

MPRA

Munich Personal RePEc Archive

Crisis management in the Baltic States

Mező, Júlia and Bagi, Ágnes

2012

Online at <https://mpra.ub.uni-muenchen.de/40366/>
MPRA Paper No. 40366, posted 06 Aug 2012 14:11 UTC

Crisis Management in the Baltic States

Júlia Mező

Ágnes Bagi

The economic and financial recession started in 2008 brought serious difficulties for every European country, although not to the same extent. The previous situation of countries plays a major role in the course of the crisis and crisis management. The three Baltic countries showed a relatively prominent economic growth after their accession to the European Union in 2004. Their performance over these years often cited as Baltic Miracle.

But this growth went hand in hand with serious macroeconomic imbalances, since the main moving factor of growth was the foreign direct investment flowing into the tertiary sector and the boom of internal consumption. These factors led to unsustainable current account deficit.

The problems of these overheated economies would have needed solution even before the global downturn; however the recession put inevitable pressure on the Baltics to take actions. In the Baltic States most of the macroeconomic indicators deteriorated in the year 2008: GDP and consumer demand decreased, unemployment increased drastically, general government expenditures and government gross debt also grew. One of the most serious problems was the significant amount of debt denominated in foreign currency, which was responsible for the financial „bubbles” popped simultaneously with the outbreak of the crisis.

The paper examines the main macroeconomic effects of the global economic crisis on the Baltic States and presents their governments' economic policy measures taken to combat the crisis. The reactions of dealing with the recession in these three countries can be a lesson to other European countries as well.

Keywords: Baltic States, financial crisis, crisis management

1. Introduction

The European economic recession started in 2008 brought serious difficulties for every country, although not in the same extent and not for the same reasons. In August 1991, the three Baltic countries (Estonia, Latvia and Lithuania) declared their independence from the Soviet Union and after a transition recession, from the middle of the 1990s they showed a prominent economic growth thanks to the implemented reforms. But this expansion went hand in hand with serious macroeconomic imbalances, such as the continuous deficit in the balance of payments, the low economic activity, the low level of domestic savings or the FDI-driven growth.

The majority of the literature agrees that main roots of these imbalances were structural weaknesses, and these internal problems met the external financial shocks during the current recession, thus worsened the countries' economic situations.

Therefore, we examine the problems of these overheated economies, which worsened the external crisis. Then we present the macroeconomic effects of the global economic crisis on the Baltic States and finally we describe their governments' economic policy measures taken to combat the crisis.

2. Structural weaknesses of the Baltic countries

The past two decades of the three Baltic countries were largely determined by the Soviet heritage. After they declared their independence, the priority was the regain of their political independence – so they joined the United Nations already in September 1991 (Samonis, 1995) – and only then came the economic recovery tasks.

The Baltic countries followed the “SLIP recipes” (stabilization, liberalization, institution building and privatization), and in the middle of 1990s they entered the path of economic growth. But a decade later this path clearly showed that it was overheated (Csaba, 2007; Koyama, 2010).

The main driving forces of the outstanding growth were the high level of domestic consumption, the FDI inflows related to privatization and greenfield investments, and the increase of inward financial capital from the Scandinavian countries (Belyó, 2009).

It is a further structural weakness that foreign investments do not flow into the export sector but mainly into companies operating in financial, commercial or construction service areas. This does not contribute to the modernization of manufacturing and the improvement of trade balance (Koyama, 2010; Meisel, 2009).

As we have mentioned in the introduction, the so-called “Baltic Miracle” is not free of contradictions. According to Meisel (2009) there were recognizable signs of the overheated and unsustainable economy even before the crisis:

- the large and rising deficit in the balance of payments;
- the low economic activity, which characterized mainly Latvia and Lithuania;
- the lag of productivity growth from growth in incomes;
- and the consumption financed by external loans because of the low level of savings (except for Estonia).

The fixed exchange rate regime in Latvia and the currency board in Estonia and Lithuania helped the Baltic countries to reduce the inflation after the transformation, but this rigidity of monetary policies made difficult to remedy the economic imbalances and the crisis management, as well.

3. The course of the crisis in the Baltics

Blanchard et al. (2010) consider that during the financial and economic crisis emerging countries were influenced mainly by external shocks. There were two important channels of these shocks: first the exports fell considerably (resulting deterioration in international exchange ratios), then the net capital flows declined. This statement is true for the Baltic countries, as well, since due to their small size they are relatively vulnerable to international economic trends. In the following we describe the most characteristic impacts of the crisis on the Baltic region.

3.1. Key indicators in the three states

For the countries joined to the European Union in 2004, the membership gave an impetus for economic growth and convergence. The Baltic States showed an outstanding growth among these economies. However, in 2008 the previous leaders suffered the largest decline in Central and Eastern Europe as a result of the crisis (Meisel, 2009; Table 1). In 2009 the crisis caused a double-digit fall in

the *gross domestic product* (GDP) in Latvia and Lithuania, but there was a strong recession in Estonia, as well.

The growth of the Baltic countries before the crisis was characterized by rising inflation, high trade and balance of payment deficits which were getting more and more difficult to handle, growing public debt and deteriorating competitiveness. These serious problems appeared and would have needed corrections even before the crisis, but it was the global recession that made the modification inevitable (Belyó, 2009). Table 1 also shows that among the ten transition countries only Latvia was not able to register economic growth in 2010, which can be traced back to internal problems originated before the crisis.

Table 1: Real GDP growth in the EU-member countries joined in 2004 (2002-2012; %)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011*	2012*
Estonia	6.6	7.8	6.3	8.9	10.1	7.5	-3.7	-14.3	2.3	8.0	3.2
Latvia	7.2	7.6	8.9	10.1	11.2	9.6	-3.3	-17.7	-0.3	4.5	2.5
Lithuania	6.8	10.3	7.4	7.8	7.8	9.8	2.9	-14.8	1.4	6.1	3.4
Hungary	4.5	3.9	4.8	4.0	3.9	0.1	0.9	-6.8	1.3	1.4	0.5
Czech Rep.	2.1	3.8	4.7	6.8	7.0	5.7	3.1	-4.7	2.7	1.8	0.7
Poland	1.4	3.9	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.0	2.5
Slovenia	3.8	2.9	4.4	4.0	5.8	6.9	3.6	-8	1.4	1.1	1.0
Slovakia	4.6	4.8	5.1	6.7	8.3	10.5	5.9	-4.9	4.2	2.9	1.1
Cyprus	2.1	1.9	4.2	3.9	4.1	5.1	3.6	-1.9	1.1	0.3	0.0
Malta	2.8	0.1	-0.5	3.7	2.8	4.3	4.3	-2.6	2.9	2.1	1.3

* Estimated data

Source: own construction based on the data of Eurostat (2012)

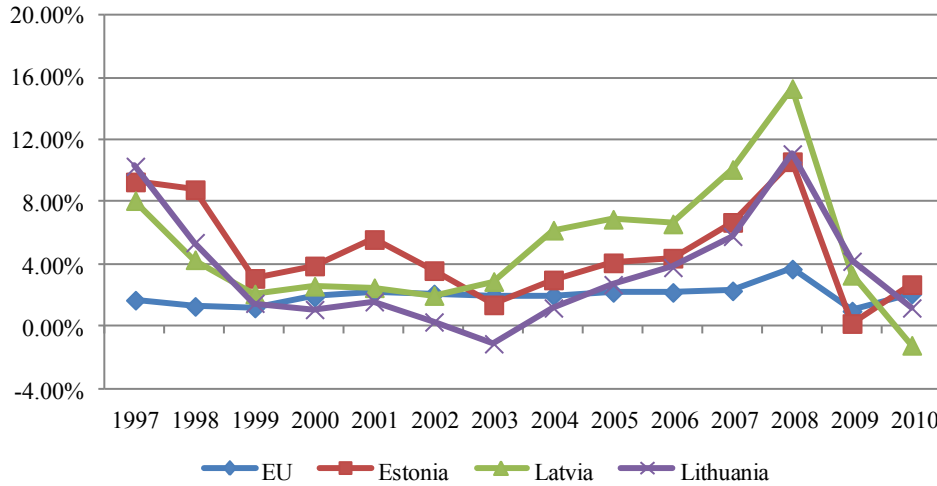
The *harmonized index of consumer prices* (HICP) in the three countries showed extreme volatility in recent years: it was increasing continually from 2003 to 2008 when reached its peak, then dropped sharply in 2009 (Figure 1). The increasing inflation was caused by higher energy and food prices, shrinking labor supply and strong wage growth, and the excessive increase in demand, which are the features of overheated economies (ECB, 2010).

The decline of the inflation in 2009 was caused by a sharp drop in domestic consumption. This is reflected in lower food and energy prices. In 2010, inflation in Latvia and Lithuania continued to decline (in Latvia there was even a deflation), but in Estonia it increased by 2.5 percentage points compared with the previous year. Analyzing the inflation, we have to take into account that annual real GDP growth in the Baltic countries was very sharp in the past decade (Table 1). In all three countries wage increase exceeded labor productivity growth each year, that generated the erosion of competitiveness. These unsustainable economic processes and the economic crisis together led to the fall of economic growth of the Baltic States in 2009 (ECB, 2010).

As we have already mentioned, the three countries have a currency board and fixed exchange rate regime, so the scope for action of the monetary policy is limited. For this reason, it is necessary to involve other areas of economic policy in order to prevent macroeconomic imbalances, such as the re-emergence of high inflation. If the gross output begins to increase, the real exchange rate appreciation is likely to lead to higher consumer price index. The convergence process is also expected to have

inflationary effect, since the GDP per capita and price levels are lower in all three countries than in the euro area (ECB, 2010).

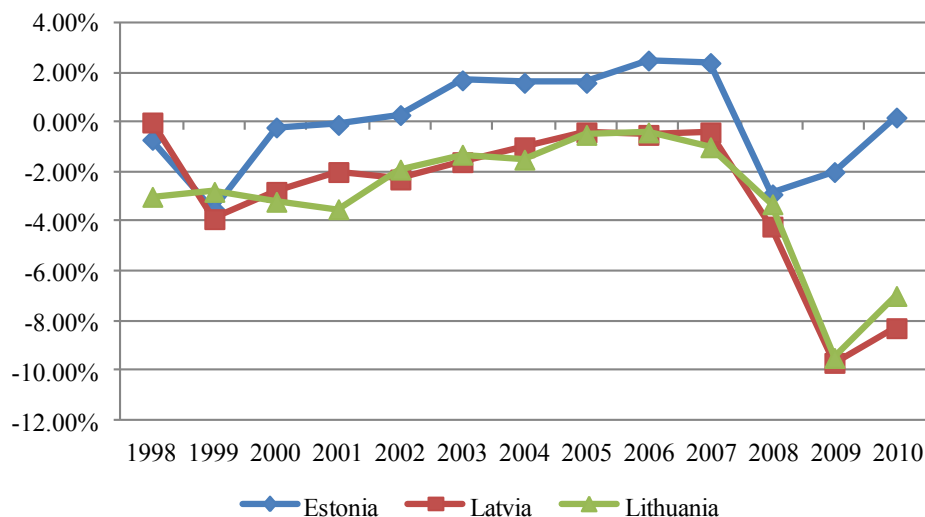
Figure 1: Annual average rate of change in harmonized indices of consumer prices (1997-2010)



Source: own construction based on the data of Eurostat (2012)

The Baltic countries had a carefully planned fiscal policy after the turn of the Millennium. From their EU-accession to 2007 (in other words before the crisis) all three states' budget deficits were below the 3 per cent of GDP required by the Maastricht criteria but in 2008 the government deficits highly increased (Figure 2). Latvia and Lithuania have already showed a deficit previously, but in 2008 the Estonian budget is turned into deficit, as well. In 2008 the Estonian and Latvian budgetary expenditures raised by 9-16 per cent, while revenues did not change significantly compared to 2007. In Lithuania there was a limited increase in government spending, while revenues stagnated in 2008.

Figure 2: Budget deficits in per cent of GDP (1998-2010)



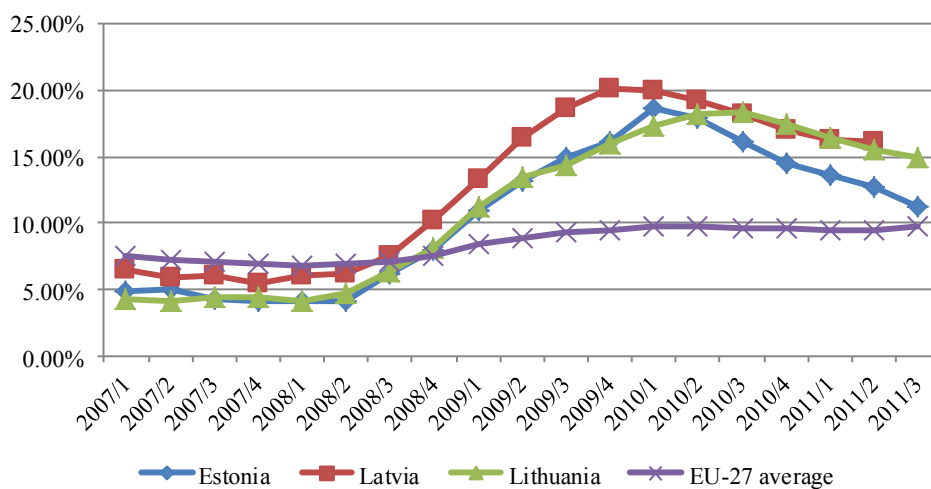
Source: own construction based on the data of Eurostat (2012)

In 2009 all three countries continued to raise their expenditures (mostly in the slowest reacting Lithuania, by 16.6 per cent). In 2009 the revenues increased significantly in Estonia (by 17.3 per cent

compared to 2008), and slightly in Lithuania, but continued to decrease in Latvia (European Commission, 2010). In July 2009 the EU Council decided that the Latvian and Lithuanian deficits were excessive (10.2 per cent and 9.2 per cent in 2009 respectively), and established a 2012 deadline for correction. However, Estonia in one of the few EU Member States which has not shown an excessive deficit: in 2009 the deficit was 1.7 per cent of the GDP (ECB, 2010). In 2010, all three countries narrowed their budget deficits, and Estonia also could achieve a 0.2 per cent surplus.

After the breakout of the crisis the Baltic States could keep their *gross public debt* below the 60 per cent benchmark dictated by the Maastricht criteria. In 2010 the Estonian public debt was equal to 6.7 per cent of the GDP, the Lithuanian was 38 per cent and even the Latvian was only 44.7 per cent (Eurostat, 2012).

Figure 3: Unemployment rate, quarterly average (2007-2011)

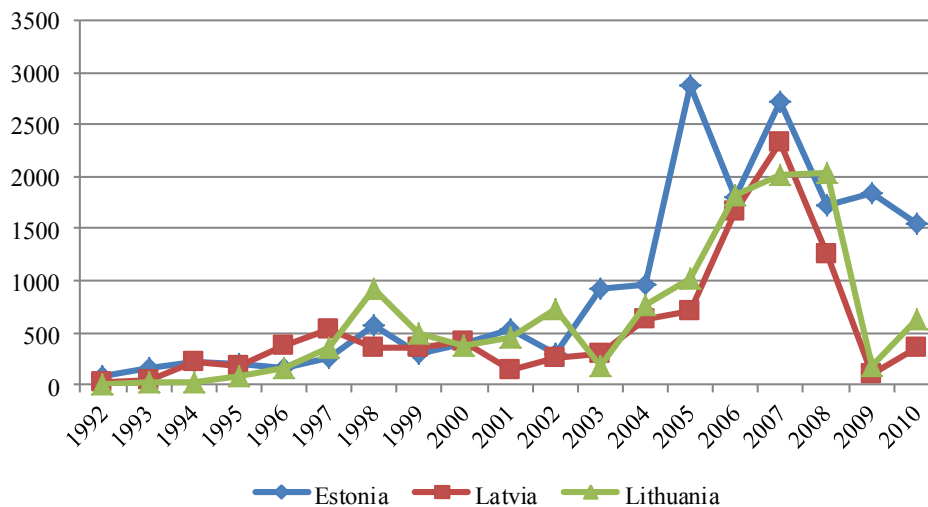


Source: own construction based on the data of Eurostat (2012)

However, the situation was worse in the labor markets. The labor market indicators responded to the crisis almost immediately. Figure 3 shows that *unemployment rates* ranged between 5-6 per cent in the first half of 2008, but began to rise in the third quarter of the year, and by the end of 2009, they exceeded 15 per cent in all three countries (Eurostat, 2012). In the first quarter of 2009 the average wages fell by 1.5 per cent, while the rate of employment declined by 6.8 per cent (Kaasik, 2009). In the same period, nominal wages in Lithuania showed a decrease of 1.9 per cent, but in Latvia the recession started only in the second quarter of 2009 (Purfield-Rosenberg 2010).

Grigonyte (2010) argues that there were various factors which attracted foreign direct investments into the region over the past two decades (Figure 4). Initially, the low labor costs and the privatization process attracted capital to the manufacturing. Later, thanks to the Baltic countries' advantageous geographical location, capital flowed into trade and logistics, as well. In recent years, financial services drew a lot of capital into the countries, too. Between 1994 and 2008, FDI inflows contributed to an average 8.6 per cent of the Estonian GDP, 5.4 per cent of the Latvian and 3.6 per cent of the Lithuanian GDP (UNCTAD, 2012). Estonia is clearly more attractive than the other two countries, especially among Scandinavian banks. From the EU accession, the majority of FDI flowed into the financial sector and real estate investments (Grigonyte, 2010). In 2008, FDI inflows came to a halt: the Baltic economies' attractiveness weakened in the eyes of foreign investors because of the crisis. A minor increase showed up only in 2010.

Figure 4: Inward foreign direct investment flows, annual (millions of USD at current prices and current exchange rates, 1992-2010)



Source: own construction based on the data of UNCTAD (2012)

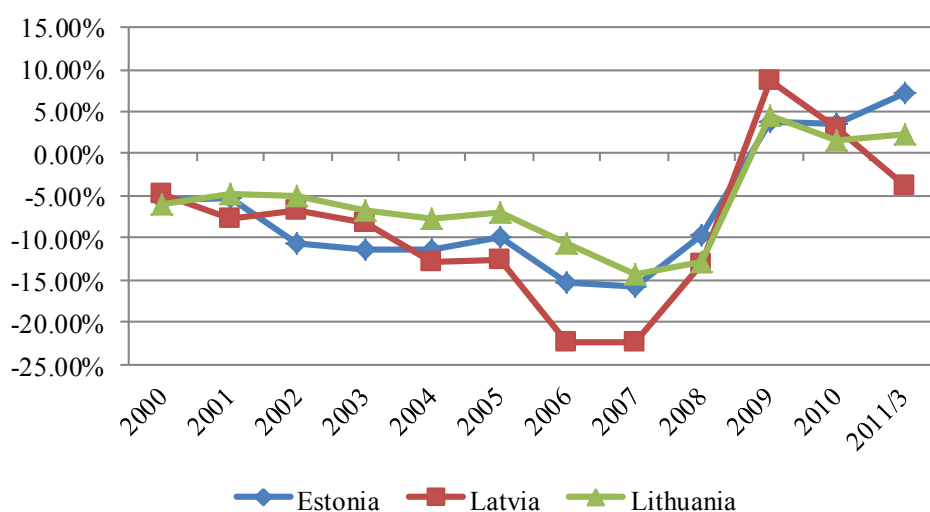
3.2. Special features of the individual states

In this section we examine the possible explanations of the extremely strong impact of the crisis in the Baltics. First, we try to give a concise overview of the general characteristics of the region, and then we analyze the situation of each country separately.

The households' and businesses' foreign currency denominated indebtedness is very high in Central and Eastern Europe. This is especially applies to the Baltic States: within the year between April 2008 and April 2009, the share of foreign currency loans in total lending was 60-70 per cent in Lithuania and 80-90 per cent in Estonia and Latvia (Koyama, 2010). All this is a consequence of the sudden drop in the region's risk premium, and this is responsible for the development of financial bubbles in the past decade (Lengyel and Fejes, 2010). The cheap foreign loans fueled primarily the housing market in the Baltic countries, therefore real estate prices rose steeply, and the largest job-creating sector was the construction industry in the years of the boom: between 2005 and 2007 the sector's employment increased by 68.2 per cent in Estonia, 38.8 per cent in Latvia and 29.0 per cent in Lithuania (Masso and Krillo, 2011). Therefore job losses due to the recession were the most noticeable in this sector, as well, which means that in 2009 36-42 per cent of all lost jobs came from the constructions (Masso and Krillo, 2011).

According to Masso and Krillo (2011), the grave problems of the labor markets in the Baltic States are caused by the real estate boom and the fact that atypical forms of employment (such as part-time or temporary jobs) are not widespread. The Baltic labor markets are inflexible compared to the EU and indeed to the other Member States that joined in 2004.

Beyond these features of the Baltic countries, their crisis was also deepened by the limited instruments of monetary policy. The Estonian and Lithuanian currency board and the Latvian fixed exchange rate pegged against the euro did not allow the Baltic countries to alleviate the shock by depreciating their currencies and special efforts were required to maintain the fixed nominal exchange rates (Koyama, 2010; Lewis, 2010).

Figure 5: Balance on current account in the Baltic States (as share of GDP, 2000-2011Q3)

Source: own construction based on the data of Eurostat (2012)

The pre-crisis prosperity of the Baltic region has been accompanied by equilibrium problems. The most visible sign of this imbalance is the increasing current account deficit due to the deteriorating trade balance. For 2005, the current account deficits soared to unsustainable levels: 22.8 per cent of the GDP in Latvia, 17.4 per cent in Estonia and 13.7 per cent in Lithuania (Figure 5; Koyama, 2010; Rácz, 2009). Imports increased extremely due to the domestic consumption boom, and increase in exports was more temperate. In addition, labor-intensive manufactured goods ratio was low within total exports. Apart from the internal structural problems, the Baltic countries could not avoid the negative effects of the crisis due to their small size. Such a small countries are very vulnerable to decline in the export (Kreivys, 2010).

3.2.1 Estonia

After the turn of the Millennium, the Estonian economic growth rate was one of the highest among the emerging transition countries, associated with low inflation until 2005. After the joining to the EU, the domestic demand was fueled by the real estate boom. The prosperity of constructions was a result of the expectations of income growth, the cheap (floating rate, foreign currency denominated) loans with related tax allowance and the large amount of capital inflows (OECD, 2009). Therefore the financial sector and the housing market are linked with many threads. However, both sectors faced difficulties due to the financial crisis: property prices fell, borrowing options narrowed and so domestic demand declined gradually from the second half of 2008. Most of the credits had been financed by foreign parent banks' loans, so the Estonian national bank had to expand its cooperation with its Nordic partners in the fields of crisis management and bank supervision (OECD, 2009).

The Estonian pro-cyclical fiscal policy worsened the crisis situation, since in the boom years the government increased its spending and reduced tax rates (OECD, 2009). Although the public debt remained far below the EU average and the Maastricht criteria even in the years of the crisis, the government was still unable to prevent the private sector's indebtedness. In Estonia, most of the private investments were financed by foreign capital inflows, and as a consequence the balance of payments was negative.

In Estonia GDP fell by nearly 10 per cent in the fourth quarter of 2008 and about 15 per cent in the first quarter of 2009 compared to the corresponding period of the previous years. Both domestic and

foreign demand declined and the companies' revenues decreased by 20 per cent at least. The volume of foreign trade with the key partners was shrinking by 30 per cent or more (Kaasik, 2009). In 2009 both exports and imports declined, but the latter to a greater extent (by about one third), and thanks to this, Estonian balance of trade turned positive again – for the first time since 2003 (UNCTAD, 2011).

3.2.2 Latvia

One of the most emblematic countries in the current crisis is Latvia. The recession here was extremely severe in the last quarter of 2008 already. Somewhat paradoxically, it realized a double digit annual GDP growth between 2005 and 2007 – uniquely in the EU. The driving forces of this growth were the FDI inflows and cheap loans (Blanchard et al., 2010; Lengyel and Fejes, 2010).

The severity of the crisis in Latvia was partly the result of high inflation. After the EU accession of the country the lat became pegged to the euro, and the previously stable inflation rate started to soar: it increased to 10.1 per cent for 2007 that thwarted the Eurozone accession in 2008 (Eurostat, 2012). The price increase is traceable to the consumption boom and the housing bubble, and the sharp increase of the financing loans (Koyama, 2010). The loans' annual growth rate was more than 50 per cent between 2005 and 2007 (Blanchard et al., 2010; Lengyel and Fejes, 2010). Foreign (primarily Swedish) banks multiplied in the country in the past years, thus by the end of 2007, foreign currency debt rose to 86 per cent of total loans and Latvia has become increasingly exposed to external shocks (Blanchard et al., 2010). For 2007 the private sector's loans amounted to 100 per cent of GDP (Lengyel and Fejes, 2010).

After the EU accession the wage-increase surpassing productivity growth and the inflation have weakened the Latvian export competitiveness. For this reason, a huge trade deficit emerged and resulted current account deficit from year to year. The nadir lasted from the second half of 2006 to the end of the year 2007 (Eurostat, 2012).

The neo-liberal governments supported the growth with pro-cyclical economic policy, and sought for internal demand-based growth instead of increasing the competitiveness of the productive sector (Lengyel and Fejes, 2010). Therefore the signs of the overheated economy have occurred already from 2005, and culminated in 2007. After the property prices reached a maximum, there was a decline by 29 per cent in 2008 (Skribans 2009). Thus the loan-to-value ratio diminished dangerously, and economic growth started to decline at the beginning of the year 2008 (Blanchard et al., 2010). In order to offset these processes, the Latvian government and central bank have tried to take measures that throttle consumption – and while domestic consumption began to slow down, these efforts did not mean an immediate solution (Koyama, 2010; Lengyel and Fejes, 2010).

Several factors contributed to the growth of the Latvian public debt in 2009. Besides the high government deficit and the IMF loan, the bank consolidation was important, as well. The nationalization of the Parex Bank and the provided liquidity and guarantees overall took 9.5 per cent of the GDP (Palócz, 2010). Therefore not only the inflation, but the public debt Maastricht criteria were also threatened (Lewis, 2010).

3.2.3 Lithuania

At the beginning of the European crisis Lithuania's situation did not seem to be as dreadful as the other two Baltic economies', since the GDP was able to expand in 2008. But this increase of 2.9 per cent was the lowest since the turn of the Millennium, and for 2009 it began to decline (Table 1). The GDP decreased by nearly 15 per cent in 2009, due to the declining consumption, investment and

foreign trade and the increasing unemployment. Thus it became clear that Lithuania could not “swim with” the crisis as easily as initially had hoped. The economic downturn slowed down mainly by the net exports (Bank of Lithuania, 2010).

After the democratic transformation, the country’s performance was outstanding in many ways: economic growth, GDP per capita, external debt and – until 2007 – inflation rate was all favorable. Price liberalization, privatization and foreign trade have reached the level of well-functioning market economies’ for 2009. This growth path was based on conservative economic policy, the main drivers of which were domestic consumption and exports. The assistance of the European Union, the rapidly expanding credits and the appearance of foreign (mostly Scandinavian) banks also played a major role in the economic growth (Lengyel and Fejes, 2010).

Similarly to the other two Baltic countries, domestic consumption in Lithuania was exaggerated, thus the current account deficit, the private sector’s indebtedness and inflation went out of control even before the crisis: external and internal imbalances clearly occurred around 2007 (Lengyel and Fejes, 2010).

4. Tools and results of crisis management

In the following we attempt to present the measures taken in order to mitigate the negative effects of the crisis. These measures can be divided into two groups: *internal* (taken by the country’s government and national bank) and *external* (related to the EU, IMF or other international organizations) steps.

4.1. Latvia

We have seen earlier the reasons why Latvia was highly exposed to external shocks, and consequently, how severely the crisis affected the country from the last quarter of 2008. Therefore, in December 2008 the government requested for an aid package. The EU, the IMF, the World Bank and the Nordic countries pooled 7.5 billion euro (10.5 billion US dollar) for Latvia (Andersen, 2009). This amount meant a serious help if we compare it to the Latvian GDP (33.7 billion USD in 2008 and 25.9 billion USD in 2009 (UNCTAD, 2012)). In order to be allowed to drawdown the loan, the Latvian government had to take various stabilization measures, such as tightening its fiscal policy by about 7 per cent of the GDP value (Lewis, 2010; Rácz, 2009). However, the loan was not sufficient for defending the fixed exchange rate, so the Bank of Latvia had to use nearly one fifth of its reserves for this purpose (Lewis, 2010).

Political consequences of the crisis occurred quickly: in February 2009 the prime minister was forced to resign and the new government formed in March. Its first actions included the development a much stronger and more coherent crisis management program that primarily focused on restraining expenditures – as the IMF had prescribed. However, there were almost no resources left for the economic stimulation, therefore only certain sectors (such as conversion of timber, pharmaceuticals and some heavy industry) was given priority by the government (Németh, 2009).

The main measures to reduce expenditures were the following: severances and reducing wages in the public sector, cuts in the health and education system, reduction of pensions and maternity benefits (Meisel, 2009; Palócz, 2010). The revenue-raising measures were more considerable (Palócz, 2010):

- increase the rate of the personal income tax from 23 to 26 per cent;
- increase the VAT rate from 18 to 21 per cent;

- increase the excise duties on alcohol, tobacco and energy;
- increase the property tax and vehicle taxes;
- introduction of new taxes.

According to Németh (2010) Latvia's situation was still critical at the beginning of 2010: unemployment rate was higher than 20 per cent and because of the growing burdens of taxation which affected the whole population. Since the government rejected the devaluation of the Lat, export growth was discontinued. In addition, all important economic sectors were decline.

4.2. Lithuania

The current Lithuanian government took office in December 2008, so the crisis management immediately became its most important task (Kreivys, 2010). Although the crisis affected the country strongly, there was no instant need for an IMF loan 2008. In order to avoid the need of borrowing from external organizations in the future, the government adopted the first elements of its saving program (Meisel, 2009). This includes the strengthening of the financial sector, the increase of VAT rates and reducing public spending and the wages in the public sector. The devaluation of the Litas has not been executed, which was disadvantageous for exporters, but prevented the bankruptcy of borrowers with euro denominated the mortgage loans (Németh, 2009). The resulted high interest rates made the loans more expensive. To counteract this, in the beginning of 2009 the state's financial funds were expanded. These funds provided preferential loans to enterprises, especially exporting small and medium enterprises, thus helping their survival in order to maintain jobs and restrain the fall in exports (Kreivys, 2010; Rácz, 2009).

In 2009 Lithuania still did not need an IMF loan, but in March it agreed with the European Central Bank on a loan of 1.132 billion euro for the EU co-financed projects. Additional external resource was the 500 million euro Eurobond issued on the international financial markets (Lengyel and Fejes, 2010).

In July 2009 the EU launched an excessive deficit procedure against Lithuania. For this reason, the government sought to restore the fiscal balance as soon as possible: public expenditures were intended to be reduced by 2 per cent annual between 2010 and 2012. As a first step, wages in the public sector was reduced by 5, then 8 per cent from August 2009. This tendency continued in 2010: salaries of public officials and public employees fell further, as well as public managers' and politicians' (Palócz, 2010). In order to tighten the austerity measures, in the spring of 2009 modifications were introduced in the tax system (Palócz, 2010):

- reduction of personal income tax by 9 percentage points to 15 per cent;
- increase the corporate profit tax by 5 percentage points (Meisel, 2009);
- increase the VAT rate by 1 percentage point to 19 per cent in the beginning of 2009, then to 21 per cent in September 2009;
- increase the excise duties.

Since Lithuania – in contrast with Latvia – had resources for economic stimulus, too, some of the sectors of the Lithuanian economy started to grow at the end of 2009. The situation of the construction industry began to be normalized and trade revived. The position of the Lithuanian banks was satisfactory, as well. So the country did not need further crisis management packages in the beginning of 2010. But at the end of 2009, inflation was surging and reached 4.2 per cent – which was the second highest in the EU after the Romanian. Politicians think that the main instrument for cutting government expenditures is the simplifying of public administration and public services. This program

causes much lower social tensions than the drastic Latvian package, but it is still not easy to implement such measures (Németh, 2010). Therefore an institutional reform began in 2009 to promote transparency in the budget. This reform was supposed to build institutional guarantees into the budgetary system, which aimed at enhancing budget planning, implementation, monitoring and transparency (Palócz, 2010).

It is worth to point out that the Lithuanian government attaches great importance to attracting foreign direct investments in the country. Therefore, it tries to create a favorable legal and economic environment for foreign investments, built on high qualification level and advanced infrastructure, mainly in the service sector (Kreivys, 2010).

These measures led to the Lithuanian economy began to stabilize by the end of 2009: in 2010 the domestic demand gradually revived, the real estate market seemed to grow stronger, exports nearly reached the two years before peak, and the GDP also increased again. Like for Latvia, for Lithuania it was important to fulfill the Maastricht criteria and join the Eurozone as soon as possible (Zabuliene, 2011).

4.3. Estonia

Among the Baltic States, the position of Estonia seems to be the most stable. The fact that the country did not have to postpone the introduction of the euro – despite the crisis and the related austerity measures – demonstrates this well. There was no thought of the need for IMF loan in 2008. In February 2009 the government brought a budget amendment connected to a vote of confidence before the legislature. The vote confirmed the government and accepted the austerity package, the main element of which was the 10 per cent reduction in public expenditure, cuts in the public sector employees and wages (Meisel, 2009). Thus the country managed to adopt the euro and so avoid financial institutions' bankruptcies due to the termination of the exchange rate risk. Otherwise, it is true not only for Estonia, but for the other Baltic countries, as well, that instead of their currencies depreciation, they choose the so-called “internal devaluation” (Aslund, 2011; Cameron, 2010). In order to achieve a balanced fiscal position, the Estonian government offset the previous increase in its spending (between 2007 and 2009) with the reduction of expenditures and with the revenue increases, as well. The most important measures taken in the past years are the following (Palócz, 2010):

- in 2009, excise tax of some products was raised and the VAT rate was increased from 18 to 20 per cent;
- the personal income tax rate was reduced (from 26 to 21 per cent), while the lower limit of compulsory social insurance contribution was raised;
- sick pay was taken away;
- tax exemption for student loans was eliminated;
- government allocated funds to local authorities were reduced;
- transfers to the private pension funds were suspended for two years from July 2009;
- raise of retirement age from 2017 was decided.

The Estonian government is to make economic stimulus measures. In the spring 2009, a 360 million euro credit line was approved for various goals: to increase the small and medium enterprises' accession to credit and to maintain their exports; to finance tourism and research and development; as well as for job creation and for social programs. In May 2009 the government signed a 700 million euro loan agreement with the European Investment Bank (Meisel, 2009). The aim of the agreement was to stimulate the economy. More than three-quarters of the amount was intended to be spent for

human resource development. The first measures in the beginning of 2010 aimed to boost the labor market, since Estonia's most serious problem was the 14 per cent high unemployment (Németh, 2010).

Since Estonia has no major domestic financial institutions (98 per cent of the banking sector is owned by foreigners), there was no need of the government's sources to bail out the financial sector. The Scandinavian parent banks made the crisis management steps (Kaasik, 2009). The Estonian government accumulated reserves in good times, and this provided the necessary room for maneuver to contribute to stabilizing the financial system. The reserves enable the government to finance the budget deficit without having to obtain funds from the markets, but this is only a temporary solution. It is very important to revive and maintain the markets trust in the economy, so the Estonian government had to strengthen its fiscal position (Kaasik, 2009).

It is a real success for the country that despite the crisis it managed to comply with the Maastricht criteria and it could join the Eurozone on the 1st of January 2011. The common currency eliminates the exchange rate risk, reduces transaction costs, and attracts foreign investors, who are primarily interested in metal and engineering industry, chemical industry, business services and information technology (Ummelas, 2011).

5. Conclusions

After their democratic transformation, the Baltic countries created an economic model that aimed at closing up to the developed countries of Western Europe. This model – built mostly on the stimulation of consumption – proved to be successful. After their accession to the EU in 2004, the Baltics showed a prominent, however controversial economic growth. It became increasingly apparent that the three economies are overheated. The resulting tensions would have needed solutions even without the global crisis, but the European recession made it urgent for the countries to take the long overdue steps in order to regain the economic balance.

In 2008 the Baltic countries' GDP growth rate dropped drastically, unemployment rate and inflation soared, budget deficits and public debt increased due to the crisis. Although the region had been attractive for foreign investors since the accession to the EU, in 2008 and 2009 FDI inflows have declined, especially in Latvia and Lithuania.

After the sudden and considerable recession, in 2010 several macroeconomic indicators showed a favorable image, but there are still tasks to be performed in order to recover from the crisis. As a first step in crisis management, each country's government sought to cut public expenditure by reducing social spending, pensions and wages in the public sector. On the other side the governments started to increase their revenues by raising different tax rates.

Latvia was shocked by the crisis mostly, therefore unlike Estonia and Lithuania, it could not start an economic recovery program in the first half of 2009 yet. The main elements of the other two Baltic countries' recovery programs were the promotion of attraction of foreign capital, the facilitation of the domestic SME's borrowing and the promotion of export.

During the crisis management process, the very narrow margin of monetary policies made the three countries' situation more difficult. But the Baltic States have chosen to introduce the euro as soon as possible instead of the currency devaluation.

The Baltic leaders was often forced to take drastic steps in the crisis management, but the governments' responses to the recession and the policymakers' behavior patterns can be exemplary to other countries, as well.

Acknowledgement

The research is supported by "4.2.1./B-09/1/KONV-2010-0005". The Project named "TÁMOP-4.2.1/B-09/1/KONV-2010-0005 – Creating the Centre of Excellence at the University of Szeged" is supported by the European Union and co-financed by the European Social Fund.

References

1. Andersen, C. (2009): Latvia Caught in Vicious Economic Downturn. *IMF Survey Online*, 28 May 2009. <http://www.imf.org/external/pubs/ft/survey/so/2009/CAR052809A.htm> (7 February 2012).
2. Aslund, A. (2011): Az új Európa meglepő ellenálló képessége (The surprising resilience of the new Europe) *Világgazdaság Online*.
<http://www.vg.hu/velemenya/kozgazdaszok/az-uj-europa-meglepo-ellenallo-kepessege-338400> (23 March 2011).
3. Bank of Lithuania (2010): *Financial Stability Review*. Vilnius.
4. Blanchard, O. J. – Das, M. – Faruquee, H. (2010): The Initial Impact of the Crisis on Emerging Market Countries. In Romer, D. H. – Wolfers, J. (eds.): *Brookings Papers on Economic Activity*, Spring 2010, The Brookings Institution, Washington, D.C., pp. 263-324.
5. Belyó P. (ed.) (2009): *Bővülő Európa – Tények és tanulmányok* (Widening Europe – Facts and studies). ECOSTAT. 2009. III.
6. Cameron, D. R. (2010): *European Responses to the Economic Crisis*. Yale University, Washington DC.
7. Csaba L. (2007): Átmenet vagy spontán rend(etlenség)? (Transition or spontaneous (dis)order?) *Közgazdasági Szemle*, 9, pp. 757-773.
8. ECB (2010): *Convergence Report May 2010*. European Central Bank, Frankfurt am Main.
9. European Commission (2010): *General Government Data – General government revenue, expenditure, balances and gross debt*. European Commission, Directorate General ECFIN, Brussels.
10. Eurostat (2012): *Statistics Database*.
http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database (13 January 2012).
11. Grigonytė, D. (2010): FDI and structural reforms in the Baltic States. *ECFIN Country Focus*. July 2010, 5, Brussels, pp. 1-8
12. Kaasik, Ü. (2009): Reserves Can Help – the Case of Estonia. In: *Recent Developments in the Baltic Countries – What Are the Lessons for Southeastern Europe?* Workshops – Proceedings of OeNB Workshops, No. 15, Wien, pp. 82-91.
13. Koyama, Y. (2010): Economic Crisis in New EU Member States in Central and Eastern Europe: Focusing on Baltic States. *Romanian Economic Business Review*, 5, 3, pp. 31-55.
14. Kreivys, D. (2010): Post-crisis Lithuania – lessons and recovery. *Baltic rim Economies*, 6, 2010.
15. Lengyel L. – Fejes E. (eds) (2010): *A gazdasági válság és társadalmi következményei 2010* (The Economic Crisis and Its Social Consequences 2010). Foundation of Financial Research, Budapest.
16. Lewis, J. (2010): How has the financial crisis affected the Eurozone Accession Outlook in Central and Eastern Europe? *DNB Working Paper*, 253/2010.

17. Masso, J. – Krillo, K. (2011): Labour markets in the Baltic States during the crisis 2008-2009: the effect on different labour market groups. *Working Paper*, University of Tartu.
18. Meisel S. (2009): A balti államok és a válság. (The Baltic Countries and the Crisis). In Novák, T. – Wisniewski, A. (eds.): *A globális válság: hatások, gazdaságpolitikai válaszok és kilátások. Az új EU-tagállamok és a tagjelöltek helyzete a válságban*. HAS Institute of World Economics, Budapest, pp. 19-25.
19. Németh V. (2009): Le a megszorításokkal! (Down with the restrictions!) *KITEKINTŐ.hu*. http://kitekinto.hu/europa/2009/09/01/le_a_megszoritasokkal (20 March 2011).
20. Németh V. (2010): Balti válságkezelés: verseny a túlélésért (Baltic crisis management: competition for survival). *KITEKINTŐ.hu*. http://kitekinto.hu/europa/2010/02/11/balti_valsgakezeles_verseny_a_tulelesert/ (21 November 2010).
21. OECD (2009): Economic Surveys: Estonia. *OECD Economic Surveys*, 2009/3.
22. Palócz É. (2010): Fiskális politikák a válság tükrében: a nemzetközi pénzügyi válságra adott fiskális politikai reakciók Közép-Kelet-Európában és Magyarországon (Fiscal policies in the light of the crisis: fiscal policy responses to the international financial crisis in Central and Eastern Europe and Hungary). *Study*, Kopint Foundation for Economic Research, October 2010.
23. Purfield, C. – Rosenberg, C.B. (2010): Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008-09. *IMF Working Paper*, WP/10/213, September 2010.
24. Rácz M. (2009): Összefoglaló a válságkezelésről az EU27-ben (Summary of the Crisis Management in the EU 27). In: Somai M. (ed.): *A globális válság: hatások, gazdaságpolitikai válaszok és kilátások*, 9, *Nagy EU-tagállamok és a gazdasági válság*. HAS Institute of World Economics, Budapest, pp. 7-25
25. Samonis, V. (1995): Transforming the Lithuanian Economy: From Moscow to Vilnius and from Plan to Market. *CASE Network Studies and Analyses*, 42.
26. Skribans, V. (2009): Latvian and Europe construction comparison: stability and reasons of crisis. *MPRA Paper*, July 2009, Riga Technical University.
27. Ummelas, O. (2011): Investors Heading to Estonia on Euro, OECD Entry, Official Says. *Bloomberg*. <http://www.bloomberg.com/news/2011-01-24/investors-heading-to-estonia-on-euro-oecd-entry-official-says.html> (21 March 2011).
28. UNCTAD (2012): *UnctadStat*. <http://unctadstat.unctad.org> (6 February 2012)
29. Zabuliene, R. (2011): Lithuania – the adjustment process towards the euro. *Baltic rim Economies*, 1.