



# POLICY PAPER

No. 6 (54), March 2013 © PISM

Editors: Marcin Zaborowski (Editor-in-Chief) • Wojciech Lorenz (Managing Editor)

Jarosław Ćwiek-Karpowicz • Beata Górka-Winter • Artur Gradziuk • Roderick Parkes • Beata Wojna

## The Baltic States' Success Story in Combating the Economic Crisis: Consequences for Regional Cooperation within the EU and with Russia

**Kinga Dudzińska**

*The global economic downturn of 2008 and the financial and ongoing fiscal crisis in the eurozone have proved to be extremely painful for newer EU Member States Latvia, Lithuania and Estonia. At the same time, however, the crises have revealed some significant differences between these three small, seemingly homogenous countries, and especially in the effectiveness of their anti-crisis policies. The diverse results of these policies were shaped in several respects by internal factors, such as the sensitivity of their economies to foreign markets or the different response times of the governments to the first signs of the economic downturn as well as the socio-political background at the time of the crisis. However, the Baltics have indeed learnt lessons, as each one implemented austerity-style policies. Since 2011, economic growth has accelerated in all of the Baltic States, and their struggle with the crisis already seems to be a unique success story that affects regional cooperation as well as relations with Russia.*

### **The Growing Tigers and First Symptoms of Crisis**

The uniqueness of the Baltic States arises due to the fact these are the only former Soviet republics that became members of the European community. For many years, their small economies were centrally planned and managed. Since the beginning of the transition process in the 1990s, the Baltic States have substantially reoriented their markets, including the structure of foreign trade as well as changes in exports and imports. During that decade, the Baltics developed trade with the West, particularly with the Nordic countries, while simultaneously limiting the importance of countries in the East. This applies specifically to Russia and the other former Soviet republics because as early as 1998 Lithuania, Latvia and Estonia were experiencing the effects of the Russian economic downturn, when the rouble was devalued and clearly affected Baltic exports. However, this was an important impulse to reorient their economies from the closed East-focused, centrally planned systems to open and diversified markets. For instance, at the beginning of the 1990s, less than 5% of Estonia's foreign trade was with Western countries, and of this, only 21% was exports. Then the privatisation process remained crucial—as early as 1995 in Latvia the share of the private sector of the country's GDP reached 60%, and in Lithuania it was even higher, about 65%, and 75% in Estonia. Moreover, relatively early after the transition, all of the Baltics introduced their own currencies and had pegged exchange rates, which significantly reduced the possibility of using fiscal policy during the upcoming crisis.

Since 2003, and especially after the Baltic States joined the EU in 2004, all three economies witnessed an unprecedented and unexpected growth cycle, resulting in dynamic increases in GDP. From 2003 to 2007,

growth rates reached about 8% to 12% year to year.<sup>1</sup> Although Lithuania, Latvia and Estonia were very often described as the “Baltic Miracle” or “Baltic Tigers,” an increasing number of imbalances in these countries became visible just before 2008. By then their economies were showing symptoms of overheating, meaning inflation had increased as a result of the prolonged high growth rate, especially in Latvia. In fact, the considerable-to-high domestic consumption, easy access to cheap credit and rapid inflow of foreign investment to the Baltics decisively created the first symptoms of overheating as early as 2007.

In the boom time, the Baltic States stood out for their low budget deficits, which were all below the 3% required by the Maastricht criteria. However, in 2007 budget deficits first increased in Lithuania and Latvia, then in 2008 in Estonia. In these circumstances, in the Baltics anyway, and due to economic cycles, a crisis would emerge, especially when economic growth was strictly linked to foreign direct investment (FDI). FDI between 1994 and 2008 reached an average of about 8% of Estonia’s GDP, more than 5% in Latvia and almost 4% in Lithuania.<sup>2</sup> That made the Baltic States especially sensitive to external market changes.

## **The Baltic Tigers’ Decline in 2008**

In 2008, Lehman Brothers, the fourth-largest investment bank in the world, declared bankruptcy, which caused a chain reaction that resulted in the worst global financial crisis and economic downturn in 70 years. The global economic downfall affected the Baltic States particularly because of the accumulation of certain factors that in the Baltics were in place by 2008. In the region, growth started slowing in early 2008 before the global crisis had hit, but the biggest decrease in GDP, from 15–17% in Estonia and Lithuania to almost 25% in Latvia, was noted in 2009.

The global economic crisis caused a harsh decrease in foreign capital inflow, especially in the financial and banking sectors. The reaction to the crisis of Swedish banks withdrawing money from their Latvian investments resulted in the deterioration of one of the largest Latvian banks, Parex. Then with the threat of a loss of financial liquidity, the Dombrovskis government decided to nationalise it (initially the government took 51% of its shares but that has risen to 85%). Moreover, the foreign currency indebtedness in the Baltic States reached a very high level. Between April 2008 and April 2009, the share of foreign currency loans in total lending reached 60–70% in Lithuania and 80–90% in Estonia and Latvia. In Estonia, paradoxically, its greater attractiveness to investors compared to Lithuania and Latvia meant that most investment was foreign, which subsequently dropped very fast to about 30% in 2009. Latvia also had a substantial amount of cheap loans and strong links to foreign investment. In contrast, Lithuania was in the best situation at the beginning of the economic crisis, only noting a drop in GDP in 2009, though the government did not react quickly, noting that GDP had grown in 2008.

Generally, the imbalances were quite common for all of the Baltic States. The crisis-related cyclical deterioration of deficits interacted with underlying structural weaknesses, mainly spending excesses. Moreover, the growth in domestic demand was financed from abroad and resulted first in large current account imbalances and second in an accumulation of substantial net foreign liabilities.<sup>3</sup> The growing bubbles in the Baltics were fuelled by easy access to cheap credit, particularly because of the nature of the banking sector’s strong integration with counterparts in Sweden. Next, this resulted in a collapse in real estate markets and a breakdown in the construction industry, which affected financial markets as well, consequently slowing consumption.

## **The Same Anti-crisis Strategy with Different Effects**

The Baltic States implemented to a similar degree the same anti-crisis strategy based on an “internal devaluation” of the domestic currency—meaning austerity policy. However, some economic experts and

---

<sup>1</sup> J. Mezo, A. Bagi, “Crisis Management in the Baltic States,” *MPRA Paper*, no. 40366, 2012, p. 428, [http://mprapaub.uni-muenchen.de/40366/1/30-Crisis\\_Management\\_in\\_the\\_Baltic\\_States.pdf](http://mprapaub.uni-muenchen.de/40366/1/30-Crisis_Management_in_the_Baltic_States.pdf).

<sup>2</sup> J. Mezo, A. Bagi, *op. cit.*, pp. 430–431. See also: Directorate-General for Economic and Financial Affairs, *Cross-country Study: Economic Policy Challenges in the Baltics. Rebalancing in an Uncertain Environment*, Occasional Papers, no. 58, Brussels, 2010, pp. 14–15/19–25, [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2010/pdf/ocp58\\_en.pdf](http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp58_en.pdf), and C. Purfield, Ch.B. Rosenberg, *Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008–09*, IMF Working Paper, WVP/10/213, pp. 3–17, [www.imf.org/external/pubs/ft/wp/2010/wp10213.pdf](http://www.imf.org/external/pubs/ft/wp/2010/wp10213.pdf).

<sup>3</sup> “Cross-country Study: Economic Policy Challenges in the Baltics Rebalancing in an Uncertain Environment,” *op. cit.*, pp. 12–13; and C. Purfield, Ch.B. Rosenberg, *op. cit.*, pp. 17–19.

the IMF advocated an external currency devaluation, which would have precluded the Baltics from joining the eurozone as a crisis exit strategy. Moreover, the decision to not devalue their national currencies was made because a large proportion of loans in the countries had been denominated in euros. In practice, austerity policy involved sizeable fiscal consolidation, which meant a reduction in funding for various needs in order to restore fiscal sustainability, for instance by raising taxes, reducing spending, and adjusting nominal wages.<sup>4</sup> Although the Baltic States chose an internal devaluation of their currencies, the implementation in each country had at least slightly different effects. This is mainly because of the various socio-political conditions in these countries, including the governments' actions, the efficiency of carrying out their decisions given the transparency of state institutions, and the level of social acceptance of the drastic spending cuts and savings policies.

Meanwhile, especially in Latvia, the deteriorating economic situation was strictly linked to the socio-political background. To a large extent, the scale of the crisis in the Latvian economy was a result of poor policy decisions, the influence of interest groups, including strong links between politicians and businesses, and an increasing number of corruption scandals (Latvia remains the most corrupt country among the Baltics—in 2011, Freedom House reported that Latvia had returned to the corruption level it had when it joined the EU). In protest of this situation, on 13 January 2009, the largest public demonstration since the recovery of Latvia's independence was organised in Riga. Intended as a peaceful protest organised by NGO activists, it turned into riots.<sup>5</sup> Despite the tense situation, the new centre-right government, formed in March 2009, has taken a lot of regressive decisions (such as increasing VAT, imposing an excise tax mainly on alcohol and tobacco products, and reducing welfare benefits by more than 20%). Dombrovskis' five-party coalition cabinet in 2009 received an aid package of €7.5 billion and had to attempt to meet the stringent conditions set by the IMF and the European Commission to keep the budget deficit in 2011 to less than 6% of GDP and reduce expenses by 3% of GDP.<sup>6</sup> This has decreased the standard of living in Latvia, where unemployment reached more than 20% in 2009. However, the government is consistent in its aim to introduce the euro in 2014, thus austerity policy seems to be successful in meeting this goal as Latvia noted GDP growth of 5% in 2012. Nevertheless, only 30% of Latvians want to switch from lats to euros and remain unconvinced about joining the eurozone in such a hurry.

In Lithuania, the conservative cabinet of Andrius Kubilius, who took power in 2008, was forced to immediately go to work to combat the crisis, using such means as cutting public sector salaries and social benefits, which rose in real terms by 44% between 2006–2008. However, for the first time in Lithuania since the country regained independence, the government remained in power for a full term of parliament. Nevertheless, Lithuanians, extremely tired of the crisis and with austerity policy (pensions and salaries in the public sector were slashed by 20–40% and taxes increased), voted for the opposition in the most recent elections in October 2012. The Social Democrats and populist parties took power, which probably will affect the previously held austerity policy, and its effectiveness in the long term. New Prime Minister Algirdas Butkevičius has already announced higher minimum wages and reforms and has also referred to a tax reduction, which in practice means the new coalition will block the Kubilius government's fiscal discipline.

Among the Baltics, the most stable situation during the crisis has been in Estonia, where the traditional socio-political cleavages based on left and right do not in fact exist. Therefore, even in this case the parliamentary elections, which in 2011 (likewise in 2007) were won by the liberal, pro-market Reform Party. There was no threat to austerity policy, and the government focused on further market liberalisation by trying to increase the competitiveness of the Estonian economy. Public sector wages were slashed, the pension age was raised and it has become harder to claim health benefits. Moreover, Estonia is a good example of the majority's trust in the government and state institutions. Transparency is also highly developed. During the last several years of the global economic crisis, Estonia, with its fiscal policy and resulting introduction of the euro in 2011, can be seen as a success story, and its methods as an effective strategy for emerging from the crisis. Moreover, Estonia is the only eurozone country with a budget

---

<sup>4</sup> J. Mezo, A. Bagi, *op. cit.*, pp. 431–433. See also: V. Kuokštis, R. Vilpišauskas, "Economic Adjustment to the Crisis in the Baltic States in Comparative Perspective," a paper prepared for the 7<sup>th</sup> Pan-European International Relations Conference, September 2010, Stockholm, <http://stockholm.sgir.eu/uploads/Economic%20Adjustment%20to%20the%20Crisis%20in%20the%20Baltic%20States%20in%20Comparative%20Perspective.pdf>.

<sup>5</sup> I. Kažoka, D. Akule, "Latvia: Extreme Political Turbulence," *Commentary*, EPIN, no. 3/9, February 2009, p. 2, [www.ceps.be/system/files/book/1794.pdf](http://www.ceps.be/system/files/book/1794.pdf).

<sup>6</sup> "Cross-country Study: Economic Policy Challenges in the Baltics Rebalancing in an Uncertain Environment," *op. cit.*, p. 21.

surplus. The country still pays close attention to the liberalisation of markets, including by establishing a favourable business environment and reducing and simplifying taxes. All the Baltic States have already noted growth in GDP, which is the basic marker of their success in combating the crisis to date. However, the crisis has also resulted in forcing initial, structural changes. Currently, in comparison, the Baltic States are better off than other European countries such as Spain and Greece, which continue to struggle with the economic crisis but unlike the Baltics are still counting on support from international institutions and are not making much headway on structural reforms. Lithuania, Latvia and Estonia, while passing over the differences between these three, have combat the crisis and come through, so much so that Latvia did not even have to use its full assistance package from the IMF. Migration has decreased and clearly fewer people are leaving the country, which was a big problem for Lithuania and Latvia. Moreover, unemployment has stabilised, even though it is still quite high—in 2012 it was almost 15% in Latvia, 12% in Lithuania, and about 10% in Estonia. However foreign trade is growing in all of the Baltic States as well as the amount of the investments, which will result in a dynamic shift in the job market.

Therefore, the success story of the Baltic States was, on the one hand, a relatively quick defeat of the crisis, resulting in an increase in GDP, while on the other hand, is a tale of the effectiveness of austerity policy, which to some extent was due to the consistency of the government's actions and its attempt to start not only cosmetic changes but also structural reforms. However, a decisive factor was also the relatively small size of these economies, and that people had to react to the crisis by leaving the country and looking for a job elsewhere. Moreover, the peaceful reaction of society to austerity policy in the Baltics is also amazing.<sup>7</sup> Frequently, however, it is explained by the sobering experiences of the Soviet period as well as by the fact that from the 1990s onwards, Lithuania, Latvia and Estonia have often struggled with other economic crises. In addition, the economic downturn in 2008 has not been indifferent to the regional cooperation of the Baltic States, which may be perceived as another point in the success story of the Baltics as they enhance cooperation as well as improve competitiveness.

### **Baltic States' Regional Cooperation after the Crisis**

The crisis is assumed, at least indirectly, to have affected cooperation in the region and triggered attempts to intensify it among the Baltic States. This is proved by their increasingly declared willingness for teamwork in the Baltic Sea Region (BSR). Lithuania in 2012 was the centre of joint Nordic–Baltic activities when it took over coordination of the NBB, a partnership of eight regional countries. This platform, as well as the Council of the Baltic Sea States (CBSS), is a clear priority in Baltic foreign policies, primarily for Lithuania, which recently has become more active in this field. However, this direction is still significant for Estonia, which defines itself as a Nordic country, sometimes even a little bit contrary to the other two Baltic States.

All three of the Baltic countries participate in the Northern Future Forum, which since 2011 has presented them a new opportunity to enhance regional cooperation. Under this banner, Nordic, Baltic and British officials and experts will meet in Riga to discuss the competitiveness of a green economy and opportunities for bridging the digital gap. Furthermore, the development of competitive and innovative Baltic economies will be high on the Baltic Assembly's agenda in 2013. However, the Baltic States' stronger activity in the wider region is partially related to the interests of other countries in the Baltic Sea, as Germany and Poland also have become increasingly active in this area. Moreover, it is to be expected that cooperation within the Baltic Sea Region will result in stronger ties also with Russia (and with Kaliningrad Oblast, especially), while a new mechanism, the Pilot Financial Instrument (PFI), and Project Support Facility (PSF), or the new South Eastern Baltic Area initiative (SEBA), were created during Germany's presidency of the Council of the Baltic Sea States and the subsequent Russian presidency. Furthermore, the Baltic States platform (B3), for instance, the Baltic Assembly, is still used, at least on the diplomatic level, by Lithuania, Latvia and Estonia on the European forum. Here the Baltic States strongly support their initiatives and underline common interests regarding, for example, negotiations on the EU's Multiannual Financial Framework 2014–2020, especially cohesion financing.

Among the Baltics, Estonia has most effectively carried on with its “Nordic” foreign policy strategy, which for years has included strong cooperation with Finland. Additionally Estonia is further building its own brand as a knowledge-based economy emphasising the role of its high level of digitalisation, development of advanced technologies, work on cyber security. At the same time, Lithuania has attempted to redirect its

---

<sup>7</sup> V. Kuokštis, R. Vilpišauskas, *op. cit.*

own foreign policy vectors to the north. Nevertheless, its focus on the Baltic Sea to some extent has been seen as a reaction to its deteriorating relations with Poland, which became strained as a result of controversies and disagreements concerning assessments of the Polish minority situation in Lithuania. The new Social Democrat government has clearly declared it is willing to improve relations with Poland. Meanwhile, in view of the February visits of Lithuanian authorities to Warsaw, it is difficult to predict a rapid change in bilateral relations. Concrete decisions are still missing, although the first, small steps in this direction have probably been taken, for example, the Lithuanian language final examination for minorities has been simplified for the next testing year. However, even if the current government fully supports the idea of a reset in relations with Poland, President Dalia Grybauskaitė is clearly not in favour of drastic changes. Nevertheless, the Nordic trend in Lithuanian foreign policy has not been squashed by the new Lithuanian government, which suggests that the Baltic Sea region really be seen as attractive for the development of multilateral cooperation. Lithuanian Foreign Minister Linas Linkevičius made his first official trip to Latvia and the second to Sweden. The latter is one of the top investors in all three Baltic States after the crisis and, at least in the initial phase of the growth in recovery, is responsible for the highest capital inflow to the Baltic States.

### **The Crisis and the Cooperation with Russia—A New Dimension?**

The economic crisis in the Baltics has proved to be an opportunity for Russian investments, or at least has made it possible to increase Russian influence in these countries in energy and media as well as the recovering real estate market, in transport and in logistics. Nevertheless, due to the import/export structure of the Baltic States, the importance of Russia remains almost unchanged, according to official statistics, and Russia at the moment seems to have the strongest links to Latvia. In 2007, a Latvian–Russian intergovernmental commission was established to discuss primarily transit and the development of an East–West transport corridor (Riga–Moscow). Moreover, in 2010, Latvian President Valdis Zatlers visited Moscow, the first time a president has done so since the 1990s. However, it is hard to prove all of the ties between politics and the economy as the main approach to get into the Latvian or the other two Baltic markets means buying companies or their shares as well as real estate (for instance, in Jurmala, Latvia, or in Klaipėda, Lithuania).<sup>8</sup> Here the crucial angle seems to be Russian investments in the Baltic energy sector, which is top of the list. That is significant considering the Baltics' obligation to implement the so called Third Energy Package. So far, Lithuania has been the hardest player aiming to complete the separation of the companies' generation and sales operations from their transmission networks. However, the new left and populist government in Vilnius has started negotiations with Gazprom regarding a new long-term contract, which could lead to weakening the government's position, especially if the implementation of strategic, regional energy projects in Lithuania become uncertain. Here, limited financial resources and highly capital-intensive projects play key roles in developing common and strategic energy undertakings. Moreover, consensus among the Baltics is often difficult to achieve as vested interests typically prevail. Currently, there is no final agreement on a planned nuclear power plant in Visaginas and no decision about a proposed regional LNG terminal. Each country now plans to build its own terminal. However, a consulting firm hired by the European Commission has recommended Estonia for the construction of the Baltic liquefied natural gas (LNG) terminal, but only if Finland joins the project. At the same time, Russia is trying to use the situation to its advantage, and as always uses different political manoeuvres for each of the Baltic States, in effect separating them, as with the case of gas prices. Moreover, Russia is attempting to halt some of the regional initiatives by building its own nuclear power plants in Kaliningrad Oblast and in Belarus.

However, since the economic crisis the Baltic States have been more interested in stronger cooperation with Russia due to the economic benefits, such as foreign investments, crucial to stimulating growth in these small countries. At the same time, business links can become more effective to further Russian influence in the region as it attempts to use large companies to create dependency on energy or oligarchic business interest groups. Nevertheless, it turns out that recently the scope of Russian influence has increasingly become limited to making the Baltic States dependent on its energy sector and business connections. For instance, Estonia is the most energy independent, has the most transparent business rules

---

<sup>8</sup> "Ilves Vexed by Lack of Progress on Lithuanian Nuke Plant," *ERR (Estonian Public Broadcasting)*, 25 February 2013, <http://news.err.ee/politics/7c398474-974b-4633-b792-f45693d73455>. See: A. Zeltiņš, "Business Interests in the Latvia–Russia Economic Relationship," in: A. Sprūds (ed.), *The Economic Presence of Russia and Belarus in the Baltic States: Risks and Opportunities*, Riga, 2012, pp. 127–130, [http://appc.lv/wp-content/uploads/2012/11/The\\_Economic\\_Presence\\_for\\_WEB\\_atverums\\_2.0.pdf](http://appc.lv/wp-content/uploads/2012/11/The_Economic_Presence_for_WEB_atverums_2.0.pdf).

of the three, and—even when taking into account recent increased tensions with Russia after a Soviet-era statue (the Bronze Soldier) was removed from central Tallinn in 2007—maintains the strongest stance on Russia of the three.

## Conclusions

The economic downturn has deeply affected the situation in Lithuania, Latvia and Estonia. Since 2008–2009, the domestic policy in the Baltics has been extremely focused on tackling the financial and fiscal crises, mainly in order to attract foreign investors and to increase the competitiveness of their markets. For small countries such as the Baltic States that do not have great capability to develop their own industries, the inflow of foreign capital is particularly important. It makes these countries particularly vulnerable to fluctuations in external markets. The economies of Lithuania, Latvia and Estonia are growing at present, unlike most other European countries, which are still combating the financial and fiscal difficulties. The Baltics' recovering economies have noted rapid growth in GDP and are among the highest in the EU. Generally, because of that, they can be presented as a success story. However, the phenomena of the Baltic States results also from the effectiveness of their austerity policies, implemented by each government and initially focused on some structural reforms.

- All three, Lithuania, Latvia and Estonia, chose austerity policy and so called internal devaluation (rather than an external devaluation—the regular devaluation of the nominal exchange rate), which forced them to cut spending significantly. **However, in each of the Baltic countries, with regard to internal factors, the effects of cutting spending appeared to be varied.** Estonia fared the best in the economic downturn because of its timely response to the early symptoms of impending economic collapse. Latvia and Lithuania found it far more difficult to cope with the breakdown, but only Latvia asked for a rescue package from IMF.
- **The economic crisis made the differences among the Baltics visible**, especially highlighting the greater adaptability of Estonia and its commitment to technology development and its fast reaction to the first signs of the crisis. It can be expected that Latvia will be determined to introduce the euro, which is now a priority objective of the Dombrovskis government. However, having the same currency does not mean directly that the economy will be healed, especially when Latvia and Lithuania still need structural reforms, including reorganisation of their health care, social benefit and education systems. The question is out for Lithuania. Although the Lithuanian authorities declared their willingness to introduce the euro in 2015, to an extent they are less visibly interested in the common currency.
- **The crisis did not result in a weakening of the pro-European course of the Baltic States.** All of the Baltics remain supporters of closer European integration and solidarity, because from their perspective the EU and NATO still remain guarantors of their security, especially in respect to Russia. The forthcoming Lithuanian presidency of the EU indicates that solidarity and security, especially in the energy sector, are its priorities for the second half of 2013. Lithuania will also use the presidency to enhance its prestige as well, as it is the first of the Baltic States to lead the EU Council. Moreover, the country still considers itself a leader in creating regional policy towards the Eastern Partnership countries, especially when the next EaP summit will be held in Vilnius.
- **The aftermath of the crisis also has seen greater openness among the Baltic States to Russia, especially regarding Latvia and Lithuania.** Russian business interests probably strengthen Russia's position in these countries, particularly given Lithuania's willingness to improve relations with the country. Russia can be expected to use its business ties, especially, to continue to exploit its presence in the Baltic States. As a result, due to the divergent interests of the Baltic States as well as Russia in the region, common energy projects that contribute to regional energy security will need stronger support from the EU. In this context, a key issue is the integration of the energy markets and liberalisation within BEMIP, which to some extent also determines the scope of Russia's presence in the region.