Pointmaker

ESTONIA: A CASE STUDY

HOW AND WHY ESTONIA EMBRACED AUSTERITY

RYAN BOURNE

SUMMARY

- Estonia provides a clear case-study of a country which has fully embraced austerity within a fixed exchange rate structure.

- An unsustainable boom between 2004 and 2007 began unravelling as Nordic banks tightened lending conditions due to concerns about private sector debt levels, and this was exacerbated by the international crisis in 2008.

- Faced with an economic crisis and shrinking tax revenues, the IMF forecast that Estonia would have a budget deficit of more than 10% of GDP in 2009 on unchanged policies.

- With many private sector debts denominated in euros and a political commitment to joining the euro currency, Mr. Jürgen Ligi took the helm at the Ministry of Finance.

- He cut government spending drastically, explaining that the surging revenue growth during the boom (2000-2007) had resulted in pro-cyclical expenditure based on somewhat illusory growth.

- Unable to devalue its exchange rate, the only way to eliminate the current account imbalance and improve competitiveness was through internal devaluation.

- In all two-thirds of the consolidation was done on the expenditure side and one-third on the revenue side. The scale of the Estonian cuts meant a decline in total nominal spending between 2008 and 2010 of 10%.

- This did, of course, weaken output in the short term. Combined with the global downturn, unemployment peaked at around 20% in early 2010.

- But since then, on several measures the Estonian programme appears relatively successful:
  - unemployment has fallen back to just over 10% today
  - the government met its deficit target – it never exceeded 3% of GDP – and was back in surplus by 2010
  - the economy rebounded with 3.3% growth in 2010 and 8.3% growth in 2011.

FOREWORD

Jürgen Ligi, Minister of Finance

Long-term economic growth is always governed by the actions we take today. Since the early days of regaining independence, Estonia has opted for a liberal and open economy. A straightforward tax system, a balanced budget and a reliable currency have been the foundations on which we have built a country trusted by entrepreneurs and investors alike, which is now integrated deeply into the European economic area.

In the middle of last decade though, we started to get ahead of ourselves. We had a period of illusory growth, based largely on spiralling private sector debt. This was unsustainable. We were then faced with a larger than expected loss of revenues as the economy started to show signs of deterioration, further amplified by the subsequent global crisis in 2008. In order to keep our economic foundations intact, the only viable way was a swift reduction in government spending.

The recession initially came at a high price. But in hindsight this was a necessity to put us back on the path of long-term, sustainable economic growth. Recovery was regained without sacrificing any of our core principles. Estonia continues to be a stable and growing economy, with a balanced budget and low debt, which are increasingly rare qualities in the world we live in today.

Jürgen Ligi has been the Minister of Finance in Estonia since 2009. He is a long-time member of the Estonian Parliament, the Riigikogu (1995–2005 and 2007–2009) where he has previously served as the chairman of the Parliamentary Committee for Budget Control.

INTRODUCTION

In a recent visit to the United Kingdom, Nobel prize-winning economist Paul Krugman appeared on Newsnight in a debate on the effectiveness of the UK Government's austerity measures. Citing the Eurozone, Krugman strongly argued that austerity within Europe had been counter-productive and self-defeating.

Towards the end of the conversation, fellow participant Jon Moulton (a member of the Board of Directors of the CPS) challenged Krugman's claim that austerity had not worked anywhere by highlighting the example of Estonia, which has been growing strongly in recent years.

This seems to have planted the seed for an online row. Shortly after the appearance, Krugman wrote a very short piece on his *New York Times* blog entitled 'Estonian Rhapsody' in which he sought to show that Estonian austerity measures had not been effective.

Explaining the chart below, he claimed that as the overall level of output was still below the pre-recession peak, it was difficult to claim that Estonian austerity had been a success. He said:

"So, a terrible — Depression-level — slump, followed by a significant but still incomplete recovery. Better than no recovery at all, obviously — but this is what passes for economic triumph?"

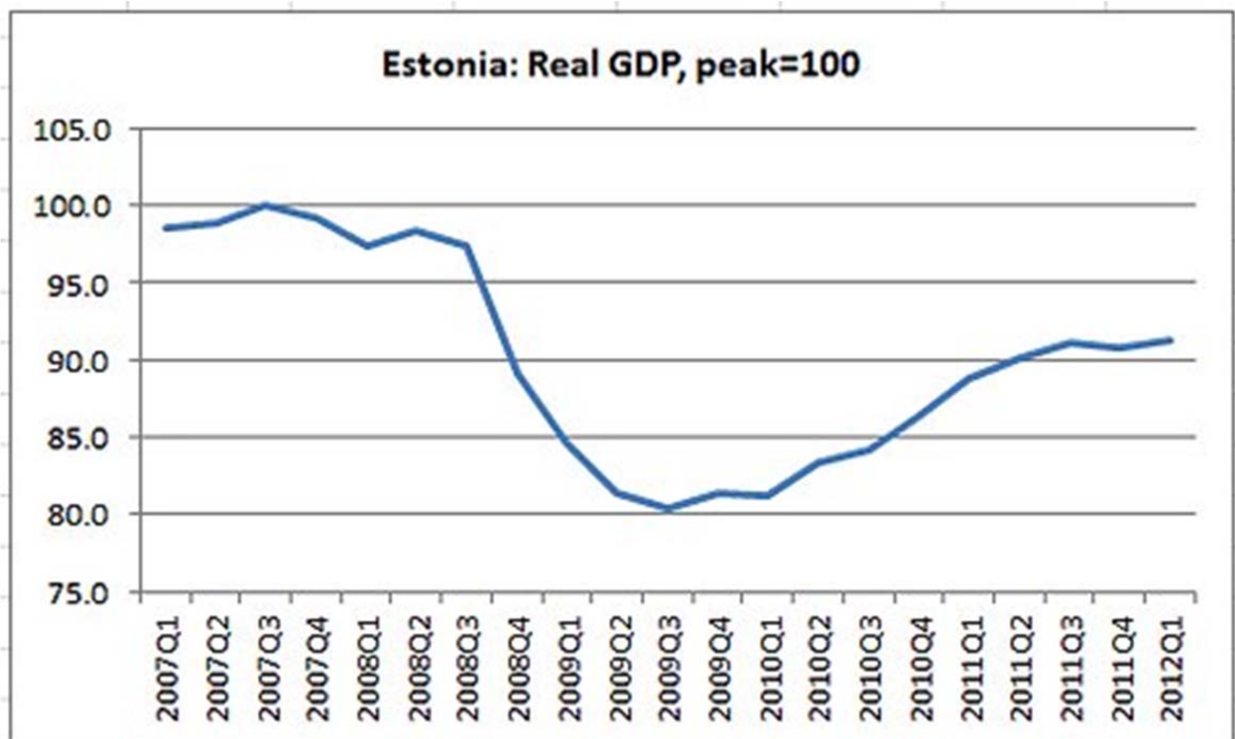
In an unusual public spat, the blog drew a very public and angry response from Estonian President Toomas Hendrik Ilves, who tweeted:

'Let's write about something we know nothing about & be smug, overbearing & patronizing"

And:

"Guess a Nobel in trade means you can pontificate on fiscal matters & declare my country a "wasteland". Must be a Princeton vs Columbia thing."

ESTONIA GDP: THE SHORT-TERM PICTURE



Source: Eurostat

The main point of contention over this debate on Estonian economic performance seemed to be the starting point used by Krugman in his chart. The economist had plotted a raw real GDP line starting arbitrarily at the height of the boom to the present day.

Looking at a longer-term graph gives a very different picture: Estonia had been growing extremely quickly between 1999 and 2007, and though the contraction between 2007 and 2009 was large, the economy has at least been making good ground in recovering since then.

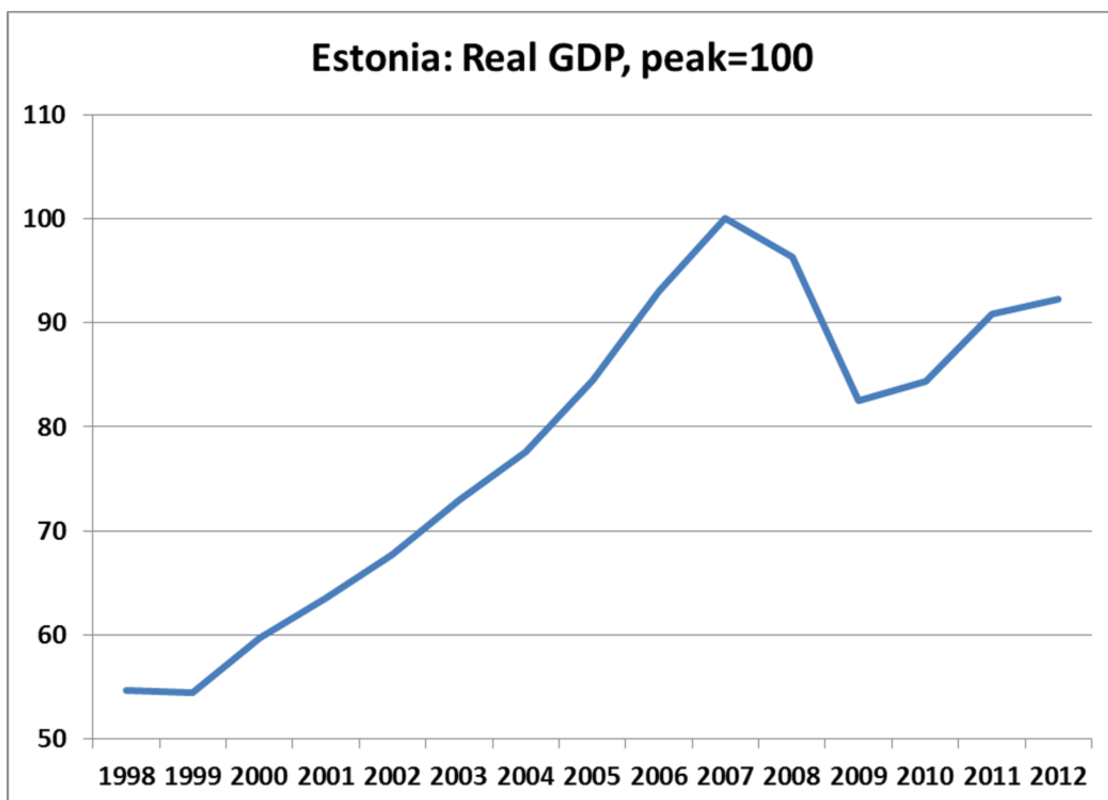
On the 1 July, Krugman did a second blog entitled 'Defining Success Down in the Baltics', focusing on unemployment. Again, he arbitrarily started the chart at 2007 and suggested that unemployment had nowhere near recovered to pre-crisis levels. Again, Ilves was unimpressed:

"Thought for the day...People who for political reasons cherry-pick data have axes to grind. (X and Y axes;-)"

It seems, therefore, that the debate about whether Estonia has been a good example of a country undertaking austerity successfully will continue to rumble.

This short paper outlines the context through which the Estonian government undertook its 'internal devaluation'. It will also outline Estonia's position today relative to other Eurozone economies, and whether Krugman's critique is justified.

ESTONIA GDP: THE LONGER-TERM PICTURE



Source: Eurostat

THE ECONOMIC CONTEXT

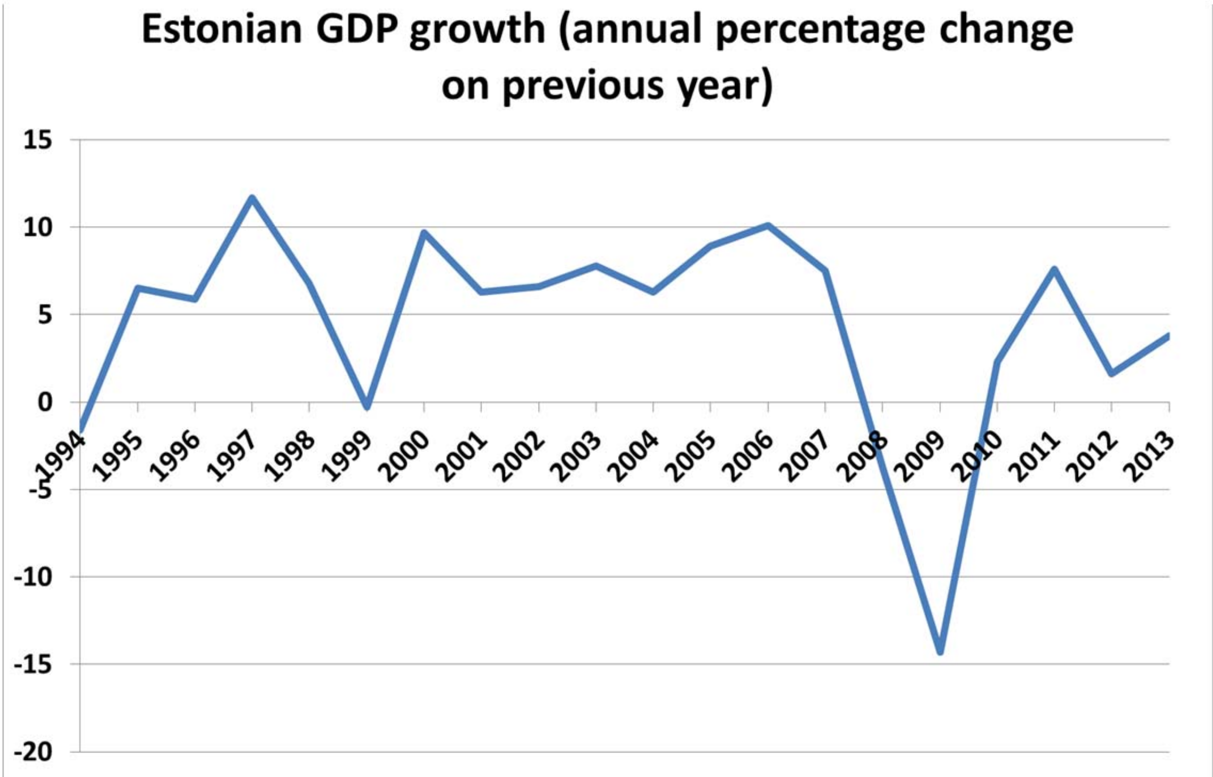
It is not enough to simply critique a country's economic policy on the basis of one output graph, as Paul Krugman would surely agree. Gauging whether the Estonian government's actions were a success or a failure depends on how you judge the sustainability of the preceding boom and the scale of the crisis faced by the government of the day. Thus, you have to judge their current situation against a relevant counterfactual scenario which takes account of the economic state prior to, and as a result of, the crisis.

The Estonian economy grew very quickly between 2000 and 2007, as can be seen by the chart below. Real GDP growth averaged 7.9% a year between 2000 and 2007, and 8.2% a year between 2004 and 2007.

The exceptional growth Estonia enjoyed between 2000 and 2007 can be divided into two clear stages. Initially it was driven by the annulled corporate income tax on reinvested profits in 2000. The following years brought Foreign Direct Investment and export driven growth, supplemented by EU and NATO entry (which were both fulfilled in 2004).

From then on, however, the country's open capital account, decreased risk profile, and the currency board facilitated substantial capital inflows, which lead to large booms in credit and real estate, as seen in many other countries.

A widening current account deficit peaked at around 18% of GDP in 2007, and was financed by large foreign investment inflows. These huge capital inflows passed through into loans, leading to an explosion of private sector debt such that it exceeded 100% of GDP by the end of 2007.



Source: Eurostat

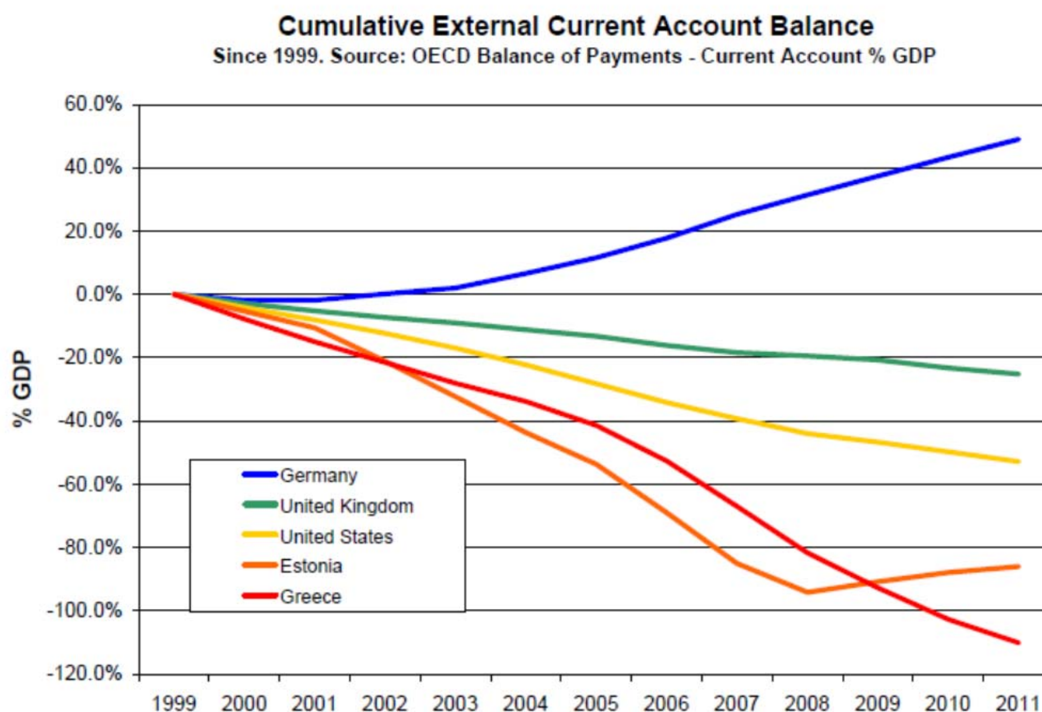
Just as in other fixed exchange rate countries, Estonia saw substantial inflation (averaging annual growth of 4.6% 1999-2008 and as high as 10.6% in 2008), real exchange appreciation and a loss of competitiveness, further amplified by overall real wage growth acceleration during 2004–2007 that stimulated domestic demand and private consumption.

It was from 2007 that this boom began to unravel, when Nordic banks tightened lending conditions due to concerns about increasing debt levels in the Estonian private sector. The tightened credit conditions led to a significant slowdown in housing loan growth and, subsequently, declining house prices, output and jobs in construction, finance and real estate services. The very industries that had driven the supposed growth of previous years were now being squeezed.

The domestic slowdown was inevitably hugely exacerbated by the international crisis and the Lehman collapse in 2008. Credit tightened still further. Exports collapsed as trading countries contracted. Unemployment rose, and the continued weak outlook led to falling economic confidence and GDP (by 4.2% between 2007 and 2008, and 15.1% in the first quarter of 2009 relative to the same period in 2008).

THE REASONING BEHIND THE AUSTERITY PROGRAMME

Faced with shrinking revenues and an economic crisis, the IMF forecast that Estonia would have a budget deficit of more than 10% of GDP in 2009 on unchanged policies. A very small debt burden at the time (4.5% consolidated gross government debt in 2008) meant that immediate fiscal sustainability was not the issue it was in many other countries, but difficult market conditions posed a risk to the use of fiscal policy. What's more, running large fiscal deficits would not allow Estonia to meet the Maastricht criteria required for the adoption of the euro.



Given the scale of the economic challenge facing the government, many were convinced that devaluation of the kroon was the easiest way to restore competitiveness (given the problem was primarily a current account imbalance), and that traditional Keynesian remedies were required to restore lost output.

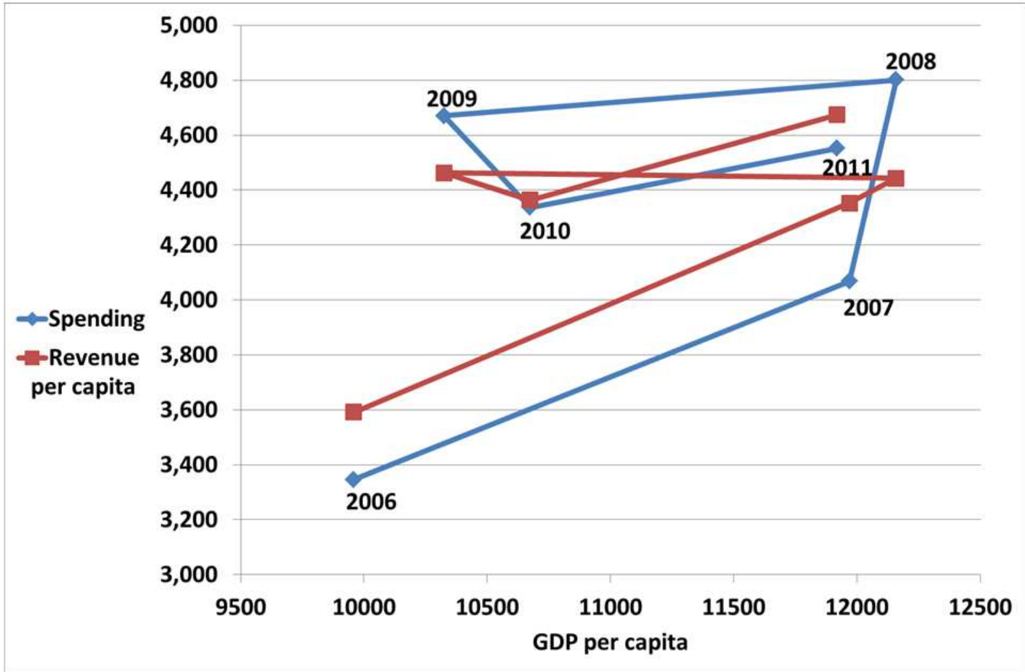
The Estonian Government, however, decided to take a different path. With Mr. Jürgen Ligi taking the helm at the Ministry of Finance in June 2009, the Government cut spending drastically, and sought to explain that the surging revenue growth during the boom (2000-2007) had resulted in pro-cyclical expenditure based on illusory growth.

This decision was at least in part due to the need to remain within the Maastricht criteria for euro entry in 2011 as well as to prevent speculation on a looming devaluation. As such it was the only option for Estonia in a competitiveness sense. Unable to devalue their exchange rate, the only way to eliminate the current account imbalance and improve competitiveness was through internal devaluation (which many argued was preferable anyway, since many of the private debts in Estonia were denominated in euros). What's more the structure of Estonia exports meant the option of full currency devaluation may not have been particularly effective. Many of Estonia's exports are actually re-exports, which entails adding value to euro denominated imports.

WHAT AUSTERITY ENTAILED

As the chart below shows, Estonia was running a budget surplus right up to 2007. In 2008 spending spiked considerably compared to the growth rate of tax revenues, leaving a budget deficit of 2.9% of GDP. At this point the economy was still growing in per capita terms, albeit much more slowly, but in absolute terms it contracted by 4.2%. Then 2009 saw a huge increase in the virulence of the recession as GDP per capita fell by just over 15%, which threatened huge hikes in spending and much lower tax revenues. Real GDP growth for the whole year was -14.1%.

RESTORING THE BUDGET SURPLUS



As outlined above, the Government took drastic measures to prevent the public finances from spiralling out of control. On the revenue side, VAT was increased from 18% to 20%. Remarkably, this helped to ensure that Estonian tax collections per capita were 19% higher in 2009 than they would have been for the same level of GDP per capita seen between 2006 and 2007. Overall tax collections remained almost entirely stable, despite the huge fall in GDP seen in that year. Though in 2010 revenues fell slightly, overall changes to the tax system meant revenues proved remarkably robust given the down-turn.

But the most significant changes came on spending. Despite the large recession, Estonia cut overall spending by 10% between 2008 and 2010. There were large cuts of operational expenditures in the public sector (20% compared to pre-crisis level), a freezing of the state's share of payments to second pensions in June 2009 (restored fully by the beginning of 2012), reform of the compensation scheme for sick days and a reduction in health insurance costs by 8%, alongside many other tough measures.

In all two-thirds of the consolidation was done on the expenditure side and one-third on the revenue side.

This did, of course, weaken output prospects in the short-term. The combined result of the severe downturn and austerity led to a total fall in output from the peak of the boom of 17.4%.

The large cuts to public expenditure, on top of the crisis itself, therefore came at a larger short-term price than experienced by other developed countries. With wages and prices sticky, the large public spending cuts meant unemployment increased much more quickly than in many other European countries from around 8% in early 2009 to 19% in early 2010.

But since then, unemployment has fallen back quickly to just over 10% today – around the EU average. With the economy projected to grow by another 3.8% in 2013 by Eurostat, this could fall further in the future (though probably constrained by the continued Eurozone crisis).

What's more, the cuts meant the Estonian government met their deficit target – it never exceeded 3% of GDP and was back in surplus in 2011. Although the economy went through an extremely difficult two years as a result of the crisis, it rebounded with 3.3% growth in 2010, 8.3% growth in 2011 and 1.6% growth in 2012. Once the unsustainable boom of 2006 and 2007 is smoothed out, the economy seems to be almost back on trend. Public debt as a proportion of GDP was just 6% in 2011. The huge current account deficits have been quickly reversed, and the internal devaluation was achieved without the deflation that the likes of Krugman feared.

It is also worth mentioning here that EU structural funds (available to all of those who joined the euro in 2004) have been used to make up for some of the financial outflows – with €3.4 billion allocated to Estonia for the period 2007-2013. This has certainly eased the pressure somewhat, as some of this is used for projects that would otherwise be publically financed, such as infrastructure investment. As such, it is fair to claim that the deficit would be higher if the funds were unavailable, or else these projects wouldn't go ahead.

The combined result of all of these measures has been affirmed by the credit rating agencies – Fitch, for example, have shifted the country's rating from BBB+ in early 2010 to A+ today.

STRONG SUPPLY-SIDE INCENTIVES

Part of the reason for the recovery has been the fall in real wages and the real effective exchange rate. But Estonia's liberal supply-side

and reforms undertaken in the wake of the crisis have also been important.

Unlike in many European states, there is not a generous safety net. In fact, unemployment support is short and brief, which means there is a high incentive to find a job or move abroad, limiting the extent of social expenditures on out-of-work insurance.

Furthermore, reforms have made it simpler to start businesses, resolve insolvency and enforce contracts. The country has maintained its flat income tax rate at 21% and is looking to cut that rate further to 20% within the next few years. This liberal economic approach which maintained incentives enabled a strong bounce-back from a very deep recession, and income per capita is now very close to its 2007 peak.

And due to the sound nature of the public finances and the economic liberalisation that the economy has extended, most international bodies consider Estonia well-placed for sustainable growth in the future.

According to the *Wall Street Journal*, Estonia now produces more start-ups per head of population than any other country in Europe. It is recognised as a pioneer in new technology (Skype for example, although founded by a Swede and a Dane, was built by Estonians).

TAKING THE PUBLIC WITH THEM

Whilst Western Governments which have imposed austerity are hugely suffering in public opinion polls, the Estonian Government was re-elected.

Why did Estonians meet the austerity measures with relative stoicism? A few explanations seem plausible. First, as the Economy Minister Juhan Parts has explained, the Estonians really were 'all in this together' in the austerity measures. Salaries across the board were all cut, but ministers' salaries fell by 20% and the average civil servants' by 10%. As Parts explained, 'the people showed a good understanding that if you do not have revenues, you have to cut costs.'

It is also likely that Estonia's history was a key factor in the acceptance of these measures. As such a small and young nation, where many remembered the days of the Soviet Union, it was arguably easier to accept sacrifices in order to prepare for a better future. Equally, it was clear that because of this history, the country was committed to greater European integration and joining the Eurozone currency. Estonia's young, cutting-edge technology sector, in particular, felt it would benefit hugely from integration into the large eurozone market.

LESSONS FOR OTHERS

It would be easy to run with Estonia's example and suggest that austerity was the answer to all other countries fiscal problems. But this would be to ignore the different conditions that the country faced – in contrast to others, the low debts meant Estonia didn't face an immediate debt crisis and the preceding boom was much more extreme than in, say, the southern European states. Perhaps more significantly, unlike countries such as Ireland, the Estonian government was not required to bail out any struggling banks, primarily because most of the large banks operating in Estonia are in fact Swedish banks (and Swedish banks managed to weather the credit crunch much better than other countries).

In political terms, the Estonians were able to rally behind the cause of joining the euro, which justified the measures, and the country was a much more open and economically free prior to the cuts (the public were far less

accustomed to big government than their southern European neighbours).

Having said that, Neil Buckley at *The Financial Times* has set out three clear lessons which should be borne in mind by all of those undertaking painful adjustments:

1) **Front-load the pain**: as the examples of Estonia, Canada in the 1990s and the UK in the 1930s seem to suggest, it is far easier to maintain support for austerity if you go hard quickly. Many of the southern European states and countries like the UK are finding it increasingly difficult to maintain public support for drawn out fiscal contraction.

2) **Implement structural reforms to improve competitiveness**: Estonia liberalised employment law, maintained its competitive flat tax and reformed compensation schemes. This seems to fit in with recent international evidence provided by Alberto Alesina, Carlo Favero and Francesco Giavazzi (2012), who concluded: "*what makes successful spending based adjustments different from recessionary tax-based adjustments is not monetary policy but a more general "pro-reform" stance of the government, on the supply side as well as on the spending side".* The UK Coalition has done some good things in this direction (corporation tax etc) but is moving slowly in other areas.

3) **Share the pain 'fairly'**: this lesson is more subjective, but it's clear from some of the savings on ministerial and civil service salaries that there was a highly visible effort in Estonia for governmental institutions to take a significant burden of the adjustment.

An additional lesson might be:

4) **Tell the public what you are doing and why:** in Estonia, the Government clearly explained the unsustainability of the preceding boom and why the actions were necessary, both to restore competitiveness and gain euro entry. In contrast, the UK public is very confused about what our government is trying to achieve (recent CPS polling has shown that 47% of the public believe that the Coalition is reducing the national debt by £600 billion whereas the reverse is true).

CONCLUSION

Unwinding an unsustainable boom is never easy. It would be wrong to attribute the same policy prescriptions to countries which might face different circumstances. Estonia had enjoyed a bubble period prior to 2007, but unlike many of the other countries in Europe its problem was primarily a current account imbalance rather than a public finance crisis. Nevertheless, the popping of the bubble threatened huge public deficits. The private sector excess was not eventually carried over to the public sector and private sector deleveraging has been the trend since 2009.

The Estonian Government chose to take the short-term pain to rebalance quickly. Of course this is anathema to neo-Keynesians like Krugman who saw the rising unemployment and falling output, even in the short-term, as unacceptable. But it cannot be ignored that Estonia appears much better set than many countries today, particularly those countries which have added huge debts and failed to undertake significant structural reform.

It has little public debt, a balanced budget, falling unemployment and relatively strong growth prospects. Though the level of output hasn't yet returned to the peak of the bubble, it is getting there. A liberal and predictable tax environment will no doubt assist going forward.

The country still faces some economic problems. Of those unemployed in 2011, 57% have been out of work for over year. This is mainly because of the huge rebalancing away from construction and a mismatch of skills for these workers which prevents them from easily obtaining new jobs. It is a problem the Government recognises, and can be seen through large increases in manufacturing vacancies.

Furthermore, Estonia has since formally joined the Eurozone, and with the continued paralysis in the EU over the future of the single currency, there continues to be a risk of significant spill-over effects for Estonia. This is particularly true if neighbouring economies, such as Sweden, begin to feel sharply the impact of the continued European downturn.

Overall, however, Estonia provides an example of a country which took the pain, and now, relative to others, has fostered the conditions to enjoy any gain.

THE AUTHOR

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