

Learning from small countries? Contemporary Nordic sagas

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The experience of small countries becomes very important when it is taken around the world as evidence that a certain approach works best.

Greece, the Baltic states and Iceland are examples of small countries whose experience is often adduced to argue for or against austerity. Paul Krugman, for example, argues that the fact that Latvian GDP is still more than 10% below its pre-crisis peak shows that the “austerity cum wage depression” approach does not work and that, Iceland, which was not subject to Brussels austerity and devalued its currency, seems to be much better off. Others have pointed out that Estonia avoided a financial crisis because it pursued a strict austerity policy in the wake of the crisis and is now growing vigorously again, whereas Greece, which delayed its fiscal adjustment for too long, experienced a deep crisis and is still mired in recession.

Both sides in these disputes, however, usually neglect to mention the key idiosyncratic characteristics and specific starting conditions that sometimes make direct comparisons meaningless.

A first key point is that Latvia, like the other Baltic states, had enormous current account deficits when the crisis started. This implies that the pre-crisis level of GDP was simply not sustainable as it required capital inflows in excess of 20% of GDP to finance outsized consumption and construction booms. It was thus unavoidable that GDP would fall by double-digit percentages as soon as the capital inflow stopped. The observation that Latvia’s GDP is now still more than 10% below its pre-crisis peak is thus misleading if one does not add that at the peak the country ran a current account deficit of 25% of GDP which could not go on forever.

Any comparison of the Baltics with the Great Depression (or the US today) is thus meaningless. The Baltics simply had to adjust to a sudden stop in external financing, which was not the problem of the US during the 1930s, nor today.

A better way to judge post-crisis performance is to look at the output gap, i.e. actual GDP relative to potential. According to the European Commission’s estimate, Latvia’s GDP was almost 14% above potential at the peak of the boom, and then fell to 10% below potential when the boom turned to bust. The government increased taxes during the bust to keep revenues roughly constant as a share of GDP, but a sizeable fiscal deficit arose nevertheless since social security expenditure, such as unemployment benefits, soared when the economy collapsed. With the almost V-shaped recovery, this expenditure fell again rapidly reducing

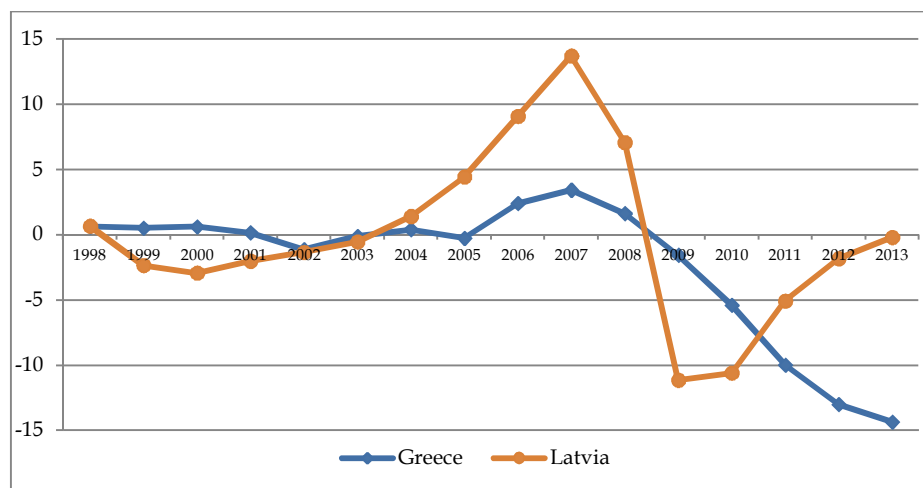
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the deficit. The recovery could only be partial because the previous level of output was unsustainable, but it was enough to allow the government to balance its books again. Latvia is thus today in a sustainable fiscal position with output close to its potential and growing. Austerity might have temporarily worsened the slump in Latvia, but it did deliver a sustainable fiscal position without inflicting permanent damage to the economy. By contrast, the GDP of Greece, which was slow to adopt austerity, is still 12% below estimated potential and keeps falling (see Figure 1).

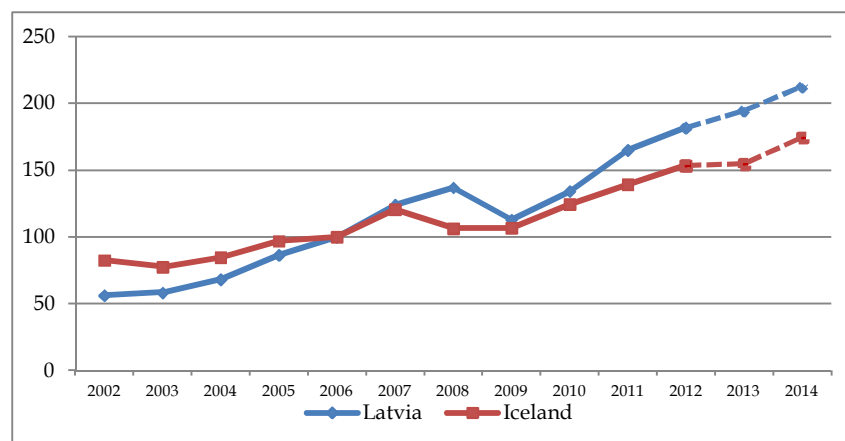
Figure 1. Gap between actual and potential GDP as % of potential GDP



Source: Ameco, 2012.

Does Iceland constitute a counter example to Latvia because its GDP fell much less, although it had similar current account deficits before the crisis? Iceland ran much larger fiscal deficits for a longer period of time and, in contrast to Latvia, let its currency, the krona, devalue massively. The devaluation was much less important than widely assumed. Icelandic exports did indeed perform very well, but they are natural resources (fish and aluminium), demand for which held up well during the global crisis of 2008. This provided an important stabiliser for the domestic economy, which the Baltics did not have. The better performance of the Icelandic economy should thus not be attributed to the devaluation of the Icelandic krona (which did little to foster its exports, given that they are natural resources) – but rather to global warming which pushed the schools of herring further North, into Icelandic waters. Figure 2 also shows that both before and after the crisis Latvian exports grew more strongly than those of Iceland. The devaluation thus did not make a big difference for Iceland's capacity to export (as one would expect, given the nature of Icelandic exports).

Figure 2. Export of goods and service, index, 2006=100

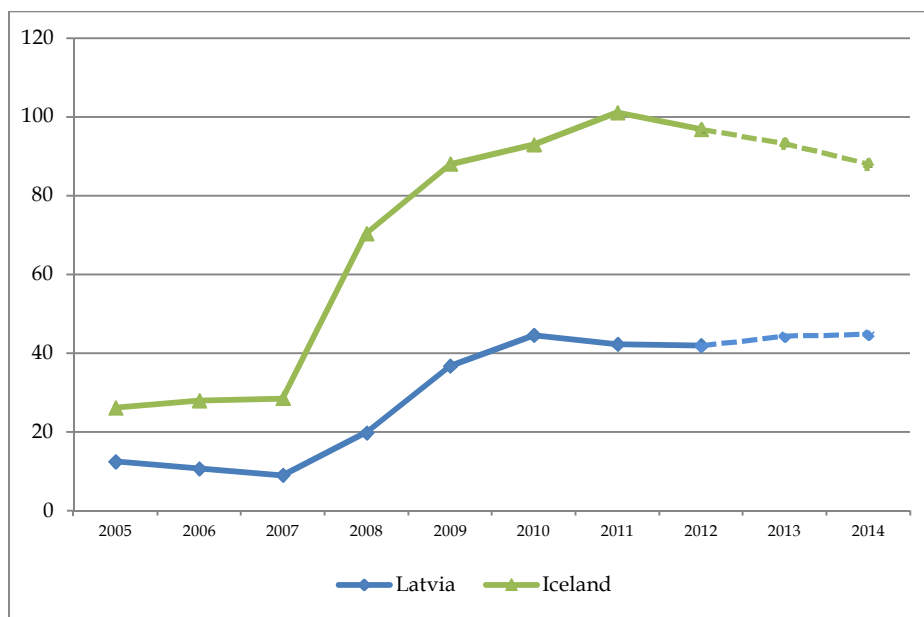


Source: Eurostat, 2012.

Nor is Iceland a poster child for the thesis that 'avoiding austerity works'. In small, open economies, higher deficits are, in any event, unlikely to sustain domestic output as most additional expenditure goes towards input. It is thus not surprising that, despite the large devaluation, Iceland still runs a high current account deficit, thus adding to its already large foreign debt.

The consequence of avoiding austerity is a public debt at 100% of GDP in Iceland, compared to only 42% of GDP for Latvia. Part of the difference is of course due to the differences in starting conditions and the cost of bank rescues. But there can be no doubt that by keeping deficits under control, the public finances of Latvia are in much better shape today with public debt no longer a problem. Both countries had rather low debt levels before the crisis. This is still by and large the case for Latvia, whose debt-to-GDP ratio is less than one-half the EU average. By contrast, the debt level of Iceland has become so large that it is likely to constitute a break on future growth.

Figure 3. Public debt as % of GDP'



Source: Ameco, 2012.

Thus, one has to be careful when drawing general lessons from the experience of small countries with sometimes very special characteristics. The one conclusion that appears to hold generally is that avoiding austerity does not allow one to avoid the problem of achieving both fiscal and external sustainability.