with shocks."

Don't engage in an orgy of "stimulus" spending. That will run up big debts without generating long-term growth. When budgets eventually are cut, as they will have to be, the economic loss and political pain will be even greater.

Make tough decisions early. People typically are ready to act after the crisis hits. In the case of Latvia, argued Asmussen, by acting swiftly "most of the required painful budgetary decisions could be passed before the so-called 'adjustment fatigue' kicked in."

Maintain fiscal responsibility. Otherwise any progress will be transitory. Growth is the natural result of reform. Delaying reform exacerbates the problem while prematurely terminating reform short-circuits the recovery.

Emphasize budget cuts. Expansive and irresponsible public outlays usually contribute to economic crisis. Moreover, the state as well as citizens should sacrifice after a crash. The answer is to cut expansive and irresponsible public outlays. In fact, economists Alberto Alesina and Silvia Ardagna found that "spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions."

Finally, don't rest on one's laurels. There always is more to do. Even nations which have implemented serious reform programs, like the Baltic States, could make further improvements.

There is no painless way out of economic and financial crisis. But the experiences of Estonia, Latvia, and Lithuania demonstrate that there are solutions.

Instead of desperately seeking bail-outs to preserve bloated social programs, troubled nations need to rediscover what is affordable, revive private sector growth, and adopt tough reforms. We all should hope that the other EU nations learn the Baltic lessons before it is too late.