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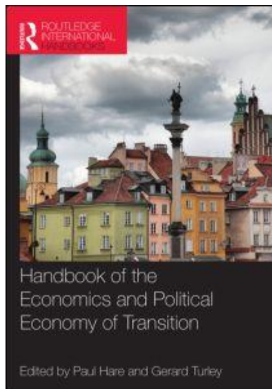

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ESTONIA

Did the strategy of deep integration fail in the 2008/09 crisis?

Pekka Sutela

Introduction

Estonia and the two other Baltic nations, Latvia and Lithuania, regained their independence in 1991. Instead of engaging in the building of a sovereign national economy, they – Estonia more consistently than the other two – engaged in *deep integration*, here defined as a conscious policy aimed at making the country part of a wider set of markets and other institutions, in this case those of north-western Europe (Sutela, 2002). While maintaining political independence, the right to issue money, national armies and control over borders, they adopted the European four freedoms (almost) overnight, abolished monetary policy sovereignty by establishing currency boards, gave over the banking sector to foreigners, privatized (in the case of Estonia) most of their industries to foreign strategic owners (thus leaving the domestic equity markets very small) and sought to become members of Western institutions as soon as possible. In doing all this, they accepted the strongest possible external policy anchors short of losing political sovereignty.

Until 2008 these small economies grew quickly. Large inflows of capital allowed huge current account deficits, and while incomes and consumption boomed the economies also overheated, especially in real estate and services. The ensuing collapse in the 2008/09 crisis was, at some 15–20 per cent of GDP, among the very steepest globally. Still, this contribution argues, there was little alternative to deep integration for these countries, it has generally served them well, and has facilitated not only a rapid welfare improvement, but also a thorough shift in their geopolitical position. The argument uses a stylized Estonia as the ideal type of a Baltic country, but also points out many of the important differences between the three economies.

Varieties of external anchor

Transition was bound to be a complex and multi-dimensional process extending over decades rather than years, when the needed development of formal and informal institutions was taken into account (Gelb and Gray, 1991). To maintain consistency across policies and over time, external policy anchors were found useful. Going beyond abandoning the old system of central planning, they would not only define the general goal of transition, but would also – if found credible and if supported by the electorate and elites alike – tie the hands of decision-makers, at

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least in broad outline. In the weakest cases the external anchors consisted of little more than a generally defined desire to become 'a normal country'. That could imply hugely different outcomes, especially as normalcy can be defined either normatively – the way things should be – or positively – the way things usually are.

A stronger kind of an external anchor was provided by dependence on external actors. This might just mean a willingness to maintain international goodwill, but more importantly, for instance, dependence on international sources of finance. Among them, the International Monetary Fund (IMF) was early on given the key role in financing transition economies. Traditionally, IMF clients are countries in deep trouble, facing a financial crisis with no access to private money. The prevailing view in the early 1990s was that credit programme conditions would therefore concentrate on the current account, money supply and budget balance. This part of what came to be called the Washington Consensus was based on Latin American experience in the 1980s.

Transition economies did not in the beginning typically receive private finance, but their predicament was much wider: it included the whole transition menu. Therefore, IMF programme conditions proliferated, often including tens of numerical conditions and qualitative targets. There was no way to ensure consistency between these goals and a programme bargaining process – very much like the plan bargaining in which the former centrally managed countries were past masters – followed. Therefore, the IMF conditionality was much weaker than might have been expected. Many countries used this weakness to avoid painful decisions, whereas a radical reformer such as Estonia went the opposite way. Thus, establishing a currency board was a solution the IMF originally objected to, and early capital account liberalization was against the prevailing IMF thinking.

What many saw as the decisive divide was between those who could credibly aim for membership of the core European and Euro-Atlantic organizations and those who could not. Membership in the European Union (EU), WTO, NATO, OECD, and so on, defined in the 1990s what it was to be a European, and their combined membership requirements (to be called for short, the *acquis*) ran into well over 100,000 printed pages. If credible, this web of conditions to be fulfilled tied the hands of an accession candidate in a huge variety of ways. The accession conditions for new and applicant states were monitored in much greater detail than the behaviour of long-established members could be. Though nobody would call these requirements in any sense optimal, they had a certain consistency and proven workability.

However, as Estonia showed, it was possible to go even further than the *acquis*. Doing that is here called deep integration. Under some circumstances it was possible to tie oneself not only to the *acquis*, but to go further by establishing very quickly the institutions, rules and regulations that established members had.

This could not be done wholesale. Some of the rules, like the Maastricht criteria for EMU accession, had been written for well-established and stable European countries. Achieving the Maastricht criteria for inflation was a major obstacle for a poor economy engaged in catching-up growth. Others were economically dysfunctional and/or politically disliked, like the Common Agricultural Policy and various social provisions. Estonia wanted to have deep integration with north-western Europe, not to become a Scandinavian welfare state. There was still much scope to integrate fast. This concerned in particular the four freedoms, monetary arrangements and privatization policies.

Why deep integration?

Stylized 'Estonia', the ideal-type Baltic country, had good reasons for choosing deep integration. It was a middle-income country, poor relative to its Western neighbours, with only 1.5 million

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inhabitants, one-third of them non-Estonians, whose loyalty was doubted (unjustifiably, as it later proved) by many. Politically, Russia's imminent collapse was feared, and Estonia therefore needed to anchor itself to the EU and NATO as soon as possible. Economically, the small domestic markets could support at best limited competition or access to finance. These features needed to be imported. Socially, decades in Soviet isolation left the country with little competence relevant for operating a successful market economy, democracy and European integration. The general development goal was clear, though. In 1938 Estonia had probably been wealthier than Finland and personal cross-border ties since the 1960s and Northern Estonian access to Finnish TV media since the 1970s reminded of what could and now should be, the faster the better. Baltic nationalism is legendary, but it was always of the defensive type. The task was to ensure national survival, and that could be ensured by lowering all walls to the West, not by trying to establish tiny nationalist fortresses. That conclusion was also supported by the generally liberal thinking of the new national elites. As elsewhere in European transition countries, political integration enforced the positive impact of financial integration on pre-crisis growth by affecting expectations (Friedrich *et al.*, 2010).

What is deep integration in practice?

How does one become, in effect, a region in a wider set of markets and institutions? First, one adopts the four freedoms (almost) overnight both inside the country and crucially across borders. Exceptions were always bound to exist, but principally freedom of trade in goods and services and mobility of capital and labour were reached very fast, in some cases also in contrast to the orthodoxy then prevailing in economic thinking. There were costs involved, for instance in the mobility of labour. Thus according to its 2010 census, Lithuania's population shrank by a fifth from 1989 to 2010. Similar findings are evident in Latvia's 2011 census. Not all out-migration is for legal employment, and neighbouring countries sometimes complain about drug-trafficking, prostitution and other crime. Mobility of labour also tended to push costs up, as wage demands could, even in the absence of unionization, be backed by credible threats of out-migration. At the same time cross-border mobility created a basis for the famed flexibility of Estonian labour markets: Finland acted as the over-flow valve. Estonian unemployment peaked at 19.8 per cent in the first quarter of 2010, but rapidly declined to 13.6 per cent in the last quarter of the year. An unknown share of this is due to increased working in Finland, especially in construction and services. It should also be noted that a part of the working population, especially industrial workers, remain non-citizens in Estonia and Latvia. In Latvia their share of the population is about 15 per cent, and less than 10 per cent in Estonia. Unable to vote in national elections, their voice remains weak. This is enhanced by the political process which has kept the parties voted for by the non-titular residents out of coalition governments. Many of those who bear much of the burden of adjustment thus have no access to national decision-making.

Immediate capital account liberalization (though limitations on buying fertile Lithuanian lands remained for years) abolished barriers of access to finance. Monetization, financial deepening and the urge to catch up in incomes created small but fast growing markets, where two Swedish banks and one Danish bank soon dominated. These banks were, after the Nordic banking crises of the early 1990s, well capitalized, effective and profitable. An anecdotal rule of thumb says that a bank's Baltic exposure in assets should be one-tenth, bringing in a third of profits. There seemed to be no reason to doubt the fixed exchange rates, which were crucial for early economic stabilization, credibility of the new currencies and the strategy of deep integration. Nordic in-house banking finance was free to flow into real estate and services. To complicate matters, bank regulation was uncomfortably divided between the Baltic and Scandinavian

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authorities. Still, the takeover of small markets by reputable foreign banks was much to be preferred to the Icelandic alternative of having competitive domestic banks go into less-regulated foreign niche markets to gain some critical mass. In Latvia one bank tried to gain critical mass through internationalization by acting as a go-between for Russians entering into international markets. Parex bank had to be duly bailed out during the crisis. In Estonia capital mobility was complemented by a major inflow of Finnish small businesses, often themselves going international for the first time. They were also an integral part of civil society integration. From the first one in 1967, the number of ferries sailing daily between Tallinn and Helsinki, both small cities of about 0.5 million inhabitants, has grown to some 35 million.

It has to be remembered that none of the three countries boasts major natural resources. Estonia has some oil shale, Latvia hydropower and Lithuania fertile lands. Together, the forest resources of the Baltic states would support one, preferably Latvia-based, modern large-scale pulp and paper plant, but for reasons not completely understood a Nordic company failed in its efforts over 10 years to establish one. As traditional Tsarist- and Soviet-era manufacturing plants have crumbled, round wood remains Latvia's biggest export item. There was thus not a self-evident specialization for these economies, but neither was there an evident basis for oligarchies and the resource curse. Estonia inherited little manufacturing from the Soviet Union, and though there are a few business men with political ambitions, no oligarchy emerged. Latvia has a long tradition of industrialization, but the inherited electrical and transport equipment industries had no chance to survive. Instead, a kind of resource curse emerged on the basis of the logistics infrastructure that had been important in the Soviet Union. Ventspils harbour became the economic basis for one of the three oligarchs who have cast a deep shadow of corruption over the political economy of Latvia. Lithuania's manufacturing and logistics, in contrast, proved unexpectedly competitive, and were privatized to domestic non-oligarch owners.

As Baltic independence was regained, outside well-wishers often pushed the Baltic countries towards intra-Baltic co-operation. More often than not that was seen as an alternative to the deep integration that was considered far too demanding. That alternative strategy, however, was unattainable. Even together, the three countries would form a small economic area. The countries are divided by history, culture, languages, religion and the finer points of outward orientation. What united them was recent history and their position between Russia and the EU. That was the basic fact determining their choices.

Various privatization methods were used. Restitution had to be limited to post-1938 claims. Otherwise the politically highly complicated claims of the Baltic Germans would have arisen. Vouchers were also used though there was little reason to believe in efficient secondary markets. Latvia tended to favour domestic oligarchs, while a more balanced domestic ownership emerged in Lithuania. Estonia favoured sales to foreign owners, often at low prices. Access to markets, technologies, know-how and brands was deemed more important. In a few well-known cases, especially in the energy sector, the Baltic states gave preference to Western owners for security and strategic reasons. In all cases the preference given to strategic owners implied that only very small domestic equity markets developed. As the governments strongly preferred to balance their budgets to gain credibility, there are also very limited markets for government bonds. Therefore the central banks have little possibility to impact market liquidity. Instead, this is largely determined by the in-house decisions of banks and their Scandinavian owners.

Currency boards – or currency board-like arrangements; there is 'theological' discussion on the exact definitions – are the best known Baltic peculiarity. Estonia was the first one in 1992; the other two soon followed. There were many reasons for adopting this exceptional institution. Currency boards are simple. The central bank is reduced to intervening in the currency market to maintain the exchange rate. Thus, demands on scarce central banking competence are

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reduced. Neither an interest rate nor a banking channel for monetary policy is needed, and thus the rudimentary character of the financial system does not matter. With capital mobility and a fixed exchange rate, the interest rate is determined by the markets. A currency board is also a credibility-enhancing institution. Devaluation, the usual threat, can be made difficult. In Estonia it would have needed a change of law in repeated parliamentary sessions. (Less emphasized was the fact that those sessions could have taken place over a weekend.)

A currency board is, in monetary policy terms, as close as a country becoming part of a region in wider markets can come to, short of actually adopting the foreign currency. However, the latter was never a realistic alternative. The Scandinavian or wider European central banks did not wish to take over the *de facto* responsibility for monetary policy in countries that remained outsiders. Still, as long as there are separate currencies, a currency risk always remains. Paradoxically, unilateral fixed exchange rates can be endangered by central banks being too credible. Trusting the fixed exchange rate commitment, economic agents, households, companies and financial institutions, undertake transactions and enter into commitments implying monetary mismatches that they assume carry no risk. In the end, too many Baltic households, especially in Latvia, had their revenue in the local currency and substantial liabilities in foreign ones. When the pre-crisis capital inflow was evidently excessive, creating overheating and current account deficits of some 15–20 per cent of GDP annually, the exchange rates could not be re-adjusted due to the existing mismatches. Furthermore, a re-alignment would necessarily have postponed the prized future adoption of the Euro.

The credibility of exchange rate pegs was further enhanced, as the strategy of deep integration implied that the usual market-based vehicles for currency speculation were absent. As companies had been sold to strategic owners, there was only limited trading in equity shares. As stabilization was prioritized, government bonds were almost non-existent. As banks were foreign-owned, they had little need for markets by themselves. What is often forgotten, however, is that a fundamental and traditional currency speculation vehicle did still exist: exporters could decide not to repatriate their revenues. To simplify, as even foreign-owned and -financed exporters had all their revenue in foreign currency and some of their costs in local currencies, they might in principle have been interested in devaluation, but the aggregate impact of any re-alignment in an economy based on currency mismatches and very major capital inflows was difficult to foresee. What the interests of foreign-based banking groups might be is unclear without access to their internal accounting. The pricing of internal transfers and head office services is not known.

The 2008/09 crisis

Baltic economic growth rates were, as is well known, extremely high in the 2000s. Estonia grew by more than 7 per cent annually, until growth peaked at more than 10 per cent in 2006. Intriguingly, overheating was slowing down already in 2007, as the dominant foreign banking groups grew worried about credit quality issues probably created by extremely high credit growth. The slowdown in credit growth may well have contributed to the steepness of the ensuing collapse of production, especially in Latvia (Åslund and Dombrovskis, 2011). Because credit growth was decided within the internationally owned and financed banking groups, there was little that the Baltic central banks could do to inject liquidity (IMF, 2010). Though the decline in production extended over two years and resulted in the loss of a fifth of GDP, Estonia was already recovering in 2010. During the first quarter of 2011, Estonia's growth was a very impressive 8.5 per cent on the back of fast recovery of exports and services.

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Latvia's growth had been even higher in the early 2000s and exceeded 10 per cent for several years. The ensuing decline was also exceptionally steep, and growth just failed to resume in 2010. Lithuania's growth was also very impressive, though not quite as high as in the northern neighbours. Neither was the decline quite as steep as there, as Table 30.1 shows.

There were no huge differences in inflation, though Lithuania posted very low figures in the early 2000s, when it famously just failed to fulfil the Maastricht criteria for EMU accession. After that the inflation rate again increased, casting doubt on the sustainability of earlier price stabilization efforts, reaching 11.1 per cent in 2008. Since 2004 Latvia has been the high-inflation country, posting rates above 6 per cent in 2004–06 and double digits in 2007–8, but ending in slight deflation in 2010. The Estonian inflation rate was more modest, fluctuating below 5 per cent in 2002–06, but then also reaching 10.6 per cent in 2008. Disinflation in 2009 was a sudden stop to 0.2 per cent, but in 2010 inflation again reached a more sustainable speed at 2.7 per cent. Details are presented in Table 30.2.

The headline statistics most debated were those for the current account balance. As Table 30.3 shows, deficits were huge, especially in Latvia but also in Estonia, reflecting imports which were booming with exceptionally fast income growth. Estonia's trade deficit varied between about 13 and some 17 per cent of GDP in 2002–08, before dropping sharply. This was partially a competitiveness issue: average nominal unit labour costs increased by 14.2 per cent in 2007 and 20.1 per cent in 2008. Partly it was a supply-side problem of a more general nature. Many goods and services demanded in the new market economy were not produced at all in these very small economies.

If the exchange rate were perfectly credible, current account deficits would arguably not really matter. The economy was just becoming increasingly owned by foreign entities. The external debt-to-exports ratio increased in Estonia from 108.0 per cent in 2005 to 153.2 per cent in 2007 and further to 180.0 per cent in 2009. While the Lithuanian figure was more modest at 160.1 per cent in 2009, Latvia, where the ratio peaked at 369.1 per cent in 2008, was again in a class of its own. No exchange rate regime is perfectly credible, and the combination of increasing debt and spiralling unit labour costs spelled trouble. Even a region inside a country has to worry about competitiveness of jobs, for otherwise it will lose jobs, population, service providers and payers of taxes to other parts of the country. As productivity rarely jumps upward,

Table 30.1 GDP change in the Baltic states, 2001–10

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Estonia	7.5	7.9	7.6	7.2	9.4	10.6	6.9	-5.1	-13.9	3.1
Latvia	8.0	6.5	7.2	8.7	10.6	12.2	10.0	-4.2	-18.0	-0.3
Lithuania	6.7	6.9	10.2	7.4	7.8	7.8	9.8	2.9	-14.7	1.3

Source: Official statistics.

Table 30.2 Annual consumer price inflation in the Baltic states, 2001–10

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Estonia	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	0.2	2.7
Latvia	2.5	2.0	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2
Lithuania	1.6	0.3	-1.1	1.2	2.7	3.8	5.8	11.1	4.2	1.2

Source: Official statistics.

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Table 30.3 Current account balances in the Baltic states in 2001–10, per cent of GDP

	2001	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Estonia	-5.4	-5.2	-10.6	-11.3	-10.0	-15.3	-17.2	-9.7	4.5	3.6
Latvia	-7.5	-6.7	-8.1	-12.8	-12.5	-21.1	-22.3	-13.0	9.4	5.0
Lithuania	-4.7	-5.1	-6.8	-7.7	-7.1	-10.6	-14.5	-13.1	4.3	1.8

Sources: EBRD, IMF.

the remaining alternative is cutting costs. In the Baltic states, this was also the only available option, as devaluation was excluded for the reasons discussed above.

Further, in a deep integration case the face value of the current account deficit hides more than it reveals. As pointed out earlier, it is essentially the counterpart of the capital account surplus. Estonian international reserves also increased, almost tripling from 2002 to 2009, but as their role in a currency board is to cover base money, the ratio of reserves to gross short-term debt actually declined from 0.7 to 0.4, while import coverage in months fluctuated around 2.5, to rise after 2008. Before 2009, net foreign direct investment corresponded annually to between 2.1 and 15.7 per cent of GDP, reinvested net earnings to between -2.2 and -6.6 per cent. As already pointed out, there is always great uncertainty over how well the book-keeping values of transfer pricing, (non-)pricing of head office services and distinguishing between credits to daughter companies and investments are actually handled.

The financial crisis started to hit the Baltic states in 2007 when banks started to limit credit growth. In Latvia, the extreme case, growth of credit to the private sector amounted to 58.3 per cent in 2006, but -6.6 per cent in 2009. Broad money that had boomed at 37.5 per cent in 2006 declined both in 2008 (-3.9 per cent) and 2009 (-1.9 per cent). There was little that the authorities could do to maintain liquidity. With the exception of the Latvian Parex bank, banking sector solvency was never endangered. The Nordic parent banks were well capitalized and dominated by wealthy – and relative to the Baltic states, not small – states. There was never a risk of another Nordic banking crisis, but a credit swap line was extended by the European Central Bank to the Swedish and Danish central banks – indirectly to support the Baltic states, in case the need arose (Åslund and Dombrovskis, 2011). There was a pioneering Nordic-Baltic memorandum of understanding on improved co-operation in bank regulation in 2010.

As noted, much of the adjustment was through increasing unemployment. In Estonia it increased from 4.7 per cent in 2007 to 13.8 per cent in 2008 and further in 2009. At the same time the previously very fast average nominal growth rate dropped to zero in 2009 and was clearly negative in 2010. The national private savings ratio surged from 16.9 per cent in 2007 to 24.6 per cent in 2009, and is bound to remain high as financial balances are further consolidated. At the same time the public savings ratio turned from 5.6 per cent to slightly negative following the fiscal balance. Without going into detail, a classic internal devaluation to regain competitiveness and credibility took place. The incumbent governments of Estonia and Latvia were rewarded by re-election to power for having continued the policy of deep European integration. Estonia entered the eurozone.

Conclusion

The Baltic experience in 1991–2011 is an exceptional one and cannot be understood properly without appreciating the political background. Still, it proves that deep European integration is not only possible but can also attract popular support in very difficult circumstances. In the crisis,

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countries with large reserves, low private sector credit and little financial openness fared better than others. After a crisis, floating exchange rate regimes may well recover faster (Cecchetti *et al.*, 2011), but this is a price the Baltic nations were willing to pay for deep integration – for which they anyway had little alternative. Post-crisis problems still remain (IMF, 2011). These are not perfect states. Many aspects of that have been noted above. Further, Latvia and Lithuania have the largest income inequalities in the EU, while Estonia is close to the medium. Loss of population is worrisome. Though regaining competitiveness through lower costs succeeded, this cannot be a desirable long-term solution. The long-term relative advantage of the Baltic states remains unclear. The share of high technology exports is among the lowest in the EU in Latvia and Lithuania, close to the medium (and improving) in Estonia. Scores in European patent applications are similar or even worse. Baltic universities do not figure in international rankings. Long-term success is thus not guaranteed, but these countries have already done what few regarded as possible two decades ago. Innovative solutions ought to be forthcoming in the future as well.

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