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Estonia's Lessons for Greece

Since Greece's troubles came to light last summer, the Keynesian chorus has sung that the country could devalue its way out of its fiscal mess if only it had its own currency. There is a better way. Estonia, Lithuania and Latvia are case studies in how to solve a budget crisis without succumbing to the siren song of devaluation.

Last week, amid the ongoing euro panic, the European Commission accepted Estonia's application to join the single-currency bloc. Estonia has a debt-to-GDP ratio of 7.2%—smaller than the annual budget deficits of Ireland, Spain, France and Portugal, to say nothing of Greece. Estonia even had the nerve to greet the Commission's decision with a call for stricter budgetary rules for the euro zone.

One secret to Estonia's fiscal success has been its monetary stability. Within a year of breaking away from the Soviet Union in 1991, the country established a currency board with the German mark, an arrangement designed by Johns Hopkins University economist Steve Hanke. It maintained that link to a stronger currency as the mark became the euro and no matter the buffeting from world events.

Lithuania maintained a currency board with the dollar until 2002, when it switched to the euro, while Latvia maintained a peg (but not a proper currency board) with the IMF's Special Drawing Rights, a synthetic currency comprising a weighted basket of the dollar, euro, pound and yen, before switching to a euro peg in 2005.

Under a currency-board, the central bank monetary authority holds reserves equal to the quantity of local currency in circulation. It cannot create new money in excess of its reserves and stands ready to exchange local currency for the pegged currency at any time and in whatever amounts are required.

The result is money as stable as the currency to which it's pegged. This precludes the central bank from trying to manage the business cycle through monetary policy, and it prevents the government from running the printing presses to inflate away debt. This is especially useful for "emerging market" nations attempting to attract foreign investors who might be worried about political mismanagement.

Even at the height of the financial panic when the IMF and others were preaching devaluation, the Balts have held firm to these currency links. Latvia cut public pay and employment by more than 20% each in 2009 to rein in government spending and avoid a devaluation of the lat. Estonia cut spending by more than 15% and brought its deficit down to 1.7% of GDP. In the process it maintained its currency board with the euro and hence also its eligibility to join the euro next year.

In other words, Estonia and Lithuania gave up their monetary autonomy more than a decade ago, and they have been better off for choosing a stable currency over one subject to the whims of politicians. Yes, this has required more fiscal discipline and government austerity in recent years, but that very discipline has revived investor confidence and prevented a deeper crash in living standards from devaluation.

The real irony in Estonia's pending entry into the euro, assuming it's finalized, is that it would be joining when the euro zone itself seems in danger of dismantling the policies that insulated the European Central Bank from political meddling. Last week, the ECB agreed to start buying euro-zone debt, public and private, to stabilize government bond markets. That calmed markets for a few days, but at great cost to the bank's independence while doing nothing to solve the underlying fiscal problem.

The EU decision to set up a €750 billion bailout fund undermines the founding principle of the euro that each country is responsible for its own fiscal house. As Estonia's finance minister noted over the weekend, Estonia now seems poised to enter a monetary arrangement that has become much less disciplined than Estonia itself has been for two decades. As the Baltic states have shown, Europe's problem isn't the euro. The problem is the failed fiscal policies of its political class.

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