

## ESTONIA AND THE EUROPEAN DEBT CRISIS

*Juhan Parts*

Estonia has had a quick recovery from the recent recession and its economy is in better shape than before the crisis. It is now much leaner and significantly more capable of handling international shocks. After a sharp contraction, in which GDP contracted by over 14 percent in 2009, GDP growth rebounded quickly, growing at a rate of 3.1 percent in 2010 and 8.3 percent in 2011.

Labor productivity has grown faster than real wages, which has increased the competitiveness of Estonian firms in the world markets. Estonian exports grew 22 percent in 2010 and 25 percent in 2011. This is a result of the rapid increase of high value-added exports by the manufacturing sector, which has also been the main job creator since the crisis. Indeed, export growth has been the main driver of the Estonian economic recovery.

Paul Krugman (2012) has pointed out that Estonia has not reached its pre-recession level of GDP, but that is because Estonia was hit particularly hard by the financial crisis in 2008 and 2009. Significant export markets disappeared and the domestic housing bubble deflated. GDP shrank by 3.7 percent in 2008 and 14.3 percent in 2009, making it the third-deepest recession in the European Union. This contraction was a result of two main factors: the fact that Estonia is a small open economy, and the previous rapid credit expansion that had significantly boosted domestic consumption. Another metric showing the extent to which Estonia was hit by the recession is the unemployment rate, which climbed to 17 percent

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Juhan Parts is Minister of Economic Affairs and Communication for the Estonian government and served as Prime Minister from 2003 to 2005.

in 2010. However, just as with economic growth, Estonia has recovered quickly from the nadir of 2009; there has already been a rapid decline in the unemployment rate to 12.5 percent in 2011, and it is expected to fall further to 10.5 percent in 2012.

It is important to understand that the low unemployment rate of the boom years was not built on a solid foundation, as the credit bubble created many unsustainable jobs in construction and retail trade with low productivity. It will take years to bring down the unemployment rate as there is mismatch between demand and supply of workers with particular skills. It is also important to keep in mind that Estonia experienced some of the most spectacular GDP growth rates in Europe in the second half of the 1990s and early years of the last decade. Per capita GDP at purchasing power parity, measured in 2009 U.S. dollars, was \$5,657 in 1993 and reached almost \$21,000 in 2007. The unemployment rate decreased to below 5 percent in 2007. While Krugman is correct that Estonian GDP may not yet be back to its 2007 level, the Estonian economy has recovered quickly and is certainly stronger and more prosperous than it was in 2005, 2000, or 1993.

## Internal Devaluation

Unlike the larger and more developed economies in Western Europe, Estonia did not have any realistic alternatives to internal devaluation. For those who understand the context of Estonian economic policymaking, it is clear that external devaluation of the currency was not an option. Estonia has not pursued an independent monetary policy for the last 20 years. In other words, Estonian monetary policy has meant not having a monetary policy—the money supply is dependent on the amount of foreign currency and assets reserves. The government instituted a currency board in 1992. The Estonian kroon was fixed to the German mark at 8:1. Since the introduction of the euro in 1999, the kroon was linked to euro at 15.6:1.

Estonia decided to delegate its monetary policy because a small and open economy like Estonia cannot have exchange rate stability, capital mobility, and an independent monetary policy at the same time. The goal has been to ensure the trust in the currency and be open to the international capital flows. The downside of the peg to the euro was inability to control inflation. As a consequence, Estonia

missed the inflation criteria set forth in the Maastricht Treaty, forcing the nation to give up its hopes of adopting the euro in 2007. Estonia was then able to join the eurozone a few years later, in 2011.

This delegation of monetary policy meant that instead of external devaluation by changing the exchange rate of the Estonian kroon to the euro, the government kept the peg and opted for internal devaluation, resulting instead in a cut in nominal wages. Because of the currency board arrangement, the currency devaluation was essentially not even an option—it would have needed a parliamentary decision, which would have taken too long to obtain. As wages went down, companies were forced to focus on increasing efficiency and Estonia actually achieved a solid increase in productivity.

## Fiscal Policy

Fiscal expansion was not an option either. The government's aim is to spend no more than it is able to collect in taxes, even during recessions or periods of slow growth. This is one of the reasons the level of government debt in Estonia is the lowest in the European Union (European Commission 2011). A cornerstone of Estonia's fiscal policy has been a simple proportional corporate and personal income tax system. The government introduced the proportional tax rate of 26 percent in 1992. It has been constantly lowered and currently stands at 21 percent. Since 1999, reinvested corporate profits are no longer subject to income tax. The main benefit of the reforms has been simplification of the tax system and tax collection.

Estonia followed its principles of fiscal conservatism in responding to the crisis. Unlike many other countries in Europe, Estonia went through fiscal tightening during the crisis. Fiscal consolidation accounted cumulatively for 16 percent of GDP. In the depths of the recession in 2009, when the economy was contracting more than almost any other country in the European Union, fiscal tightening accounted for 9 percent of GDP.

While the size of the fiscal consolidation was important, the composition of the consolidation was also significant. Estonia's fiscal tightening included significant measures on the expenditure side, as opposed to relying almost entirely on revenue increases. Fully two thirds of fiscal consolidation measures were on the expenditure side, and these measures were wide-ranging. Estonia reformed health care benefits and enacted an 8 percent reduction in the

health insurance budget, in addition to limiting the increase in pensions. In addition to benefit and pension measures, Estonia also made real cuts to operating expenditures, defense spending, and farming subsidies.

Alongside the aforementioned expenditure measures, one third of the fiscal tightening was on the revenue side. Estonia increased the level of unemployment insurance contributions to 4.2 percent, in part to deal with the elevated number of unemployed people. The government also raised excise taxes on alcohol, fuel, and tobacco, and raised the value-added tax from 18 to 20 percent. Estonia also temporarily stopped the step-by-step lowering of the income tax rate that had been pursued over a number of years.

As a result of these measures, Estonia has remained a beacon of fiscal prudence, keeping the public sector debt level at around 7 percent of GDP, the lowest in Europe and one of the lowest levels in the world. The overall public sector budget deficit was 1.7 percent of GDP in 2009 and against all odds we had surplus of 0.1 in 2010 and 1 percent in 2011. Estonia has not issued and does not issue government bonds, thereby essentially making this country the “Anti-Greece,” to use a term coined in a *Financial Times* editorial in 2010.

Estonia did not need a bailout because throughout the boom years the government ran constant budget surpluses and built up emergency reserves. Estonia has had a budget surplus of 0.2 percent of GDP on average in the last decade (2001–11). Throughout the crisis the Estonian government still had more reserves than debt. The reserves were 11.6 percent of GDP in 2009 and 12 percent of GDP in 2010.<sup>1</sup>

## Labor Market Reforms

As integral as fiscal policy was to our performance, our response to the crisis was not limited to fiscal consolidation. Estonia also carried out labor market reforms. The government boosted financial support by speeding up the use of EU structural funds for public

<sup>1</sup>It is important to note that the largest commercial banks in Estonia are owned by Swedish banking groups. Thus, the Estonian response to the crisis was easier than in countries where governments had to help rescue the banking sector.

investments in transport infrastructure as well as for Estonian companies throughout the crisis by supporting existing and new entrepreneurs in creating jobs.

The government set up programs that help job seekers to increase their qualifications, fund training programs for the unemployed, and offer internships. The labor market services have been made more accessible, quality has been improved, and labor markets have become more flexible.

The Estonian government actually increased spending on different company support measures, especially focusing on companies with an emphasis on exports. As it became more and more difficult for competitive companies to find any access to financing, the Estonian government stepped in and created a whole new set of financial measures to make it easier for companies to go forward with their investments.

The total sums for revitalization of the economy were actually at the OECD average levels, but with a different focus. Instead of increasing consumption, we focused on maintaining the competitiveness of our companies—for example, by supporting investments in research and development. We also made significant investments in infrastructure by building roads, airports, ports, and improving broadband networks. Those projects directly contributed to job creation and indirectly attracted investments that have led to job creation. In addition, we increased pensions to take care of our older generation.

## Public Support

Perhaps these additional measures help to explain why Estonia did not have any major strikes and why the people were more accepting of the internal devaluation and fiscal consolidation than other countries in Europe. Obviously, there were many other factors at play, such as ability of the people to find jobs in Finland and other European countries. Nevertheless, the Estonian people accepted the policies based on rational reasoning. Most of the measures of fiscal consolidation were carried out by center-right minority government consisting of the Reform Party and IRL. In the elections of spring 2011, both parties received a strong boost from the voters, which allowed us to form a majority government.

## Key Lessons

The role of decisionmakers is important even when all the odds seem to be against them. It took courage to follow the chosen path when international bankers, organizations, and prominent economists were convinced that our decisions would lead to a disaster. Estonia's economic performance and ability to tackle the most challenging economic situation with radical economic policies in the difficult climates is a clear indication that fiscal conservatism and economic liberalism work well in any economic circumstance.

Our experience suggests that the best way to respond to the current debt crisis in Europe is by pursuing conservative fiscal policy and carrying out economic reforms. Obviously, fiscal consolidation in the eurozone can affect the demand for Estonian exports and slow down our recovery in the short run. Nevertheless, this can be compensated by lower interest rates and trust in the long run. Estonian experience makes it clear that the currency peg to the euro and joining the eurozone offers benefits as long as a country is willing to carry out structural reforms and keep the books balanced. This, of course, implies that government is willing and able to carry out necessary reforms.

From our perspective, the common currency in Europe can work as long as eurozone member countries carry out sufficient fiscal consolidation and structural reforms and stick to the principles of fiscal conservatism and economic liberalism.

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