

The Politics of Economic Sustainability:

Baltic and Visegrad Responses to the European Economic Crisis



Edited by Karlis Bukovskis

UDK 327(4)+33(4)
Po 275

The collection of articles entitled “The Politics of Economic Sustainability: Baltic and Visegrad Responses to the European Economic Crisis” is an attempt by an international collection of authors to explain the political economy of the long and winding road of the Baltic States (Estonia, Latvia and Lithuania) and the four Visegrad countries (Poland, the Czech Republic, Slovakia and Hungary) in facing economic and financial problems domestically and/or on the European level. Authors from all the abovementioned countries contributed their ideas, explanations and projections on the future development of their respective countries based upon the lessons learned from the crisis. The book chronicles the economic environments and challenges and compares the political and social results of diverse macroeconomic choices that have been made in these seven European Union member states. The publication is available for free at www.liia.lv.

Scientific editor and project director: Karlis Bukovskis (karlis.bukovskis@liia.lv)
Reviewers: Edijs Bošs, Andres Kasekamp

Authors: Aldis Austers, Karlis Bukovskis, Juraj Draxler, Brian Fabo, Vytautas Kuokštis, Michal Mudroň, Vitalis Nakrošis, Ryszard Petru, Zoltán Pogátsa, Michal Rot, Viljar Veebel, Ramūnas Vilpišauskas

English language editor: Talis Saule Archdeacon

© Latvian Institute of International Affairs, 2014
© Authors of the articles, 2014
© Cover design: Aldis Ozoliņš, 2014

ISBN: 978-9984-583-49-5
ISBN for electronic issue: 978-9984-583-50-1

This publication is supported by



Contents

Introduction: Facing the Realities <i>Karlis Bukovskis</i>	6
Latvia's Controversial "Success Story" <i>Aldis Austers</i>	9
The Politics of Reacting to the Crisis in Lithuania from 2008-2013: Exiting the Crisis, Entering Politics as Usual? <i>Ramūnas Vilpišauskas, Vitalis Nakrošis, Vytautas Kuokštis</i>	38
Estonian Economic, Social and Political Developments in the Years of Financial Crisis and Austerity, 2008-2011 <i>Viljar Veebel</i>	64
The Effects of the Great Recession on Hungary <i>Zoltán Pogátsa</i>	90
Economic Sustainability in Slovakia <i>Brian Fabo, Michal Mudroň</i>	107
The Czech Republic: From Supply-side Economics to Aggressive Deficit-Cutting. And Now an Expansionary Turn? <i>Juraj Draxler</i>	126
Poland – a "Not-So-Complete" Success <i>Michal Rot, Ryszard Petru</i>	151
Concluding Remarks: Stabilisation Lessons and Their Sustainability <i>Karlis Bukovskis</i>	170
Selected Further Reading	177
Notes on Authors.....	179

Introduction: Facing the Realities

Karlis Bukovskis

The financial instability and economic problems in the so called eurozone countries and in the European Union (EU) in general have tormented decision makers and challenged experts and businesses to find the proper, most sustainable and stabilising solutions to the situation. The European economic crisis, as it is sometimes labelled, started around 2008 and is considered to be over by representatives of some EU countries and EU institutions. Many European Union member states in 2014 still face the realities of unemployment, cuts in public expenditures, stabilisation and the “stress-testing” of the largest banks, and of course the economic restructuring that would lead to a return to dynamic and sustainable economic growth.

This book, “The Politics of Economic Sustainability: Baltic and Visegrad Responses to the European Economic Crisis”, is dedicated to observing and discovering the economic, financial, social and political results of the European economic crisis in one particular group of EU member states: the three Baltic States (Latvia, Lithuania and Estonia) and the four Visegrad countries (Hungary, Slovakia, the Czech Republic and Poland). The book seeks to define and explain the Baltic and Visegradic responses to internally and externally caused political and economic problems since 2008. The authors of this collection of articles tend to account for both the economic and political environments of the seven EU member states when they entered the European economic crisis, the mechanisms decision makers chose and the outcome of the stabilisation programmes, thus providing the reader with both empirical data and material for comparative analysis. Each of the chapters is a separate article where the authors seek to explain their respective country’s economic and political developments by covering a number of the main structural matters, like the central sources of financial problems, the influence of foreign banks, real estate sector developments, external trade and the current account balance, the role of political preferences, and ideologies. Authors also evaluate the role of the eurozone and EU funds, as well as international financial markets and institutions, in parallel with the main domestic political arguments for stabilisation, austerity, monetary policy, fiscal adjustments, sectoral structural reforms, migration, the fate of ruling political parties, labour market figures and other notable factors.

And each of the countries have their specific story to tell. The financial and economic problems that the Baltic States and Visegrad countries experienced have had different levels of severity and thus different solutions. While some were using monetary instruments to boost their exports, others had to engage in bailing out other partners in the eurozone. While some were drastically cutting public expenditures, others were softer on austerity. While some were issuing government bonds, others engaged in borrowing from international institutional lenders. While some had sustainable saving policies before the crisis, some were bailing out their national banks. Many common trends can be observed as well. The presence and structural economic role of the Western or Nordic banks in the Baltics and Visegrad countries, for example. Similar exposure to the “European Common Market”, relatively similar plans for an eventual membership in the “eurozone” and relatively similar general economic structures. The diverse experiences of a traditionally unitarily perceived region is an important object for analysis. Although all of the seven countries will mark their 10th anniversary of membership in the EU and have experienced a transition from the planned economic systems 20 years ago, their individual economic choices and environments, as well as their political results, demonstrate a rather colourful picture. Therefore, this collection of articles is meant to serve the purpose of informing and explaining the different paths the countries had taken while recognising the similarities as well.

Politics and economics are not separable. They form the basis and realities of state and normative human existence. The choices that are made in politics are nowadays calculated in economic expenses. Economic reasoning and macroeconomic decisions always make an imprint on the functioning and wellbeing of societies, and thus their political satisfaction. It is this political satisfaction that is the most difficult goal during the times of sovereign financial or general financial problems. Political satisfaction is not easily achievable if the satisfaction of immediate individual needs is not secured. It is the stabilisation maneuvering between the external environment and the domestic situation that the politicians and decision makers (regardless of the political regime) have to face. Although democratic leaders traditionally have a less patient public to please, non-democratic political figures tend to face legitimacy questions every time serious economic disturbances occur. The Baltic and Visegrad countries are excellent examples of political entrapment between externally triggered financial difficulties and domestic demands for stabilisation. The realities of the European

economic crisis revealed more than the necessity to seek sustainable development models in the post-communist European Union member states. Besides the political and societal urges to achieve income cohesion with the average of the EU level, this also demonstrated the political maturity of each of the countries. Namely, the Baltic and Visegrad leaders were facing public pressure for achieving the “European dream” of stability and sustainability of personal income and societal welfare. Together with external economic ideologies and mutual competition, the countries opted for accelerated and excessive economic growth models. Moreover, the further from the average EU level the country was, more reckless it was ready to be. The more reckless a country had been in economic (mis-)management, the harsher the stabilisation measures that had to be implemented.

Taking all this into account, the book generally seeks to face these realities again after the the general understanding in the European Union approaches the acknowledgment of the end of the financial crisis and macroeconomic uncertainty. The authors tend to look at whether the choices during the years of economic stabilisation have made the economies more solid and growth sustainable. Have the Baltic and Visegrad countries had a “politics of economic sustainability”? Is the aftermath of the European economic crisis in the seven countries been made economically sustainable through political action?

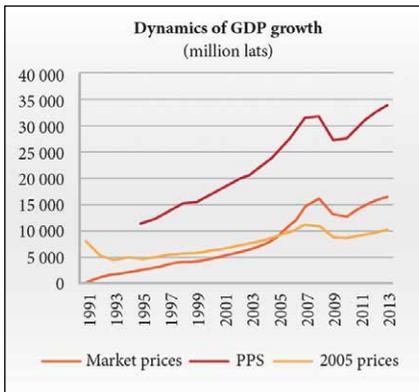
This collection of scientific researches is an another example of successful collaboration between economists, political scientists, international relations specialists and political economists from the Baltic and Visegrad countries under the leadership of the Latvian Institute of International Affairs and with instrumental support from the Friedrich Ebert Stiftung. Contributions by authors from the Estonian National Defence College, the Latvian Institute of International Affairs, the Institute of International Relations and Political Science in Vilnius, the Centre for European Policy Studies in Brussels, the Hungarian Academy of Sciences, the Central European Labour Studies Institute in Bratislava, PKO Bank Polski and the the Association of Polish Economists, have all turned this project into a valuable intellectual contribution combining elements of both political and economic affairs. Thus, “The Politics of Economic Sustainability” has the ambition of being handy for readers of both the expert community and the general public by taking the best research on politics and economics.

Latvia's Controversial "Success Story"

Aldis Austers

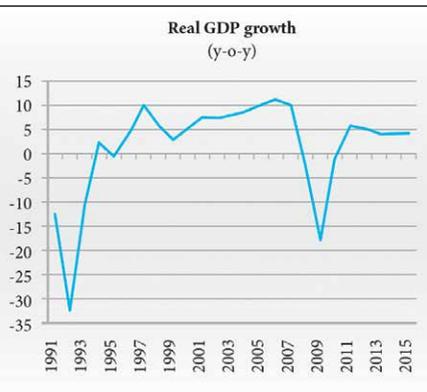
The last 20 or so years of independence have brought to Latvia steady economic growth based on the Western tradition of liberal democracy and a market economy. In purchasing power standards, the prosperity of the Latvian society has tripled over between 1993 and 2013 (see Figure 1). From the late 1990s until 2008 the Latvian economy grew with an annual average speed of around 7 to 8% – an astonishing achievement for a country with a limited labour supply. However, this economic growth has been perforated with repeated slumps and rapid slow-downs (see Figure 2). Thus, the economic collapse of early 1990s (GDP fell by around 49%) was caused by the disintegration of the USSR and Latvia's transformation from a Soviet style command economy with immense productive overcapacity (Latvia used to be a huge manufacturing site for supplies to the whole Soviet Union) to a small market-based economy. Another disaster happened in 1995, when due to a banking crisis 53% of household deposits vanished, and then again in 1998, when due to Russia's financial crisis Latvia's eastern exports crashed, causing a considerable plunge in the GDP growth rate – from 9.6% in 1997 to 2.9% in 1999. Thus, the crisis of 2008-2010 can be seen as just another episode in a drama related to Latvian experience in a capitalistic world.

Figure 1.



Source: Eurostat

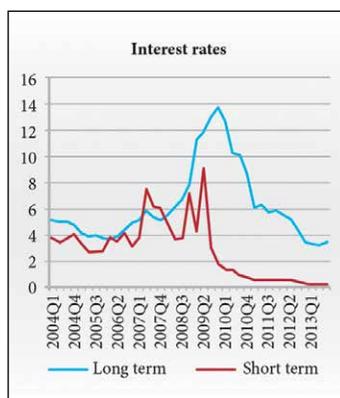
Figure 2.



Source: Eurostat

The calamities of 2008-2010 were preceded by a period of unprecedented growth in Latvia. It was a boom that turned ugly. This boom was driven by a glut of foreign funding, which consisted of foreign direct investment, foreign credit for companies and financial institutions, European Union funding, and also labour remittances. After a period of healthy growth between 1999 and 2004, signs of overheating appeared in late 2004, not long after Latvia's accession to the European Union and the North Atlantic Treaty Organization. From 2005 until the beginning of 2007 the speed of the expansion of the national economy followed a geometric progression: between the first quarters of 2006 and 2007 the economy, in nominal terms, grew by 36%! There was even a period in 2007 during which the short term

Figure 3.



Source: Bank of Latvia

interest rates exceeded the long term interest rates by 1.7% (see Figure 3). A surge in consumption and housing construction was observed, as the average level of wages and real estate prices tripled in Latvia at that time. The spree of domestic consumption was accompanied by an increase in Latvia's external indebtedness (from 80% in 2003 to 165% in 2010), to which the major contributor was the rapidly widening current account deficit (from 5% in 2000 to 25% in mid-2007). Unemployment reached a record low level for Latvia – 6% – but at the cost of inflation going from 6.2% in 2004 to 15.3% in 2008. In the meantime, Latvia's net international investment position expanded from minus 52% to minus 83% of GDP. Such dependence on foreign funding was suggestive of Latvia's excessive exposure to the risk of an abrupt shift in investor sentiment.

The party was followed by a dreadful hangover. The ensuing slump took away a quarter of Latvia's economy, shot unemployment up to 21%, and made every fifth banking loan non-performing. Fifty-six percent of Latvian households had reported being affected by the crisis (in Lithuania 52% and in Estonia 50%).¹ In the words of Elena Flores, the then-responsible director for Latvia within the European Commission, “[in Latvia] it was a combination of fiscal, financial, monetary and structural challenges.”²

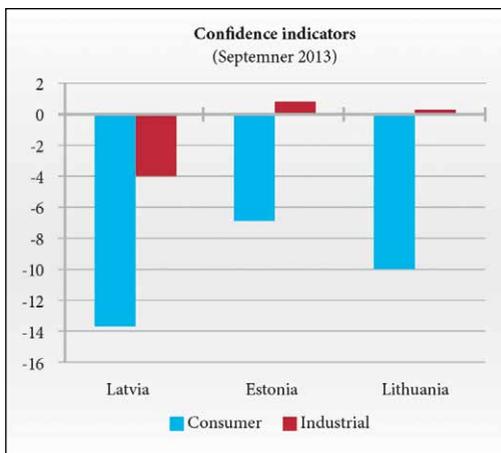
¹ *Life in Transition: After the Crisis* (European Bank of Reconstruction and Development, 2011), http://www.ebrd.com/downloads/research/surveys/LITS2e_web.pdf

² Elena Flores, “Opening Remarks” in *EU Balance-of-Payments Assistance for Latvia: Foundations for Success*, European Economy Occasional Papers no. 120 (European Union, November 2012), 9.

A perfect storm, in other words. In order to avoid a complete financial and economic melt-down, the government was forced to request an international bail-out, which was delivered at the end of 2008 with stringent conditionality attached. During the following three years Latvia had to undergo severe economic adjustment. The task was controversial and not easy to implement. Yet the bail-out programme was officially ended already in January 2012 and was declared a success, as Latvia used only a fraction (60%) of the assistance, had returned to healthy economic growth, and saw a return of investor confidence. The harsh adjustment was vindicated by receiving permission for Latvia to join the eurozone as of 1 January 2014.

Despite this good news, not everything is going in the right direction in Latvia. The most serious challenge stems from the demographic decline and the outflow of people. Latvia's economy is becoming smaller and smaller in terms of economically active people. The other related problem is linked to the shortage of well paid jobs available on the local market. The perennial problem of increasing investment – both local and foreign – and hence increasing employment in productive (tradable) sectors of the

Figure 4.



Source: Latvian Statistics

economy has so far not been resolved. Without transition to technology rich economy, Latvia risks being stuck in the “middle-income trap”. And last but not least, the perseverance of inequality, poverty and unregistered economic activity not only reduces the chances for economic growth, but also hurts social relationships between people. It reduces trust in the government, which is essential for high and sustainable growth in any country. Relief from the economic depression thus

far is being felt only in Riga, the capital of Latvia, where around 50% of Latvia's economy is concentrated, and also in some regional centres like Valmiera. The other regions of Latvia continue to suffer from a scarcity of economic activity, jobs and income (see Figure 4).

In the following sections of this paper: (1) the causes of Latvia's extreme growth and slump will be dissected; (2) the effectuated crisis resolution strategy and alternatives to it will be examined; (3) popular reactions to the crisis resolution measures in terms of social and political responses will be scrutinised; and (4) prospects for the future growth of Latvia's economy will be outlined.

The causes of Latvia's economic extremes

Accelerated economic growth was a common feature in the countries of Central and Eastern Europe, particularly in those countries which joined the European Union in 2004. Integration into the European market and improvements in the institutional and legal framework resulted in growing investment in the region. Low taxation, cheap and qualified labour, inexpensive local assets, unsaturated local consumption, and the prospect of income equalisation with Western European countries provided ample opportunities for investment. However, the investment frenzy turned into a phenomenon dubbed "convergence play", which denotes a situation in which expectations of further convergence lead to ever increasing investments ultimately leading to overpricing and crash (e.g., the expectation of asset price convergence leads to heightened interest in buying these assets while low-priced, but that also pushes those prices up). Latvia represents an extreme case of this "convergence play". In order to understand the causes of the rarely seen developmental imbalances in Latvia, some insights into the behaviour of foreign investors, the dynamics of the domestic market and the performance of the manufacturing and exporting industries between 2004 and 2008 are required. The impact of fiscal, monetary and prudential policies should also be scrutinised.

Foreign investment in Latvia. Latvia has been struggling to attract foreign direct investment since it became independent. After its departure from the collapsing U.S.S.R., Latvia was very short of capital. In order to attract foreign funding, the government of Latvia adopted harsh monetary stabilisation measures (a fixed exchange rate, a suppressed money supply) with the aim to push down inflation and make the newly introduced national currency freely convertible. Latvia privatised public assets, liberalised all financial accounts and set itself towards opening trade with Western countries. This solution is called "free-market radicalism".³ In addition to liberalisation, Latvia also adopted a number of policies

³ Anders Åslund and Valdis Dombrovskis, *How Latvia Came Through the Financial Crisis* (Washington DC: Peterson Institute for International Economics, May 2011), 8.

targeted at the attraction of foreign investment: a zero tax on capital gains and reductions to corporate income tax applied to businesses with foreign direct investment. However, despite these measures, the investment attraction performance of Latvia was far less effective than that of Estonia (see Figure 5). Apparently, in the 1990s, foreign investors were still too cautious about the long-term prospects of Latvia or, also very probable, met with resistance from the local power elite to cede the control of the economy. Besides this, allegedly a major part of foreign investment in Latvia at that time was of local origin, as domestic businesses moved their earnings to offshore zones, from whence they reinvested it as foreign investment with the aim to profit from the beneficial treatment accorded to foreign investors.

Figure 5.

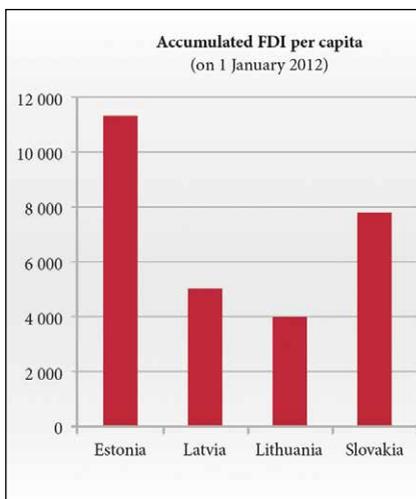
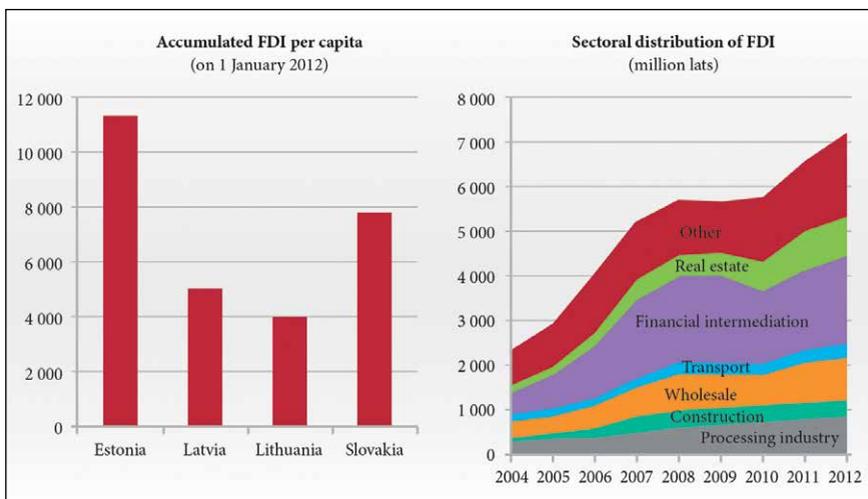


Figure 6.



Source: Eurostat

Source: Eurostat

The foreign investors' attitude started to change in 1998, the year that Latvia was invited to start accession negotiations with the European Union. Only then did Latvia see the first large foreign investment led projects: foreign (mostly Scandinavian) banks and retail chains established subsidiaries in Latvia. These foreign banks and shops substantially modernised Latvia's financial and retail segment – however, they did very little to resolve Latvia's perennial problem of a weak production base and an insufficient number of high value added jobs. Since then only a

small fraction of foreign investment has reached manufacturing, with the majority of investment going into financial intermediation and retail (see Figure 6). This trend has stood in a stark contrast to what happened, for example, in Slovakia, the Czech Republic and Slovenia.⁴ In the Latvian case, investors were mostly interested in exploiting Latvia's particularly low level of indebtedness and the high potential for income growth, and had little interest in building factories. Via banks and retailers foreign lending was transformed into household and business loans, with local actors remaining the ultimate agency responsible for economic growth. Yet, the local people, having little understanding of perils hidden behind the debt economics, very willingly engaged in this game, because for them access to cheap credit meant better living standards, bringing a heavenly blessing after a protracted fasting.

The domestic market and exports. Due to Latvia's small size (2 million people), the labour market has not been a motivator for large scale investment.⁵ With the exception of Riga, the capital of Latvia, the supply of labour is limited in Latvia. Scarce distribution, demographic decline and emigration are major causes of this. However, as has been already noted, back in 2004 the low level of indebtedness and the prospect of swift convergence of income levels with other European Union member states in combination with unrestricted access to Latvia's (and other Baltic countries') markets provided a "golden moment" for the development of local consumption. According to IMF experts: "Growth [in Latvia] had become reliant on domestic demand, supported by a continued rapid expansion of credit, large capital inflows, and continued asset price appreciation, and any slowdown or reversal of foreign financing was bound to hit the economy hard".⁶ Indeed, this "domestic market" game was unsustainable and was bound to crash sooner or later.

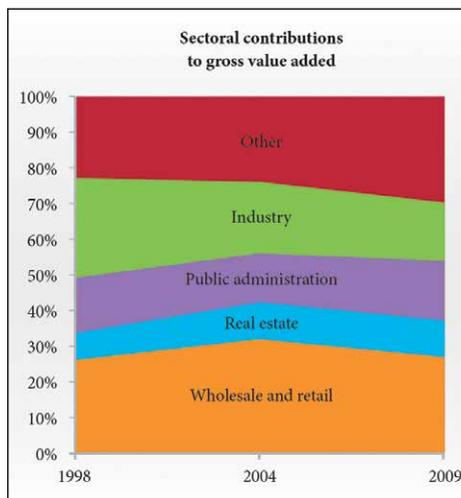
At the same time, the share of manufacturing in gross value added fell from 20% in 1997 to 14% in 2004, and further to 10% in 2009 (see Figure 7). This result stands in contrast to what happened in the other Baltic countries. Thus, if in 1997 the share of manufacturing in the GDP was more or less equal among the Baltic three, then in 2004 a gap had already appeared between Latvia, Lithuania and Estonia, and this gap continued to widen until 2008 (see Figure 8). In essence, Latvia's spectacular growth was

⁴ Jan Drahokoupil, „The Rise of the Comprador Service Sector: The Politics of State Transformation in Central and Eastern Europe“, *Polish Sociological Review* 2 Iss. 162 (2008).

⁵ Nor have natural resources been contributing to Latvia's economic growth. With the exception of wood and the unspoiled landscape, Latvia falls rather flat on the riches of nature.

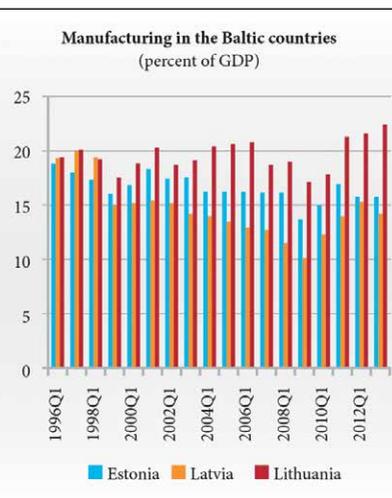
⁶ Bas B. Bakker and Christoph Klingen, *How Emerging Europe Came Through 2008/09* (Washington DC: International Monetary Fund, 2012), X.

Figure 7.



Source: Eurostat

Figure 8.



Source: Eurostat

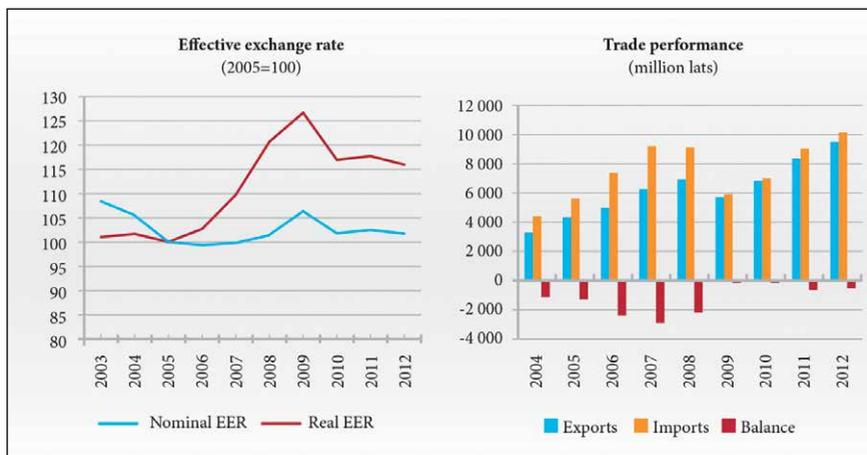
largely achieved on account of Latvia’s financial integration with Western markets, and not so much on account of the modernisation of production.

Export plays essentially important role in the Latvian economy, though the assessments of Latvia’s export performance during the boom years differ. Until recently it was widely believed (e.g., on the part of the IMF and the European Commission) that Latvia was losing its international competitiveness due to overheating, leading to weakened trade performance. It was calculated that the real effective exchange rate of Latvia’s national currency in 2009 was 127% of its 2005 level (see Figure 9). From a theoretical perspective this meant a considerable loss of export potential. However, as later studies revealed, despite producer cost inflation, Latvia’s external trade performance actually was improving. According to Beņkovskis, “[a]lthough Latvia’s export unit values were increasing relative to those of its main rivals, the relative quality of Latvia’s exports was rising even faster, fully compensating the price effect and improving overall competitiveness”⁷

This conclusion is very relevant in the context of the debate about the appropriate exchange rate policy during the boom. The policy of the Bank of Latvia, the responsible institution for the exchange rate in Latvia, was to

⁷ Konstantins Beņkovskis, “Evaluation of Non-Price Competitiveness of Exports from Latvia” in *EU Balance-of-Payments Assistance for Latvia...*, 60-67.

Figure 9.



Source: Eurostat

Figure 10.

Source: Eurostat

maintain the national currency's exchange rate peg to the euro⁸ throughout the whole period of economic boom. The argument was that the credibility of the fixed exchange rate was the optimal solution to the situation of confusing market signals – namely, when, on the one hand, huge inflows of foreign capital required a revaluation of the exchange rate in order to reduce the pressure on prices, and, on the other hand, the inflation of producer costs necessitated currency devaluation, in order to keep the import and export industries competitive. In hindsight, the latest studies on Latvia's trade performance suggest there was some room for currency exchange rate adjustment to help the economy to cope with the large inflow of foreign funding.

Fiscal, monetary and prudential policies. It has to be noted that the public authorities responsible for fiscal, monetary and prudential policies failed in a spectacular manner to recognise the imminent risks stemming from macroeconomic imbalances and to introduce appropriate and coordinated measures. Warnings from international bodies like the IMF were effectively played down. It was believed that integration within the structures of the European Union had reduced the risk of a sudden stop in investment flows and that the imbalances (the high current account deficit and external debt) were of a temporary nature, characteristic of emerging economies.

⁸ The exchange rate parity of Latvia's national currency against euro was agreed in May 2005 by the Latvian and European authorities (1 euro = 0.702804 lats) with fluctuation margin of +/-15%. The Bank of Latvia though unilaterally committed to reduce that margin to +/- 1%.

More specifically:

- Fiscal policy was pro-cyclical, and no provisions for rainy days were created. On the surface the government's fiscal behaviour looked flawless, at least from the point of view of the Maastricht criteria – the annual budgetary deficits were kept within the limit of 3% of GDP. However, considering the scale of annual windfall revenues, the fiscal stance was pro-cyclical and provided a huge additional boost to the economy.⁹ Even more disturbing was the government's willingness to maintain business and capital friendly taxation in a situation of huge capital inflows. The diminishing risk associated with investment in Latvia due to EU membership provided a good opportunity to reverse the low corporate taxation policy; however, such actions would have been in conflict with the vested interests of governing political forces. Thus, instead of extracting the excess liquidity from the economy through taxation, the government opted to continue with a policy of "small government" in terms of revenues (in fact, Latvia still has one of the smallest governments in the European Union in terms of tax income – only 28% of GDP).¹⁰ When fiscal crisis stroke, the government had no reserves to rely on.
- Monetary and exchange rate policies played a role too. The general wisdom is that without the possibility of recourse to restrictions on capital movement (the EU integration aspect), a small and open economy with a high import component in both domestic consumption and manufacturing (the openness aspect) and a shallow domestic financial market (the smallness aspect) should give preference to a fixed exchange rate over inflation targeting as its monetary policy goal. This approach has been an imperative for the Bank of Latvia since 1994. Moreover, countries like Latvia find it difficult to borrow internationally in their own currency; hence, a major part of the national debt is denominated in foreign currencies. Exchange rate variations expose the government and private sector to disquieting currency risk in relation to these foreign borrowings. Yet the comfort offered by a credible exchange rate peg, delivered by the Bank of Latvia, was quite betraying. As the risk of exchange rate variability seemed to be low, private borrowers and the government were more inclined to borrow in foreign currencies than they

⁹ According to estimates, the government, in order to extract excess liquidity created by the credit boom and foreign capital inflows, had to run budget surpluses of 1.2-2.5% percent of GDP annually from 2004 to 2007. See Mārtiņš Bitāns, „Latvijas tautsaimniecības attīstība pēc pievienošanās Eiropas Savienībai – klasisks ekonomikas pārkaršanas piemērs” (The Development of Latvia's National Economy after Accession to the European Union is a Classical Example of Economic Overheating) in *Latvijas Bankai XC* (Riga: Bank of Latvia, 2012).

¹⁰ *Taxation Trends in the European Union*, Eurostat Statistical Books, 2013 edition.

would be otherwise. And, more alarmingly, the fixed exchange rate rendered the traditional monetary instruments for the correction of market failures (e.g., reserve requirements, policy interest rates, etc.) toothless. Thus, the onus for balanced and sustainable economic growth fell completely on the shoulders of the government – a responsibility the Latvian government was not in fact ready to accept¹¹.

- The activities of the supervisors of credit institutions – both local and foreign – were also conducive to the extreme overheating of Latvia's economy. To begin with, fierce competition among commercial banks over market shares led to very aggressive marketing policies with little regard on the part of authorities. The Latvian public was literally brain washed – people were encouraged to take loans for everything: house construction, the purchase of apartments, cars, furniture and household equipment, and even for weddings and other festivities. As a result, crediting expanded at an annualised rate of more than 50%. Moreover, the struggle for market share led to a worsening of credit standards: loans were issued to people with low and obscure sources of income, the maturity of loans was steadily extended (in the case of mortgage loans even up to 30 years), and in some instances the loan value even exceeded the value of collateral. Furthermore, the commitment by the Bank of Latvia to defend the parity of national currency's peg "at any cost" led to the decision of the banking supervisor, the Financial and Capital Market Commission of Latvia, to treat euro denominated credit transactions of banks as currency risk free as of June 2005.¹² The aim of such a policy was to underline Latvia's irrevocable commitment to introducing the euro as soon as possible. However, the continuation of such policy after 2006, when the decision was taken to revoke the initial target date for joining the eurozone (this date was 1 January 2006), led to a euroisation of the Latvian economy. The share of loans issued in euros reached 82% in 2007. The Bank of Latvia intervened several times by raising the reserve requirements

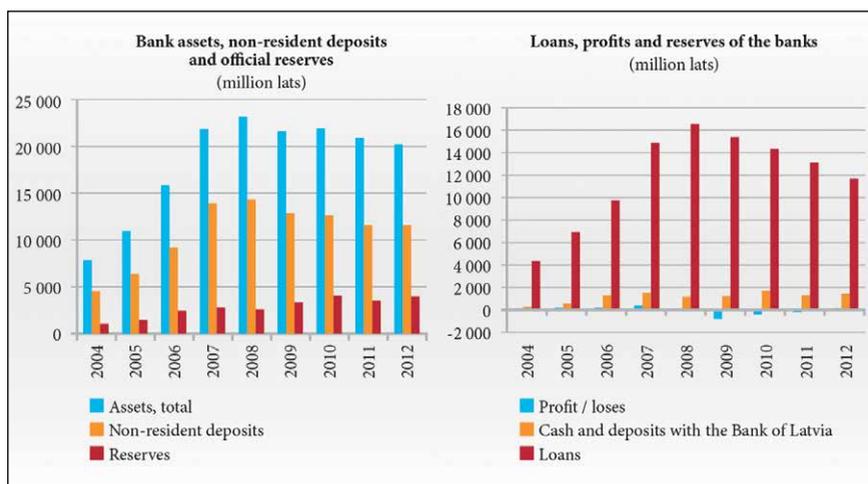
¹¹ In fact, when Latvia joined the Exchange Rate Mechanism (ERM II) in May 2005, the Latvian government issued a commitment to achieve a sustainable reduction in inflation, reduce the external imbalance, and to introduce measures to restrain excessive domestic demand and the growth of domestic credit. Not one aspect of the promised fiscal prudence was implemented.

¹² *Republic of Latvia: 2006 Article IV Consultation – Staff Report*, IMF Country Report No. 06/353 (Washington DC: International Monetary Fund, October 2006), 53.

for banks, but to little avail.¹³ With no risk associated with euro transactions, banking and non-banking institutions found ways to bypass prudential restrictions (e.g., by switching from crediting to leasing operations, or even to direct loan issuance across borders). The tacit acceptance of the euro as a domestic currency alongside the national currency was a risky path. As Latvia was not a member state of the eurozone, Latvian credit institutions did not have access to the liquidity and lender-of-last-resort instruments of the European Central Bank. In fact, the national foreign currency reserves of the Bank of Latvia were the only effective guarantee for the currency peg and the source of emergency funding for local banks in difficulty. Yet, as the case of the Parex Banka revealed, these official foreign reserves of Latvia were too thin to cope with the flight of capital from the country (see Figure 11 and 12).

Figure 11.

Figure 12.



Source: Bank of Latvia

Source: Bank of Latvia

- Finally, analyses of the causes of credit boom in Central and Eastern Europe point to problems with cooperation between the home and

¹³ Among the monetary measures effectuated by the Bank of Latvia (BoL) was a gradual lifting of the refinancing rate from 3% in 2004 to 6% in 2007, and of the reserve requirement from 3% in 2004 to 8% in 2006. Besides this, in 2005, the base of reserve requirements was widened to include short-term liabilities with foreign banks and, in 2006, to also include liabilities with a maturity of over two years. See Mārtiņš Bitāns, „Latvijas tautsaimniecības attīstība pēc pievienošanās Eiropas Savienībai...”, 249, and *EU Balance of Payments Assistance for Latvia: Foundations for Success*, 49.

host country supervisors of cross-border banks.¹⁴ The ignorance of the supervisory institutions of home countries was a perfect match for the complacency of host countries' policy makers. The Latvian case represents a good example of this cooperation problem. As Swedish banks own the largest share of the Latvian banking sector, the Bank of Latvia issued repeated pleas to restrict the parent banks' lending in Latvia. Little action followed, even though Sweden had the experience of its own banking crisis in the early 1990s.¹⁵ Instead, in "ping-pong" style negotiations, improved prudence from the Latvian authorities was requested.¹⁶

The crisis and the state's response internationally

In this chapter the development of the financial crisis from 2007 to 2010, the impact of international assistance, and also the debate regarding the exchange rate of the Latvian currency in the context of crisis resolution will be explored.

The growth of the Latvian economy started to slow down during the second part of 2007. By that time domestic demand in Latvia had become almost completely dependent on the issuance of new credit. The economic slowdown was not a consequence of a concerted action by the Latvian authorities; instead, global financial turmoil and an increased perception of risk in the overheated Baltic markets forced foreign parent banks to cut funding to their subsidiaries.¹⁷ As a consequence, the daughter banks introduced stricter conditions for new credit issuance, thus triggering a drop in demand for consumption goods and real estate properties. In March 2007, the Latvian government adopted long delayed measures for reducing inflation, which by that time had reached 15%. The adopted measures had little effect on the economy due to the already changed market sentiment. In fact, by that time the Latvian economy already needed a plan for the stimulation of economic growth.

The "X" hour for the Latvian economy arrived some months later, in the

¹⁴ *EU Balance of Payments Assistance for Latvia: Foundations for Success* and Bas B. Bakker and Christoph Klingen, *How Emerging Europe Came Through the 2008/09 Crisis*.

¹⁵ Letters of moral suasion were sent from Latvia and Estonia to parent banks and supervisory authorities from the Nordic countries requesting a more cautious approach. See *Cross-Country Study: Economic Policy Challenges in the Baltics: Rebalancing in an Uncertain Environment*, European Economy Occasional Papers no. 58 (European Union, February 2010), 50.

¹⁶ See, e.g., Stefan Ingves, "The Crisis in the Baltic – the Riksbank's Measures, Assessments and Lessons Learned," Speech delivered at Riksdag Committee on Finance, Stockholm, 2 February 2011, <http://www.bis.org/review/r100203b.pdf?frames=0>.

¹⁷ *Baltic Boom: The Adjustment is Likely to Be Painful and to Start Soon*, Goldman Sachs Global Viewpoint 07/30, November 6, 2007.

autumn of 2008. The collapse of the Lehman Brothers investment bank and of Icelandic commercial banks sent a new shock wave around the global financial world. As a result of this shock, Latvian local banks were cut off from their habitual source of re-financing – international syndicated loans. The locally owned Parex Banka, which happened to be the second largest bank in Latvia, became insolvent. In order to stave-off a local financial and economic crash, the government was forced to recapitalise the bank with an estimated amount of injected capital of 1.4 billion euros (around 7% of GDP). With Latvian sovereign bond yields already soaring due to accumulated huge fiscal imbalances and investor nervousness over the sustainability of the currency peg¹⁸, the government found it impossible to borrow money from private capital money markets at affordable interest rates, thus having no choice apart from seeking international assistance.¹⁹

On 10 November 2008 the Latvian government approached the IMF and the European Commission with a request for international financial assistance. The amount of financial assistance agreed on by the Latvian government and international donors was worth 7.5 billion euros²⁰ (the Latvian GDP in market prices was 23 billion euros at that time), which was to be dispensed in several instalments over a four year period (2009-2012). The money was meant to cover the primary financial needs of the government, to refinance maturing public debt until Latvia regained access to capital markets, and to stabilise the financial system. In exchange for international financial assistance, an agreement was reached on an economic stabilisation programme for Latvia for the 2009-2014 period (hereinafter the stabilisation programme).

The stabilisation programme was completed in January 2012, a year earlier than initially envisaged. Out of an earmarked 7.5 billion euros, Latvia used only 4.5 billion. A successful completion of the stabilisation programme was a rare event. Strong political ownership and a fair degree of flexibility are perceived as the main reasons behind the success of the Latvian stabilisation programme.²¹ The programme's implementation allowed Latvia to return to international money markets with yields

¹⁸ Latvia's massive current account deficit (above 27% in 2006: Q4) and gross external debt (128% of GDP in 2007) with relatively short maturity (the share of external debt with maturity below one year exceeded 50% of GDP), in the perception of investors, made Latvia prone to an abrupt and uncontrollable adjustment, with a high probability of the currency peg being abolished. By the time international assistance was provided (2008:Q4), the foreign reserves of Latvia had already diminished by 15%.

¹⁹ At the end of 2008 the spreads over 5-year sovereign credit default swaps (CDS) for Latvia reached 1,000 basis points, and 10-year bond yield reached 10.5%.

²⁰ The bulk of the assistance was delivered by the European Commission (3.1 billion) and International Monetary Fund (1.8 billion). The Nordic Countries (Sweden, Denmark, Norway and Finland) agreed to provide up to €1.8 billion; the Czech Republic, Poland and Estonia – additional €0.2 billion, €0.1 billion and €0.1 billion respectively.

²¹ Mark Griffiths, "Lessons for Europe from the Latvian crisis" in *EU Balance-Of-Payment Assistance for Latvia...*, 138-140.

substantially lower than some eurozone countries, stabilised Latvia's public debt at a level of 45%, and allowed Latvia to return to economic growth with rates outpacing other European countries.²² From the point of view of financial stabilisation, the programme was indeed a success.

The dark side of the story is that during the programme's implementation Latvia's GDP shrank by 25% (from peak to trough), a figure much higher than initially expected, and unemployment reached 21%. Banking losses amounted to 1.8 billion euros.²³ The boom and the ensuing financial crash left many households and businesses with large financial arrears. Many well-situated families went broke and were deprived of a means of subsistence when the crisis struck (the number of overdue loans in Latvia jumped to 20%, while in Estonia to only 7%).²⁴ Besides high indebtedness, the boom had another ugly feature – a growing inequality among the people. There was a rather small group of “haves” and a growing faction of “have-nots”. Although in 2007 inequality receded slightly, Latvia continued to feature among the leaders on inequality scores. While the number of people under severe material deprivation decreased from 39% in 2005 to 19% in 2008, the number of people at-risk-of-poverty after social transfers increased from 19.2% in 2005 to 25.7% in 2009.

Today, five years after the programme's initiation, the size of the economy, though showing promising signs of recovery, has not still returned to its pre-crisis level. The defendants of the programme (mostly government officials) praise the merits of the stabilisation programme's design and point to the instability in external markets as a restraint on the speed of Latvia's recovery. The programme's critics, however, contest the programme's benign character and argue that the programme or, at least, some of its elements, have exacerbated Latvia's economic woes. It seems that the truth lies somewhere in between the two viewpoints. A closer look at some essential aspects of the programme's design – the fixed peg for the national currency and internal devaluation – would help provide a better informed answer about the nature and impact of the programme. But, before providing a deeper analysis of the programme, two general caveats should be introduced. First, taking account the immense scale of Latvia's problems, any adjustment strategy would have been very painful. Second, Latvia's problems were to a large extent a result of its own brewage – namely, the failure to deliver appropriate actions during the boom severely limited the policy makers' options for action during the crisis, e.g., a lack

²² *European Economic Forecast: Autumn 2013*, European Economy 7/2013 (European Union, 2013).

²³ The data from the website of the Association of Commercial Banks of Latvia, www.bankasoc.lv.

²⁴ Mārtiņš Kazāks, “From Boom to Bust and Back: The Banking System” in *EU Balance-Of-Payments Assistance for Latvia...*, 145-148.

of fiscal prudence (no savings for rainy days) and an unwarranted blind faith in the irrevocability of the national currency peg despite a lack of institutional support for such an approach (a high degree of euroisation with no access to ECB emergency funding).

Would a devaluation of the national currency have helped to mitigate the pain of the adjustment?

The issue of the currency peg was the central and also the most controversial element of Latvia's stabilisation programme. The ultimate decision was to proceed with stabilisation based on the hard peg of the currency. Devaluation was not considered a viable solution for several reasons: first, exports relied heavily on import content; second, due to the high share of euro-denominated liabilities, a devaluation would have had meant immediate insolvency for many households and businesses; third, several domestic banks may have followed Parex Banka into insolvency; fourth, a devaluation would have provided no incentive to solve the deep-rooted structural problems Latvia was facing²⁵; and finally, given the fragile global funding environment, the spill-over risks would have substantially increased for other emerging European economies, especially in the Baltics and South-Eastern Europe.²⁶

Yet the issue of currency devaluation stirred an international debate and revealed significant opinion differences among the donors to the Latvian stabilisation programme. On the one side there were those who had familiarity with earlier boom-bust situations in emerging economies, in particular in Latin America and Asia. This included mostly international, America-based experts (including also IMF staff). To their mind, currency devaluation was the most viable option to start with, as the alternative – an internal devaluation or adjustment through internal wage and price compression – even if it was desired, had not worked earlier because of the exorbitant pain imposed on people and businesses.

The most ardent opponent to devaluation was the Bank of Latvia, which, supported by other regional central banks and government officials, argued that taking into account the peculiar features of the Latvian economy (most notably the flexibility of the labour market, the high degree of integration into the European financial market, the long standing tradition of adherence to a fixed exchange rate, and the high import component in Latvia's foreign trade) devaluation would have been without merit; hence,

²⁵ Gabriele Giudice et al., "Introduction" in *EU Balance-Of-Payment Assistance for Latvia...*, 3.

²⁶ *Republic of Latvia: Request for Stand-By Arrangement – Staff Report*, IMF Country Report No. 09/3 (Washington DC: International Monetary Fund, January 2009), 10.

internal adjustment represented the only viable option for a way forward.²⁷

The Latvian government and European Commission adhered to the position of the Bank of Latvia. Although according to the official position of the Commission a currency devaluation would not have helped to resolve the structural challenges faced by the Latvian economy (e.g., an allegedly bloated and inefficient public sector, wages exceeding productivity, a profligate fiscal attitude), it seems that the main concern of the Commission was the risk that the instability brought by a Latvian devaluation would spread to other countries in the Baltic region and Central and Southern Europe, with a negative feedback loop infecting the economic performance of the European economy in general. If this happened, European institutions would not have had enough financial resources at their disposal to stabilise the markets.²⁸

The preferred option of the IMF was an “accelerated euro adoption at a depreciated exchange rate”.²⁹ The IMF estimated that currency devaluation would help to restore the competitiveness of Latvian exports to some extent and close the current account deficit more quickly due to import compression. The IMF was aware that because of the huge foreign currency exposure of Latvia’s private sector, devaluation initially would have led to a deeper fall in Latvia’s output than in the case of an internal adjustment, yet the positive impact on export competitiveness would have ensured a quicker recovery, according to IMF calculations. Moreover, devaluation would have strengthened the position of the official foreign reserves of Latvia. Eventually, the IMF acceded to the demands of the Bank of Latvia and the European Commission. The IMF was contributing only a fraction of the Latvian financing, with the European Commission delivering the largest part of the assistance; hence, the responsibility for success fell to the European Commission. Besides, Latvia’s immediate accession to the eurozone would have been against EU rules as Latvia did not fulfil the Maastricht criteria.

In hindsight, it seems that the chosen path of adjustment without the devaluation was no less risky than the alternative with devaluation, at least from the internal perspective of Latvia’s economy (see Figure 13). The hard peg did not help avoid output crash, massive credit problems,

²⁷ The governor of the Bank of Latvia, Ilmārs Rimšēvičs, has expressly stated that the Bank of Latvia should be uniquely credited for maintaining the stability of the exchange rate. See Arnis Rītups, “Latvijas krīzes” (Latvian Crises), *Rīgas Laiks*, August 2011, 19.

²⁸ The capacity of the facility under which the European Commission was granting assistance to Member States with balance-of-payment problems was restricted to a miniscule 12 billion euros. Out of this amount, 6.5 billion euros were pledged to Hungary and 3.1 billion to Latvia by 2008. Therefore, in 2008, this capacity was increased to 25 billion euros, and in 2009 to 50 billion euros.

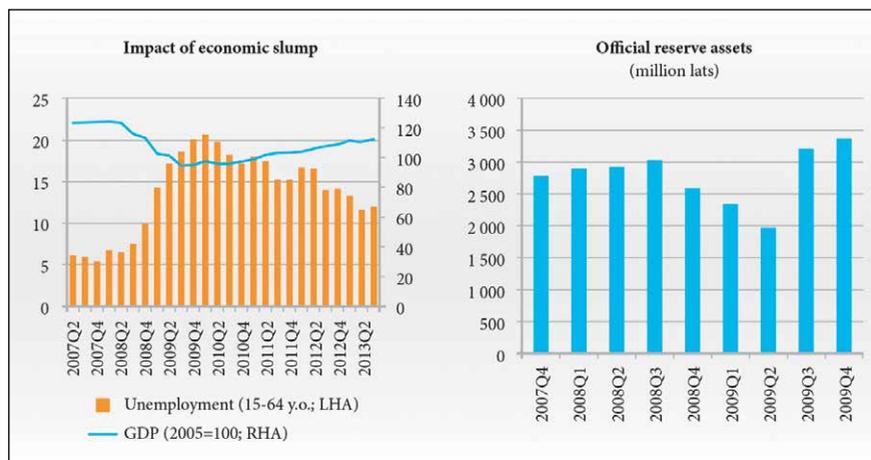
²⁹ *Republic of Latvia: Request for Stand-By Arrangement – Staff Report*.

or banking losses.³⁰ Moreover, the initial fears of the IMF materialised in a sense that the government initially could not mobilise political support for the fiscal compression required by the programme. The programme's implementation was possible only after a change of the government in the middle of 2009, eight months behind the original start of the programme.

Moreover, the belief that the hard currency peg provided an anchor for economic agents amidst general economic and financial chaos had little empirical support. On the contrary, in the markets support for the currency peg was extremely thin. As a result, disruptions in the stabilisation programme's implementation and delays in the release of the consecutive tranche of monetary assistance led to massive pressure on the currency peg in June 2009. During the panic the foreign reserves of the Bank of Latvia diminished by 35% (see Figure 14), and the interbank rates of the national currency, the lats, were pushed up to 80%. Presumably it was the shallowness of the lats' money market which ultimately saved the peg, as it was difficult for institutional speculators to hoard a significant amount of the Latvian currency and thereby launch a terminal attack against the peg.³¹

Figure 13.

Figure 14.



Source: Eurostat

Source: Eurostat

The release of the second tranche of international assistance arrested the market turmoil in July 2009. In fact, the IMF had strong objections

³⁰ The governor of Sweden's central bank, Stefan Ingves, has pointed to the fact that abstention from currency devaluation did not save the banks from huge losses. In both scenarios the magnitude of losses was equal, the only difference was in the timing of the occurrence of those losses. See Stefan Ingves, "The crisis in the Baltic ...".

³¹ The life-line of the Bank of Latvia in that situation was currency swaps with other regional central banks, although, as pointed out by A. Åslund, these swaps did not come easily. See Anders Åslund and Valdis Dombrovskis, *How Latvia Came Through the Financial Crisis*, 47.

to that release as there had been little progress on the part of the Latvian government. It was the European Commission which unblocked the assistance. Once the financial assistance was released, market confidence quickly returned, pressure on the currency peg receded, and economic growth resumed. This episode suggests that the resolution of the crisis was rendered possible mainly thanks to the huge financial assistance received from abroad. Were international donors not ready to commit that large of a chunk of money, the strategy of maintaining a fixed currency peg would not have worked in the face of a massive loss of investor confidence. Yet the stabilisation programme worked, at least in the sense that these problems were localised within the borders of Latvia. This should be counted as a major achievement of the chosen path of adjustment without currency devaluation.

The state's response to the crisis domestically

The concept of “internal devaluation” denotes an alternative path of action to external or currency devaluation. This approach is used in the case of countries that need adjustment but are part of a monetary union or have a currency that is tightly tied to another currency. The aim of both internal and external devaluation is to restore the balance in a country's external transactions and foster its international competitiveness. A number of internal actions – e.g., fiscal austerity and a decrease in the money supply – are ascribed as having an effect equal to external devaluation, as they lead to a contraction in wages and later also in domestic prices. However, this is a risky strategy, as the application of an “internal devaluation” is slow and socially painful. The wage contraction is achieved by means of high unemployment and massive bankruptcies. Unless there is solid support from the population, such measures can lead to riots. The flexibility of the labour market is critical: the more protected labour is, the more difficult to implement such measures, as such austerity measures can be challenged in court.

Were the applied measures of fiscal consolidation justified? In Latvia's case, the internal devaluation was triggered by liquidity squeeze and massive fiscal consolidation which meant higher taxes and simultaneous substantial cuts in government spending. Opponents to fiscal consolidation have argued that fiscal consolidation aggravated Latvia's economic calamities, because it reinforced the contractionary effect stemming from liquidity problems. Yet, as will be explained below, the consolidation was not the major problem. Besides, substantial fiscal consolidation was unavoidable

in Latvia anyway. The expansion of public spending during the boom of 2004-2007 created large expenditure overhangs, which could not be met by plummeting public revenues when the economy entered a phase of recession. Without any corrective measures, the budget deficit would have reached 16% in 2009 and 23.9% in 2010. Such gaps in the state budget were not sustainable either in the long-term or in the short-term because of the sovereign confidence crisis. However, the argument here is that if the problem of liquidity squeeze was resolved at early stage, the scale of fiscal consolidation would have been considerably smaller.

From the start the strategy behind the Latvian fiscal consolidation had two imperatives: first, there would be no external (currency) devaluation; second, Latvia had to be in a position to qualify for membership in the eurozone by 1 January 2014. Accordingly, these imperatives determined the pace and scale of fiscal consolidation. The quantitative target was to push the budget deficit below 3% by the end of 2012 (from 9.8% in 2008). Consolidation was kick-started in July 2009 and continued throughout 2010 (two consecutive budget cycles). The bulk of budgetary consolidation (around 10% of GDP) took place during the second part of 2009, and this represented a “strongly front-loaded and credible adjustment”.³² The overall scale of fiscal consolidation undertaken by the Latvian government was estimated to be 15% of GDP: around 3.3% on account of revenue increases and the other 11.7% on account of expenditure cuts.

According to general wisdom, during an economic crisis taxes should be increased in order to provide the government with revenues which then could be used to finance both the expansion of social spending and the most essential governmental programmes. Tax revenues were also increased in the Latvian case. This increase concerned the value added tax (from 18 to 22%), personal income tax and excise duties for certain kind of goods. However, there were two major problems with tax increases in Latvia:

- Despite the applied sizable tax measures, the share of tax revenues declined, pointing to a considerable deterioration of tax compliance during the crisis years. This inferior performance of tax collection in Latvia is at odds with the Estonian and Lithuanian experience, where taxes had also been increased, but with a positive effect on public revenues³³ (see Figure 15).
- The applied tax measures were of a regressive nature and fell disproportionately on the poor. Thus, the increase in value added

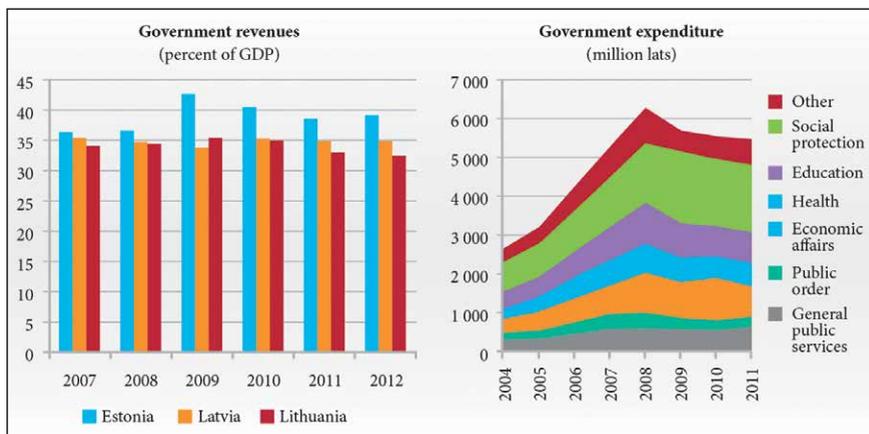
³² Francesco Di Comite et al., “Fiscal Consolidation in the Midst of the Crisis” in *EU Balance-of-Payments assistance for Latvia...*, 77-99.

³³ Francesco Di Comite et al., “Fiscal Consolidation in the Midst of the Crisis”.

tax without proper compensation for the households under severe material deprivation and at risk of poverty decreased the purchasing power of poor people to a greater extent. Moreover, the government lowered the flat rate of personal income tax from 25 to 23% - a move mostly beneficial to those with large financial arrears. At the same time the threshold for the personal income tax allowance was reduced from 100 euros to 55 euros, thus increasing the effective tax rate for the bottom third of the income distribution by 7%, versus 1.5% for those in the top decile. Finally, the Latvian government opposed an increase in the rate of corporate profit tax and with great reluctance agreed to broadening the base of capital taxes.³⁴

Figure 15.

Figure 16.



Source: Eurostat

Source: Eurostat

The heaviest part of Latvia's fiscal consolidation was carried out through scaling back public expenditures. The extent of the measures undertaken was unprecedented and, one must conclude, cruel: as a result government consumption contracted by almost a third in nominal terms between 2008 and 2010, the number of public officials was reduced by one-third, the remuneration bill for public officials was cut by 25%, and the number of state agencies was halved. Of government functions, the most affected sectors were health (by 27%), education (by 27%), and defence (by 50%) (see Figure 16).

On the one hand, the consolidation facilitated a much delayed restructuring in public sectors like health and education (these sectors,

³⁴ Anders Åslund and Valdis Dombrovskis, *How Latvia Came Through the Financial Crisis*, 45.

by the way, were the main profiteers from profligate spending during the boom). The experts of the World Bank had observed that difficult structural reforms, normally requiring years, were accomplished in Latvia in the short space of just a few months.³⁵ On the other hand, the public sector was not that bloated in Latvia, as sometimes it is depicted, e.g. by the European Commission. First of all, as already noted in this paper, Latvia has one of the smallest governments of European countries. Second, the number of public sector employees between 2004 and 2008 increased only by 11%, which cannot be counted as a serious problem in the context of a deflection of human resources from the private sector. Furthermore, the across-the-board cuts impaired the quality of public services, created additional future costs and weakened public-sector institutions.³⁶ Thus, the IMF concluded in 2009 that many of the savings were coming from reductions either in the quality or the scope of public services (e.g., the suspension of selective surgery unless the patient pays in full, the abolition of university grants for poor students, and cuts in research spending).³⁷ Many essential social programmes, which were already underfinanced during the boom years, had still to suffer further from the consolidation. This concerns the public funding for higher education and science, the fight against growing inequality and poverty, and co-payments and prescription medication in the health sector.

To the surprise of many, soon after the first substantial consolidation measures were introduced (July 2009), the market sentiment reversed from negative to positive, and economic growth returned (at the end of 2009). Commission officials believe that the credibility of the consolidation measures provided the relief. This seems to be only a partial truth. The release of the delayed financial assistance was of equal, if not superior, importance, as this assured that the currency would not be devalued and the government would not go broke. The market rejoiced at the departure of excruciating indeterminacy. The economy was suffering from a liquidity freeze already in the summer of 2008. The disbursement of assistance, however, was made conditional upon the implementation of the stabilisation programme (namely, of the austerity measures). If the money had been made available in early 2009 with less stringent conditionality, the recession would have been less harsh and consolidation less severe.

As to the issue of internal devaluation, despite the optimistic notes by the Commission's officials and the Bank of Latvia, who believed that fiscal consolidation had an impact on internal devaluation in Latvia (mainly thanks to the right policies, the flexibility of the labour market, and frontloading the adjustment),³⁸ there is little evidence of such kind of

³⁵ *Latvia – From Exuberance to Prudence. A Public Expenditure Review of Government Administration and the Social Sectors* (World Bank Human Development Sector Unit, September 2010).

³⁶ *Republic of Latvia: Request for Stand-By Arrangement – Staff Report*.

³⁷ *Republic of Latvia: Selected Issues*, IMF Country Report 06/354 (October 2006).

³⁸ Kārlis Bauze et al., "Labor Market Flexibility and Fiscal Consolidation" in *EU Balance-Of-Payments Assistance for Latvia...*, 141-144.

success of internal devaluation in Latvia. First, the public wage cuts had a limited impact on the general wage level. On the contrary, wages remained sticky. The adjustment in unit labour costs was achieved mostly from an increase in productivity, which points to massive labour lay-offs and harder work for those who remained employed.³⁹ Second, price deflation lasted only for a rather limited time period (in 2010). The prices in general remained as sticky as wages.

Popular and economic responses

Despite these dismal economic consequences, the public reaction to austerity measures and reforms was rather calm. The only noticeable public manifestation of displeasure happened on 13 January 2009. This manifestation was organised by the political opposition soon after the then-in-power government announced the scale of austerity measures. Around 10,000 people showed up in this manifestation. The aim was to demand the resignation of the government and call new parliamentary elections. The manifestation turned violent as a number of mobs attacked police units and several government buildings. To the luck of politicians, this was the only episode of violence during the financial crisis in Latvia. People accepted their fate quietly. In the perception of the people there was a general sense of the inevitability of some kind of adjustment, because everybody understood that the fortune brought by the “fat years” was not sustainable. Besides, people had also learned from the January 13 event that such rioting was prone to provocations from mobsters.

Yet people wanted revenge. At the political level it was delivered through the governmental crisis of March 2009. The international assistance was requested and negotiated by the government of Ivars Godmanis. However, due to internal strife, the implementation of the stabilisation measures was delayed. This hesitation to implement the agreed measures caused serious economic harm because it reinforced market expectations of an imminent default on public debt and an ensuing devaluation. In February 2009, under pressure from the state president, Godmanis government resigned. A new government led by a representative of an opposition party, Valdis Dombrovskis, was formed in March 2009. This government

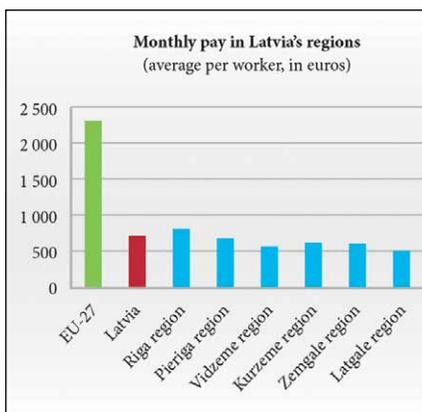
³⁹ Olivier Blanchard et al., *Boom, Bust, Recovery: Forensics of the Latvian Crisis*, Final Conference Draft to be presented at the Fall 2013 Brookings Panel on Economic Activity, September 19-20, 2013.

According to a study from the World Bank, in Latvia it is quite difficult to hire and fire employees; in the meantime, the protection of labour and compensations after discharge are among the lowest. However, as massive lay-offs were a reality in Latvia, this rigidity of the labour market seems to be nominal, and points to serious deficiencies in the implementation of labour laws in Latvia. See Aline Coudouel and Pierella Paci, „Selected Labor Market Reforms” in *Analyzing the Distributional Impact of Reforms – A Practitioner’s Guide to Pension, Health, Labor Markets, Public Sector Downsizing, Taxation, Decentralization, and Macroeconomic Modeling*, eds. Aline Coudouel and Stefano Paternostro, Vol. 2 (Washington D.C.: World Bank, 2006).

had a clear mandate from the president to go ahead with the austerity measures, as delays were severely harming the Latvian economy. During the parliamentary elections of 2010, the party of Valdis Dombrovskis, *Unity*, got the largest support of the electorate, while the parties considered responsible for the Latvian calamities – united under the alliance *For Good Latvia* – saw their representation in the parliament being dwarfed.

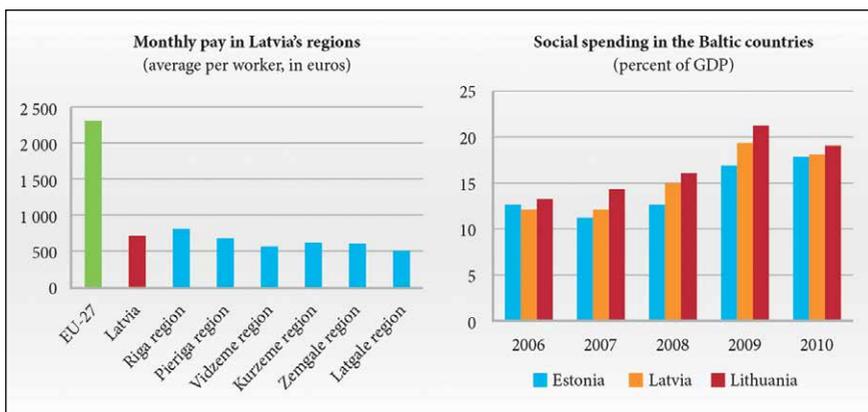
Another major event in the political drama of the Latvian crisis was the dissolution of the parliament in 2011. This was an unprecedented move by the state president. People endorsed the president’s decision in a referendum in June 2011 and extraordinary elections were called.

Figure 17.



Source: Eurobarometer, EBRD Life in Transition 2011

Figure 18.



Source: Eurostat

When compared to the election result of 2006, after the 2011 elections the Latvian political landscape changed considerably. More than half of the members of parliament are newcomers to politics. The same goes for the government. The majority of parties in power before the crisis – the so-called oligarch or pro-business parties – have been ousted from politics. Yet it seems that the changes will continue, but in a different direction. The next parliamentary elections in Latvia are due in October 2014. Support for currently governing centre-right, pro-justice parties of *Unity* and *Reform Party* is waning, suggesting that people have become tired of reform politics. One can expect that the Latvian political scene will become more polarised, as more radical right and left (Russian) forces have gained in popularity. In Latvian politics the traditional cleavages of right and left don’t operate. Instead, the electorate is split along ethnic allegiances. The parties defending the interests of Russians living in Latvia are strongly left-leaning. Despite their sizable representation in parliament (the alliance

Harmony Centre has around 30% of the seats), the Latvian electorate do not trust them. As a result, the government coalitions as a rule are of centre-right or right ideology. Clashes among the right wing parties are related to issues surrounding business interests and anti-corruption. The pretext for the dissolution of parliament was accusations that a member party of the governing coalition, the alliance *For Good Latvia*, acted in the interests of big businesses and sabotaged the reform work of the government.

The social picture in Latvia remains grim. Many people feel insecure and frustrated about what Latvia as a state can deliver. Even though the rate of inequality has slightly decreased during the crisis, poverty broadened, making social cleavages more entrenched. The remuneration level in Latvia also remains uncompetitive at a regional level. The average wage is almost four times smaller the European average (see Figure 17). At the same time, the level of unemployment remains stubbornly high, though it is gradually diminishing. The number of people at-risk-of-poverty or social exclusion exceeded 40%, while 31% were suffering from severe material deprivation. The shadow economy also became more widespread – according to some estimates, close to 40% of GDP.⁴⁰ The situation in the countryside became particularly sore. In Latgale, the poorest region of Latvia, the level of people at-risk-of-poverty jumped to 44% and unemployment has remained stubbornly high – above 20%, while in Latvia in general unemployment is decreasing (see Figure 18). Yet the government's social safety services had poor coverage for those who were the neediest. It was only after the intervention of the World Bank that the government devised measures to provide relief to the poorest people⁴¹ (see Figure 19).

Latvia is losing people at a terrifying speed: between 2001 and 2011, the size of Latvia's population decreased by 15%, and will continue to decline at a high speed for years to come. The negative demographic trend and emigration (particularly of young people, aged 18-35) are the twin causes for Latvia's depopulation. It is estimated that around 200,000, or 10%, of Latvia's population has emigrated. Although emigration long predates the crisis, the severity of the slump substantially contributed to the outflow of people: average net emigration jumped from 0.5% in 2000-2007 to 1.3% in 2008-2011. Recently this rate has returned to the pre-crisis level of 0.5%.⁴² The streams of emigration have created a powerful social network of migrants, fostering further emigration, e.g. of friends and relatives, from Latvia (see Figure 20). Ironically, people have become Latvia's major export good. Yet through emigration many people avoided the misery of joblessness and personal default. It is estimated that if people had stayed, the level of unemployment would have been from 3 to 6% higher (the actual level was

⁴⁰ Shadow Economy Index for the Baltic Countries. See *Latvian Competitiveness Report 2011* (Riga), 86-87.

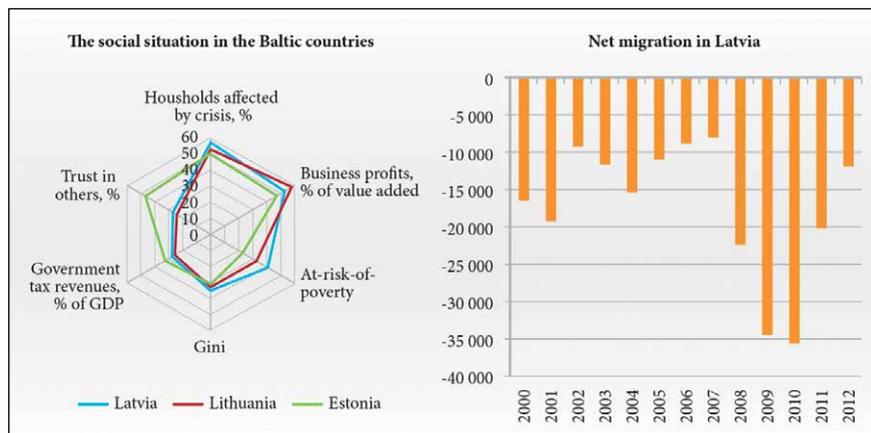
⁴¹ Peter Harrold et al., "Fiscal Sustainability, Demographic Change and Inequality: The Social Sectors from Crises to Growth in Latvia" in *EU Balance-of-Payments Assistance for Latvia...*, 100-133.

⁴² Olivier Blanchard et al., *Boom, Bust, Recovery...*, 28.

around 21%).⁴³ Remittances are sent to sustain family members and repay debts to banks – in 2012 these amounted to more than 500 million euros, or 2.3% of GDP.

Figure 19.

Figure 20.



Source: Eurobarometer, EBRD Life in Transition 2011

Source: Eurostat

The path forward

At the moment Latvia's macroeconomic situation looks impeccable. Since the second part of 2009 Latvia has enjoyed an uninterrupted period of growth of around 4 to 5% annually. According to forecasts⁴⁴, growth will continue at the same flat pace for at least couple of years to come. Inflation is down to 2%, and the deficit of the current account balance will also remain low – below 3% of GDP. Public debt will continue to diminish, reaching 33% in 2015. The determinants of Latvia's growth are improvements in external markets, in particular in the eurozone countries, and a recovery of internal demand. The share of labour intensive exports is decreasing, giving place to products with greater added value. Latvia's economy is becoming "smarter". Besides, Latvia's success has been rewarded with incremental improvements in sovereign ratings. Latvia's participation in the eurozone is expected to further enhance investors' confidence.

Yet the scars of the financial crisis and recession are still being felt and will haunt Latvia's economy and society for years to come, posing a considerable challenge to the sustainability of Latvia's economic growth. Thus:

⁴³ Olivier Blanchard et al., *Boom, Bust, Recovery...*, 31.

⁴⁴ *European Economic Forecast: Autumn 2013*.

- Although Latvia's nominal GDP has already surpassed the pre-crisis level as of the middle of 2013, the real GDP is still lagging behind the peak by around 10%, and it could take a further 3 to 5 years to cover this gap;
- Latvia's labour market has become smaller. Although unemployment is receding, the number of employed people is still far below the pre-crisis level (at the end of 2013, it was only 77% of the peak at the beginning of 2008);
- The level of unemployment, though gradually diminishing, still remains elevated (11.5% in June 2013 from a peak of more than 20% at the beginning of 2010). Long-term unemployment remains stubbornly high at 7.8% (in Estonia, 5.5%; in Lithuania, 6.5%);⁴⁵
- The indicators of both consumer and industrial confidence, though showing substantial improvement, are still negative, and are worse than in the neighbouring countries of Estonia and Lithuania;
- The size of the banking sector is also diminishing. Growth in household credit remains negative. Growing deposits of commercial banks within the Bank of Latvia point to commercial banks' cautiousness with lending (these deposits amounted to 11.7% of all assets at the end of September 2013, up by 21% compared to the beginning of 2013);⁴⁶
- The dynamics of price development also point to low activity in the economy. Price growth started to decelerate in 2012 and continued to recede until the annual inflation rate turned to deflation at the beginning of 2013. The annual inflation rate in 2013 is estimated at 0.3%. The disinflationary effect, according to the European Commission, comes from lower prices for natural gas and oil, the reduction in value added tax (the tax rate was reduced from 22 to 21% in the middle of 2012), cuts in telecommunication prices, and, essentially, from prudent fiscal spending.⁴⁷

The international financial assistance helped Latvia to resolve its financial woes. However, the perennial problem of upgrading the capacity of productive side of the economy has remained. According to the Global

⁴⁵ The Bank of Latvia insists that the current high level of unemployment is natural for Latvia due to structural features (a mismatch of skills, a geographical mismatch) and, as such, can be removed only through policies promoting better training, superior pairing of jobseekers with potential employers, and removing incentives for people to stay outside the job market. Academic researchers, nevertheless, believe that the unemployment level is still affected by the persistence of the effects of the recession; hence, the current level of unemployment is cyclical. Researchers point a shortage of well-paid positions, which forces many young and talented Latvian people to emigrate. For a summary of this debate see Morten Hansen, "How Big is Structural Unemployment in Latvia?", *Irlv*, March 13, 2013, <http://www.ir.lv/2013/3/13/how-big-is-structural-unemployment-in-latvia>

⁴⁶ For more information consult the websites of the Bank of Latvia (www.bank.lv) and of the Association of Commercial Banks of Latvia (www.bankasoc.lv).

⁴⁷ *European Economic Forecast: Spring 2013*.

Competitiveness Index (GCI)⁴⁸, Latvia has reached the transition stage between an efficiency-driven and an innovation-driven economy. This suggests room for further growth for Latvia through better efficiency. However, the efficiency improvements alone will not ensure Latvia's catching-up with the advanced European countries. Without policies and investment targeted towards business sophistication and the creation of new products and technologies, Latvia risks being caught in the so called "middle-income" trap.

In order to continue to develop, Latvia's economy, and in particular its industry, needs capital and technological know-how; however, as has been pointed out earlier in this study, the rate of foreign direct investment inflow in the productive sector has remained disappointing. Some optimists claim that with Latvia's accession to the eurozone investments will flock in. This optimism is misplaced for two reasons. First, Latvia's demographic picture is rather bleak, and with an aging population neither production nor the domestic market has huge potential. This diminishing population means an ever smaller domestic market and pool of qualified labour.⁴⁹ For a European business person it is less costly to move labour across borders than to build a new factory in Latvia. Secondly, without industry it will be difficult to achieve stable growth, as demand for services, now Latvia's leading sector, is prone to abrupt cyclical swings. Besides, the service sector is very mobile and prefers clustering; hence, it cannot be relied on as a base for balanced territorial development.

In order to attract more investment, in 2011, Latvia's government decided on further measures to alleviate the fiscal burden on businesses. Thus, a rebate for corporate income tax (between 15 and 25% of the effective tax amount) was reintroduced for investments made in priority sectors. Moreover, Latvia has introduced a simplified (unified) tax for

⁴⁸ The GCI assumes that economies in the first stage are mainly *factor-driven* and compete based on their factor endowments – primarily low-skilled labour and natural resources. Countries will then move into the *efficiency-driven* stage of development, when they must begin to develop more efficient production processes and increase product quality. At this point, competitiveness is increasingly driven by higher education and training, efficient goods markets, well-functioning labour markets, developed financial markets, the ability to harness the benefits of existing technologies, and a large domestic or foreign market. Finally, as countries move into the innovation-driven stage, companies must compete by producing new and different goods through new technologies and/or the most sophisticated production processes or business models. For more details, see *Global Competitiveness Report 2012-2013* (World Economic Forum, 2012), http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf.

⁴⁹ According to the Ministry of Economy, Latvia will have around 130,000 vacant working places by 2030, but the working age population will shrink to 946,000. The seriousness of the problem has been recognised also by the IMF: according to IMF estimates the labour market is not going to contribute to potential growth in the coming years, and the organisation suggests introducing policies aimed at reducing the natural rate of unemployment, the net rate of emigration, and the demographic decline. See *Report on Development of Latvia's National Economy* (Ziņojums par Latvijas tautsaimniecības attīstību) (Riga: Ministry of Economy of Latvia, December 2012), 82, and *Republic of Latvia: Selected Issues*, IMF Country Report No. 13/29 (January 2013), 10.

microenterprises: companies with an annual turnover of below 100,000 euros and fewer than five employees could apply for the status of “microenterprise” and pay a flat tax rate of 9% of annual turnover (this tax replaces all other business and labour taxes). Finally, investors purchasing real estate or investing a specified amount in a Latvian bank have become entitled to a Latvian temporary residence permit (this option is actually widely used by people from the countries of the former Soviet Union).

However, these measures are displaced for two reasons:

- It seems that the introduced measures will not achieve their aim of attracting fresh investment. The main beneficiaries from the new regime will be existing local businesses. Data on business profitability in Latvia already reveal extremely fat profit margins – actually, the highest in the European Union (e.g., in 2011, the rate of net return on equity [after taxes] was 44.3%, while the share of gross profit in value added -51.2%);
- The current path of development is not socially sustainable. Latvia urgently needs to re-focus away from the well-being of businesses towards the well-being of its people. The crisis has seriously damaged people’s faith in Latvia’s capability to provide a decent quality of life. As has been noted in Latvia’s National Development Plan 2014-2020, “the economic and fiscal problems have resulted in a considerable deterioration of the people’s capacity to act; therefore, individual solutions (emigration, the grey economy) prevail over collective solutions (payment of taxes, participation, social entrepreneurship), deepening the crisis in the society”⁵⁰.

Still, the problem with foreign investment exists. According to *Baltic Expert.Com*⁵¹, among the major obstacles to foreign investment is a lack of efficient and fair procedures for dispute resolution, the resistance of local residents, and a lack of strategic vision by the government. In addition, problems related to distortions of competition in the domestic market and institutional barriers to entry for new players should also be listed.

There will be a lot of positive impact from Latvia’s membership of the eurozone like cheaper trade and financial transactions with partner countries within and outside the eurozone (euro is the second most popular currency for international invoicing). Latvia will also have access to emergency funding from the European Central Bank in case of crises (which Latvia missed very much during the recent crisis). Moreover, the

⁵⁰ *National Development Plan of Latvia for 2014–2020* (Riga: Cross-Sectoral Coordination Centre of Latvia, December 2012), 11.

⁵¹ See website <http://balticexpert.com/>.

membership of the eurozone has a geostrategic significance to Latvia.

Despite these positive things, the participation in the eurozone will not reduce the growth volatility in Latvia. At the moment it is difficult to foresee in which direction Latvia's economy will develop. It could take the same direction as it did after 2004, when investor euphoria led to the local market being swamped with cheap credit, with another cycle of overheating ensuing. Or, the economy could stay downbeat for a prolonged period due to the demographic decline and emigration. In both cases the problems stem from Latvia's still low level of income convergence and asymmetric development cycle with core eurozone member states like Germany. Depending on the path of development, Latvia may need either a stronger or, on the contrary, weaker monetary approach. This is something the eurozone cannot provide; therefore, one should expect that the one-size-fits-all monetary policy of the European Central Bank will force Latvia into even sharper cycles of development. The problem is that Latvia's government's capacity to intervene and correct growing imbalances will be very limited (e.g., due to the time inconsistency problem, political meddling, and the rules of free capital movement), and the eurozone does not yet provide instruments to assist governments in levelling out the macroeconomic imbalances among the eurozone member economies.

The hope is that despite the bitter internal strife between the southern and northern member states of the eurozone, the instinct for euro survival will ultimately prevail, and in exchange for greater fiscal vigilance a stronger bonds of financial solidarity among the eurozone countries will be established. Indeed, in an increasingly unpredictable world even the seemingly strongest states could one day fall from grace, as evidence from the recent IMF research paper on the prospects of the fiscal union of the eurozone suggests.⁵² A loose European Union, as propagated by the United Kingdom and Sweden, is not in Latvia's interests. Sooner or later Latvia will need assistance in the form of external public investment. Without this solidarity, Latvia will be at risk of permanent underdevelopment with huge social and political costs.

⁵² Céline Allard et al., *Toward a Fiscal Union for the Euro Area*, IMF Staff Discussion Note SDN/13/09 (International Monetary Fund, September 2013).

The Politics of Reacting to the Crisis in Lithuania from 2008-2013: Exiting the Crisis, Entering Politics as Usual?

Ramūnas Vilpišauskas, Vitalis Nakrošis and Vytautas Kuokštis

In this chapter we aim to present and explain the main political and economic trends in reacting to the financial-economic crisis in Lithuania in the 2008-2013 period. Lithuania, like the other Baltic States, has experienced at least three crises in the two decades since the re-establishment of its independence, a rather extraordinary experience, which might have contributed to the development of the “culture of patience” that characterised public reactions to the latest crisis. First, the initiation of economic reforms in the early 1990s brought a temporary economic decline (as large as a 70% drop in GDP over several years) due to the restructuring of the economy, and this resulted in measures to stabilise the economic environment, such as the introduction of a currency board arrangement. Later, in 1998-1999, an external shock resulting from the financial crisis in Russia, which was an important foreign trade partner, sent the country’s economy into decline, resulting in across-the-board spending cuts and the simultaneous introduction of public management reforms (such as strategic planning) in the early 2000s. Finally, at the end of 2008 and even more notably in 2009, the Lithuanian economy experienced a severe decline resulting from another external shock – this time the global financial crisis that started in 2007-2008. It is the reaction to the latter crisis by Lithuania’s authorities and the consequent reaction of the markets and voters to the anti-crisis policies, the short-term effects of these reactions and the sustainability of post-crisis economic developments which interest us in this chapter.

A number of studies have addressed the effects and management of the recent crisis in Lithuania. Several political economy analyses discussed the effects of the crisis on structural and administrative reforms in Lithuania. They argued that despite the fact that crises are traditionally seen as triggers for reforms, the existence of factors such as the presence of reformers with a clear reform vision, the support of an expert community and external actors, as well as the availability of resources, were needed for reform.¹ The analysis of public management reforms implemented amid the economic crisis found a trend toward de-agencification in the Lithuanian agency landscape based on the post-New Public Management model (involving agency deaths, mergers and absorptions), which contributed to fiscal consolidation by reducing the operational costs of agencies.² Other analyses focussed on the choice of internal adjustment (as opposed to external devaluation,

¹ Ramūnas Vilpišauskas, “Crisis as an Opportunity for Reform: Only Some Windows Open”, *Pinigų studijos* XIII, no. 2 (2009): 37-53.

² Vitalis Nakrošis and Žilvinas Martinaitis, eds., *Lithuanian Agencies and Other Public Sector Organisations: Organisation, Autonomy, Control and Performance* (Vilnius: Vilnius University, 2011).

which is used most often in similar situations to regain competitiveness) stressing the importance of institutional and political factors, such as political and expert consensus regarding economic policy measures, popular reactions towards spending cuts and wage reductions, as well as whether initial pre-crisis policies allowed (or restricted) room for fiscal policy measures in response to the crisis.³ Another recent analysis focussed on assessing fiscal consolidation measures in Lithuania in response to the crisis and presented a detailed analysis of revenue and expenditure related policy measures and the way the government reacted to the crisis with a combination of short-term fiscal consolidation measures and structural reforms.⁴

In this chapter we use a political economy perspective to address the economic trends and political factors that account for the relatively deep crisis, the choice of domestic adjustment as the key feature of the response to the crisis, as well as the effects of structural reforms undertaken during the financial-economic crisis in Lithuania. We draw on several factors to explain the choice of reforms, including (1) the recent history of pro-cyclical fiscal policy and the resulting constraints on reacting to the crisis; (2) the electoral cycles, government composition and coalition politics; (3) the relatively silent public accepting the policies of domestic adjustment with little open contestation, instead withdrawing into the shadow economy or emigrating (“exiting”), combined with a passive opposition which was unable to propose a credible alternative anti-crisis programme. The latter factor, together with a highly diversified export base and flexible domestic economic structures have been the main reasons that account for the relatively fast implementation of fiscal consolidation measures and the economic recovery continuing to be among the fastest in the EU. We discuss fiscal consolidation measures and structural reforms, which were created by the 2008-2012 Lithuanian government in order to save budget resources as part of efforts to maintain financial stability and restrain the growth of the budget deficit and debt. Finally, we assess the evidence regarding the economic and political effects of these policies – how markets, voters and international institutions reacted to fiscal consolidation and structural reforms, as well as how sustainable some of these reforms might prove to be.

³ Vytautas Kuokštis and Ramūnas Vilpišauskas, “Economic Adjustment to the Crisis in the Baltic States in Comparative Perspective”, paper prepared for the 7th Pan-European International Relations Conference, September 5-7, 2010, Stockholm.

⁴ Vitalis Nakrošis, Ramūnas Vilpišauskas, and Vytautas Kuokštis, “Fiscal Consolidation in Lithuania in the Period 2008-2012: From Grand Ambitions to Hectic Fire Fighting” (2013), draft article submitted for the publication in the International Review of Administrative Sciences, prepared within the Working package 7 of the COCOPS grant agreement.

What caused the crisis and what affected fiscal consolidation and structural reforms in Lithuania?

Hit unprepared: the pre-crisis context. At the outset, it should be noted that fiscal consolidation efforts and related reforms in Lithuania were triggered by the worsening external economic environment and declining market expectations. They also coincided with the parliamentary elections that took place in October 2008, which complicated a timely reaction to the worsening economic outlook. These complications stemmed from a few different factors. First, massive increases in budgetary spending were approved by both opposition and ruling parties in the parliament, eager to show generosity to their voters in the context of approaching parliamentary elections. Second, the incumbent centre-left government led by the Social Democratic Party denied for several months that Lithuania would be affected by the external shock when governments in the other Baltic States, especially Estonia, started adopting measures to mitigate potential fiscal imbalances.

The need to react quickly to the rapidly worsening economic situation and the projected decline of budget revenues just as a new centre-right government was starting its work in December 2008 dominated the political agenda of the newly formed coalition.⁵ Lithuania, along with the other Baltic countries, was among the worst hit economies in the world in 2009. Lithuania's real output fell by almost 15% during 2009. This can be explained by specific vulnerabilities that Lithuania had accumulated prior to the crisis in the context of an extremely pro-cyclical fiscal policy, delayed political reaction to the crisis, and a rapid worsening of market expectations.

During the boom, the Lithuanian economy was expanding very rapidly. This trend of economic growth goes back to around 2002, when EU accession negotiations were concluded and borrowing costs for Lithuania dropped significantly, signalling a perception among investors that Lithuania was becoming a less risky sovereign. Accession into the EU in May 2004 further contributed to this positive market sentiment. The annual average economic growth rate remained high, at levels of 7-8% of GDP, which exceeded significantly the average growth rates of the eurozone (exceeding also the income convergence rates of most other new member states). The unemployment rate went down to the lowest levels since the early 1990s and reached 4.3% in 2007 (when the average of EU-27 exceeded 7%). These trends were affected both by the expanding economy and migration opportunities to wealthier EU member states that opened their labour markets from the day of accession (mostly to Ireland and Great Britain, less so to the Nordic countries and Spain). Actually, just before the crisis, the flow of returning migrants

⁵ This factor of rapidly worsening economic projections for 2009 and the need to readjust the draft budget prepared by the previous government, which had become out of touch with economic reality, to introduce measures to deal with the approaching financial crisis and to assure the legitimacy of these decisions by including them into the Government Programme were stressed in the interviews with Andrius Kubilius and Ingrida Šimonytė (on 13.02.2013 and 11.02.2013 respectively).

started increasing, partly due to wage increases, but this trend was interrupted by the crisis.

As the economy was growing, budgetary revenues were on the rise, allowing the Lithuanian authorities to reduce the budget deficit and the state debt levels. However, the picture was not unequivocal. On the one hand, Lithuania had a relatively low level of government debt (below 20%, and fiscal deficits had been decreasing prior to the crisis). On the other hand, even during the high growth period Lithuania did not manage to achieve surplus budgets. Moreover, budget expenditure grew by 20-25% on a yearly basis during the 2004-2008 period. A high positive correlation between annual real GDP growth and real government consumption growth in Lithuania (0.83) confirms a very pro-cyclical budget policy in the 1995-2010 period.⁶ Therefore, Lithuania failed to accumulate fiscal reserves, in contrast to Estonia. Though Lithuania's actual fiscal deficits were small, structural deficits were much larger. However, there has been a lack of political consensus regarding an anti-cyclical fiscal policy, with each coalition partner in the centre-left coalition trying to get more funding for their "own" ministries. Most likely, there was also too little understanding of the importance of a prudent fiscal policy in the country, whose monetary regime is based on a currency board. Therefore, despite impressive rates of economic growth, budgetary revenues and expenditures were not balanced. The state also encouraged households to take mortgage loans by providing guarantees and other incentives, contributing to a real estate boom.

Moreover, rapidly growing budgetary expenditures, together with EU funding, remittances from migrant workers, salaries growing on average at around 20% annually, and overall positive expectations among consumers willing to take on credit amidst the growing economy, contributed to the acceleration of price growth in Lithuania. Inflation reached the Maastricht criteria in 2006 and exceeded it afterwards, effectively preventing the introduction of the euro in 2007. It should be noted that accession to the EU allowed Lithuania, with its currency peg, to formally join the exchange rate mechanism II, where it remains today. However, after almost two years of EU membership in which the country met all nominal convergence criteria, inflation became the only obstacle to introducing the euro.

It should also be noted that the share of Lithuania's trade with EU countries stabilised in 2004, amounting to around two-thirds of Lithuania's exports. In absolute terms, Lithuania's exports to Russia and other non-EU countries were growing rapidly, reflecting the growing demand in these markets. This reliance on the Russian market was a positive factor in the context of recent economic decline in the eurozone economies, but it left the Lithuanian economy – or at least some sectors and companies – vulnerable to demand shocks in Russia. Another important feature of Lithuania's exports was the high degree of product diversification.

⁶ Zsolt Darvas, "The Impact of the Crisis on Budget Policy in Central and Eastern Europe", *OECD Journal on Budgeting* 1 (2010), 1–30.

According to some estimates, Lithuania has one of the most diversified export product base of all EU member states (coming second after the Netherlands), which probably significantly contributed to export-led growth and the fast recovery of the economy after the 2009 crisis.⁷ Another feature differentiating Lithuania somewhat from other EU member states was the relatively low share of FDI. Although the country was declaring the attraction of FDI as a priority, most of it came during the process of late privatisation (particularly in the fields of infrastructure and financial services) with little green-field investment. While some of its industries, in particular banking and telecommunications, were well integrated into the Nordic markets, the overall level of FDI remained comparatively low. Inside the country, there has been a shift in value-added creation from manufacturing to the services sector, although Lithuania has preserved its strong manufacturing and agricultural base compared to the other Baltic States.

Domestic politics also contributed to the deteriorating economic situation in 2008-2009 by leaving policy-makers less prepared to withstand the external shock. A significant fiscal expansion, which was launched in 2007-2008 (including increases in public sector wages and social expenditures, such as pensions and maternity leave, as well as introducing automatic indexing), was to a large extent motivated by the approaching parliamentary elections in Autumn 2008. Both the ruling coalition and opposition members voted for an increase of these types of government expenditure before the elections. When the new coalition was formed after the elections, the blame game started shifting responsibility to the previous ruling coalition, with explanations made to the public of the required spending cuts and tax increases in 2009 and the possible catastrophic effects of an alternative scenario if these measures were not adopted. This contributed to a rapid deterioration of market sentiment and possibly added to the depth of recession in 2009.

To sum up, though initially economic growth was driven by productivity gains and positive expectations from joining the EU, it increasingly became reliant on the expansion of domestic demand fuelled by overly optimistic expectations, a credit boom and rapidly growing public spending. The credit boom also resulted in asset price inflation, most importantly in the housing market. Major macroeconomic imbalances (inflation, wage growth and especially current account deficits) developed and were worsened by the continuous growth of budgetary expenditure and the inability to accumulate a budget surplus during the years of fast economic growth. All this meant that Lithuania was very vulnerable when the global financial crisis struck and external capital financing dried out.

Preparing to do it all: fiscal consolidation and structural reforms. Lithuania has a fixed exchange rate; more specifically, it has a currency board regime with the

⁷ Lietuvos bankas, *Lietuvos ekonomikos apžvalga* (Bank of Lithuania, *Overview of Lithuanian Economy*), 2013 m. gegužės mėn. (Vilnius: Lietuvos bankas), 8.

national currency litas pegged to the euro since 2002. Most mortgage loans have been issued in euros and Lithuania's import structure is heavily based on non-eurozone countries, especially for such products as energy resources. It therefore could not revert to a devaluation of the currency in order to stimulate exports without serious negative consequences for the economy and undermining trust of the population in the stability of the country's monetary policy. Therefore, the Lithuanian authorities had to rely on fiscal consolidation and a downward adjustment of wages to both safeguard the exchange rate and restore the country's competitiveness. Actually, the preservation of financial stability, which first of all meant defending the existing currency board arrangement by consolidating public finances, became the main priority of the newly formed centre-right coalition government that came into office in December 2008. Defending the fixed exchange rate was also one of the reasons that the Lithuanian authorities did not turn for financial assistance to the IMF, which by late 2008 and early 2009 was negotiating the terms of assistance with Latvia, because initially the position of the IMF regarding the preservation of the fixed exchange rate of lats in Latvia was ambivalent and a domino effect was feared if Latvia was forced to devalue.⁸ It should also be stressed that this choice of preserving exchange rate stability and focussing on fiscal adjustment was based on a very strong political and expert consensus within the country.

The Government Programme adopted at the end of 2008 included (1) an anti-crisis plan consisting of spending cuts (a reduction of wages in the public sector, as well as cutting social expenditures such as maternity leave, old-age pensions and others, many of which had been raised just before the parliamentary elections), tax increases (VAT, profit tax, excise tax and the abolition of VAT exemptions for some products and services) and measures to restore economic growth, (2) a list of long-term structural reforms, such as higher education reform, social policy reform, health care reform, energy sector reform and public administration reform. "It's time for reform" and "the crisis provides an opportunity for long-overdue reforms" – these were the slogans of the 2008-2012 government, which had to deal with the crisis as soon as the election results were announced and the new coalition made up of the Homeland Union (Lithuanian Christian Democrats), the Lithuanian Liberal Movement, the Liberal and Centre Union and the recently created show-biz National Revival Party was formed.

In 2009, the Ministry of Economy prepared an economic stimulus package in order to reduce the impact of the crisis on the Lithuanian economy. In contrast to stimulus packages in the West aimed at increasing consumption, the Lithuanian stimulus plan was intended to boost corporate competitiveness and export capacity. The plan consisted of the following elements: (1) easing business financing

⁸ Interview with Andrius Kubilius (13.02.2013).

conditions; (2) increasing the energy efficiency of housing; (3) the faster use of EU structural support; (4) improving the business environment; and (5) support for exports and investments.⁹ The plan received a lot of (mostly negative) publicity and met with numerous difficulties in its implementation. Businessmen complained about having difficulties accessing the allocated funds. The government had high expectations in the housing renovation programme, which turned out to be unsuccessful due to bureaucratic hurdles and the mistrust of the population, which was unwilling to co-finance renovation projects.

It should also be noted that the intentions of the newly formed government to initiate far-reaching structural reforms in so many areas seemed especially ambitious when one takes into account the large amount of discussion about structural reforms in the pre-crisis boom years with very few actual accomplishments. The 2004 pension reform, which introduced the second and third pillars of the pension system in addition to the pay-as-you-go (PAYG) state insurance fund, was probably the only area where reforms have been initiated since Lithuania's accession to the EU in 2004. Part of this gap between the rhetoric regarding the need for structural reforms and actual delivery of those reforms could probably be explained by the political fragmentation in Lithuania's ruling coalitions since 2004.¹⁰ This fragmentation, which became even more prominent after the parliamentary elections of 2004, and resulted in frequent shifts in the governing coalition since 2004 resulted in a lack of public sector reforms, despite their need recognised by most political actors in the country. For example, most parliamentary parties signed a political agreement to reform higher education in 2006, and a concept paper (a framework for health care development in 2008-2015) for reforming the health sector was adopted in 2007. However, no specific measures were taken to implement these structural reforms. The 2006-2008 Lithuanian government established the Sunset Commission for the reform of public administration. However, due to a lack of political support the majority of proposals from this commission were not implemented.¹¹ On the contrary, the number of civil servants and other public administration employees had been constantly increasing since 2004, and was justified by the need to administer functions related to EU membership. Whereas fast economic growth allowed for increasing public spending (in particular public sector salaries, social support and public investments), it was not used to restructure key public sectors that remained unreformed after joining the EU.

Thus, despite the growing availability of resources, encouragement to reform the public sector by the EU through the Lisbon process and convergence

⁹ Ūkio ministerija, *Ekonomikos skatinimo planas* (Ministry of Economy, *Plan of Economic Stimulus*).

¹⁰ Ramūnas Vilpišauskas, "Crisis as an Opportunity for Reform..."

¹¹ Vitalis Nakrošis and Žilvinas Martinaitis, eds., *Lithuanian Agencies and Other Public Sector Organisations...*, 76.

programmes aimed at preparing the country for eurozone membership, the need for structural reforms frequently voiced by the president and expert community and even acknowledged by the ruling coalition government, there was little progress in reforms until 2008. As previously mentioned, it could be argued that the fragmented coalition government, in particular after becoming a minority government, was incapable of undertaking structural reforms, which required overcoming the resistance of vested interests. It could also be said that the left-centre coalition government was also reluctant to start structural reforms associated more with the right-wing and liberal agenda because of the risk that it would be accused of betraying its ideological ground. Finally, economic growth and EU membership, while providing resources which could be used for reforms, had quite the opposite effect of reducing incentives for structural change.

So, when a new government started its work in late 2008, it declared a list of seven priority areas where structural changes will be implemented. However, it had to devote most attention first to fiscal consolidation measures.

The main elements of fiscal consolidation

Overall, fiscal consolidation served the following goals: “(1) reduce fiscal funding needs, (2) restore fiscal sustainability, (3) bring deficits to the Maastricht limit of 3% budget deficit of GDP as soon as feasible and (4) support a correction of the real exchange rate by containing domestic demand growth and forcing a reduction of wages, thus keeping open the option of speedy euro adoption.”¹² According to the International Monetary Fund, fiscal consolidation in the Baltics “was unprecedented by historical and international standards”.¹³

Fiscal consolidation in Lithuania largely occurred on the expenditure side. According to the authors of the plan, the initial intention was to place about two-thirds of the fiscal adjustment burden on the expenditure side and one-third on the tax (revenue) side but the eventual outcome was about 70-80% of fiscal consolidation falling on expenditure cuts and about 30-20% falling on tax increases.¹⁴

Reducing budget spending: again and again. During the 2008-2012 period, the Lithuanian authorities made a total of five government-wide cuts to expenditure in the state budget. Although the need to start fiscal consolidation became apparent already in 2008, Lithuanian political parties (both from the ruling majority and opposition) did not support unpopular cut-back measures ahead of the forthcoming parliamentary elections. Therefore, the reduction of government expenditure

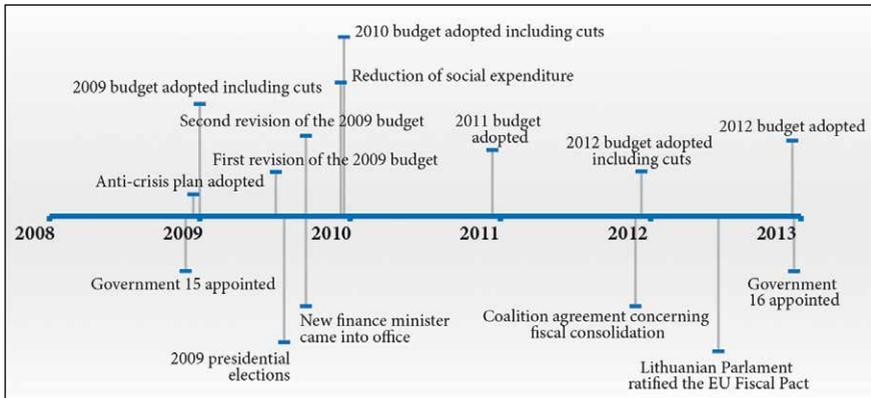
¹² Catriona Purfield and Christoph B. Rosenberg, *Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008-09*, IMF Working Paper, 2010, 12, <http://www.imf.org/external/pubs/ft/wp/2010/wp10213.pdf>

¹³ Catriona Purfield and Christoph B. Rosenberg, *Adjustment under a Currency Peg...*, 18.

¹⁴ Interviews with Andrius Kubilius and Ingrida Šimonytė (13.02.2013 and 11.02.2013 respectively).

started only at the start of 2009 (see Figure 1 below). Initially Lithuania’s expenditure cuts were broad-based, but later more progressive reductions in areas of different government expenditure (appropriations, public sector wages, pensions and other social benefits) were adopted.¹⁵

Figure 1. **Timeline of the main fiscal consolidation events, 2008-2012**



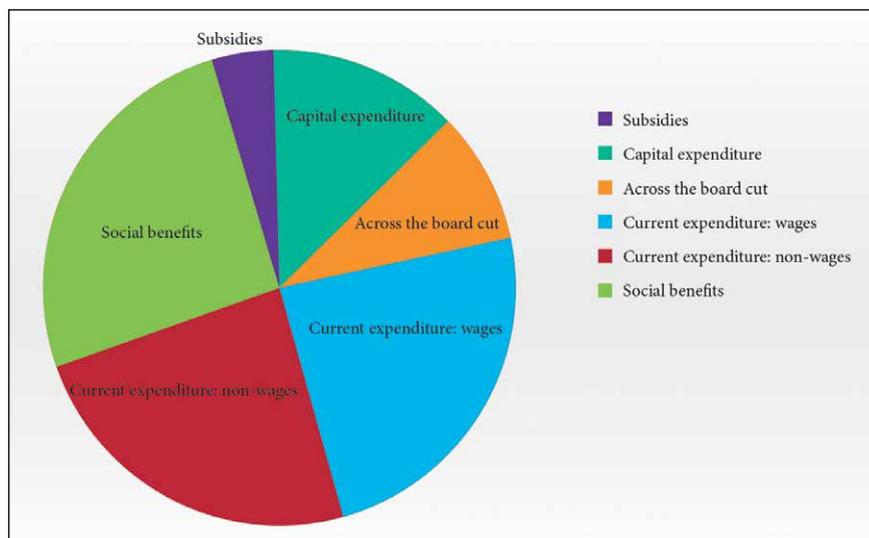
Source: the authors of this paper

The first cuts were proposed by the newly appointed government in December 2008. The expenditure part of this plan provided for broad-based cuts: a 12% cut in remuneration funds for central-level budget institutions and local authorities, a 15% cut in the other expenditures of central-level budget institutions (including special grants to local authorities), as well as at least a 10% cut in the investments of budget institutions, and additional expenditure cuts in the sectors of social security and national defence. According to the authors of those measures, broad-based (horizontal) cuts across most sectors were easier and quicker to implement; they also seemed fairer, despite the fact that this logic was not in line with the logic of prioritising structural reforms and introducing long-term structural changes. The proportional nature of spending cuts is illustrated in Figure 2, which indicates the share of each spending category in total government expenditure. However, when additional cuts were later undertaken, they became more differentiated and left more room for particular ministries and other state institutions to differentiate cuts in line with their priorities.¹⁶

¹⁵ Ian Hawkesworth, Richard Emery, Joachim Wehner, and Jannick Saegert, “Budgeting in Lithuania”, *OECD Journal on Budgeting* 3 (2010), 7.

¹⁶ As former Prime Minister Andrius Kubilius and former Minister of Finance Ingrida Šimonytė noted, many institutions simply “tightened” their budgets by way of temporary measures such as unpaid leave to live through the crisis, but did not introduce any effectiveness-oriented structural changes (interviews with A.Kubilius and I.Šimonytė on 13.02.2013 and 11.02.2013, respectively). In contrast, most private sector organisations reacted by lay-offs rather than a reduction of wages and similar measures.

Figure 2. The structure of expenditure-based measures in Lithuania, 2009-2012 (% of GDP in parentheses)



Source: International Monetary Fund¹⁷

The worsening economic crisis made it necessary to make *three rounds of cuts to government expenditure throughout 2009*. The first 2009 cut, which was adopted by the parliament on 7 May 2009, focussed on central-level budget institutions (except the Lithuanian ministries), whose 2009 expenditure was reduced by between 6% (for educational, cultural and science organisations) and 16% (for county administrations). The second 2009 cut, which followed on 23 July 2009, just after the presidential elections, involved more targeted reductions in public sector wages (by 8% for teachers and other public sector employees). The third 2009 cut, which was made during the preparation of the 2010 state budget at the end of 2009, involved further cuts to the remuneration fund for civil servants (by 10%) and other public sector employees (ranging from 2% to 8%), as well as additional cuts to other non-co-financed expenditures of budget institutions (by 5% on average). Furthermore, an important reduction of social expenditure was adopted at the end of 2009 (on 9 December 2009), when the parliament cut pensions, maternity and unemployment benefits, as well as other social expenditures.

Although the Lithuanian authorities adopted a number of saving and efficiency measures in 2010-2011, no government-wide cut-backs were made until *the end of*

¹⁷ International Monetary Fund, *Republic of Lithuania: Selected Issues*, IMF Country Report No. 13/82 (2013), 5-6, <http://www.imf.org/external/pubs/ft/scr/2013/cr1382.pdf>

2011, when the revision of a draft 2012 state budget became necessary due to the worsening outlook of the Lithuanian economy. The 2012 budget law was adopted by the parliament on 20 December 2011. Since the 1% cut to 2012 government expenditure that was planned during the budget preparation in the middle of 2011 proved to be insufficient, a further reduction of 4% for all state budget managers was approved at the end of 2011. This government-wide cut was not evenly distributed across all policy areas: though the budget for the Ministry of National Defence stayed almost untouched, that of the Ministry of Environment was cut by as much as 28% (see Part 3 of this article for more information). The deeper expenditure cuts were needed because at the end of 2011 the Lithuanian authorities made the decision to allow the 2009 pension cuts to expire, restoring the pre-crisis pension levels (as of 1 January 2012). This decision was publicly supported by the Lithuanian president as an anti-poverty measure and was promoted by the ruling Homeland Union party as an appeal to its electorate before the approaching parliamentary elections in autumn 2012.

Although the Lithuanian authorities reduced the volume of state budget expenditure by EUR 1.6 billion through the five government-wide cuts, overall government expenditure only decreased from EUR 7.7 billion (planned for 2008) to EUR 7.5 billion (for 2012) in the 2008-2011 period, which makes the application of the term “austerity” questionable. This is associated with an increasing share of EU funding in the state budget, which peaked at EUR 5.6 billion in 2011. Government co-financing on projects supported by EU funds was also untouched during the consolidation process, in order to maintain good rates of absorption of external assistance from the EU budget.¹⁸

However, there was little re-allocation of government spending from budget programmes not co-financed by EU structural funds to programmes that were co-financed. Although this could have reduced the need to cut important non-co-financed expenditure from the state budget and could have increased the efficiency of absorbing EU financial support in Lithuania, only a few Lithuanian ministries exploited this opportunity during the financial crisis. The Ministry of Education and Science was one of the ministries which actively used EU funding for advancing and financing structural reforms.¹⁹ Though the *Lithuanian civil service* suffered from deep spending cuts (affecting both the number of civil servants and their salaries), the ESF continued to provide a large volume of support to state and municipal institutions by investing in their administrative capacity building.²⁰

¹⁸ International Monetary Fund, *Republic of Lithuania: Selected Issues*, 5.

¹⁹ Interview with the former Vice-Minister of Education and Science Nerija Putinaitė (14.02.2013).

²⁰ Therefore, the implementation of this assistance faced the challenge of falling staff motivation arising from a combination of salary cuts, staff layoffs and increased workloads for staff involved in ESF project implementation. See Vitalis Nakrošis, “Theory-Based Evaluation of Capacity Building Interventions,” Paper for the 10th EES Biennial Conference, Helsinki, 1-5 October 2012.

Finally, we also assess the breakdown of spending cuts across policy areas based on the COFOG classification. It was national defence that became the main loser of fiscal consolidation measures in Lithuania (see Figure 3 below). Defence expenditure dropped by 27% in the 2007-2011 period. Moreover, the Lithuanian civil service experienced deep cuts in staff expenditure and staff layoffs. Actual layoffs in Lithuanian state and municipal institutions amounted to about 10% (or 7,282 positions) from 2008-2011. In this respect, Lithuania is similar to Great Britain, Germany and the Netherlands, where public administration became the main target of spending cut-backs.²¹

There was no straightforward set of winners of fiscal consolidation. Although *health expenditure* from the state budget increased by 24% from 2007-2011, this increase was used largely to offset decreasing contributions made by employees and their employers to the National Health Insurance Fund (one of the existing off-budget funds) (from 75% in 2007 to 55% in 2010) due to higher unemployment and lower salaries in the labour market. Nevertheless, overall health expenditure rose by about 11% from 2007-2009 according to Eurostat data (no data was available for 2010 at the time of writing). Also, government expenditure for *general public services* increased by 12% from 2007-2011. This is associated largely with the higher costs of government debt service during the financial crisis. This spending is treated as ‘automatic’, whereby the Lithuanian authorities have no room for manoeuvre.

Table 1. Changes to approved government expenditure according to the COFOG sectors, 2007-2011, EUR billion

	2007	2008	2009	2010	2011
General public services	1.8	1.9	1.9	2.0	2.3
Defence	0.4	0.4	0.3	0.3	0.3
Public order and safety	0.4	0.7	0.6	0.6	0.6
Economic affairs	2.3	1.9	1.7	2.0	2.0
Environment	0.3	0.4	0.2	0.3	0.3
Housing and community amenities	0.0	0.1	0.1	0.0	0.0
Health	0.4	0.5	0.6	0.7	0.6
Recreation, culture and religion	0.2	0.2	0.2	0.1	0.2
Education	0.7	0.8	0.8	0.8	0.7
Social security	0.6	0.8	0.8	0.8	0.7
Total	7.1	7.7	7.2	7.6	7.7

Source: the authors’ calculations according to data from the Lithuanian Ministry of Finance

²¹ Walter Kickert, “State Responses to the Fiscal Crisis in Britain, Germany and the Netherlands”, *Public Management Review* 14, no. 3 (2012), 299-309.

Budget revenue measures: lots of noise, little effect. Though Lithuania's fiscal consolidation primarily relied on expenditure reduction, tax changes were also implemented. The 2008-2012 government focused on increases in existing tax rates rather than introducing new ones. There were also discussions regarding the introduction of a comprehensive residential real estate and automobile tax. The then Minister of Finance, I.Šimonytė, and the then Prime Minister, A.Kubilius, expressed their support for these measures, but ultimately they were not adopted because of opposition from the liberal parties and the president of Lithuania (who vetoed the introduction of a tax on automobiles). Besides, although there had been an initial support for the introduction of a flat tax of 19 or 20% for VAT, profit and personal income taxes, due to opposition from liberal parties in the coalition, the idea was eventually modified. Furthermore, there was a need to make quick decisions and thus little time for the technical development and political consensus-building necessary for such a major reform of the tax system. Thus, coalition politics and time pressure had a major impact on the eventual composition of the tax changes. At the end of 2008, the government quickly produced a comprehensive list of tax changes to enter into effect mostly from 1 January 2009. This later became known as 'the night reform', stressing the hasty and eclectic nature of the changes, leaving the president less time than required by the Constitution to sign or veto the proposed laws. The tax measures mainly relied on an increase in consumption taxes. The standard VAT rate was raised from 18% to 19%, followed by a further increase to 21% from 1 September 2009, and several types of VAT exemptions were abolished.²² Excise rates on alcohol, fuel and tobacco were raised (cigarette duties were raised in two stages – from 1 March and 1 September 2009).

Concerning income taxation, personal income taxes were effectively lowered from 24% to 21%. Tax deductions for mortgage payments and personal computer purchases were abolished. Dividend income taxation went up from 15% to 26%. Furthermore, health insurance tax payments were set at two rates (6% and 9%). Since health insurance was previously included in personal income taxation, the tax burden on employment income did not change as a result of this measure. In contrast, the tax burden grew for certain groups of individuals who were not subject to health contribution payments before: those receiving royalties, individual activities, sportsmen, artists and performers. The categories of people subject to social security payments were expanded to include sportsmen, farmers and those receiving royalty payments. In addition, social security contributions for self-employed individuals went up. The profit tax was increased from 15% to 20% starting from 1 January 2009, but tax incentives were granted for firms investing in research and development for the years 2009-2013.

²² According to the former Minister of Finance Ingrida Šimonytė, an increase in the general VAT rate and abolition of exemptions have become the most effective measure, whereas changing direct (profit and income) taxes could be regarded as the least effective (the interview on 11.02.2013).

The numerous changes and the rather chaotic manner in which they were designed and implemented drew harsh criticism from the opposition, economic experts and society at large. Additionally, lot of criticism from the media was aimed at the removal of tax exemptions for journalists and some other professions. At the beginning of 2009, following massive protests in Latvia, a big protest took place next to the Parliament building in Vilnius. A group of people turned violent and clashed with the police. This, however, was the only violent protest against fiscal consolidation measures. The relative absence of protests against fiscal adjustment measures has been linked to society being accustomed to living in conditions of change and relative instability over the last two decades, which fostered a “culture of patience”, as well as the relative weakness of trade unions.²³

There were significantly fewer tax changes in 2010. Corporate taxation was lowered from 20% back to 15%. Furthermore, small companies (with less than 10 employees and an annual income of less than 500,000 litas) were granted a special corporate tax rate of 5% (replacing the previous rate of 13%). Dividend payments were exempted from health contributions, reducing the effective rate of dividend tax to 20%.

Another controversial decision was linked with the reduction of contributions to second-pillar private pension funds. When the 2008-2012 government undertook the first revision of the 2009 budget, it proposed an amendment to the pension system that would reduce the share of social security contributions transferred to second-pillar private pension funds from 5.5% to 3%. Despite a veto by the president, the parliament adopted the amendment in January 2009, thus reversing the trend of pension reform and creating uncertainty about its continuity. This uncertainty was further aggravated when the second government-wide cut of expenditure was adopted in spring 2009, further reducing the share of contributions to 2%. This time, however, the reduction was compensated by increasing the share to 6% from 2012 for several years.

However, despite a declared commitment to continue with pension reform in the future, these decisions were revised again at the end of 2011, when the need for additional budgetary savings arose after a downward revision of forecasts for Lithuania's economic growth. The share of social security contributions to second-pillar private pension funds was reduced further to 1.5% with a pledge to increase them to 2.5% in 2013. Moreover, despite the creation of a working group in 2010 to prepare alternatives for long-term pension reform, the reform adopted in the parliament at the end of 2012 concerned only the second pillar of the pension

²³ As noted by the former Prime Minister Andrius Kubilius, “we are not used to welfare and stability like some countries in Southern Europe. When we were negotiating a National Accord Agreement with social partners, some organisations like the Union of Former Deportees were saying that they could live even with more radical reduction of pensions if this is needed for the state. They were saying that we have seen much worse when we were deported to Siberia” (the interview on 13.02.2013). Although other organisations opposed proposed welfare reductions, there were no open protests against fiscal consolidation in Lithuania.

system rather than the unsustainable PAYG part.

In October 2010, the Lithuanian government signed the National Accord Agreement with major interest groups, including business and labour organisations.²⁴ In the Accord, the government made a commitment not to introduce new taxes or increase existing taxation until 2011, except for higher social security contributions that had been planned previously. The government also emphasised the need to fight smuggling, tax evasion and illegal trade activities.

Although economic contraction was the main reason behind falling tax revenues, there is evidence of an expansion in the shadow economy during the crisis. Based on an economic survey carried out by the Lithuanian Free Market Institute, the shadow economy as a percentage of GDP increased from 18% in 2008 to 29% in 2011.²⁵ In order to extract additional revenue from the shadow economy, the government adopted a special plan. As part of the plan, it passed a law requiring the installation of cash registers in market places, which turned out to be a controversial decision and caused some protests by traders.²⁶ Overall, the return of the shadow economy, which had been on the decline during the boom years, could be seen as another societal reaction (an “exit”) to the crisis and the measures adopted by the government.

Structural reforms: less is more?

The government and especially Prime Minister A. Kubilius envisioned using the crisis as a window of opportunity to advance long-overdue structural reforms. The idea was to use the period of “extraordinary” politics – when certain decisions are bound to be unpopular – for introducing structural changes in different public policy sectors that might only have positive effects in the long-term. Therefore, in the Government Programme adopted in late 2008, after the section on fiscal consolidation measures, a list of the areas where reforms intended *for 2009* was presented: public administration, the reduction of corruption, the development of an innovative economy, energy, the education system, the health care system and the reduction of social exclusion.

Clearly the list was too extensive, not just for the year 2009 but for the whole term of four years of the government. As the government was dealing with the crisis and focussing first of all on fiscal consolidation, other areas of reform gradually

²⁴ *Nacionalinis susitarimas* (The National Accord), 2009, http://www.lrv.lt/bylos/Naujienos/Aktualijos/20091028_susitarimas.pdf.

²⁵ Lithuanian Free Market Institute, *A Survey of the Lithuanian Economy* 1 (2011/2012), <http://files.lrinka.lt/LET28.pdf>

²⁶ DELFI, VMI viršininkas: „šešėlinė“ ekonomika didėja, įmonės grįžta prie mainų (Head of State Tax Inspection: enterprises are returning to exchanges), 31.03.2009, <http://verslas.DELFI.lt/business/article.php?id=21264293&categoryID=11>

gained priority depending on the existence of already prepared reform concepts (as in the case of higher education), the existence of political leaders determined to proceed with reforms (as in the cases of higher education and the energy sector), the possibility to use EU funding for reforms (as in the case of higher education), or whether there was a close connection between fiscal consolidation through efficiency gains and structural (institutional) changes (as in the case of public administration). Thus, already in spring 2009, the government initiated higher education reform with the two key elements – the reform of funding by introducing competition among universities for students’ choices (under the principle of “money follows a student”) and that of university governance. Elements of the latter were later found to contradict the Constitution by the court and had to be revised.

Energy reforms focussed on a number of projects. First of all, a vertically integrated company – LEO (Lithuanian Energy Organization), created by a private investor and a previous government – was recently dissolved and the company renationalised and restructured. Second, the government accelerated work on preparing the ground for building electricity connections to Sweden and Poland. Third, after the revision of LEO, the government started work on a new nuclear power plant project to be built jointly by Lithuania, Latvia and Estonia and a strategic investor which eventually turned out to be Japanese investor Hitachi. Finally, work on creating alternative sources for the natural gas supply was conducted, in particular, costing construction of a LNG terminal on the Baltic Sea and gas pipeline to Poland. Most of these projects have been included into the Baltic Energy Market Interconnection Plan (BEMIP), which has been adopted by the EU and included all participating EU member states in the region and the European Commission.

In health care, as with most other areas, reforms were limited to some attempts at restructuring the network of health care institutions in the country to optimise the use of resources in the face of decreasing numbers of inhabitants in smaller towns and regions, and even these efforts had a mixed record after meeting resistance. Although the network of personal health care organisations was restructured by reducing the overall number of these organisations from 81 to 62, the reform was not fully implemented in the three largest Lithuanian cities (Vilnius, Kaunas and Klaipėda) due to resistance from local authorities and other stakeholders, and the scale of changes was reduced during the implementation process.

The record of implementing public administration reforms, which were directly linked to fiscal consolidation measures and aimed at bringing the double benefit of budget savings (efficiency) and effectiveness in terms of delivering public services, proved to be mixed. In terms of organisational reforms, all the Lithuanian ministries were restructured, and several government and many ministerial

agencies were abolished or reorganised from 2009-2011, while one new ministry (the Ministry of Energy) was created – a sign of the political importance given to this sector.²⁷ According to the Sunset Commission, the number of central-level institutions decreased from 1,190 in 2008 to 855 in 2011. The number of budgetary institutions decreased by 35% (from 842 to 551 institutions) and the number of public non-profit institutions by 13% in this period (see Table 1 below).²⁸ However, this considerable change to the organisational landscape at the central level was achieved largely through the abolition or reorganisation of territorial units that are included in the overall number.²⁹

Table 2. Change to the number of central-level organisations in the 2008-2012 period

Type of central-level organisation	2008	2010	2011
Budgetary institutions	842	733	551
Public non-profit institutions	181	168	156
State enterprises	100	100	93
Joint stock and closed joint stock companies	67	60	55
Total:	1190	1061	855

Source: Saulėlydžio komisija³⁰

Although a number of efficiency measures were adopted by the 2008-2012 Lithuanian government, these measures suffered from problems of scale and/or implementation. First, in order to improve the profitability of *state-owned companies*, reforming their management was proposed. When the initiative of transferring all state property to a new holding company called ‘Visuomis’ was rejected both by the government and the parliament, a common state property management policy was announced. Its implementation brought higher dividends to the state budget, which increased from EUR 12 million (in 2010) to EUR 151 million (in 2012)³¹, but the sustainability of these results is uncertain.

Second, Lithuanian public procurement authorities were encouraged to switch to *centralised procurement* during the financial crisis. Despite the evidence of efficiency gains brought by a centralised procurement of goods and services and

²⁷ See Vitalis Nakrošis and Žilvinas Martinaitis, eds., *Lithuanian Agencies and Other Public Sector Organisations...* for more information about organisational changes to the Lithuanian landscape during the financial crisis.

²⁸ Saulėlydžio komisija, *Valstybės valdymo tobulinimo komisijos (Saulėlydžio Komisijos) 2009–2012 veiklos ataskaita: rezultatai ir gairės tolesniems pokyčiams*, 2012 m. lapkritis (Sunset Commission, Report of the Commission for the Period 2009-2012 and Guidelines for Further Activities, November 2012), http://www.lrv.lt/bylos/veikla/veiklos-ataskaitos/Saulėlydžio%20ataskaita_2012%2011%2014.pdf

²⁹ For instance, 46 local labour exchanges were reorganised into 10 territorial exchanges in 2010, while 47 territorial units were integrated into the State Food and Veterinary Service in 2011. See Nakrošis and Martinaitis (eds).

³⁰ Saulėlydžio komisija, *Valstybės valdymo tobulinimo komisijos...*

³¹ Ministry of Economy of the Republic of Lithuania, *Lithuanian State-Owned Enterprises in 2011: Annual Report* (2012), <http://vkc.vtf.lt/index.php?r=document/view&id=1851>

the existence of a centralised procurement unit, the share of this remained rather low, amounting to 6% from the total value of public procurement in 2010.³² This is associated with the unwillingness of individual procurement authorities to give up their procurement powers.

The economic and political effects of fiscal consolidation

Financial-economic effects: finances back in order, muddling through with reforms. It should be first acknowledged that the government managed to preserve Lithuania's credibility by avoiding default and ensuring that salaries for public sector employees and social expenditures, i.e. pensions, are paid on time. This was the most important task and the government achieved it. However, in terms of targeted public spending cuts, and linking them to structural changes, the picture is much less clear. A more detailed analysis of Lithuania's budget consolidation measures revealed little change in the budgeting policy, despite the large government-wide spending cuts and operational measures in different policy areas. First, the main principle of fiscal consolidation decisions was to bring government expenditure down to its 2006 level in order to effectively remove the effect of excessive spending in 2007 and 2008, when a large part of short-term revenue windfalls was turned into long-term social commitments. Second, a significant share of spending cuts (about 40% of the consolidation in the 2009 and 2010 budgets) was legally defined as temporary, taking into account the special circumstances of austerity. For instance, pension reductions expired already at the end of 2011, although reductions in public sector wages (including those of the civil service) were extended beyond 2012.

This shows that by cutting government expenditure in times of economic decline the Lithuanian authorities were basically continuing the same pro-cyclical approach (increasing government expenditure in good economic times and reducing spending in bad times). Therefore, one can expect that government expenditure will gradually recover upon the return of economic growth, unless the constraints resulting from reinforced EU economic governance and the Fiscal Stability Pact adopted by the Lithuanian parliament will reduce the tendency for pro-cyclical fiscal measures. In the middle of 2012, the Lithuanian Finance Ministry prepared a draft constitutional law enforcing a balanced budget, which was needed to implement Lithuania's commitment under the EU pact. The target date for introducing the euro in 2015, set by the newly formed centre-left coalition government and declared in early 2013, could also limit the growth of expenditure in the short term.

³² Viešųjų pirkimų tarnyba, 2010 m. centralizuotai vykdytų viešųjų pirkimų rezultatų ataskaita (2011) (Public Procurement Office, Report on the results of centrally organized public procurements in 2010 (2011)), http://www.vpt.lt/admin/uploaded/Centralizuoti_pirkimai/2010%20m.%20centralizuotai%20vykdytu%20viesuju%20pirkimu%20rezultatu%20ataskaita.pdf

Lithuania's government-wide cuts in government expenditure were little informed by evidence about the efficiency of government spending and the possible impact of cut-backs. I.Šimonytė, the former Minister of Finance, recognised that across-the-board cuts at the government level are the only possible political solution during fiscal consolidation: "When you sit at a table with 14 [cabinet] colleagues, not a single one volunteers to cut his/her spending".³³ A former Deputy Prime Minister's Chancellor confirmed that any reallocation of government spending is the result of political compromises: "Every party fights until the last blood in order to avoid spending cuts".³⁴

Also, the potential for new managerial instruments was not exploited to promote the setting of political priorities during fiscal consolidation. First, since 2009 the 2008-2012 Lithuanian government has annually adopted government priorities for the following financial years. However, these documents laid out the main reforms of public policy or management rather than setting priorities for government expenditure. Therefore, they were not effective in driving the allocation of government expenditure for different sectors of the economy and in such a way linking fiscal consolidation measures with structural reforms. Second, although for the 2011 budget the government modified the process of strategic planning and budgeting, the 2010 OECD report raised concerns about resolving the gap between "what they need" and governmentwide constraints.³⁵ Third, despite the introduction of new systems for the evaluation of budget programmes and functional reviews, no comprehensive government expenditure review with a medium-term outlook has been undertaken by the Lithuanian authorities.

In this respect, the government could be characterised as quite attentive to the recommendations of the European Commission and other expert institutions that practice evidence-based policy-making, although in its own work it often failed to dedicate enough financial and human resources to this type of evidence gathering, analysis and the use of it. The difficulty of using evidence in decision-making during the crisis is partly associated with coalition politics – each coalition partner is reluctant to undertake deeper expenditure cuts than the other partners and does not want to be publicly seen as taking on the bulk of savings. Moreover, soon after the start of their work many ministers became "captured" by their bureaucracies, which started framing policies on the basis of their institutional

³³ Alfa.lt, *Kas yra valstybės „šventa karvė“?* (What is "The Sacred cow" of the State?), 2.03.2012, http://www.alfa.lt/straipsnis/13935158/Kas.yra.valstybes.sventa.karve.=2012-03-02_07-57/

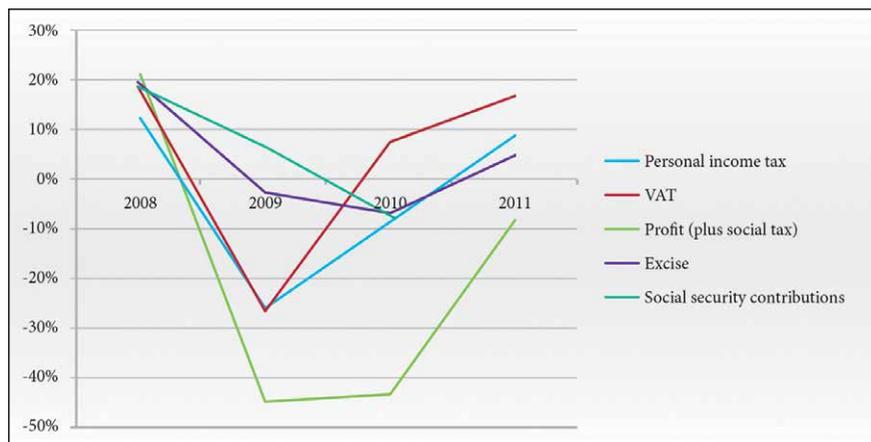
³⁴ Interview with the former Deputy Prime Minister's Chancellor Giedrius Kazakevičius (on 11.05.2012), cited in Justinas Pimpė, *XV-osios Lietuvos vyriausybės viešųjų išlaidų mažinimo politika* (Public expenditure reduction policies of the 15th Lithuanian Government), Master's thesis, Institute of International Relations and Political Science (Vilnius: Vilnius University, 2012).

³⁵ Ian Hawkesworth, Richard Emery, Joachim Wehner, and Jannick Saeger, "Budgeting in Lithuania", 12.

needs rather than the Government Programme.³⁶ Finally, the pressure of time, in particular at the start of crisis, and the large number of structural reforms foreseen in the ambitious Government Programme contributed to the rather hectic and widespread approach the government took instead of implementing focussed and well-prepared measures combining fiscal adjustment with long-term reforms.

On the revenue side, the record is even more modest. Despite increases in tax rates, the total tax revenue (including social contributions) fell by 20% in 2009. It further dropped by more than 4% in 2010 (according to authors' calculations based on Eurostat data). In 2009, all major tax revenue sources fell: VAT and personal income tax revenue dropped by a quarter and profit taxes by more than half (see Figure 4 below). This has been an outcome of the deep economic decline. In 2011, as the economy recovered, tax revenues also started growing.

Figure 3. Annual changes in tax revenue by type of tax, in percentage, 2008-2011



Source: authors' calculations based on data from the Lithuanian Ministry of Finance and Eurostat

Regardless of significant expenditure cuts and tax reforms, the fiscal situation deteriorated rapidly. The fiscal deficit expanded to 3% in 2008 and further to 9% in 2009. The deficit only started falling in 2010 when it reached 7%. Naturally, government debt also expanded, reaching about 38% of GDP in 2010 and 2011 (from the pre-crisis low of 16% in 2008).

³⁶ Interview with Andrius Kubilius (on 13.02.2013).

Table 3. Main macroeconomic indicators for Lithuania (2008-2013)

	2008	2009	2010	2011	2012	2013 ^f
Real GDP per capita (euros per inhabitant)	8000	6900	7100	7700	8100	NA
Real GDP per capita in PPS (EU28=100)	65	58	61	66	70	NA
Real GDP growth rate	2.9	-14.8	1.6	6.0	3.7	3.4
General government deficit/surplus (% of GDP)	-3.3	-9.4	-7.2	-5.5	-3.2	-3.0
General government gross debt (% of GDP)	15.5	29.3	37.8	38.3	40.5	39.9
Inflation (all-items HICP, annual average rate of change)	11.1	4.2	1.2	4.1	3.2	1.4
Unemployment rate (ILO)	5.3	13.6	18.0	15.3	13.3	11.7

Source: Eurostat, European Commission, 2013, f = forecast

Lithuania's GDP started growing in 2010 and jumped by more than 6% in 2011 (see Table 2 above). This is associated with a recovery in the global economy and the competitiveness of Lithuania's export-led industry. Labour market flexibility is another important factor that might have contributed to the quick recovery. Although according to the World Bank Doing Business indicators Lithuania and the other Baltic States rank relatively unfavourably in terms of the rigidity of labour regulations, other surveys seem to indicate that Lithuania has a very flexible labour market with relatively low collective agreement coverage and a quite high flexible wage share, and the country is among the most flexible economies in the EU-27.³⁷ This contrast between the World Bank surveys and studies of labour market flexibility might result from a gap between the quite rigid legal rules of the Labour Code, in particular regarding part time and temporary employment, and their application in practice, where businesses seem to be able to find the ways around these restrictions. Private sector wages decreased by 9% from 2008 to 2010, but by 2013 had returned to pre-crisis levels. According to forecasts of the European Commission, Lithuania had been identified as one of the fastest growing economies in the EU in 2013-14, allowing it to further reduce the budget deficit to below 3% of GDP. It should be noted that it was around the year 2012 that the Lithuanian economy reached its pre-crisis level in nominal terms and in terms of GDP per capita (in real terms Lithuanian GDP is expected to exceed pre-crisis level in 2014). However, the level of unemployment, although expected to decline below the EU average, is still rather high, being above 11% in 2013 and expected to remain above 10% in 2014.³⁸

The efforts of the government to restrain the growth of the budget deficit at the start of the crisis and later to bring it down to sustainable levels have been

³⁷ See, for example, Christoph Rosenberg, „Assessing the Boom and its Aftermath – Re-establishing Competitiveness”, presentation at the DG ECFIN Seminar “Economic policy challenges in the Baltics”, Brussels, 25 March, 2009, and Uldis Rutkaste, „External Competitiveness of Latvian Economy: Developments So Far and Challenges Ahead”, http://ec.europa.eu/economy_finance/events/2009/20090325/presentations-list_en.pdf

³⁸ European Commission, Spring 2013 Macroeconomic Forecasts, http://ec.europa.eu/economy_finance/eu/forecasts/2013_spring_forecast_en.htm

noted and positively assessed by financial markets and credit rating agencies. Lithuania's borrowing costs have been brought down rather quickly and already in early 2010 its credit default swaps returned to the pre-crisis level of around 220 (for five year term) from the peak of above 800 just a year ago. Credit rating agencies upgraded their ratings of Lithuania at the time as well. For example, Standard and Poor's upgraded the country's perspective (in foreign currency) from negative in 2009 to stable in 2010 and positive in 2013, referring to fiscal consolidation efforts of the government as the key factor and also noting the dominance of Nordic banks in the country, which helped avoid a banking crisis. Moody's, which was the last of the big three agencies to upgrade Lithuania's status from negative to stable, in its announcement of the news in March 2010 also noted that Lithuania's economy has stabilised faster than initially expected – the fastest among the Baltic States.³⁹

However, if we look into the broader indicators of institutional quality, the business environment and competitiveness indexes, Lithuania has remained rather stable throughout most of the period since 2008 (with some fluctuations downwards after the crisis and some improvements later) on most of these international rankings by the World Economic Forum, KOF Globalization, INSEAD Innovation, the Heritage Foundation, Freedom House, Transparency International and others. One interesting exception stands out – a recent jump by 10 ranks up to number 17 on the World Bank Doing Business rating 2013, which is mostly a result of the reform of the regulatory environment that has been undertaken in a joint effort of the Ministry of Economy and the Ministry of Justice. But overall, especially looking at the period since 2004, Lithuania has remained somewhere beyond 20th place within the EU-27 (now 28) without making any visible breakthroughs.

Finally, the start of the crisis again reinforced migration from Lithuania to other EU member states. During the whole period of independence more than half a million people are estimated to have emigrated from Lithuania. According to the Lithuanian Department of Statistics, between 2001 and 2010 around 205,000 people left the country, most of whom did so after joining the EU in 2004 with another wave following the crisis in 2009 (see Table 3 below). Recently those numbers started getting smaller, with around 54,000 people leaving in 2011 and 41,000 leaving in 2012. Also, the difference between outflows and returning flows of migrants seems to be getting smaller, with 41,000 people estimated to have left Lithuania and almost half of this number estimated to come back in 2012. Overall, Lithuania seems to be leading all EU member states in terms of the number of emigrants in proportion to the country's population – in 2012 there

³⁹ „Moody's pagerino Lietuvos skolinimosi reitingo perspektyvą“ (Moody's Upgraded Lithuania's Borrowing Prospects), http://www.marketnews.lt/naujiena/moody%E2%84%A2s_pagerino_lietuvos_skolinimosi_reitingo_perspektyva;itemid=17447

were 13.7 emigrants per 1000 people. Thus, although the public seems to have accepted anti-crisis measures without any open contestation, a significant share of population seems to have simply “exited” the country or moved to the shadow economy. In addition to still-high unemployment and low entrepreneurship, attracting these people back to Lithuania and back to official “white” activities is an important challenge for all the authorities of the country.

Table 4. Migration trends in Lithuania, in thousands (2005-2012)

	2005	2006	2007	2008	2009	2010	2011	2012
Emigration	62.8	34.7	32.3	26.8	40.4	83.2	53.9	41.1
Emigrants per 1000 inhabitants	18.9	10.7	10.0	8.4	12.8	26.9	17.8	13.7

Source: Statistics Lithuania⁴⁰

Political effects: praise from abroad, thumbs down at home. When we look into assessments of the Lithuanian government’s fiscal consolidation policy, one feature particularly stands out – it has been widely praised by international organisations, the EU and member states’ leaders, but it has seen a very low approval rating at home. Regular missions of the IMF have supported the policy of fiscal consolidation undertaken by the government, though underlining the need to implement measures that reduce the level of unemployment. The strongest appreciation of the government’s fiscal policy was publicly voiced the by the head of the IMF, Ch. Lagarde, who, talking in a conference in Vilnius in July 2013, commended that it was “Lithuania’s astute crisis management and decisive policies that restored credibility, secured the stability of financial system, and helped stage a recovery”⁴¹. Similar praise has been publicly voiced by the European Commission and President of the European Council H. Van Rompuy.

Although many publicly active experts in Lithuania have also positively assessed the government’s anti-crisis policies, at least its focus on fiscal consolidation and efforts to undertake structural reforms, the reaction of the general public has been quite different. The approval rating of the government and Prime Minister fell deeply already in early 2009, after the first package of fiscal consolidation measures and tax reforms were announced. It has never recovered since and the share of those surveyed who assessed the government negatively has been fluctuating at around 70-80% (see Table 4 for the Eurobarometer data on trust in national parliament and government).

⁴⁰ Statistics Lithuania, <http://web.stat.gov.lt/lt/news/view/?id=11625&PHPSESSID=twmjucjxideyz>

⁴¹ BC, „Lagarde: Lithuania Must Preserve Achievements of Competitiveness and Public Finance”, *The Baltic Course*, July 18, 2013, <http://www.baltic-course.com/eng/analytics/?doc=77900>

Table 5. Trust in national government and national parliament in Lithuania (% of population who tend to trust) (2008-2012)

	Spring of 2008	Spring of 2009	Spring of 2010	Spring of 2012
Government	16	19	13	15
Parliament	11	10	7	7

Source: Standard Eurobarometer

Still, despite the very low popular approval rating of the government and Prime Minister A. Kubilius, this has been the first government since the re-establishment of independence in 1990 which worked a full four year term. It managed to survive despite the fact that some of its coalition partners (the National Revival Party) lost some members who left the ruling coalition, and for most of the four year term the coalition barely had a majority of 71 seats in the parliament. It had to regularly mobilise all of its MPs when important votes were taking place, for example, the adoption of the next year's budget or measures related to higher education reform, which was strongly resisted by the Lithuanian Social Democratic Party. Still, despite balancing on the verge of being a minority coalition, the government managed to survive all four years of its term. Support from the President of Lithuania could be one of the explanations for this, as both the Homeland Union and Lithuania's Liberal Movement supported D.Grybauskaitė when she was standing for president in 2009. Another, probably an even more important, explanation is that the opposition was not really eager to take over and form a centre-left government throughout the crisis. It had no credible alternative plan in terms of how to react to the crisis, aside from some very general slogans on the need for economic stimulus, and it was not really active in preparing one. Most likely it had strategically decided to wait until next parliamentary elections in 2012.

Although new parliamentary elections in Autumn 2012 did bring power to the former opposition, the results for the Homeland Union and Lithuania's Liberal Movement were not significantly worse than during the elections of 2008, with the former getting 33 seats (down from 46), becoming second largest faction in parliament, and the latter earning 10 seats (down from 11). But they lost both smaller coalition partners, which did not pass the threshold to get into the parliament. The Lithuanian Social Democratic Party increased the number of its seats by 13, getting 38 after the 2012 elections to become the biggest political group in parliament and the main actor in the new centre-left coalition. The coalition was also joined by the Labour Party, which increased its presence to 29 seats (from 10), despite being on trial for shadow accounting and tax evasion, followed by the Law and Justice Party with 11 seats and the Lithuanian Polish Election Action (with 8 seats, enough to establish its own faction for the first time).

Conclusions

The main reason for the sudden drop in Lithuania's economy was the vulnerability that was created first of all by extremely pro-cyclical fiscal policy during the period of economic boom from 2004 to 2008. This left the 2008-2012 government very little room for manoeuvre when fiscal consolidation had to be undertaken, and it was already too late when the process was started because the parliamentary elections of October 2008 prevented a timely reaction. More accurately, because of the elections budgetary expenditures increased even more in 2007 and early 2008 without leaving any reserves for the "bad times".

This newly formed government had to act as fast as possible in the context of the economic situation and market sentiment deteriorating every week. It drafted a package of laws, most of which focussed on cutting budget expenditures and some on tax increases. It undertook a number of rounds of fiscal consolidation measures, while in parallel initiating structural reforms in the areas of higher education, energy and public administration. Its fiscal adjustment soon brought results by bringing down borrowing costs and receiving approval from rating agencies and international organisations. Its record on structural reforms was mixed at best, with a lot of muddling through coalition politics, bureaucratic inertia and resistance from vested interests. Although its guiding principle was using the crisis as a window of opportunity for reforms, it did not really succeed in connecting the fiscal consolidation and structural reform processes.

Although the 2008-2012 government earned a lot of praise from the IMF and EU institutions for the results of its fiscal consolidation, its policies were not so well appreciated by the domestic public and voters in the parliamentary elections 2012, who confirmed a well know argument that you cannot win elections by undertaking unpopular reforms, even though some reforms were actually only limited to political rhetoric. Most likely the majority of voters could not really perceive a direct connection between preserving the fixed exchange rate of the national currency with respect to the euro on the one hand and fiscal consolidation measures, such as cutting wages, pensions and increasing taxes, on the other. While the former was strongly supported by the majority of citizens, the latter was strongly opposed by the majority of them. Therefore, the elections of 2012 brought to power a centre-left coalition led by the Lithuanian Social Democratic Party, many of whom, for example the Minister of Finance, were in the 2006-2008 government, which was reluctant to initiate any anti-crisis measures in advance.

The main issue that remains to be addressed in the future is whether or not the changes made and outcomes achieved by the previous government will remain sustainable. The new government contested many of the decisions of the previous one, but it was very cautious with any new reforms after assuming office. It seems

to continue the general trend of reducing and maintaining a budget deficit below 3% of GDP, but this is mostly linked with the objective of introducing the euro in 2015. It is not clear whether it will manage to accumulate a surplus if the economy continues growing. Therefore, there might be a painful repetition of the same pro-cyclical story again when the next economic decline unravels. The new government is debating the undoing of higher education reform and unsure about continuing public administration reform. It scaled back its ambition to improve the efficiency of state owned enterprises and planned only EUR 60 million of dividends in 2013 (by November 2013 revenues were EUR 14 million lower than planned). It is also not really clear about how to increase employment and attract people from the shadow economy or from abroad, especially Lithuanians who left the country. So, ultimately, the question of sustainability remains political.

Estonian Economic, Social and Political Developments in the Years of Financial Crisis and Austerity, 2008-2011

Viljar Veebel

The developments, choices, dilemmas and achievements of the Baltic States and Visegrad countries in the years of financial crisis (2008-2011) offer both valuable practical experience and academic inspiration for research. These countries, while following similar goals and paths between regaining independence and accession to the European Union (EU) in 2004, have chosen in many aspects different priorities after the EU accession, which led them into different situations at the beginning of global financial crisis in the year 2008.

Comparative regional research on financial, economic and social stress management during the crisis in 2008-2011 is extraordinarily interesting, as it includes a set of very similar states historically and economically, but these states chose rather different strategies in 2008-2011 to solve the crisis. The financial crisis management experiences in the Baltic States and Visegrad countries also offer bases for theoretical analysis in terms of transition models and strategies, as the region consists of countries following the shock-therapy model, like Estonia and Latvia, and countries following a model of gradual adaptation, like Lithuania or Poland.

From the Estonian perspective, financial crisis management provided the valuable possibility to research the social and political reaction to the “broken hopes” of long term stability and economic growth, which was expected to arrive after Estonia’s accession to the eurozone and Schengen visa-free regime as a reward for years of reforms and efforts.

Estonia’s path through the financial crisis in the years 2008-2011 was in many aspects different from the rest of the Baltic States, the Northern countries and the Visegrad countries, as during the process of fiscal stabilisation, Estonia also set the goal of fulfilling the eurozone accession criteria (the Maastricht criteria) and joining the eurozone. This additional demanding goal defined clear limits to the stabilisation and rescue strategies during the hottest stages of crisis. As a result, Estonia was one of the rare societies in the EU and the eurozone where austerity was chosen to combat the financial crises, and this led to strict austerity measures in the years 2009 and 2010.

But the final costs of austerity and financial stability were even higher, as joining eurozone forced Estonia to participate in financial stability mechanisms and bail-out programmes. Accordingly, the Estonian experience is valuable from the wider future perspective of the European Union and eurozone, as it offers experience and answers as to whether extreme austerity is an efficient solution to

counter a financial crisis, the economic and social costs it includes, and the best practices when implementing austerity.

The following chapter will focus on three main questions: first, what were the main expectations, choices and dilemmas for Estonia in the beginning of the crisis in 2008; second, how was financial, economic and social consolidation achieved during the crisis; and third, what are the long term social and economic consequences of budget cuts and foreign banks' protective actions during the crisis in 2008-2011.

Economic developments: broken hopes, choices for fiscal consolidation and actual economic outcomes

How did the financial crisis start in Estonia and what was specific about Estonian choices when looking for financial and economic consolidation?

In the Estonian case, as was quite similar for all three Baltic States, the starting point and the amplitude of the crisis were influenced by the interlinked housing and credit boom, fuelled mostly by foreign-owned Swedish and Danish banks. The second complicating aspect was that through commercial bank ownership, in terms of loans and money supply completely Estonia was dependent on the Swedish krona and the Swedish Central Bank's (Riksbank) preferences and monetary policy.

The third aspect that gave the Estonian government and financial stability a high dependence on external factors was the currency-board system used by the Estonian Central Bank, which does not allow the government or central bank to regulate interest rates or the amount of currency in circulation and makes the monetary supply completely dependent on the foreign currency account balance. The problems of the Estonian economy are more evident when looking at the foreign trade balance and current account balance. For example a year before the crisis in 2007, the foreign trade balance was in deficit with -42.4% and the current account balance was in deficit with -15.9%.¹

As a result of these four components, at the starting moment of financial crisis the Estonian national fiscal system was very open to external factors and the national government was able to regulate it only by tax-policy and the governmental budget.

Estonian choices during the first years of crisis were in many aspects dependent on choices made by the private sector and choices that the government made a year before the crisis. In the year 2007 the Estonian economy was speeding up – GDP was growing 7.5% on a yearly bases (while growth was mostly based on an

¹ Bank of Estonia, *Estonia's Economy in 2012* (2013), <http://statistika.eestipank.ee/?lng=en#listMenu/1017/treeMenu/MAJANDUSKOOND>

increase of local consumption and real estate loans), government debt was only 4.4% of GDP (which is one of the lowest rates in the EU) and the government was also saving special reserves in case of a future economic crisis. Concerning these circumstances, the planned state budget for 2007 was very conservative, with a foreseen income of 4.85 billion euros and planned spending of 4.21 billion euros, resulting in a respectable positive balance.²

Actual results were also impressive as budget income reached 5.23 billion euros while costs stayed at the level of 4.85 billion euros. This encouraged the Estonian government and parliament to plan the next budget for 2008 with far more optimism.

The state budget for the year 2008 was the biggest in Estonian history, with a planned amount of 6.14 billion euros, which was 900 million euros more than actual revenues the year before.³

While government and public sector were optimistic, the first problems were already coming in the private sector, in parallel with the global financial crisis causing a liquidity squeeze, the Estonian private sector's debt reached 110% of the GDP⁴; as a result, in the first quarter of 2008 commercial banks started to restrict real estate based loans and close business credit lines for private sector clients. Foreign direct investments (FDI) dropped from 2 billion euros in 2007 to 1.2 billion euros in 2008. This led to a fast drop of the GDP in 2nd quarter and a decrease of budget revenues.⁵ This banking sector decision triggered the next cycle of the crisis, as tax revenue dropped and as a result the government was unable to fulfil its planned obligations in terms of social services, contracts and salaries; this also reduced consumption, which again reduced both the government's tax revenues and the profits of commercial banks. As a result, the purchase power and loan service capability of the private sector was dropping even more and foreign owned banks started to additionally reduce risks by withdrawing their assets from Estonia – then the real estate market started to drop, which fuelled the crisis even more. Due the crisis, demand in export markets was also dropping in 2008 and 2009 and many former successful Estonian exporters, especially in the agricultural and construction material sectors, turned their attention towards EU subsidies and support programmes.

When government realised the amplitude of crisis, a budget reduction was legislated by parliament on 19 June 2008, reducing the cost for the rest of 2008 by 384 million euros, which was almost 7% of the budget amount. But this was only half of that what was missing – eventually the 2008 budget reached only 5.3 billion

² Bank of Estonia, *Estonia's Economy in 2012*.

³ Ministry of Finance database on state budgets (2012), <http://www.fin.ee/riigieelarve-2012> and <http://www.fin.ee/riigieelarved-2001-20100>

⁴ Bank of Estonia, *Estonia's Economy in 2012*.

⁵ Estonian Central Office of Statistics, *Main Economic Indicators* (2013), www.stat.ee/main-indicators

euros in income, with 5.75 billion euros in costs.

In this case, the Estonian government acted exactly according to the theory described by Rubin⁶, whereby governments start with small cuts in terms of spending hoping that crisis is temporary, followed by unsuccessful attempts to grow revenues as the economic situation keeps worsening, then followed by forced and drastic cuts in terms of spending to overcome the budget deficit.⁷

When the time for drastic cuts arrived at the end of 2008, the Estonian government preferred the approach of making “across-the-board” measures⁸ instead of targeted cuts, as consensus was not reached on which sectors should be priorities during the cuts. The majority of the expenditure cuts were introduced as temporary, mostly with a length of 2 years.⁹

In terms of the long term crisis management strategy, the fundamental question for Estonian government was whether financial consolidation should be achieved by cutting costs, increasing revenues or simultaneously doing both. As fulfilling the eurozone criteria (the Maastricht Criteria) was a parallel goal to crisis stabilisation, Estonian political elite decided to choose the first option. As a result, the Estonian experience offers a valuable contribution also to fiscal consolidation theory, which has otherwise supported the opposite model of revenue based measures providing immediate gains (and if this not sufficient then reduce the costs).¹⁰

The tradition only to approve state budgets without a deficit was broken during the failing attempts to balance the governmental budget in the year 2008. The state budget for the year 2007 had a 2.4% in surplus (to the GDP), then year later it changed to a 2.9% deficit – of course when it is compared with the EU average deficit level in that period, which was 6.5%, then it was an exceptionally positive result. The reason for the budget deficit was not only stagnating incomes (5.2 billion euros in 2007 and 5.4 billion euros in 2008), but rapidly growing costs (4.8 billion euros in 2007 and 5.7 billion euros in 2008).¹¹

The Estonian government, while able to use special strategic crisis reserves (around 250 million euros), was unable to borrow from international markets because of high interest rates and also not allowed to go into deficit as the Maastricht criteria require a budget deficit of below 3%. To stop growing budget costs and the deficit, first the salaries of civil servants were reduced around by 15%-

⁶ Irene Rubin, „Retrenchment and Flexibility in Public Organizations” in *Fiscal Stress and Public Policy*, eds. Charles H. Levine and Irene Rubin (Beverly Hills: Sage, 1980).

⁷ Rainer Kattel and Ringa Raudla, “Fiscal Stress Management During the Financial and Economic Crisis: The Case of the Baltic Countries,” *International Journal of Public Administration* 36 Iss. 10 (2013), 732-742.

⁸ Christopher Pollitt, „Cuts and Reforms – Public Services as We Move into a New Era”, *Society and Economy* 32 Iss. 1 (2010), 17-31.

⁹ Government of Estonia, *State Budget Strategy 2009-2012* (Tallinn, 2008).

¹⁰ Harold Wolman and Barbara Davis, „Local Government Strategies to Cope with Fiscal Pressure” in *Fiscal Stress and Public Policy*; Craig S. Maher and Steven Deller, „Municipal Responses to Fiscal Stress”, *International Journal of Public Administration* 30, Iss. 12-14 (2007).

¹¹ Ministry of Finance Database on State Budgets (2012).

25% from the 4th quarter of 2008, and some state procurements were cancelled. A year later salaries of teachers and medical workers were also cut. Because of cuts and stabilising tax revenues, the deficit decreased in the year 2009 (-2.0% of GDP) and was avoided in 2010 (+0.2%) and 2011 (+1.2%).

Table 1. Estonia's main economic indicators in 2007-2012

	2007	2008	2009	2010	2011	2012
Production and consumption						
GDP in current prices (Bil. €)	16.07	16.23	13.76	14.32	15.95	16.99
GDP growth (%)	7.5%	-4.2%	-14.1%	3.3%	8.3%	3.2%
Industrial production change (%)	6.4%	-4.6%	-24.0%	22.7%	19.8%	0.3%
Consumer price index (%)	6.6%	10.4%	-0.1%	3.0	5.0%	3.9%
Unemployment rate	4.7%	5.6%	13.8%	16.9%	12.5%	10.2%
Average monthly wages (€)	724.5	825.2	783.8	792.3	839.0	887.0
Average monthly pension (€)	226.3	278.4	301.3	304.5	305.1	312.9
Government budget and debt						
Government's income (Bil. €)	5.23	5.42	5.48	5.61	5.89	6.43
Government's spending (Bil. €)	4.86	5.76	5.58	5.6	5.83	6.48
Government budget balance (%)	2.4%	-2.9%	-2.0%	0.2%	1.2%	-0.3%
Government debt to GDP (%)	4.4%	3.7%	4.5%	7.2%	6.7%	6.2%
Foreign trade and investments						
Foreign trade balance (%)	-42.4%	-28.6%	-12.1%	-6.0%	-5.9%	-9.7%
Current account balance (%)	-15.9%	-9.2%	2.8%	2.9%	1.8%	-1.8%
Foreign direct investment inflow (Bil. €)	1.98	1.18	1.32	1.21	0.24	1.18
Gross external debt (Bil. €)	17.40	19.02	17.20	16.41	15.25	16.62

Sources: Ministry of Finance¹² and Bank of Estonia¹³

Despite the budget deficit, the government coalition decided to raise the average monthly pension from 226 euros to 278 euros because of upcoming parliamentary elections. In the labour market there was no immediate negative effect in terms of employment as many companies hoped that the crisis would be temporary, so unemployment rose from 4.7% to 5.6% at the end of 2008.¹⁴

Quite unexpectedly, the first years of the financial crisis and economic pressure did not help the Estonian government to fulfil the Maastricht criteria in terms of the consumer price index (CPI). The necessary benchmark of 3% on an annual basis looked quite hopeless in 2007 when the CPI reached 6.6% and even worse in 2008 when the CPI reached a remarkable 10.4%.¹⁵

The drop in the GDP in the first year of crisis (2008) was mild, as in the first quarter of the year the GDP was still growing and the labour market was not yet

¹² Bank of Estonia, *Estonia's Economy in 2012*.

¹³ Estonian Central Office of Statistics, *Main Statistical Indicators of Estonia* (2013), www.stat.ee/main-indicators

¹⁴ Estonian Central Office of Statistics, *Main Economic Indicators* (2013).

¹⁵ Bank of Estonia, *Estonia's Economy in 2012*.

reacting to decreasing incomes. This was followed radical drop in 2009 as the GDP decline reached 14.1%.

The second year of crisis (2009) meant in many aspects that there was a new reality for Estonia in terms of salaries, GDP, CPI and governmental budget. While the GDP dropped by 14%, industrial production dropped even more, by a remarkable 24%. This also led to a drop of salaries (the average changed from 825 to 783 euros) and a fast rise in unemployment, which reached 13.8% at the end of 2009.¹⁶ Only pensioners were saved as the government decided again to raise the monthly pension to ensure political support among the older electorate.

No lesson was learned in terms of state budget planning, as the budget for the year 2009 was planned very optimistically with an estimated of 6.3 billion euros, which set a new record in terms of volume and later also a new record in terms of deficit, as in practice only 5.4 billion euros were collected. The 2009 budget was also the first budget after regaining independence that was already planned with a deficit (the 2008 budget was planned to be positive but ended in practice in deficit). As the situation was seen dangerous in terms of state finances, the Estonian parliament legislated in December 2008 a new law regulating civil servants' salaries as one of the main possible areas for austerity. Despite cutting salaries and high inflation, no public strikes or riots were initiated and the first strike took place in post crisis period (the teachers strike in 2012).

There were also a positive side to the crisis as the consumer price index dropped in 2009 to -0.1% and the budget deficit remained well inside the Maastricht criteria (2% deficit). The third positive effect was the further balancing of the foreign trade balance, where the deficit dropped from 28% in 2008 to 12% in 2009. Even more positive was the effect on the current account balance, where a 9.2% deficit in 2008 was replaced by a 2.8% surplus a year later.¹⁷

From 2010 the economy already started to recover slowly by showing a 3.2% GDP growth on an annual bases. Even more remarkable was the growth of industrial production (+22.7%). In terms of the central government budget some lessons were learned and changes were made. First, the costs were planned at a more realistic level, at 5.4 billion euros, and the budget was planned with a deficit of 320 million euros, which was not allowed by law in Estonia but was widely accepted by public. In practice everything worked out much better for government: the costs and revenues were precisely equal at the level of 5.6 billion euros.¹⁸

In 2010 the Estonian government also decided to save some budget assets by reducing payments into the second pension pillar by 50%. Stabilising the economy also caused a growth of CPI, which reached 3.0% on a yearly bases. With that, Estonia's

¹⁶ Bank of Estonia, *Estonia's Economy in 2012*.

¹⁷ Bank of Estonia, *Estonia's Economy in 2012*.

¹⁸ Bank of Estonia, *Estonia's Economy in 2012*.

level of inflation allowed it to fulfil the Maastricht criteria. As global financial markets and the European Central Bank offered more credit, the Estonian government also decided to cover part of its costs with additional debt, which led government debt to grow from 4.5% of GDP to 7.2%. The foreign trade deficit continued to reduce (from 12.1% to 6.0%), leading the economy to further balancing.¹⁹

In 2011, the crisis was already in many aspects left behind as the GDP was growing by 8.3% (in Latvia 5.5% and in Lithuania 5.9%). The growth of industrial production continued and reached 19.8%, the new highest level since regaining independence. In the 2011 budget the lessons of crisis were left behind and government costs started to grow again, reaching 5.88 billion euros. As the economy and tax revenues were growing, the government succeeded in avoiding a budget deficit by collecting 1.2% (of GDP) more revenues than spending in the same period. As government expenditures were growing alongside overall economic growth, the consumer price index also sped upwards to reach 5% on a yearly bases, which was the highest in eurozone.

The foreign trade balance remained at the same level as the year before – -5.9%. As a result of austerity and foreign commercial banks continuing capital outflow, gross external debt scored to a new lowest level during the period (2007-2011), at 15,249 million euros. Unemployment, after reaching its highest level the year before, started gradually to drop, stabilising at the 12.5% level at the end of 2011. Both salaries and pensions continued to grow; while the growth of pensions was more cosmetic (from 304 euros to 305 euros), average salaries were growing by 5%.²⁰

The year 2012 symbolised the end of crisis in many respects. First, GDP growth stabilized at the level of 3.2%, which was less than in Latvia and Lithuania. Second, summarised GDP reached a higher level than before the crisis in 2008. Also, the consumer price index showed some stabilisation at 3.9% (which was once again the highest in the eurozone)²¹.

The economy itself was turning towards consumption and an internal market as industrial production rose only 0.3% and the importance of services in the GDP increased. Positive experiences from 2011 transformed once again into an optimistic budget proposal for 2012, where planned revenues (6.12 billion euros) were over 10% smaller than planned costs (6.80 billion euros). Results at the end of year were much more balanced, as both revenues and cost were 6.4 billion euros.²²

From the positive side, foreign investors restored their interest and capital inflow to Estonia in 2008 (1.2 billion euros), but there is long way to reach the record level of 2007 (2 billion euros).

¹⁹ Bank of Estonia, *Estonia's Economy in 2012*.

²⁰ Estonian Central Office of Statistics, *Main Economic Indicators* (2013).

²¹ Bank of Estonia, *Estonia's Economy in 2012*.

²² Ministry of Finance Database on State Budgets (2012).

The unemployment level continued to drop, reaching 10.2% at the end of 2012, but this was also because of changes in legislation that restricted the possibility to register as unemployed.²³

Some negative aspects, however, appeared next to the government budget deficit: the foreign trade deficit increased to -9.7%, the current account also ran a deficit (-1.8%) and gross external debt grew from 15.2 billion euros to 16.6 billion euros. The growth of salaries and pensions continued: average salaries grew from 839 euros to 887 euros and the average monthly pension from 305 euros to 313 euros.²⁴

Accordingly, Estonia was very rapidly but intensely going through the stages of economic crisis – suffering one year of medium decline and one year of radical decline of the GDP, then one year of compensatory growth, followed by stabilised growth. If we analyse summarised GDP dynamics, then the impact and length of the crisis is even more visible as the level of GDP in 2007 was only re-reached again five years later in 2012.²⁵

In terms of economic indicators, the summarised changes to the economy and the main reasons for these were as follows:

Industrial production reacted to the crisis more than GDP: growth started to slow down in 2007 (+6.4%) and produced mild decrease in 2008 (-4.6%), which was followed by a remarkable negative in 2009 (-24.0%). The recovery of industrial production in 2010 and 2011 was also remarkably fast, at 22.7% and 19.8%.

The growth of industrial production was also influenced by a constant increase in the consumer price index, which was of central importance for Estonia to fulfil the Maastricht criteria and access the eurozone. CPI grew 6.6% in 2007 and 10.4% in 2008. During the highest GDP decline in 2009, the CPI did not fall but remained stable. Growth of CPI continued in 2010 and 2011 at the speed of 3% and 5%. The correlation between the crisis stages and CPI dynamics also did not appear in 2012, when GDP and industrial production changes were stabilised but CPI continued to grow 4% in a year.²⁶ The introduction of the euro in Estonia in 2011 also did not influence the CPI in a positive way, as CPI growth quickened and was one of the highest in the eurozone in 2011 and 2012. Taking a longer perspective, the summarised CPI during the 2007-2012 period reached 29%.

Average monthly wages reached to 724 euros in 2007, followed by more than 10% growth to 825 euros in 2008, a decline to 783 euros in 2009, small growth in 2010 to 792 euros and a 5% growth in 2011 to 839 euros, and finally a 5% growth

²³ Jaan Masso and Kerly Krillo, *Labour Markets in the Baltic States During the Crisis 2008-2009: The Effect on Different Labour Market Groups*, University of Tartu, Faculty of Economics and Business Administration Working Paper No. 79 (2011).

²⁴ Bank of Estonia, *Estonia's Economy in 2012*.

²⁵ Estonian Central Office of Statistics, *Main Economic Indicators* (2013).

²⁶ Bank of Estonia, *Estonia's Economy in 2012*.

in 2012 to reach its final level of 887 euros.²⁷ Accordingly, the summarised growth of wages during the period was 22.5%, which looks reasonably good before it is compared with Consumer Price Index growth in the same period, which reached 29%. As a result, the average salary receiver lost 1% of their purchase power every year from 2007-2012.

What differed in the Estonian wage correction process and dynamics from the other Baltic States was that at the beginning of the crisis Estonia's public sector salaries were higher than private sector salaries (in 2007 Estonia's public sector average salaries were 108% of private sector salaries, while in Latvia this indicator was 76% and in Lithuania 93%). In 2008, when salaries were still growing, this indicator reached 106% in Estonia, but dropped fast in 2010 to 96% and stabilised at 98% in 2010. In Latvia, the process was the opposite: in 2008 public sector salaries grew to 78% level compared to private sector salaries, in 2009 growth continued to 86% and in 2010 to 91%. Lithuania was following a more similar pattern to Estonia: from 93% in 2007, the public sector salaries dropped to 85% of private sector salaries in 2010.²⁸

Despite the drop in the GDP and the fluctuations of average monthly gross wages, the average monthly pension continued to grow at a remarkable speed even in the years of crisis, rising in 2008 by more than 23% and in 2009 by 8% (see table 1). The growth of pensions also continued in 2010, 2011 and 2012 but in an average range 1% in a year. As a result, the average monthly pension has in the same period grown by 38%, which is 9 percentage points more than the growth of the CPI. This indicates from the one hand how important pensioners as voters were for coalition parties but on the other hand it caused the fast growth of pension costs in the state budget.

To the Estonian labour market, the influence of crisis was evident: when in 2008 the unemployment rate was 5.6%, in 2009 it already reached 13.8% and continued to grow, reaching 16.9% in 2010. In 2011, when crisis started to ease, unemployment dropped to 12.5% and continued to fall, reaching 10.2% in 2012. With that result, Estonia found itself at the end of 2011 exactly at the average level of eurozone employment.²⁹

The foreign trade balance showed impressive deficit in 2007 (-42.4%). The high foreign trade deficit during the boom years (2004-2007) was caused by the growth of import goods, while former exporters also tended to re-orient to internal markets. The deficit in the area of goods was compensated by a surplus in the area of services and capital. In 2008, the situation improved slightly, as commercial banks started to decrease loan opportunities – the foreign trade deficit was reduced

²⁷ Bank of Estonia, *Estonia's Economy in 2012*.

²⁸ Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis: Early Application of Fiscal Austerity Measures" in *Public Sector Shock. The Impact of Policy Retrenchment in Europe*, ed. D. Vaughan-Whitehead (Edward Elgar, 2013).

²⁹ Jaan Masso and Kerly Krillo, *Labour Markets in the Baltic States During the Crisis 2008-2009...*

to -28.6% and the current account balance to -9.2%. As a result of the constant trade deficit and capital inflow to compensate for it, the private sector debt reached 100% of the GDP in 2008. In 2009, foreign trade started to balance as the deficit was reduced to -12.1% and the current account balance had a 2.8% surplus. This positive trend continued in 2010 and 2011, when the foreign trade deficit dropped to -6.0% and then -5.9%. Also, the current account balance continued at a positive level, with +2.9% in 2010 and +1.8% in 2011.³⁰ Accordingly, at least in the area of trade deficit and private debt dynamics, the financial crisis had a stabilising role.

Foreign direct investment (FDI) inflow, which had its peak in 2007, dropped by 40% on a year-to-year bases in 2008, but grew again to 12% in 2009. It was followed by a 9% decline in 2010 and an extraordinary 80% decrease in 2011. These fluctuations can be explained by the nature of FDI to Estonia, which was at the first level targeted at recapitalising the local branches of foreign banks and at the second level used mainly to finance real estate purchases. When loan conditions for real estate hardened during the crises, fewer loans and less capital was offered or needed.

In terms of governmental budget discipline and long term debt, Estonia was doing very well in comparison with the other EU and eurozone member states. One of the main reasons for this was that after regaining independence Estonia has mainly been governed by right-wing coalitions, and the principle of limited government has been constantly followed. Compared to the Central European states (Poland, Hungary), Estonia (as well as the other Baltic States) introduced relatively small public sectors with basic service provision (34.3% in Estonia, 27.5% in Latvia and 27.4% in Lithuania in 2010). The Estonian government sector is in fact one of the smallest in terms of GDP in the OECD.³¹

The government's budget discipline has been dependent on GDP growth or decline, but has still fit well inside the 3% mark, both in terms of surplus and deficit. The most positive was situation in 2007, when the budget had a +2.4% surplus, which was followed by -2.9% in 2008 and -2.0% in 2009. The situation improved again from 2010, with a budget surplus of 0.2%, and it reached the level of 1.2% in 2011. Quite unexpectedly, in 2012, when economy was already stabilising, the budget went into deficit again. However, even in 2009, which marked the deepest point of the crisis, Estonia met the Maastricht criteria and the fiscal balance again turned positive in 2010. During the crisis, defence costs and pensions were seen as a priority and were never reduced in the governmental budget. As result, at the end of 2011 Estonia had (alongside Poland) the highest military cost per capita in the EU.

Tax revenues were growing during the years of crisis – starting from 31.5% of GDP in 2007, the tax percentage grew to 31.8% in 2008 and to 35.8% in 2009

³⁰ Jaan Masso and Kerly Krillo, *Labour Markets in the Baltic States During the Crisis 2008-2009...*

³¹ Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis...", 46.

(falling slightly to 34.3% in 2010). While this level is significantly lower than the EU-27 average (39.6% in 2010) it is higher than tax levels in Latvia (27.5% in 2010) and Lithuania (27.4% in 2010). Also, the trends in both southern Baltic States and Europe-27 have been different from Estonian choices – while the Estonian government grew the tax share in terms of GDP, the EU-27 kept it stable, and Latvia and Lithuania were able to reduce it.

The crisis did not have a remarkable influence on Estonia's government debt, which increased only from its lowest level of 3.7% in 2008 to 6.2% in 2012, but this remains very low compared to the eurozone average³², which was 90% of GDP in 2012. Latvia and Lithuania again chose a different strategy than Estonia by growing their external debt fast (from 10% to 44% of GDP in Latvia and from 17% to 38% of GDP in Lithuania from 2007-2010) to cover decreasing tax revenues. It was possible to maintain low indebtedness in Estonia thanks to the fiscal reserves that were accumulated during the boom years, and as a result Estonia managed its way out of the crisis even without issuing governmental bonds. The effect on Estonia's public finance was also softer than in Latvia or Lithuania, as Estonia did not need to help or bail out national commercial banks.³³

Maintaining and increasing Estonia's investment grade was set as one main priority by the Estonian government during the crisis. At the end of 2011 Estonia had managed to keep an A1 rating by Moody's, AA-/Stable by Standard and Poor's and A+/Stable by Fitch (which was better than Italy's grade and equal to Spain's grade). Estonian grades have also been higher than the grades of its Baltic neighbours, which both scored in the range of BB+/BBB. Despite its efforts Estonia never joined the countries with triple A AAA rating, symbolising balanced state finances and a stable economy. In the scoreboard of economic freedoms, Estonia gradually lost its positions during the years of crisis, mainly as tax regulations were developed to a greater level of complexity, and was located in position 14 at the end of 2011. In the global competitiveness index Estonia held 33rd position, being in this category the best country among 5th and 6th accession round newcomers.

To conclude, in the 2008-2011 period, the fiscal consolidation measures in Estonia were designed in a non-targeted way and similarly the budgets of all ministries were cut – these were of a temporary nature and were removed when budget revenues started to grow again. The cuts were greater in areas of investment, training and research and less in the areas of salaries and infrastructural costs, mainly on the basis of practical rational needs, as salaries and service costs were better protected by long term contracts and laws. In terms of sustainability and long term growth, the optimal would have been the opposite distribution: by

³² Bank of Estonia, *Estonia's Economy in 2012*.

³³ Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis..."

cutting actual costs and salaries instead of research and investment.³⁴

Estonia's radical choice was justified by Minister of Finance Jürgen Ligi and Minister of Economy Juhan Parts as the only remaining practical influential tool, as Estonia was unable to raise the surplus of national currency and was according to law not allowed to have state budget with deficit. As a result, the Estonian government was using a pro-cyclic fiscal and economic policy, which tends to fuel economic growth in times of boom and hinder the economy even further in years of crisis. Despite heavy economic pressure during the years of crisis, no reforms were planned or implemented to avoid similar consequences during a future crisis.

Leading Estonian economists have during debate supported the government's decision to choose budget cuts instead of revenue based measures (tax-raise and borrowing). It was eventually seen as a better way as actual GDP decline was longer lasting than predicted by theoretical models, and in the hottest stage of crisis the Estonian government could only sell sovereign bonds in the market at fairly high interest rates, if at all.³⁵

How will the Estonian economy and fiscal stability develop in upcoming years? As of the year 2012, the years of fastest economic growth might be over for some period for Estonia, as the cost of labour and the cost of energy grew faster than productivity during the years of crisis. As a result, Estonian goods and services meet with harder competition in internal markets and globally. Also, the level of innovation and investments into technology have been at a low level when compared with the rest of the CEE countries. According to European Union's Multiannual Financial Perspective for 2014-2020³⁶, Estonia will year after year be more dependent on EU subsidies to continue its regional development and rural development projects.

But there are also several positive signs, especially in terms of public finance and debt. In 2012 Estonia's government debt was only 6.2% of GDP (the average in the EU is 90%) and the government budget had a minor (0.3%) deficit.³⁷ This will allow additional investments into innovation and knowledge-based production to increase productivity.

Have the fiscal and economic lessons of crisis been learned in Estonia? Estonia's fiscal situation has generally been regarded as relatively healthy due to the limited

³⁴ Rainer Kattel and Ringa Raudla, "Fiscal Stress Management During the Financial and Economic Crisis: The Case of the Baltic Countries..." .

³⁵ Raul Eamets, "Employment, Labour Market Flexibility and the Economic Crises in the Baltic States" in *Estonian Human Development Report 2010/2011* (2011); Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis..."; Karsten Staehr, *The Global Financial Crisis and Public Finances in the New EU Countries from Central and Eastern Europe*, Bank of Estonia Working Paper No. 2/2010 (2010); "Urmas Varblane: Me peame riiki nagu miljardäride klubi", *Postimees*, March 16, 2013, <http://arvamus.postimees.ee/1171472/urmas-varblane-me-peame-riiki-nagu-miljardaride-klubi>

³⁶ European Parliament, "Multiannual Financial Perspective", 2013, <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2013-0389&language=EN>

³⁷ Bank of Estonia, *Estonia's Economy in 2012*.

sovereign debt burden and strong commitment to a balanced budget, thus there is no direct need to consolidate public sector expenditure to improve the ability cope with a debt crisis³⁸. The main conclusion of the prime minister and the government coalition has been that Estonia was one of the most successful EU members in combating the financial crisis and no structural changes in terms of fiscal policy, economic policy or reserves are needed – and the other member states, especially the ones in a debt crisis, should learn from Estonia.³⁹

Some leading Estonian economists in this case held an alternative position, stressing that even when Estonia's fiscal and economic situation has generally been seen as relatively healthy, both before and after the crisis, due to the limited sovereign debt burden and the government's strong commitment to a balanced budget, there is no direct need to consolidate public sector expenditure to cope with a debt crisis. They stress that compared to Latvia and Lithuania, the Estonian public sector was in a better situation before the crisis due to previous reforms.⁴⁰

Social reactions and the impact of austerity in Estonia from 2008-2011: the price to be paid

When observing the impact of forced salary cuts on social security, almost non-existent social protection for long time unemployed people, big and growing migration numbers and one of the lowest male life expectancies in Europe, three questions arise. First, how many from these developments are directly or indirectly caused by the financial crisis and the need for austerity; second, what was the actual social and human price that was paid to be the country with the best fiscal balance and smallest debt in the eurozone; third, if this sacrifice came in form of austerity that was made to join the eurozone, has it or will it repay itself in terms of future welfare, stability and security.

During the radical economic decisions that took place from 2007-2011, social policy and social developments remained in many aspects secondary and were even seen as possible areas for cutting costs to rebalance the budget. The main decisions and changes concerned the salaries of civil servants and medical workers, unemployment conditions and parental benefits, which were created to encourage less wealthy families to have more children.

Despite the government's efforts, costs for social policy were also growing during the crisis, pushed by a quickly growing CPI and political promises to raise pensions every year. According to OECD data, Estonian social costs grow from

³⁸ Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis..."

³⁹ Andrus Ansip, Speech in Riigikogu (2012), <http://valitsus.ee/et/valitsus/peaminister-ja-ministrid/andrus-ansip/peaministri-koned-ja-seisukohad/71892/peaminister-ansipi-poliitiline-avaldu-2013.-aasta-riigieelarve-%C3%BCleandmisel-riigikogule.-27.-september-2012>

⁴⁰ Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis..."

12% of GDP in 2007 to 18% of GDP in 2011.⁴¹

When measured in the human development index (HDI), Estonia's human development has in nominal terms been in constant growth, including in the period of financial crisis from 2008-2011, increasing from 0.835 in 2007 to 0.844 in 2011. This ranked Estonia in 34th place among 187 countries (Estonia shared its position with Andorra) at the end of 2011, which was exactly same position as the year before, when Estonia shared the position with Malta and Cyprus. In 2009, Estonia was located six positions lower in rank, at 40.⁴²

Estonia achieved an improvement of six position in the HDI ranking during financial crisis, but a decline of three position since its accession into the EU. To put this development in a regional context: Latvia has improved by four positions during the crisis and has also improved by two positions since EU accession. Lithuania survived the crisis with an improvement of three positions and has progressed one position since accession into the EU. Finland has lost nine positions since the beginning of crisis and seven positions since 2005. With these results, Estonia is surprisingly the best survivor of the financial crisis in terms of human development, but the only Baltic State to have today a lower position than before the EU accession. The results however unexpectedly indicate that years of austerity helped Estonia to grow its human development rank faster than its Baltic or Nordic neighbours, while during the years of growth (2005-2009) the trend was opposite. It was also surprising that all three Baltic States improved their positions during the crisis, while welfare society Finland lost seven positions.

What was the impact of different HDI components on general HDI progress in Estonia, and which component had highest impact from austerity?

While the expected number of years of schooling and the actual years of schooling have stayed at the same level since 2005, the life expectancy, accessibility to medical help and Gross National Income (GNI) per capita have slowly grown, which helped the index to increase.⁴³ A UNDP report pays special attention to the fact that despite a high value of human development, high social inequality does not allow all members of Estonian society to enjoy it, as HDI adjusted for inequality is 9% lower than nominal HDI.

⁴¹ OECD, „Pro- and Anti-Social Behaviour” in *Society at Glance 2011: Social Indicators* (OECD Publishing, 2011)

⁴² Estonian Cooperation Assembly, *Estonian Human Development Report 2010-2011* (Tallinn, 2012), http://kogu.ee/public/eia2011/EIA_2011.pdf

⁴³ Estonian Cooperation Assembly, *Estonian Human Development Report 2010-2011*.

⁴⁴ Estonian Central Office of Statistics (2013), www.stat.ee/main-indicators

⁴⁵ Estonian Central Office of Statistics (2013), www.stat.ee/main-indicators

⁴⁶ Estonian Cooperation Assembly, *Estonian Human Development Report 2010-2011*.

⁴⁷ Estonian Cooperation Assembly, *Estonian Human Development Report 2010-2011*.

⁴⁸ Legatum Institute (2013), <http://www.prosperity.com/#!/?asperrorpath=%2Fcountry.aspx>

⁴⁹ Bertelsmann Transformation Index (2013), http://www.bertelsmann-stiftung.de/cps/rde/xchg/SID-049B7004-CB104567/bst_engl/hs.xml/307.htm

Table 2. Estonia's main social indicators and positions in international rankings 2007-2012

	2007	2008	2009	2010	2011	2012
Population (mil)	1,341	1,340	1,340	1,340	1,339	1,290
Life expectancy at birth (years)	73,4	73,8	74,3	74,6	74,9	76,2
Gini Index (equality in society)	0,309	0, 314	0,312	0,320	0,326	0,313
Satisfaction with socio-economic progress	56%	42%	42%	45%	28%	n/a
Rank in Human Development Index	37	31	40	34	34	34
Rank in Legatum Prosperity Index	n/a	n/a	31	35	33	35
Rank in Bertelsmann Transparency Index	6	6	4	4	5	5

Inequality in general has not been a central topic in socio economic debates among Estonians since regaining independence. During the years of economic growth, inequality (measured by the Gini index) was also growing, reaching a record level of 0.358 in 2006, but the number dropped sharply in 2007 to 0.309. In 2008 the index made slight increase to 0.315, dropped in 2009, continued steady growth in 2010 and 2011, and dropped again in 2012. While Estonian inequality has been high in comparison with its Nordic neighbours, during the years of crisis it was lower than the inequality index in Latvia, Lithuania or Poland.

According to official government data, 60% of the Estonian population was among 20% of the poorest EU population and in direct poverty risk at the beginning of 2012. At the end of 2011, Estonia's wealth level of 26,000 euros per capita was one of the lowest in the eurozone, being only higher than the Slovakian level, while reaching only 50% of the Slovenian level and 17% of the eurozone average.⁵⁰

One of the main components of HDI, life expectancy, has been one of the central variables pushing Estonian HDI down, and the impact of this has been growing during the 2007-2012 period. In the years of crisis, despite limited investment into the healthcare sector, life expectancy at birth has been gradually growing – from 73.4 years in 2007, it reached 74.9 at the end of 2011. One of the key components of Estonia's balanced budget and low social costs has been that men rarely lived to the pension age. There is 10 year difference between men and women: when women are expected to live 80.1 years, men can expect to reach only 69.8 years. This more than 10 year difference between male and female life expectancy is one of the biggest in Europe and has been explained by social expectations and role models, which was amplified even more during the years of financial crisis, as men felt the need to take responsibility and manage the risks both in families and in business.

But the process of ageing, which will quickly increase social costs and decrease Estonia's economic advantages, has already started and the dependency ratio (the number of working labourers divided by the number of pensioners) is rapidly

⁵⁰ Estonian Central Office of Statistics, *Main Economic Indicators* (2013).

growing and has already reached 50%. At the end of 2011, the population aged 15 and over accounted for 84.6% of the 1,294,455 permanent residents of Estonia. If this trend continues, 60% dependency will be reached in 2025, which will increase pressure on social costs in state budget.

The accessibility of medical help was one of the areas of social security where the impact of austerity was most measurable. In 2005, 171,700 persons were on a waiting list for medical help, while in the year 2011 waiting lists grew to 250,000 persons and in the year 2012 to 290,000 persons. The reasons for this are varied, but most were initiated directly or indirectly by the crisis and budget cuts. The first reason was the decision to cut all bonuses for doctors in 2008, which demotivated them to work extra hours and simultaneously motivated them to look for work in Finland and Sweden (in 2011, approximately 2.5% of specialised doctors left Estonia to work in Finland or Sweden). Migration trends emerged approximately a year after the start of the recession and peaked in 2011.⁵¹ This led to a decrease of offered medical services, which ironically met well with the government's wish to reduce the costs for medical help. While in the last fully financed year (2008) only 54 operations were declined due a lack of financial resources, in 2011 more than 2,000 patients were refused because of insufficient financial resources. To avoid negative reactions from taxpayers, official rules on healthcare waiting periods and prices were changed in 2009-2010. The maximum allowed waiting time was increased from four weeks to six weeks, the quantity of planned stationary services decreased by 4% and the reference prices for services decreased by 6%.⁵²

Migration has been one of the central topics in media debates concerning the effects of the financial crisis, austerity and the socio-economic future of Estonia. While the changes in statistics regarding a healthy life-time and life expectancy will not take place instantly, the dynamics of migration and the rate of suicides provides some feedback as to how satisfied or stressed permanent residents are. Economic reforms and social tensions have significantly reduced the population of Estonia – from regaining independence in 1991 until 2011 Estonia has lost approximately 15% of its population (this is approximately equal to population developments in Latvia, while Lithuania has lost less than 10% of its population since regaining independence).⁵³

During the years of crisis, social pressure started to influence migration (starting from the year 2009), when emigration grew 20% on a yearly basis. In 2010 this growth continued with the same speed and reached a remarkable 80% growth in 2012. As a result, in the 2007-2012 period the average net migration from Estonia was 7,000 people per year, which means there has been a loss of 0.75% of the population every

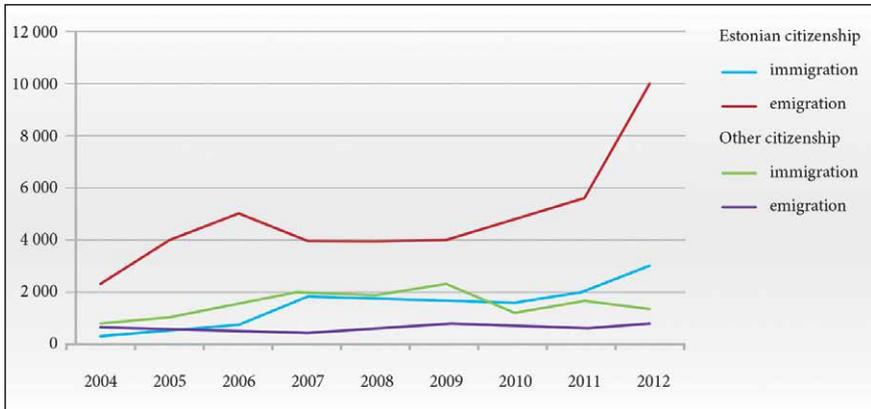
⁵¹ Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis...".

⁵² Jaan Masso and Kerly Espenberg, "Baltic States' Public Sectors During the Crisis...".

⁵³ Estonian Cooperation Assembly, *Estonian Human Development Report 2010-2011*.

year⁵⁴. This statistic is incomplete without the knowledge that approximately 50,000-60,000 Estonians work in Finland, Sweden and Norway on a temporary basis, but may not return if they are able to find a permanent job and acceptable living conditions. Growing migration, the lack of a labour force and concerns about competitiveness also sparked debates about immigration liberalisation to compensate the lack of labour in the areas of medicine and engineering.

Figure 1. **Migration from Estonia 2004-2012**



Source: Estonian Central Office of Statistics⁵⁵

The main destination countries of emigration for Estonians are Finland and the United Kingdom, while people immigrate to Estonia mainly from Finland and Russia. This trend has continued for the past five years. In 2012, the net migration level of Estonia was positive with regards to Russia and Ukraine, from whence more people came to Estonia than emigrated there. The net migration level with Finland and the United Kingdom was negative – a net total 4,000 persons in 2011 and 5,000 persons in 2012 emigrated to Finland and over a thousand more people emigrated in 2011 and 2012 to the United Kingdom than immigrated from there to Estonia.⁵⁶ By age, the most active participants in emigration were persons aged 20–44, who also accept the possibility for longer stays abroad. Estonian migration trends are similar to those in Latvia and Lithuania, where emigration has also intensified during recent years – the share of emigrants among citizens of the countries has increased.⁵⁷

⁵⁴ Estonian Central Office of Statistics (2013), <http://www.stat.ee/65371>

⁵⁵ Estonian Central Office of Statistics (2013), <http://www.stat.ee/65371>

⁵⁶ National Radio of Estonia, „Baltics Had Highest Population Shrinkage in 2012”, November 21, 2013, <http://news.err.ee/society/7c873c61-84e9-4493-a6d0-417ca3234a92>

⁵⁷ Estonian Central Office of Statistics (2013), <http://www.stat.ee/65371>

Is growing migration a sign of dissatisfaction with life in Estonia? According to Human Development Report⁵⁸ research, public support of Estonia's socio-economic progress was 56% in 2007, 42% in 2008 and 2009, started gradually grow in 2010, but dropped again to 28% in 2011.

The situation in Latvia and Lithuania has been more dynamic but the final results are more similar to the starting levels. In 2007, 39% of Lithuanians and 26% percent of Latvians were satisfied with their country's development. A year later support dropped dramatically in both states to 19%. The decline continued in 2009, when only 7% Latvians and 10% Lithuanians supported their country's progress. In 2010 public support started to grow in Latvia, and in 2011 Latvia reached the level of 28% of public support for the country's development. Public support in Lithuania also improved quickly in 2010, reaching 25%, but declined again for next year to 23%.

For the whole period the decline was biggest in Estonia, followed by Lithuania and Finland, while it stayed quite stable in Poland and there was a positive change in Latvia.

The Legatum Prosperity Index (LPI),⁵⁹ calculated since 2009, offers a view of socio-economic progress both based on actual material criteria and also the attitudes of the population during the years of crisis and austerity. Estonia was placed in 31st position in 2009 and moved into 35th position in 2012. According to Legatum reports for 2011 and 2012, the main strengths of Estonia were in the areas of entrepreneurship, governance and education, while the weakest areas were personal freedoms and the economic situation. While the country's southern Baltic neighbours were ranked lower than Estonia, than Finland achieved the rank of fourth in 2009 and the rank of seventh in 2012.

As seen, the LPI gives quite different view than the Human Development Index about Estonia's starting position and dynamics during the crisis years. First, the LPI ranked Estonia much higher than the HDI in 2009; second, when in the HDI Estonia improved its position by six places during 2009-2012, in the LPI Estonia lost four positions. The final rank in the 2012 report is very similar: the HDI ranks Estonia in 34th position and the Legatum Index in 35th position. While both indexes rank Estonia higher than its Baltic neighbours, the Legatum Index sees Poland as more developed than Estonia, while the HDI places Estonia higher.

In the Bertelsmann Foundation Transformation Index⁶⁰ (BTI), which evaluates transition countries in the areas of political stability and economic transition, all the Baltic States and Poland are also included. While the highest results in the Bertelsmann index were scored by the Czech Republic and Slovenia, Estonia has

⁵⁸ Estonian Cooperation Assembly, *Estonian Human Development Report 2010-2011*.

⁵⁹ Legatum Institute (2013), <http://www.prosperity.com/#/!/?asperrorpath=%2Fcountry.aspx>

⁶⁰ Bertelsmann Transformation Index (2013), http://www.bertelsmann-stiftung.de/cps/rde/xchg/SID-049B7004-CB104567/bst_engl/hs.xsl/307.htm

been showing stable performance – in between third and sixth place from 2005-2012. At the start of the financial crisis it was ranked sixth, and the country moved to rank four for 2009-2010 report, but dropped back one position a year later. While Latvia has stayed stable in position 12, Lithuania has dropped from second place to seventh.

While the European Commission has been very supportive of Estonia's fiscal decisions and progress, there has been much less support for the social consequences of these decisions.

In May 2012, the European Commission pointed out in its annual assessment on the Estonian National Reform and Stability Programme about Estonia's progress in 2011⁶¹ that social policy and social security is seen one of the most problematic areas, needing decisive reforms. High unemployment, especially long term structural unemployment, was seen as problematic, and special measures have been seen as necessary to avoid a growth in youth unemployment. The second evident problem seen both by the European Commission and also the Estonian public was the need to improve the inclusion of women in the workplace and reduce the salary gap (the gender salary gap in Estonia was biggest in the EU in 2010, according to Eurostat). The years of crisis, however, produced in these questions some progress – while the salary difference remained at around 30%, female employment was growing (especially in public sector), reaching 67% at the end of 2011.⁶²

What conclusions have been made in Estonia after the crisis years, and what will be the main focus points in terms of social security and development?

Before the parliamentary elections in 2011, the government coalition (which later continued to be on power) produced some new social promises, of which one quite remarkable promise has already found its way to practice – universal unpaid higher education is replacing the previous combined system of state funded and free higher education from autumn 2013.

The main aim of this reform was to achieve the goal of 40% of the Estonian labour force will having higher education by the year 2020. Reforms to raise education and innovation are needed, as the Global Competitiveness Index ranks Estonia based on education quality at 49th place in world, which is remarkably lower than Estonia's position in the HDI or in Legatum Prosperity Index.

In terms of longer socio-economic developments, problems seem more evident, as the previous socio-economic advantages of Estonia are slowly disappearing and the rising cost of energy and shrinking labour force will put growing pressure on the economy and social system. Also reform is needed to counter the drop in the quality of primary education because of a lack of finances in regional and rural areas.

⁶¹ Parliament of Estonia, *Stenogramm*, June 6, 2012, <http://www.riigikogu.ee/?op=steno&stcommand=stenogramm&pkpkaupa=1&toimetatud=0&toimetamata=1&date=1338980464&paevakord=10520>

⁶² Parliament of Estonia, *Stenogramm*, June 6, 2012.

Political developments in Estonia from 2008-2011: the development of a national EU-policy and the impact of crisis on internal policy

The transformation of Estonia's EU policy in the years of financial crisis and austerity. Estonian policy in the pre-crisis years of the EU membership (2004-2007) can be described as exhibiting active political participation to promote Estonian and European growth, competitiveness, deregulation and a liberalisation of the internal market, with the aim to allow member states to use their specific economic advantages and use their national resources. Even when it was in some aspects a bit optimistic, it was definitely active and participatory. In the years 2004-2007, the Estonian political elite did not show support for growing subsidies and to solidarity to the non-competitive economies of some member states. Estonia was also a supporter of the Growth and Stability Pact and a growth of research and development investments.⁶³

The Estonian political line in terms European policy started to gradually change in the second half of 2008. Previous ideas on liberal competitiveness, a full-market economy and “own-responsibility” were replaced with the importance of solidarity, the unavoidability of market regulations and providing additional support to rural and regional funds and subsidies. In practical terms this resulted in full support of the European Financial Stability Mechanism (EFSM) in May 2010, the Greece Loan Facility (GLF), and European Financial Stability Facility (EFSF) in May 2010, and later also the European Stability Mechanism (ESM) in September 2012. Estonia's new approach was based on ideas of common-family and shared responsibility, which was in clear opposition with its previous positions of own-responsibility and market-rules.⁶⁴ The government also adopted the approach that more integration and more federalisation is in interest of small member states like Estonia, and therefore the Estonian government supports European Union federalisation. At the same time, Estonia's ability to actively represent its interests and special needs at the EU level did not increase during the years of austerity.⁶⁵

This change of political lines in terms of fundamental values and principles was reasoned and justified with the following four reasons:

- a) The need for full political support among member states before acceptance into the eurozone;
- b) A desire to get better funding from structural funds in next financial;

⁶³ Government of Estonia, *Estonian EU Policy 2004-2006* (2004), https://valitsus.ee/UserFiles/valitsus/et/riigikantselei/euroopa/eesti-eesmargid-euroopa-liidus/eesti-euroopa-liidu-poliitika-2007/Valitsuse_Euroopa_Liidu_poliitika_2004_2006.pdf

⁶⁴ Government of Estonia, *Estonian EU Policy 2007-2011* (2007), https://valitsus.ee/UserFiles/valitsus/et/riigikantselei/euroopa/eesti-eesmargid-euroopa-liidus/eesti-euroopa-liidu-poliitika-2007/ELPOL_2007_2011.pdf

⁶⁵ Viljar Veebel and Ramon Loik, “Estonia: Life in Post-Communist Eastern Europe after EU Membership” in *Life in Post-Communist Eastern Europe after EU Membership* (Routledge, Taylor & Francis Group, 2012).

- c) The understanding that financial solidarity might be one day needed by Estonia;
- d) A lack of hope that the existing model of rural and regional subsidies can be changed in the near term.⁶⁶

One of the central reasons for the value-shift was that since the EU accession in 2004, the Estonian economy and state finances were gradually but increasingly becoming more dependent on the finances and support of structural funds. Some leading Estonian economists even claimed that the central government, local governments and many companies are too dependent on EU programmes and subsidies instead of trying to improve innovation and exports, as at the end of 2012 the percentage of EU funding in the governmental budget grew to 22%.⁶⁷

This has also forced the Estonian government to be more supportive of the European Commission's and European Central Bank's positions when negotiating the terms of Estonia's participation in financial stability frameworks. Both Prime Minister Andrus Ansip and President Toomas Hendrik Ilves often liked to comment that Estonia receives every year from the European budget four times more money than it contributes into the common budget, and therefore has no moral right to question the terms of solidarity programmes. This dependency is about to become even bigger for next financial period (2014-2020), as Estonia is planning to receive 5.8 billion euros in subsidies from the EU budget.⁶⁸ In return, Estonia has in the frameworks of the ESM and the EFSF already given guarantees in the amount of 2.99 billion euros and made payments in the amount of 148 million euros, which has also given the Estonian government 0.18% of votes in both financial stability institutions.

As Estonian priorities in terms of regulations, subsidies and solidarity were changing from 2007-2009, this also led to changes in Estonia's main European coalition partners. The previous deep partnership with the United Kingdom, Denmark and Ireland, based on liberal values, was forgotten and replaced by a partnership with Germany and Belgium as the main supporters of federalisation and deeper integration. The financial crisis and the process of stabilisation has also changed the Estonian relationship with its regional neighbours: Latvia, Lithuania, Finland and Sweden.

In 2007 Estonia welcomed the conclusions of the European Council, calling on the European Commission to develop a Strategy for the Baltic Sea Region, but only two years later Estonia focussed its efforts on the Maastricht Criteria, not many common interests were found with its regional partners and neighbours: Latvia was fighting with debt and the economic crisis, Lithuania chose the slow way to the

⁶⁶ Government of Estonia, *Estonian EU Policy 2007-2011*.

⁶⁷ "Urmas Varblane: Me peame riiki nagu miljardäride klubi".

⁶⁸ Government of Estonia, *Estonian EU Policy 2011-2015* (2011), http://valitsus.ee/UserFiles/valitsus/et/riigikantselei/euroopa/Eesti%20EL%20poliitika_EST.pdf

eurozone, Sweden was following its own monetary interests and Finland, the only regional member in the eurozone, was one of the few hard-liner troublemakers in terms of the financial solidarity mechanism.

Estonia's combined efforts in terms of budget balance, government debt, and support for deeper fiscal integration and financial solidarity have not been left without positive feedback from the European Commission and European Central Bank. Estonia is one of three eurozone member states (next to Finland and Luxembourg) which has from 2007 up to 2012 fulfilled the Maastricht criteria in terms of budget deficit and central government debt (but not in terms of CPI). Accordingly, Estonia has received very few critiques, guidelines and suggestions from the European Commission and European Central Bank. The European Commission also strongly supported Estonia in continuing austerity, strict budget balancing and using its special reserves for extra payments to the EFSF and the ESM.

When the government coalition was united and committed in terms of deeper European financial solidarity, eurozone crisis initiated an open debate among Estonian society about weather countries which have fulfilled the Maastricht criteria with the cost of austerity and social pressure (like Estonia and Finland), should bail out the member states in a debt crisis – countries which quite often have a better living standard. Other central questions were whether the chosen measures will solve the crisis or only postpone it and whether the financial stability mechanism is balanced in terms of payments and votes that Estonia receives in exchange.⁶⁹

Debates in the Estonian media on the financial crisis and solutions have also been concerned with the destiny of other Baltic States and Visegrad countries. The hottest debates were about the budgetary and legal choices of Latvia and Hungary. Both were in some cases used as examples of what can and will happen to countries which are not loyal member states of eurozone.

To conclude: As public support for integration and the European Union was high and stable in the years 2008-2011, the political elite understood it as a mandate to follow the EU's official recommendations on crisis management – austerity at home and solidarity with indebted member states at the European level. One of the central arguments was that in the 2007-2013 period approximately 3.4 billion euros from the Structural Assistance Fund was allocated to Estonia, so even if we need to pay 150 million euros to the stability mechanism this is less than 5% of Estonia's earlier gains. Finally, there was not too much dialogue between the officials from the government, critical academic thinkers and newspaper columnists, as each group preferred to remain inside its own comfortable paradigm.

⁶⁹ Viljar Veebel, „0,18 protsendine hääleõigus”, *Postimees*, April 23, 2013, <http://arvamus.postimees.ee/1211962/viljar-veebel-0-18-protsendine-haaleoigus>

Impact of European dimension to Estonian internal policy

What has been the impact of the financial crisis and austerity on Estonian election results and coalition building? In terms of internal public support for parties and political activity, the preferences of electorate have not been very significantly influenced by the economic and social pressure of the financial crisis and austerity. The impact on the ruling coalition of the Reform Party (liberals) and Pro Patria Res Publica Union (national conservatives) in some aspects is passively negative but is generally supportive, which has resulted in the fact that Estonian Prime Minister Andrus Ansip is longest-lasting active head of government in the European Union, having served as prime minister since 13 of April 2005.

The first elections during the crisis period were European Parliament elections in May 2009. The influence of the Russian speaking minority, who in Estonia can only vote in European Parliament elections and in local elections, on the results and dissatisfaction with the ruling coalition was quite evident. The leading force behind the parliament opposition and a main supporter of Russian speaking minority privileges, the Estonian Central Party, collected 26,% of votes and two seats, missing a 3rd seat very narrowly. The second best result, with 25.8%, was scored by independent protest candidate Indrek Tarand, in opposition to all the traditional ideologies and parliamentary groups.

The leading party of the national coalition, the Estonian Reform Party, received the 3rd best result with 15.3%. The second member of the national government, The Pro Patria and Res Publica Union, collected 12.1% of votes and one seat. The last seat in the European Parliament was collected by the Social Democratic Party, with 8.7% of votes.⁷⁰ The Social Democrats were the biggest losers of the 2009 European Parliament elections, because of the growing popularity of independent candidates and the loss of their main vote-magnet Toomas Hendrik Ilves.

The second year of crisis, 2010, was empty in terms of elections, but full with symbolical ratifications of treaties and amendments concerning European integration, financial stability and membership in stabilising institutions, which all influenced support for the coalition:

- On the 25th of November a protocol on transitional provisions annexed to the Treaty on the European Union, to the Treaty on Functioning of the European Union and to the Treaty Establishing the European Atomic Energy Community⁷¹ was amended.
- On the 9th of December an Agreement on the terms of accession of the

⁷⁰ Central Electoral Committee of Estonia, "Elections of European Parliament" (2011), <http://www.vvk.ee/varasemad/?v=ep09?lang=eng>

⁷¹ European Council, "Decision of 13 July 2010 in accordance with Article 140(2) of the Treaty on the adoption by Estonia of the euro on 1 January 2011", <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:196:0024:0026:EN:PDF>

Republic of Estonia to the Convention on the Organisation for Economic Co-operation and Development (OECD) was amended.⁷²

- Additionally, the European Council legislated a decision on 13 July 2010 on the adoption of the euro on 1 January 2011 by Estonia. On 25 March 2011 the Estonian parliament (Riigikogu) amended Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro.⁷³

The following year, 2011, national parliament elections were held in March, and public support had changed remarkably on the positive side for the coalition because of the financial crisis. The Estonian political elite was consensually following the official goals and values of the European Commission and European Central Bank. As the results of the 2011 elections show, this was also supported by a majority of the electorate. Following the end of hottest stage of the eurozone crisis, the electorate showed support for the prime minister and his Reform Party, which received 28.6% of votes and 33% of seats in the Riigikogu. Also, a second former coalition partner – Union of Pro Patria and Res Publica – grew its support base by receiving 20.5% of votes and 23% of seats. The coalition interpreted this as a sign of support for their pro-European political line and a mandate in terms of solidarity.

The largest winner of the Riigikogu elections was the Social Democratic Party, receiving 17% of votes and 19 seats, which was 9 seats more than in the previous Riigikogu. The main losers were the Estonian Green Party and the People's Union, both losing their previous representation of six seats and falling out of the Riigikogu⁷⁴.

Table 3. Estonia's election results for 2007 and 2011 Riigikogu elections

Party	Ideology	Year	Votes	% of votes and change	Seats in parliament
Estonian Reform Party	Classical liberalism	2007	153044	27.8% (+10.1%)	31 (+12)
		2011	164275	28.6% (+0.8%)	33 (+2)
Estonian Centre Party	Social liberalism	2007	143518	26.1% (+0.7%)	29 (+1)
		2011	134090	23.3% (-2.8%)	26 (-3)
Union of Pro Patria and Res Publica	Conservatism	2007	98347	17.9% (-14%)	19 (-16)
		2011	118023	20.5% (+2.6%)	23 (+4)
Social Democratic Party	Social democracy	2007	58363	10.6% (+3.6%)	10 (+4)
		2011	98302	17.1% (+6.5%)	19 (+9)
Estonian Green Party	Green politics	2007	39279	7.1% (+7.1%)	6 (+6)
		2011	21828	3.8% (-3.3%)	0 (-6)
People's Union	Agrarianism	2007	39215	7.1% (-5.9%)	6 (-7)
		2011	12192	2.1% (-5%)	0 (-6)
Russian Party in Estonia	Russian minority	2007	1084	0.2% (0)	0 (0)
		2011	5027	0.9 (+0.7)	0

Source: Central Electoral Committee of Estonia⁷⁵

⁷² Official Journal of Estonia, "Agreement on the terms of accession of the Republic of Estonia to the Convention on the Organization for Economic Co-Operation and Development was amended", https://www.riigiteataja.ee/akti/2241/1201/0005/Agreement_terms.pdf

⁷³ European Council, "Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro", <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:091:0001:0002:EN:PDF>

⁷⁴ Central Electoral Committee of Estonia (2011), "Parliamentary Elections 2011", <http://vvk.ee/past-elections/riigikogu-parliament-elections/riigikogu-elections-2011/>

⁷⁵ Central Electoral Committee of Estonia, "Results of Past Elections" (2011), <http://vvk.ee/past-elections/>

After the elections, a coalition was formed between the liberal Estonian Reform Party and the conservative Union of Pro Patria and Res Publica. Despite differing official ideological alignments, both coalition partners shared similar values, supporting liberal economic policies and a conservative social policy.⁷⁶

Political activity and changes of support for different political groups were influenced also by technical reform in 2010 – namely, the option for electronic voting in parallel to traditional voting. This reform increased participation especially among the younger, pro-technological generation.

At the same time, debates about voting and participation rights for non-citizens continued, although the actual situation where persons with a permanent living permit (27% of the population) can vote and participate in local elections and European Parliament elections but not in national parliament elections remained unchanged⁷⁷.

Conclusions

Among the CEE countries and the Baltic States, Estonia has often symbolised an open, innovative, liberal economy with low social costs, a balanced government budget and a low debt level. While the years of economic boom in 2004–2007 offered numerous temptations in terms of social spending and institutional investments, the following years (2008–2011) of pressure and austerity tested the hidden values of the political elite, the resilience of the economy and the preferences of population in the previously listed categories.

Real austerity, what Estonia tested in practice – causing shock therapy in social security – was something that some member states supported rhetorically, while themselves not following what was seen as an unreasonable and unsupported solution to the crisis by most of other member states. While outside the eurozone, Latvia and Hungary had the even more complicated task of budget stabilisation in front of them, inside the eurozone, the Estonian experience with extreme austerity and its long term consequences serve as valuable experience for other member states when preparing scenarios for future crises.

When the Baltic States were hit by the global financial crises their starting points and the strategies chosen for the fiscal consolidation were different. First, the aim to join the OSCE and the eurozone played an important role for Estonia when choosing its strategy, and in many respects it used different tools than its Baltic partners during the economic crisis. Second, the goal to join the eurozone was seen as a priority at any cost and fulfilling the Maastricht criteria seemed possible only through austerity and budget cuts. Third, there was both a political and social

⁷⁶ Viljar Veebel, *The Estonian Elections of March 2011*, EuPI Policy Brief (Sofia, March 2011).

⁷⁷ Central Electoral Committee of Estonia, “Electoral Act in Estonia” (2013), <http://vvk.ee/general-info/legal-acts/>

consensus that additional costs and loans would not be a part of the solution, as these would destabilise the situation. Fourth, Estonia was able to choose austerity as it had no pressure of long term government debt, no tradition of budget deficit and a low cost level for social services. During the financial crisis Estonia continued its previous practice as a hard-liner in terms of social security, but added to this the image of a committed follower of European solidarity.

One of the central variables that makes the financial crisis more complicated for Estonia (but is quite similar in Latvia and Lithuania) than for most EU member states was the ownership of the commercial banks (as the main suppliers of money and liquidity). First, the Baltic national governments had very limited influence and impact on foreign owned and securitized commercial banks. Second, being motivated only by their own economic interests and assets, foreign banks had low motivation to contribute to the general socio-economic stabilisation in the countries.

There were not too many regional partners and supporters of Estonia's austerity policy – especially in financial and legal terms, Estonia more closely followed the decisions and debates of Finland than its Baltic neighbours, as Finland and Estonia were the only states (next to Luxembourg) actually fulfilling the Maastricht criteria in 2010 and 2011.

Despite austerity and social pressure, no public interest or open opposition appeared against Europeanisation and fiscal solidarity: Estonia ratified the Lisbon Treaty in 2010, the EFSF Treaty in 2011 and the European Stability Mechanism Treaty in 2012 without any major public debate.

When looking at the cost of austerity, two problems arise, which will slow Estonian development in the upcoming years: first, the growth of unemployment (and especially structural unemployment); second, missing investment in the energy sector, which has resulted in the highest energy costs per person (in terms of GDP) in the EU.

At least at the governmental level no decisions from the austerity period have been regretted; according to the opinion of Prime Minister Andrus Ansip and Minister of Finance Jürgen Ligi, Estonia was one of the most decisive, moral and successful member states in solving problems during the crisis, and the other member states should learn from the Estonian model. But can Estonia's austerity experience serve as an example for the other eurozone members and newcomers? This is possible only for the countries that don't have a high level of government debt that needs renewing systematically and no tradition of a budget deficit. Among eurozone members only Finland and Luxembourg meet these central pre-conditions. The important question to answer before following Estonia's way of austerity is whether the measures taken have supported long term economic and social stability and growth, or lowered competitiveness and social security.

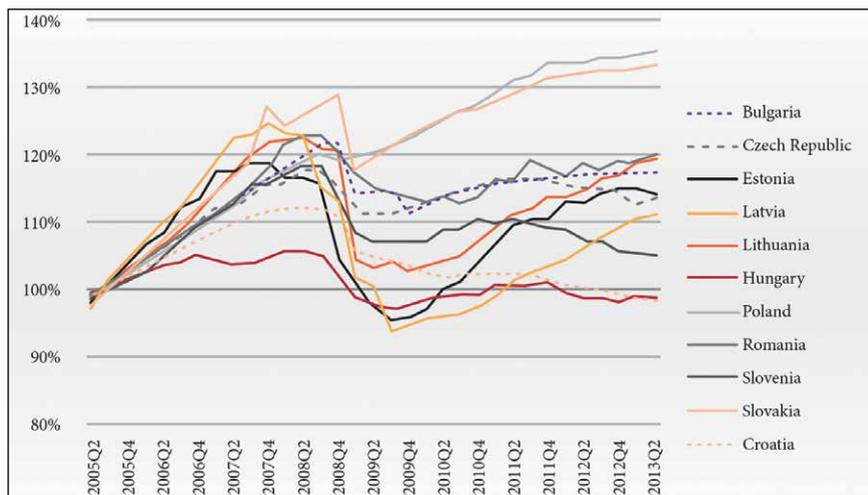
The Effects of the Great Recession on Hungary

Zoltán Pogátsa

The Great Recession affected Hungary through two major channels. One was the renewed focus on indebted nations after the collapse of global liquidity and yield hunting, which set in abruptly after the near default of Dubai. This constrained the market based refinancing capacity of relatively indebted states and necessitated the assistance of international financial institutions, with whom Hungary eventually developed a notoriously uneasy relationship. The other major impact was through poor macroprudential oversight that had enabled excessive household and municipal indebtedness in foreign currencies, primarily in euros and Swiss francs.

Hungary was unique amongst the new European Union member states that joined the bloc in 2004 – unlike the rest of the pack, it did not show significant convergence to the EU average even in terms of GDP per capita. While the real convergence of most of the other new entrants is also doubtful for a number of reasons, as arguably indicators such as disposable household income and employment have failed to converge across Central and Eastern Europe (CEE)¹, in the rest of the region the leading output indicator showed signs of catching up. Once the steam ran out of its post-transition economic recovery model, Hungary, star transition student of the nineties, entered a phase of economic stagnation. This enabled many of its partner countries to overtake it in terms of per capita output. It was in this already negative situation that the Great Recession hit the Hungarian economy.

Figure 1. The GDP growth of Central and Eastern European economies, 2005=100%



Source: Eurostat

¹ Zoltán Pogátsa, „Still an Iron Curtain: Competitiveness and Responses to the Global Economic Crisis in Central and Eastern Europe” in *Partnership for European Progress – Welche Wachstumsstrategien für Europa?* Conference Proceedings (Berlin: Das Progressive Zentrum, 2010).

The multinational foreign direct investment based model Hungary had pioneered in the former Soviet Bloc² had enabled the country to reduce the 80% debt burden it had inherited from the state socialist period to about 53%, well below the Maastricht criteria for the introduction of the euro, by 2001. This debt reduction was mostly a consequence of privatisation revenues being turned towards this goal. However, the transition model that had helped Hungary avoid a catastrophic (rather than simply a deep) transition-related recession began to expose clear weaknesses in the country around 2005-2006. This was not long after the rest of the region began to emulate the Hungarian model, which was based on a large inflow of FDI, having failed with domestically oriented privatisation. Hungary remained stuck in a low employment, low value-added, low wage corner of the European and the global economy. Essentially it became a low cost, low tax³, flexible labour market re-export base for the German⁴ economy within the framework of the single internal market. These features instilled long term structural weaknesses into the model that would have needed addressing. An upgrade would have involved improving productivity and employability by investing in human capital in order to raise added value.

Table 1. The structural weaknesses of the Hungarian economy: a low productivity, low wage, low employment economy

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real unit labour cost % (100%=2005) [Nama_aux_ulc]	100	98.6	99.3	98.5	97.8	94.9	94.6	94.1	91.7(f) SK:116.7(f) CZ:116.2 (f) PL:118.7(f) EU15:111.9(f)
Labour productivity per hour worked [tsdec310]	100	103.6	103.3	105.9	102.1	102.8	103.1	106	SK:123.2 CZ:112.9 PL: 124.1 EU15:n.a.
Employment rate [t2020_10]	62.2 EU27:68 CZ:70.7 SK:64.5 PL:58.3	62.6	62.6	61.9	60.5	60.4	60.7	62.1	EU27:68.5 CZ:71.5 SK:65.1 PL:64.7

Source: Eurostat

² Zoltán Pogátsa, „Hungary: From Star Transition Student to Backsliding Member State”, *Journal of Contemporary European Research* 4 (2009).

³ Except for taxes on wages, which necessarily became high because taxation on capital and property remained low, and the tax base was narrow because of the already mentioned low level of employment.

⁴ Necessarily, this is an oversimplification. Dutch, Austrian, Italian, Belgian, and other European direct investors also took advantage of low production costs, while for Japanese and US investors Hungary also offered EU country of origin status once they decided to manufacture and assemble in Hungary.

Indebtedness and relations with the IMF

Instead of the direly needed upgrade, however, the Hungarian political elite added midterm policy irresponsibility to the already existing longer term structural weaknesses. As a consequence of continued excessive fiscal deficits, the favourable debt trend reversed, and in a matter of no more than seven fiscal years it returned to the original level of above 80% of GDP by 2009, the beginning of the crisis. In terms of the fight against indebtedness, Hungary was back to square one, albeit with the fundamental difference that formerly state owned assets had now been sold, and privatisation income was no longer available as a means towards debt reduction. Leading Hungarian economist George Kopits dubbed the phenomenon “fiscal alcoholism”, while the Economist magazine called it the “worst mismanagement of any economy in post Socialist Europe”.⁵

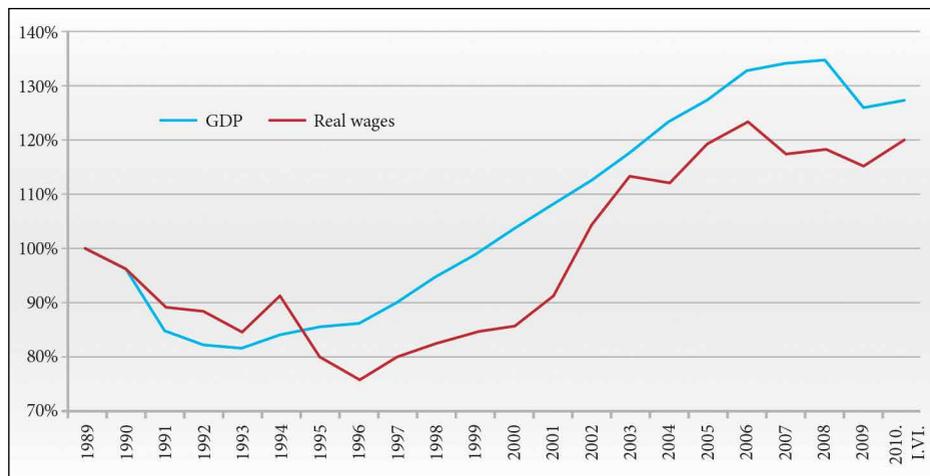
The process began with the 2002 election. The right wing Fidesz government lost the election in spite of election spending that ran contrary to the fiscal stability they had managed to achieve during their single term, when they ran primary surpluses. Spending was then expanded even further by the incoming Socialist Prime Minister Péter Medgyessy, who was hoping to win the local elections in the second half of that year. Together, the political opponents managed to create a 5% primary deficit for that year.

Prime Minister Medgyessy added another 5% of primary borrowing in the two remaining years that he was in office. He ran a theme entitled “welfare transition”, whereby he attempted to share some of the growth resulting from the restructuring-based recovery with households. This prompted the opinion-leading community of liberal economists to put the blame on him for indebtedness through his “reckless populism”. A more social democratic interpretation⁶ asserts that wages had fallen far behind GDP growth since the transition. Medgyessy was simply sharing some of that gain with households who had suffered the pains of transition.

⁵ *The Economist*, „Hungary’s Dreadful Politicians,” April 6, 2006.

⁶ Erzsébet Hanti, *A bérek közterheinek alakulása 1989-2010* (Budapest: MszOSz, 2011).

Figure 2. The growth of GDP and real wages in Hungary after the transition. Medgyessy's 'welfare transition' was very timely and can hardly be blamed on populism



Source: Hanti⁷, based on KSH

In 2004 the Socialist-Liberal coalition decided to replace Medgyessy with Ferenc Gyurcsány for political reasons. In 2005 he ran a 4% primary deficit in a non-election year, followed by a 5.5% primary⁸ and a shocking 9.3% secondary deficit⁹ in the 2006 election year. Gyurcsány defeated his challenger, former Prime Minister Viktor Orbán of Fidesz. In that year his party leaked the famous “lie speech”, which became well known internationally.¹⁰ In it he admits in no uncertain vocabulary that his government had cheated voters and misgoverned.

Yet Gyurcsány refused to resign. In 2007 he still ran a 0.9% primary deficit, with a secondary deficit of 4.9%. Growth dropped to 1% and inflation rose dramatically, so the country was still on a markedly unsustainable course. By the year 2008 he was engaged in a stabilisation programme and the primary budget deficit was slightly positive. However, the overall deficit was still 3.7%, with almost no growth (0.6%) and high inflation (6.1%). The sustained drop in growth was at least partly caused by austerity, which was necessitated by the continued deficits of the same government.

⁷ Erzsébet Hanti, *A bérek közterheinek alakulása 1989-2010*.

⁸ All primary deficit data are from the ECB.

⁹ All secondary deficit, total debt and GDP growth data are from Eurostat.

¹⁰ <http://news.bbc.co.uk/2/hi/europe/5359546.stm> The leaked speech, dotted with swearwords, describes how his government has “only pretended to govern”, “lied day and night”, and had no clue on how to take the country forward.

Table 2. The phenomenon of ‘fiscal alcoholism’: the re-emergence of indebtedness¹¹

Year and Prime Minister	Primary fiscal balance as % of GDP*	Total deficit	Total primary deficit (interest payments)	Real GDP growth %	Debt to GDP ratio
2001 Orbán					52.7 (low point)
2002 Orbán/Medgyessy	-4.9	-9	4.1		55.9
2003 Medgyessy	-3.2	-7.3	4.1	3.9	58.6
2004 Medgyessy	-2	-6.5	4.5	4.8	59.5
2005 Gyurcsány	-3.8	-7.9	4.1	4	61.7
2006 Gyurcsány	-5.5	-9.4	3.9	3.9	65.9
2007 Gyurcsány	-1	-5.1	4,1	0.1	67
2008 Gyurcsány	0.45	-3.7	4,15	0.9	73
2009 Bajnai	0.1	-4.6	4.7	-6.8	79.8
2010 Bajnai	-0.2	-4.3	4.1	1.1	82.2

Source: ECB, Eurostat

It is important to ask the question of what caused the continued deficits. It is often claimed that the fiscal alcoholism of the Gyurcsány government was caused by populist overspending on consumption. Empirical data fails to confirm this view. Purchasing power based final consumption per inhabitant¹² increased from €8,000 in 2001 to €10,100 by 2005, a 26% increase for a roughly 7% increase in debt over little more than two years of the Medgyessy government. In this period Prime Minister Medgyessy could rely on an average 4.6% real GDP growth rate, meaning that GDP was growing faster than primary debt accumulation. Thus the primary deficit added in this period was less than the growth of the GDP, while citizens benefitted from the gains of growth! PPS individual consumption then peaked at €10,800 in 2008, just before the crisis, at the end of Gyurcsány’s prime ministership. That is a 7% increase in consumption during his time in office, with a 10% increase in debt over four years (if we do not add the IMF loan that became necessary at the end of his rule). In contrast to the previous period of high growth, Prime Minister Gyurcsány could only rely on a 2.4 % average growth rate in this period. Thus even primary debt was growing significantly faster than GDP. If we add the extra IMF related debt of 13% of GDP, we arrive at 23%, plus an enormous drop in the GDP level. With the austerity measures implemented by the last of the three Socialist governments (2009-2010), PPS consumption per inhabitant dropped back down to €10,500 in 2009 and up to only €10,900 in 2010. It is obvious from these figures that electoral populism in the sense of income policy was not what was responsible for the ongoing deficit. In reality, Hungarian public debates have never really gotten

¹¹ In the shaded years more debt was added than the GDP growth rate would have allowed.

¹² All consumption data: [prc_ppp_inc] Eurostat Actual individual consumption, real expenditure per capita on PPS EU27.

to the end of what caused these massive deficits. The parliamentary opposition of the time blamed it on the clientelism of the Socialist party, while the Socialists themselves have by and large remained silent on the issue. Rampant corruption was definitely part of the explanation. Music halls that ended up costing three times the original planned amount, as well as highway construction at double the European price average, allegedly channelled towards party financing, have all contributed to the wasteful leakage from the central budget. Supporters of Gyurcsány have claimed that increased investment into high infrastructure accounted for a major part of the deficit. If this were true, it would be possible to claim that the resurgence of indebtedness was more of an investment characteristic than a wasting of public resources. Unfortunately, that political group has never been able or willing to produce a comprehensive report on the financing and projected returns of highway investment in that period. Allegations of party financing therefore continue to circulate.

Unfortunately for Gyurcsány, Hungary became caught up in the international effects of the Lehman collapse of that year, when once again highly indebted Hungary was forced to turn to the International Monetary Fund for refinancing, with market rates on long term bonds having climbed to 13.6%, an unsustainably high level. Gyurcsány resigned at the end of March 2009, having reached an all-time low popularity rating for Hungarian prime ministers of 15%.¹³

Hungary received a €12.3 billion loan from the IMF, to which the EU added a further €6.5 billion and the World Bank €1 billion. In exchange, the new Prime Minister Gordon Bajnai, promoted from economy minister, a post he held during the overspending of previous years, accepted new harsh austerity measures. There were budget cuts for local governments and public media. The retirement age was further increased, to 65, effective from 2012. Maternity leave was cut from three years to two, along with various cuts in family allowances. Public sector wages were frozen for two years. Thirteenth month public sector wages and thirteenth month pensions were eliminated. Energy price compensation for the poor was eliminated, together with severe cuts in support for public transport. The overwhelming majority of the long list of anti-crisis measures in the programme were expenditure side cuts hitting ordinary citizens. On the revenue side, the value added tax was drastically increased from 20% to 25% (with a special 18% key for dairy and bakery products, as well as communal heating). The basis for the calculation of personal income tax was broadened to gross wages plus contributions paid. At the same time, a 5% cut to employers contributions to social security was also introduced, a measure that was intended to increase employment with no apparent success. The government was relieved of introducing a meaningful property tax, a recurring

¹³ „Lesújtó értékelést kapott a Bajnai-kormány”, May 14, 2010, http://www.mfor.hu/cikkek/Lesujto_ertekelest_kapott_a_Bajnai_kormany.html

issue repeatedly defeated by liberal opinion leaders since the transition. This tax would have helped to balance the unjust tax burden on wage earners vis-a-vis asset holders, but it was found by the Constitutional Court to be “inadequately prepared”.

The results of the programme were very disappointing when compared to the hardships endured by the population. The overall budget deficit became 3.9% in 2009 and remained 3.8% in 2010. This is not much of an achievement given that it was already 3.7% in 2008. The primary deficit fared similarly: it rose from 0.4% to 0.5%, after already having been 0.4% in 2008. These insignificant changes must be viewed in light of the fact that the debt to GDP level rose from 65.8% of GDP to 78.9% as a result of the IMF loan. At the same time GDP fell by 6.3% in 2009 and stagnated at -0.2% in 2010. Bajnai left office in 2010 with a 24% popularity rating.¹⁴ The fact that politics operates according to a logic of its own is symbolised by the fact that Gordon Bajnai gained a reputation as a successful technocrat and stabiliser on the political left in Hungary. As far as the opinion of the political right is concerned, Bajnai was featured by Fidesz on posters across Hungary, together with Gyurcsány, under the motto: “They ruined the country together”.

The right wing Fidesz party won a two-thirds majority in parliament in the 2010 elections with 53% of the popular vote. In 2012-2013, the Orbán government was undertaking negotiations with the IMF for yet another loan. During negotiations, however, market financing rates and IMF rates converged. The basic IMF lending rate would have been 0.09%, with a 1% surcharge. Hungary had overused its quota by more than 300% after the 2008 loan (it stood at 374.61%).¹⁵ According to IMF rules, this would have added a 2% extra interest rate. In addition, overusing the quota for more than three years adds yet another percentage point. Thus the renewed indebtedness of the previous decade, resulting in the 2008 loan, had the prolonged effect of making institutional borrowing, the alternative to often costly market based borrowing, more expensive! There are also the conversion costs of a currency swap from Special Drawing Rights, in which an IMF loan is denominated, to another currency, as well as additional fees. This would have further increased institutional borrowing costs. If the EU would have chipped into the loan, this would have reduced the costs somewhat. All in all, the Hungarian State Debt Management Centre calculated that at around 4.05% plus fees, the IMF loan was too high a benchmark for institutional borrowing. Hungary was able to issue dollar denominated debt at lower costs. Even the yields on forint denominated debt were converging down on this benchmark, partly because the government was able to halt the rise of debt while other nations became more indebted, but

¹⁴ According to a poll carried out by the opinion survey agency Median (<http://www.mfor.hu/cikkek/Lesujto-ertekelest-kapott-a-Bajnai-kormany.html>), 58% of respondents said the Bajnai government was irresponsible, and two-thirds believed it governed according to vested political party interests.

¹⁵ „Túl nagy árat fizetett Magyarország a dollárkötvényekért?“, February 28, 2013, <http://m.napi.hu/tozsdekapocok/tul-nagy-arat-fizetett-magyarorszag-a-dollarkotvenyekert.546629.html>

mostly because of the global hunt for higher yields that emerged as a result of the quantitative easing programmes run by the US Fed. Naturally, market based debt came without all the strings attached. What exactly these strings would have been is hard to tell. The Orbán government ran a billboard and newspaper ad campaign making outlandish claims about what the IMF would have demanded in exchange for a loan. Due to the IMF's policy of communicating solely with governments and not with the population at large, it was unable to effectively refute the claims. The Orbán government, claiming to fight a "freedom fight" against the IMF, clearly won the communication battle. It ended up sending the IMF packing out of Budapest, a move that made it popular in both extreme left and extreme right wing circles across Europe.

All of this is not to say that the demands of the IMF would have been beneficial. Though not necessarily what Hungarian government propaganda advertised, we can still deduce from the IMF programmes in other countries such as Latvia, Romania or Greece what "stabilisation measures" Hungary would have been required to introduce. The irony of the situation is that previous Hungarian governments had already implemented most of the measures that the IMF supported in these other countries, such as the freezing the wages of civil servants, reductions in the size of the public sector, the elimination of thirteenth month wages and pensions, the raising of the retirement age, and so on. Thus, these could not have been requested in exchange for a loan. On other matters, such as tax reductions and labour market liberalisation, the IMF even complimented the Orbán government.

The main thrust of the economic programme of was a reduction of the tax burden through the lowering of corporate taxation for small and medium sized enterprises and the introduction of a low, 16% flat personal income tax. The latter formed the key element in the government's economic policy, and in fact it was the only element of it that Fidesz had disclosed during the election campaign. Not only was tax reduction popular among the electorate, but enthusiasm for it was also shared by the finance minister of the previous Bajnai government. There was a clear but misguided reference to Slovakia, where the tax had been introduced before but had had more of a public relations effect than an economic one.¹⁶ The irony of the situation was that by this time Slovakia was already revoking the flat tax, as had other countries that had introduced it, such as the Czech Republic. In Hungary the economic logic was the traditional Lafferite one, namely that a lower tax rate would lead to higher tax revenues and more jobs.¹⁷ It is by now clear that Hungary was no exception: the expectations tied to the flat tax materialised just as

¹⁶ Zoltán Pogátsa, "Slovakia: Tatra Tiger or Belated Reconstruction?", *Acta Oeconomica* 4 (2009).

¹⁷ Arthur Laffer, *The Laffer Curve: Past, Present and Future*. Backgrounder #1765 on Taxes (The Heritage Foundation, 2004).

little as elsewhere.¹⁸ At the end of 2013 the employment rate remained by and large where it was in 2010, and whatever employment was created was through massive public works programmes. At the same time, the introduction of the flat tax blew a €1.47 billion hole in the budget. Voters were increasingly disappointed as an astounding 74% of the tax cut benefitted the top 20% of wage earners, while at the lower end of the wage spectrum earners actually lost out through the elimination of tax deductions.¹⁹ (The tax cuts were combined with extra tax reductions for larger families, which did in fact have a significant positive social impact, especially on households with three children or more).

The €1.47 billion measure was intended to be self-financing in the sense described above. As it became obvious that this hope was not justified, more and more extra measures became necessary to balance the budget. The first and most significant such measure was the absorption of private pension fund savings by the state. Hungary had pioneered a three tier pension fund in 1998, with a state, a private and a voluntary leg. By 2010 it had become clear that private pension funds were strongly underperforming. The state had to remedy its losses each year by a significant amount, increasing the public sector borrowing requirement. Some of these losses were the direct result of the market downturn brought about by the Great Recession, but in the case of several pension funds the losses went further back. Prime Minister Orbán used strong rhetoric and claimed that the private pension funds were “playing casino” with people’s savings. The government instituted an assertive regulatory measure whereby private pension fund members were told they would lose their right to a public pension if they did not voluntarily redirect their private pension fund savings into the public pension fund within a matter of a few months. With the exception of a few hundred thousand people, most citizens obliged, and the funds of the private pension schemes, some €10 billion, were essentially absorbed into the state system. This one-off measure had a very positive effect on state financing, tilting the 2011 budget strongly into the positive in spite of losses arising from the tax reductions.

The other main measure that was introduced to compensate for tax revenue related losses was the introduction of special sectoral taxes. The first such taxes were introduced on telecommunications, retail and energy, and were meant to be temporary stop gap measures to compel transnational firms, who had benefitted from government subsidies in good times, to contribute to crisis management in times of recession. They then became permanent features of the government’s tax policy, and were even extended by other special taxes in areas such as fast food. The Orbán government was not the first to introduce such special taxes. The first

¹⁸ Mitchell J. Daniel, „Eastern Europe’s Flat Tax Revolution,” *Tax Notes Internationall* (2005) 989-90; Michael Keen, Kim Yitae, and Ricardo Varsano, The “Flat Tax(es)”: *Principles and Evidence*, IMF Working Paper 06/218 (Washington: International Monetary Fund, 2006); Hall E. Robert and Rabushka Alvin, *Low Tax; Simple Tax; Flat Tax* (New York: McGraw Hill, 1983).

¹⁹ Péter Virovác and Csaba G. Tóth, “Nyertesek és vesztesek – A magyar egykulcsos adóreform vizsgálata,” *Pénzügyi szemle* 4 (2013), 385-400.

such tax in Hungary, the energy tax, was introduced from 2004 onwards. A special tax on financial institutions was introduced for 2005-2006, based on the argument that the financial sector had been earning high yields due to the high domestic rate of interest and the state financed interest rate support scheme for property purchases, and they would now have to return some of that into the budget. This is essentially the same argument that the right wing government was going to use a few years further down the line. By the time the two years expired in 2007, the Socialist-Liberal coalition was working on fixing a dramatically destabilised fiscal situation. It chose reintroduce the special tax on the financial sector in a modified form. This time it was complemented by another special tax on pharmaceuticals, and yet another tax on energy providers and traders, which came to be known in common parlance as the Robin Hood tax. Thus, special taxes had a history before the Great Recession. The European Commission started proceedings based on the argument that taxation should be sector neutral according to EU principles. The arguments for neutral taxation are less than obvious, given that there are dramatic differences in the profitability of various sectors of the economy. Why, for instance, the highly profitable diamond trade and the tight profit margin small retail sector should have the same level of taxation needs argumentative backing. Eventually the Commission accepted the sustained existence of these taxes once they started to proliferate throughout the European Union. It is also important to remember that Hungary, like much of the Eastern European flank of the EU, historically undertaxed capital in comparison to Western Europe.

What changed radically during the crisis management strategy of the new, right wing government was the scale to which special taxes came to be utilised. Revenues from special taxes increased from €0.27 billion in 2009 to almost €2.5 billion in 2013 – that is, from 0.3% of GDP to 2.6% of GDP, or 6.2% of all government revenues.²⁰ Even more significant is that special taxes increased from only 21% of the sector-neutral tax on capital, the corporate tax, to an astounding 233% by 2013. Most of this increase can be explained by a sharp rise in special taxes, but corporate tax revenues also decreased from 1.5% of GDP to 1.1%, mostly due to lower tax rates for small and medium sized enterprises.

The new two-thirds parliamentary majority accepted a new constitution, which carried a debt ceiling clause of 60% of GDP in it. Having realised the degree to which renewed indebtedness had imposed an economic straitjacket on policymaking, the new government sought to gradually decrease the debt burden. Whether this has been a success is a very complex debate. A first glance at official figures reveals that the general trend of fiscal alcoholism that characterised the previous decade was halted. Accordingly, the European Commission released Hungary from the excessive deficit procedure in 2013, where it had been continuously since its entry into the European Union in 2004, the longest of any member state. Notably, the

²⁰ All tax data are from the Central Statistical Office.

lifting of the procedure came during a recession, when fiscal stability usually deteriorates. In fact a great number of other member states actually came under the procedure anew in this period. Overall figures indicate that a budget reduction of around 4% of GDP is likely to be achieved during the 2011-2014 cycle (2011 being the first fiscal year budgeted by the new government).

Table 3. Fiscal stability and the fight against the debt burden during the Great Recession

Year and Prime Minister	Primary deficit	Overall deficit	Real GDP growth %	Total debt / GDP
2009 Bajnai	0.1	-4.6	-6.8	79.8
2010 Bajnai	-0.2	-4.3	1.1	82.8
2011 Orbán	8.4 (with pension funds)	4.3 (with pension funds)	1.6	82.7
2012 Orbán	2.29	-2	-1.7	79.8
2013 Orbán	n.a.		0.2 forecast	79.2 (budgeted)

Source: European Commission EDP procedure

The full picture is more complicated, however. Debt reduction included the one-off measure of the nationalisation of private pension funds in 2011. Since the total amount of pension fund wealth amounted to around 10% of GDP, if we do not take into account the effect of this one-time measure, we see an increasing trend in indebtedness per GDP in this period. (The reductions in 2012 and 2013 come from severe austerity measures). Although Eurostat has accepted the overall figures consolidated with the nationalised pension funds, it makes sense to keep in mind that in the longer run the nationalisation of the pension system generates implicit liabilities if we assume that universal pension entitlements remain a pay as you go system. (The latter is not an obvious assumption. The wording of the new constitution does not automatically guarantee entitlement, although no explicit statement to the effect of revoking these universal rights has been made.)

The picture is complicated even further by the fact that at the same time as introducing severe cuts in 2012-2013 (including cuts to strategic areas of investment into productivity, such as education and healthcare), the state purchased significant shares in private companies. These included the energy sector (the oil company Mol and the gas storage facilities of E-ON), vehicle manufacturing (Rába) and other firms. On the one hand, this increased the public sector borrowing requirement and consequently the debt level, but also increased the wealth of the state. Regrettably, much of the value these investments has been lost due to downturns on the stock exchange.

Except for the heavily negative 2011 primary balance (without the pension fund effect), the primary balance of the budget has remained positive. Thus, in other

years it was the decline in GDP that caused the deterioration of the debt situation.

Given two countries with the same level of indebtedness, it is preferable that they become exposed domestically rather than externally. The example usually used to demonstrate this is the case of Japan, which although enormously indebted still enjoys low refinancing bond yields due to the fact that most of its debt is owed to domestic investors. By 2011, Hungary had an exposure of around 70% to foreign investors, and the share of the domestic public debt had decreased to around 2.5%. Another strategic goal of the Hungarian government was to reduce the degree to which Hungary was exposed to foreign investors. Some success was achieved in convincing domestic private investors, whose share redoubled to around 7%, but domestic institutional investors proved harder to attract. The overall share of foreign investors remained at 65% at the end of 2013.

Another aspect of debt accumulation must be mentioned. In addition to the central government, local governments also accumulated serious levels of debt. The municipal debt to GDP ratio rose from around 1% to around 4.7% by 2010.²¹ While in the case of the central government debt it was the Socialist-Liberal coalition that was responsible for debt accumulation, the municipal debt is mostly the responsibility of the then-opposition Fidesz, the party that heavily dominated municipal governments after 2002.

Excessive household and municipal indebtedness in foreign currencies

The other channel through which Hungary was impacted by the Great Recession was through the excessive indebtedness of households in foreign currency, especially euros and Swiss francs. This mechanism was in many ways analogous to the artificial bubble based on inadequately low euro interest rates that had developed in the PIIGS economies inside the eurozone²², or the carry trade that ruined the Baltic economies.

The process began just prior to European Union accession. The starting point was the high interest rate for borrowing in Hungarian forints. Due to unrelentingly high rates of inflation and high sovereign yields, borrowing in forints remained inaccessibly expensive. The second factor is perhaps more important – due to high sovereign debt, yields on Hungarian state bonds remained in the 6-12% territory. Since banks could regard these instruments as close to zero risk investment vehicles, they came to serve as a benchmark for lending. With banking costs and profits added on, as well as the individual risks of clients, the actual lending rates

²¹ Tamás Vasvári, „Az önkormányzatok 2011. évi gazdálkodása adósságszolgálatuk kizorító hatásának tükrében,” *Pénzügyi Szemle* 3 (2013), 310-335.

²² Costas Lapavistas et al., *Eurozone Crisis: Beggar Thyself And Thy Neighbour* (London: Research on Money and Finance Occasional Report, 2010).

in Hungarian forints remained over the payment capacity of ordinary Hungarians. This contrasted with very unfavourable fundamentals in Hungarian society. Young employees were looking to move out of oversized households with several generations living together.²³ Others were forced to finance major expenses in their lives that they had put off earlier, but found themselves without savings. Some 89% of Hungarian households had no significant non-property savings²⁴ to cover such expenses. This is mostly due to the fact that Hungary had adopted a strategy of competing globally with low wages, which remain at a nominal 33% of the EU27 average for median income (30% in the case of mean income)²⁵, while there was an 83-109% convergence of prices²⁶ with the EU average in areas that are crucial for the average and poor Hungarian consumer. Forint based loans would simply have been unaffordable for most.

It was at this point that banks came forward with foreign currency based loans. Most were euro based, some Swiss franc based, and even a low level of Japanese yen based lending took off, especially in the area of mortgages. The advantage of these loans lay in the significantly lower interest rates that had to be paid on them. As an illustration, a typical forint based mortgage (€16,667, 20 years) would have had an interest rate of around 18-20% in 2005, while a foreign currency based one only 6-7%. The downside, of course, was in the risk of exchange rate volatility, which was bound to have an effect on the monthly payments of debtors. In this respect, however, we must differentiate between euro based and CHF/JPY based loans. The reason for this is found in Hungary's accession treaty to the European Union, in which the new member state pledged itself to introduce the euro as soon as it meets the relevant criteria. Since the first target date for accession to the Economic and Monetary Union was 2006 (EU accession plus two years in ERM2), Hungarian citizens were rightfully looking forward to receiving their income in euros. It was therefore realistic to assume that after a rather short initial period exchange rate risk would be eliminated for the rest of the loan period. This is what they were told by the lending banks, as well as by their own government. When the target date was extended again and again, the European Commission reassured citizens that convergence was still on track by (reluctantly) accepting Hungary's Convergence Plan, an incoherent and unrealistic document that was never completely implemented. In reality, the indicators were diverging from their targets. Thus the government of the time, as well as the European Commission, were complicit in creating an economic context in which euro based borrowing

²³ According to a March 2013 survey by the building society Fundamenta, 47% of young people between the ages of 18 and 35 lived with their parents and 11% rented. A total of 75% of the sample had no savings, and those who did were only able to save a negligible amount of 9,529 forints a month.

²⁴ According to the market survey firm GfK Hungária, only 11% of households had any bank savings in 2011.

²⁵ "Mean and median income by age and gender. [ilc_di03] Eurostat."

²⁶ Food 83%, clothing 85%, footwear 95%, transport services 71%, communication 109% [prc_ppp_ind] Eurostat.

was clearly preferable to Hungarian forint based borrowing. The situation with Swiss franc or Japanese yen based borrowing was widely different. Since Hungary was not about to adopt these currencies, and was not even planning to use these currencies for an exchange rate anchor, it was highly unrealistic to calculate that over the 10 to 20 year lifespan of a mortgage loan the borrower would not suffer exchange rate volatility significant enough to cause concern. In this sense the responsibility for Swiss franc or Japanese yen based loans rests on the shoulders of borrowers.

The amount of risk involved in these loans is significant. As we have already mentioned, Hungary competes in the world economy with low wages. With the average wage at about one-third of European wages, the average borrower spends around 15% of their regular income on monthly loan repayments. Thus, even in the case of temporary volatility in exchange rates, the Hungarian borrower is much less able to cope with increased monthly payments than in countries where pay is higher.

This is what happened after the outbreak of the Great Recession. The already described Hungarian debt crisis had the effect of significantly increasing volatility in the value of the forint. It also depreciated as a longer term trend against the euro, and more significantly against the Swiss franc. The latter was due to the fact that the Swiss franc became a global escape vehicle during the crisis for those forced to divest elsewhere. Was it not for the determination of the Swiss Central Bank to hold the appreciation of the franc, the situation could have become much worse for Hungarian households.

It is clear that the FX indebtedness of Hungarian households represents a major constraint for economic policy and a risk to the financial system. The government has been seeking a long term solution, whereby banks would be forced to share the costs with the state. At the end of 2013 the minister for the economy and his state secretary summarised their goals in five points:

1. FX loans should disappear within 3-5 years,
2. Monthly payments should decrease by 15-20%,
3. Monthly payments should be transparent in the longer term,
4. FX loan holders should not receive worse terms than forint loan holders,
5. The stability of the financial system should be maintained.

This equation seems impossible to solve. If the fixed exchange rate would remain where it has been in recent years (CHF=HUF180), it would simply be too expensive for the budget. It is also important to realise that banks would have to swallow hundreds of billions of forints in one go at the very beginning of the programme. This would certainly threaten the stability of the financial system. In addition, the strengthened macroprudential regulation that has been applied to banks does not allow them to maintain open FX positions for a sustained amount of time.

It is also a huge question whether the FX programme will include property loans only, or unconditional loans as well. The argument for moral hazard naturally looms over the entire debate. At the end of 2013 some 17% of FX property loans, 26% of unconditional FX loans and 21% of all FX loans had arrears of more than 90 days.

The impact of the crisis on migration

In recent decades Hungary hasn't been a major destination country for foreign workers or refugees, save for a brief period during the Yugoslav wars. The free movement of labour in the European Union after 2004 did not have a significant impact on the labour market of the country either. Up until around 2006, some 90,000 Hungarian nationals worked in other EU countries, predominantly in Germany and to a lesser degree in Austria and the United Kingdom. This number had remained flat since the middle of the nineties, but then began to grow and even doubled by around 2010, with the same countries remaining the top destinations. At less than 2% of the total population, this migrant population ratio still leaves the Hungarian labour force less mobile than every other country in the Central and Eastern European region with the single exception of the Czech Republic.²⁷

The role of the EU transfers

Hungary has been the recipient of a significant allocation of European Union development transfers in the spheres of employment creation, economic development and environmental policy. Guarantee and orientation transfers in the field of agriculture have been allocated at an increasing amount since entry into the union in 2004.

These transfers have played a significant role in the development of certain areas. Hungary is one of the member states where essentially all development policy is EU financed. The autonomous national development policy is insignificant. The two main impact areas have been the development of railway communication infrastructure and municipal waste water and selective waste management. Unfortunately both of these valuable impact areas are hidden from the view of the ordinary citizen. Another key impact area has been employment creation. Unfortunately the employment policy of the post-2010 Hungarian government runs directly contradictory to the EU2020 principles of creating employment by investing in the knowledge base of citizens. Funds for these purposes were severely cut, and the employment policy relies on the flat tax, the elimination of unemployment subsidies, as well as unsustainable large scale public works. The European Commission has no real competencies in sanctioning a member state whose policies run so contrary to the principles of the commonly agreed European

²⁷ Ágnes Hárs, *Magyarok külföldi munkavállalása* (Budapest: Társi, 2011).

Employment Strategy. The distribution of agricultural support has also been highly criticised in Hungary, with most support going to large scale land owners and technological development rather than expanding rural development, the expansion of the knowledge base and facilitating cooperation in the agricultural sector.

It is important to highlight that European Union transfers constitute development resources, as opposed to operational funding. Unending waves of “stabilisation”, which in Hungary have continued since as far back as the early eighties, have left state subsystems underfinanced, fractured, and operating very far from the ideal of a monitored, long term policy area with institutional stability. Inputting European Union development resources into such a system amounts to little more than substitute operational funding in far too many cases. In the absence of real long term stability and the prospective for development, final beneficiaries are looking for ways to make use of EU grants to finance their ordinary operations. This leaves the developmental impact of EU transfers highly questionable. For this reason, EU transfers cannot and do not play a key role in crisis economies.

In 2013 the payment of EU transfers was briefly suspended for Hungary by the European Commission for reasons pertaining to a lack of transparency. The issue was resolved by the government as a matter of urgency, to the satisfaction of the EC. Hungary was also threatened with the withholding of Cohesion Fund resources as a consequence of the excessive deficit procedure, but with member states being cleared of this procedure this threat is now eliminated. Hungary contracted 64% of its allocation for the programming period by the end of 2011, as opposed to a 67% average for the 10 new member states. This puts the country in sixth place out of 10. Twenty-eight percent of the allocation had been paid by the end of 2011, which is exactly the new member state average, putting Hungary in sixth place once again.²⁸

Conclusions

Hungary was hit by the global financial crisis mostly through two mechanisms. Macroprudential regulation had been weak, permitting the development of a foreign currency based loan crisis in the case of households. In this case we can be confidently optimistic in that the lessons have been learned, macroprudential oversight strengthened, and the country will not have to face the development of a crisis of similar nature in the future. Unfortunately the already accumulated FX loan stock is likely to burden economic policy making for a long time to come.

The more important mechanism through which Hungary was impacted by the crisis was the sovereign debt trap. Due to heavy fiscal irresponsibility in the

²⁸ Source: KPMG, *EU Funds in Central and Eastern Europe*, Progress report 2007-11 (c2012), <http://www.kpmg.com/CZ/cs/IssuesAndInsights/ArticlesPublications/Press-releases/Documents/KPMG-EU-funds-2011.pdf>

preceding half a decade, Hungary had re-accumulated a critical sovereign debt burden by 2008. In light of developments in Dubai, Greece and the rest of the PIIGS countries, Hungary also faced a sudden lack of access to debt markets and had to switch to IMF financing and oversight.

In this regard there are both positive and negative developments. The new government has viewed the curtailing of the debt level as a priority, and has been by and large successful in stopping the further growth of the debt level. With other countries experiencing rapid explosions of sovereign debt, Hungary's stabilised debt to economic output ratio is now below the European average. It can be hoped with a degree of realism that the Hungarian political elite has learned from the experience and has accepted the need for fiscal prudence. The negative aspect is that the short term stabilisation measures implemented by successive governments have eliminated the potential for growth. The debt to GDP level can only be improved in a sustainable way in the longer run if there is sustained economic growth without overspending. With already long working hours, the growth of economic output requires an increase in employment and a simultaneous increase in productivity. Unfortunately, repeated cuts, continuously declining spending, haphazard policy measures and institutional instability regarding investment into human capital during the recurrent fiscal stabilisations have eliminated the potential for the growth of these vitally important economic macroindicators. The long term depreciation of human capital, documented by relevant Eurostat data, threatens a return of macroeconomic (and especially fiscal) instability. With a 83-109% convergence of key consumer prices to the EU27 average, and a 30-33% convergence of nominal wages²⁹, as well as a constantly low employment rate, Hungary is still threatened by the inability raise enough revenue to sustain public expenditure.

Hungary's response to the challenges of the Great Recession fits into its 30 year old cyclical pattern of fiscal cuts → crisis → fiscal cuts. A more proactive policy that would install a cycle of circular cumulative causation is yet to come.

²⁹ Both figures Eurostat, 2011.

Economic Sustainability in Slovakia

Brian Fabo and Michal Mudroň

The nature of the Slovak economic system places the country somewhere between its Visegrad Group (V4) neighbours and the Baltic countries. Traditions connect the country to the former – after all, Slovaks spent most of the 20th century in one state with the Czechs, not to mention the legacy of Habsburg Empire also shared by Poles and Hungarians. An additional shared legacy for all these countries stems from the transformation of identities of nationality and territoriality, government institutions and the re-distribution of economic and political power at the same time¹, which posed a major policy challenge to the both V4 and the Baltic countries.

Nonetheless, as noted by Bohle and Greskovits² in the early 2000s, the economic and social dynamics in Slovakia have diverged from the rest of the region; welfarist concerns took a secondary place to nation-building. Slovaks, painfully aware of their position as regional laggards following the period of autocratic rule of the strongman Vladimír Mečiar, enacted daring reforms with the aim to turn the country into a great place for doing business. Even though these reforms came at great social cost, Slovakia managed to catch up with its neighbours in terms of European integration and enjoyed a flood of capital inflows into the country, resulting in growth approaching double digit values.

The crisis represents an important turning point for the development of Slovakia. The fast growth evaporated and painful socio-economic problems ranging from unemployment to regional divides again became salient topics. European integration is no longer just a source of pride for Slovaks, but also a challenge due to obligations associated with eurozone membership at a time when the currency union itself is facing difficult challenges. Economic stagnation and disillusion with European integration have caused a rearrangement of political opportunity structures. The scope of these changes is evident by the landslide victory of the left wing political party SMER, which was successful in bringing together more than 40% of Slovak voters under its banner with promises of economic and social security in the 2012 elections.

The following text is dedicated to exploring the profound changes that Slovak society underwent in the few short years since the outbreak of the crisis. However, we do not want to limit ourselves to retrospection. At the end of the debate, we will try to extrapolate political and economic dynamics and determine the answer to our main research question – what is the post-crisis Slovakia going to look like?

¹ Claus Offe, “Capitalism by Democratic Design? Democratic Theory Facing the Triple Transition in East Central Europe”, *Social Research* 4 (1991), 865-892.

² Dorothee Bohle and Bela Greskovits, *Capitalist Diversity on Europe's Periphery* (Ithaca: Cornell University Press, 2012).

The economic and political background of Slovakia

Economic developments leading to the crisis. When the crisis came to Slovakia, the country was enjoying unprecedented levels of economic growth. At its peak in 2007, Slovakia recorded double digit growth figures, which positioned the small Eastern European country among the fastest growing economies in the world. The outbreak of the crisis was followed by a plunge of the GDP growth figure deep into the negative territory. Nevertheless, the country returned to growth the following year and is currently poised to avoid a double dip recession. Additionally, while the drop in Gross Domestic Product (GDP) growth came as a shock after a period of very fast growth, the recession was shallower than the one the country experienced after the fall of communism (see Figure 1). Unlike many other countries, therefore, the Great Recession³ does not signify the toughest time experienced by Slovaks.

Figure 1. GDP growth in Slovakia 1989-2012



Source: The Crisis and the Consequences of Austerity Policies in Eastern and Central Europe. Data: Slovak Statistical Office

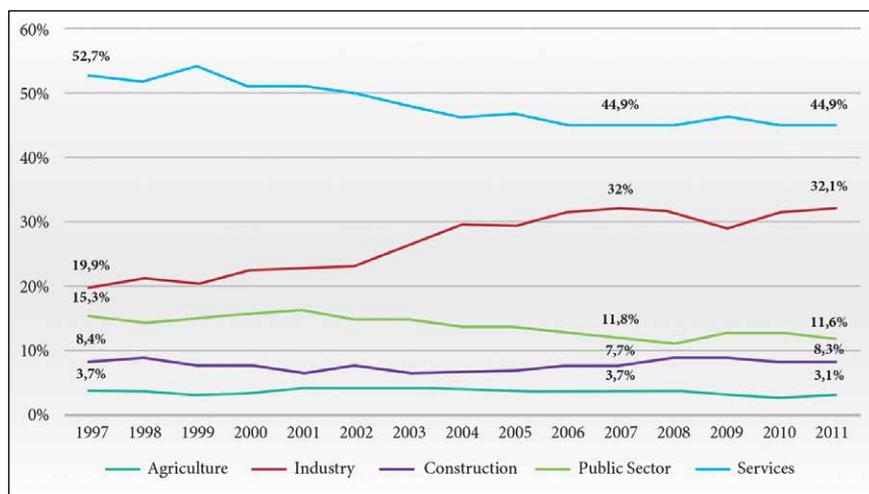
Being a small, open economy, international capital inflows have been crucial for economic growth in Slovakia. In the 1990s, the country was a regional laggard

³ The *Great Recession* is a widespread term, particularly in the economic and financial press, referring to the global economic decline started by the burst of the US real estate bubble 2007 and which has spilled over globally, causing a severe decline in economic activity. See Catherine Rampell, „Great Recession: A Brief Etymology”, March 11, 2009, <http://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology/>.

in terms of Foreign Direct Investment (FDI) due to the nature and policies of the autocratic regime of Vladimír Mečiar (1993-1998). Mečiar ruled in an authoritarian fashion and attempted to create a domestic capitalist class through insider privatisation and a preference for domestic firms. One particular feature of Mečiar’s regime was state ownership of the banking sector, which played an important role in channelling credit towards domestically owned companies, allowing them to avoid bankruptcy despite lackluster management and low productivity.⁴

After Mečiar lost power, however, the country managed to catch up with the rest of the region, initially by privatising the existing industrial base to foreign investors and later by attracting greenfield investments, mainly in the automobile sector. As a result, the industrial sector became much more prominent in the Slovak economy in the 2000s, growing from 20% to 30% of GDP over the course of the decade. Meanwhile, the construction sector remained small at 8.3% of GDP and the share of the public sector actually dropped significantly. In addition to this capital, the Slovak economy also profited from technology transfer and a diffusion of standard management practices, which accompanied the arrival of foreign investors, in particular transnational companies (TNCs). To increase competitiveness, Slovak policy makers of the early 2000s focussed on decreasing the role of the state in the economy, as evidenced by the decline of the public sector’s share of GDP from 15% to 11% (see Figure 2).

Figure 2. GDP composition in Slovakia 1997-2011



Source: The Crisis and the Consequences of Austerity Policies in Eastern and Central Europe. Data: Slovak Statistical Office

⁴ Katarína Mathernová and Juraj Renčko, “Reformology”: The Case of Slovakia,” *Orbis* 4 (2006), 630-631.

The country's banking sector was plagued by heaps of bad debt following the Mečiar era, but has since healed. The recovery of the banking sector was managed by the government bailout of banks in the 2000s, and the subsequent acquisition of those banks by foreign financial companies.⁵ Perhaps as a result of this experience, Slovak banks are generally quite conservative and as a rule did not behave in the reckless way that characterised the banking system of some Western European countries. Unlike other countries, therefore, Slovakia did not have to commit resources to the stabilisation of its financial sector.

Nevertheless, Slovak industrial production is overwhelmingly destined for export, which creates a major structural weakness for the national economy. When the crisis broke out, the manoeuvring space for the government to counter the external shock caused by the sharp decline in demand for Slovak goods abroad was limited due to the relative underdevelopment of domestic demand. Consequentially, Slovakia was heavily hit by the slowdown of the EU economy.

In 2009 Slovakia replaced its national currency, the Slovak koruna, with the euro. At the time this was perceived as great success, because Slovakia had the reputation of being a laggard in terms of European integration due to the impact of Mečiar's regime, and yet it became only the second Eastern European country to join the eurozone (Slovenia being the first). The adoption of the euro in Slovakia did not result in a bubble of the kind observed in the peripheral eurozone countries, in particular in Greece. Nevertheless at the same time the hopes that connected the common currency with easier attraction of FDI also did not come through. In fact, FDI inflows froze after the outbreak of the crisis in Slovakia, just like in the other countries of the region that maintained their own currencies. At this point, therefore, it is not possible to tell whether Slovakia has benefited from euro adoption or not.⁶

The political landscape. Politically, for the most of the 2000s both the centre-right government of Mikuláš Dzurinda (2002-2006) and its successor, the centre-left government of Róbert Fico (2006-2010), maintained a fiscally rather conservative policy. For the former, fiscal prudence was a matter of political dedication to a liberal economic doctrine. The centre-left government came to power in an environment of rapid economic growth, making it possible to fulfil the demands of the electorate, such as the termination of co-payments in healthcare and a Christmas bonus for retirees, while keeping the budget deficit in check. Additional

⁵ According to the Slovak National Bank, foreign capital in Slovak banks equals 2.58 billion euros, while the size of domestic capital is just 0.2 billion euros. Most foreign capital in the country comes from the neighbouring Czech Republic and Austria, as well as the traditional financial centres of Luxembourg and Cyprus. The capital flight from Slovakia in the crisis years was not significant and foreign capital reached pre-crisis levels again by Q3 2011. See Národná banka slovenska, <http://www.nbs.sk/sk/statisticke-udaje/prehľad-o-rozvoji-penazneho-sektora/podiel-zahranicneho-kapitalu-na-zakladnom-imani-bank-v-sr>

⁶ Jarko Fidrmuc and Andreas Wörgötter, "Slovakia: The Consequences of Joining the Euro Aea before the Crisis for a Small Catching-up Economy" in *CESifo Forum*, Ifo Institute for Economic Research at the University of Munich, 1 (2013), 57-63.

incentive was provided by the prospect of early eurozone membership on fulfilling the convergence criteria.⁷

When the crisis struck in 2009, budget revenues fell but expenditures increased due to the centre-left government's efforts to prop up the fading economy through public investments. As a result of this, the deficit in 2009 jumped to 8% (see the 'responses to the crisis' section of this chapter for details). The centre-right government which took power in 2010 only brought the deficit down at the cost of several austerity drives and tax hikes. These policies were, naturally, very unpopular and the 2012 elections brought Fico back to power in an unprecedented landslide victory. The newly formed left wing government (Fico's SMER party had no need for coalition partners this time around, having managed to secure more than a half the seats in the Slovak parliament) has not repeated its attempts from 2009-2010 to prop up the economy through spending and maintained Slovakia's commitment to fiscal prudence.

Table 1 details the composition of all governments in Slovakia since independence and their general ideological orientation.

Table 1. Chronological overview of Slovak governments

1993-1998	1998-2002	2002-2006	2006-2010	2010-2012	2012-present
Nationalist coalition led by authoritarian strongman Vladimír Mečiar	Big Coalition of democratic, pro-European forces including both left wing and right wing parties. Led by Mikuláš Dzurinda	Centre-Right coalition led by Mikuláš Dzurinda	Centre-Left coalition led by Róbert Fico	Centre-Right coalition led by Iveta Radičová	One party left wing government led by Róbert Fico

Responses to the crisis

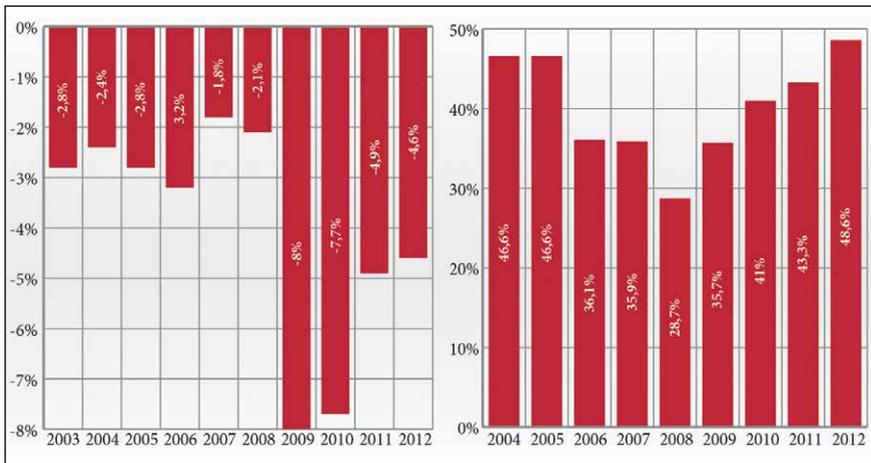
Domestic responses: reasons and legitimisations for austerity. Immediately following the outbreak of the crisis in Slovakia, the centre-left government in power at the time tried to counter the recession by stimulating growth through ad hoc policy measures. The government subsidised the purchase of 44,200 cars at a total cost of 55.25 million euros to offset the fall of foreign demand for Slovak-made automobiles. Additionally, the authorities attempted to directly subsidise job creation through offering subsidies to businesses and even sponsoring newly created 'social enterprises'. The intention was to subsidise 358,000 workplaces, and Slovakia spent as much as 284.25 million euros for this purpose. The government also intended to invest more in infrastructure development through PPP projects, but these projects were largely later cancelled. In addition to spending, the government also attempted to protect employment through the introduction of

⁷ John Gould, "Slovakia's Neoliberal Churn: The Political Economy of the Fico Government" (2009), http://www.fses.uniba.sk/fileadmin/user_upload/editors/UESMV/Books/WP_01_2009_John_Gould.pdf

the so-called ‘flexikonto’, which allowed employees to retain employees they had no work for by ‘stockpiling’ their labour for the better times.⁸

Even though Slovakia managed to recover from the recession fairly quickly and return to growth in 2010, the government’s response to the crisis was quite costly. The budget deficit exploded up to nearly 8% of GDP and public debt grew accordingly. As evidenced by Figure 4, the rapid growth of debt, which is currently nearing 50% of GDP, has quickly erased all progress made in the time of prosperity, when growth outpaced borrowing and as a result the relative size of debt represented as a share of GDP declined, despite budget deficits.

Figure 3. **The budget deficit of Slovakia and size of public debt in Slovakia 2003(04)-2012**



Source: The Crisis and the Consequences of Austerity Policies in Eastern and Central Europe. Data: Slovak Statistical Office

While attempts by the government to counter the crisis through increased state investment certainly led to big deficits and accumulating debt, their impact on the economy is not clear. Even though the economy quickly recovered, the growth did not prevent the deterioration of the social situation of Slovaks, in particular manifested by the quickly growing unemployment rate (see the ‘social impact of the crisis’ section of this chapter). The growing joblessness and stagnating wages made Slovaks turn their backs on the ruling centre-left government coalition in favour of the centre-right parties that were behind the reforms that started the ‘Golden Age’ of the Slovak economy in the mid-2000s.

The ascent of centre-right forces to power led to the abandonment of pro-growth policies and the embracement of austerity as a means to lead Slovakia away

⁸ Katarína Mathernová and Juraj Renčko, “Reformology’: The Case of Slovakia,” 630, 631.

from the ‘Greek way.’⁹ This narrative was complemented by a moralistic narrative of the hard-working Slovak who has endured painful reforms and was, therefore, rightly rewarded by economic growth¹⁰, unlike the lazy Greek who cannot survive without government handouts. This moralistic argument presented the suffering of certain social groups as a sort of price that needs to be paid so that prosperity can come again.

Figure 4. Long term interest rates for Slovak sovereign debt 2001-2013¹¹



Data: Slovak Statistical Office

At the same time, there was very little discussion about the distribution of gains associated with economic prosperity and the losses that come with reforms and austerity. This can be illustrated by the example of the labour code, which was reformed in 2011 with the intention to strip employees of the gains they made during the reign of the centre-left coalition, thereby benefiting employers. Meanwhile, it was employers who benefited from the good times the most, not the

⁹ A reference to perceived mismanagement of national budget in Greece blamed on the alleged populist behavior spending of the Greek governments. SITA, „Mikloš: Slovensko ide gréckou cestou”, May 4, 2010, <http://spravy.pravda.sk/domace/clanok/166156-miklos-slovensko-ide-greckou-cestou/>

¹⁰ „SDKU Election Manifesto 2010”, http://www.sdku-ds.sk/data/MediaLibrary/625/2010-04-12_SDKU-DS_program.pdf

¹¹ The red circle shows a spike in borrowing costs in the current crisis.

workers, because productivity grew faster than wages in the industrial sector, which is crucial for the Slovak economy.¹² At the same time, the need for austerity was also rationalised by external factors such as European Union (EU) level initiatives (to be discussed later) and increased costs of borrowing at the high point of the eurozone crisis (see Figure 4).

As far as the real economy is concerned, the individual sectors of the economy differed in the way in which they coped with the shock. This divergence can be demonstrated using comparison between two important sectors of the Slovak economy: the automotive sector, which has been the driving force of the Slovak economy, and the healthcare sector, which is struggling with insufficient resources and a declining labour force caused by the migration of qualified medical personnel out of the country.¹³

The automotive sector, which was the single most important source of economic growth in pre-crisis times, has continued to perform relatively well, despite decreasing demand for its products in Western Europe. Slovak automobile plants still benefit from a strong competitive advantage due to the relatively cheap, technically skilled labour available in Slovakia. At the same time, negotiations between employers and trade unions continued during the crisis and contributed to the smooth implementation of important anti-crisis measures.¹⁴ Furthermore, employers benefited from the measures introduced to mitigate the impact of the crisis, such as the flexikonto and car purchase subsidy. Consequentially, it can be said that the automotive sector managed to cope with the recession quite well.

In the healthcare sector, the impact of the crisis has been two-fold. On one hand, the shortage of qualified labour was partly mitigated by the return of the workforce that had migrated in times of growth. At the same time, the government faced the need to consolidate the budget by way of decreased funding for healthcare establishments, leaving especially smaller hospitals facing serious budget constraints. Nevertheless, despite reduced resources and an increased supply of labour, the collective bargaining mechanism remained strong. The highly unionized sector (even though the healthcare unions were increasingly fragmented) managed to sustain collective bargaining powers and thus prevent a serious worsening of the welfare of healthcare workers. Nevertheless, structural problems in the healthcare sectors remained unaddressed and the crisis has likely even deepened the already pressing issue of insufficient resources in the Slovak

¹² See OECD, *OECD Economic Surveys 2009: Slovakia* (2009), 47, <http://books.google.sk/books?id=On6FuTmMch8C&lpq=PP1&hl=sk&pg=PA37#v=onepage&q&f=false>

¹³ Martin Kahanec and Klaus Zimmerman, *EU Labour Markets after Post-Enlargement Migration* (Berlin: Springer, 2010); Dorothee Bohle and Bela Greskovits, *Capitalist Diversity on Europe's Periphery*.

¹⁴ Brian Fabo, Marta Kahancová, and Monika Martišková, *Industrial Relations and Inclusive Development: The Case of Slovakia*, Background study for the ILO (forthcoming 2014).

healthcare system.¹⁵ Unlike the automotive sector, healthcare is unlikely to undergo necessary structural changes in the foreseeable future.

The European Union context. Since the outbreak of the crisis, EU funds have been often cited as a source of financing for a wide range of policies designed by various Slovak governments to dampen the negative impact of the crisis. All three successive governments that have been in charge of Slovakia since the outbreak of the crisis have outlined their own priorities on which the money should be allocated. The first centre-left government wanted to promote social dialogue and integrate low skilled and handicapped citizens into the labour market through social enterprises. The centre-right government, which took power in 2010, abandoned these efforts, partly due to the associated controversy and fraud allegations¹⁶, and instead wanted to focus the funds on infrastructure, in particular the highway construction. The EU funds were supposed to replace the previously planned Public-Private Partnership (PPP) projects, which were now deemed too costly. Finally, the left-wing government that arose from the 2012 elections decided to focus on combating unemployment, in particular focussing on young people. To this end, the government introduced subsidies to companies for creating or maintaining workplaces in Slovakia.

At the same time, Slovakia did not suffer from high levels of sovereign debt at the outbreak of the crisis and has been able to finance its debt on the capital markets. Therefore, unlike other eastern countries such as Hungary or Romania, there was no need to apply for external aid in the Slovak case. Slovakia's ability to secure needed funds without the assistance of international organisations or other nations has given Slovak policy makers significant space to manoeuvre. As a result, it has been so far possible for Slovak governments to avoid unpopular reforms, although Slovakia had already implemented some of the reforms in respect to taxation, eligibility for welfare transfers and the pension system in the early 2000s, instead of waiting for the last possible moment when the crisis made maintaining status quo impossible. The relatively strong initial fiscal position allowed Slovakia to delay austerity measures and attempt to counter the crisis with an economic stimulus at the outbreak of the crisis. Nevertheless, the fast growing debt level, visible on Figure 3, quickly closed the window of opportunity for any attempts to counter the crisis through increased government spending.

The EU was nevertheless crucial. In addition to the EU funds' role as a source of

¹⁵ Organisation for Economic Cooperation and Development (OECD) data show that while Slovakia spends a relatively high portion of total government expenditure on healthcare in terms of GDP, public spending on healthcare in the Slovak Republic amounts to only 17.9 % of GDP as of 2013, way under the 21.9 % average for the OECD. At the same time, private spending on health care is not particularly big; the most recent available OECD data on total healthcare spending from 2009 show that Slovakia only spends 18.5% of its GDP on healthcare, again significantly lower than the OECD average of 22.1%.

¹⁶ Ivan Kuhn, Dušan Sloboda, and Radovan Kazda, *Využívanie eurofondov na Slovensku – príležitosť pre rast alebo korupciu a klientelizmus?* (The Use of the European Funds in Slovakia – An Opportunity for Growth or for Corruption and Clientelism?), http://www.konzervativizmus.sk/upload/pdf/Studia_KI_eurofondy_SK.pdf

funding for governmental priorities, the EU and eurozone membership have been a source of double pressure on the Slovak political system:

1. The EU pushes for austerity and newly introduced eurozone instruments for the enforcement of fiscal responsibility. In 2011 Slovakia followed the example of other EU member states, most notably Germany, when Slovak parliament passed constitutional law number 493/2011 to establish a Council for Budgetary Responsibility to monitor and evaluate the fiscal performance of the country. Additionally, the law defined thresholds on the share of GDP that sovereign debt is allowed to reach before the onset of automatic limitations for the government, ranging from a mere discussion in parliament, through mandated expenditure cuts and a decrease of wages received by the members of the government, to an explicit ban on deficit spending. Additionally, through being in the eurozone, all instruments of European governance, including the Fiscal Compact, Europe 2020 and the ‘Six-pack’, apply.

2. Slovakia has been expected to contribute to financial mechanisms established to assist struggling eurozone members. These obligations were turned into a political issue already in the 2010 elections, when the centre-right parties promised not to participate in a bailout package for Greece. Following their election triumph, Slovakia became the only eurozone country that did not participate in the bailout. Slovakia did participate in the European Financial Stability Facility (EFSF), yet the permanent extension of the facility caused a breakdown of the ruling coalition, even though it was eventually passed with the support of opposition votes. Ironically enough, the size of Slovakia’s contribution to the EFSF comprises only 1% of the total guarantee commitments by the 17 eurozone member states (see Table 2 for a breakdown of contributions by eurozone member states).

Table 2. Comparison of EFSF guarantee commitments by the EU member states

Country	Guarantee Commitments (EUR) Millions	Percentage
Austria	21639.19	2.78%
Belgium	27031.99	3.47%
Cyprus	1525.68	0.20%
Estonia	1994.86	0.26%
Finland	13974.03	1.79%
France	158487.5	20.32%
Germany	211045.9	27.06%
Greece	21897.74	2.81%
Ireland	12378.15	1.59%
Italy	139267.8	17.86%
Luxembourg	1946.94	0.25%
Malta	704.33	0.09%
Netherlands	44446.32	5.70%

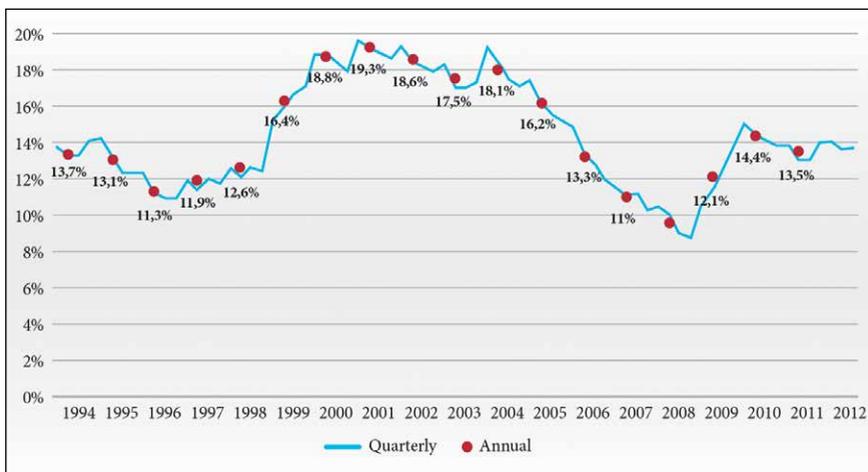
Portugal	19507.26	2.50%
Slovakia	7727.57	0.99%
Slovenia	3664.3	0.47%
Spain	92543.56	11.87%
Eurozone (17)	779783.1	100%

Source: European Financial Stability Facility and Euro Area Loan Facility Act after the 2011 amendment

Social and political impacts of the crisis

The jobless recovery? The social impact of the crisis. Since its independence Slovakia has suffered from high unemployment rates. Even though at the peak of economic growth the unemployment rate shortly dipped below 10%, it has since again rose to 14% (see Figure 6). Unemployment has also been significantly connected to the austerity policies enforced by the Slovak governments since 2010 (discussed more in depth in the ‘future outlook’ part of this chapter).

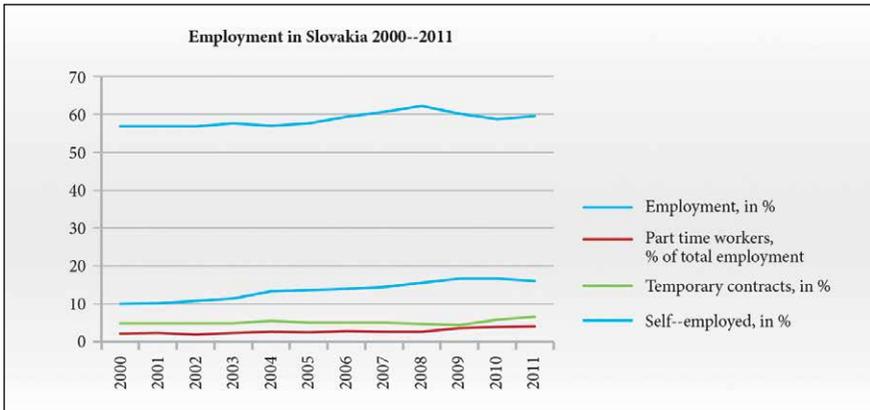
Figure 6. Unemployment in Slovakia 1994-2012



Source: The Crisis and the Consequences of Austerity Policies in Eastern and Central Europe. Data: Slovak Statistical Office

The growth of unemployment has been accompanied by a changed employment structure, with the increased prominence of ‘alternative’ work arrangements, including temporary contracts, work agreements and bogus self-employment replacing standard employment contracts (see Figure 7.1).

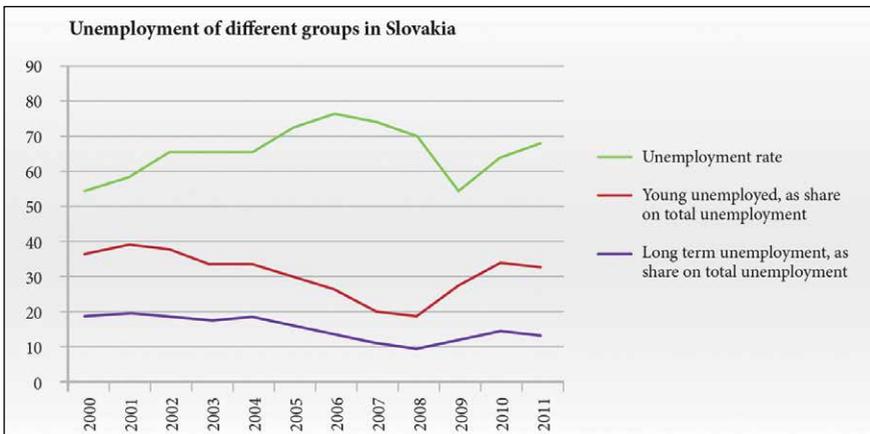
Figure 7.1. **Employment in Slovakia (2000 – 2011)**



Source: Eurostat LFS

Two groups were particularly hit by the crisis – the youth and low-skilled workers. Slovakia suffers from traditionally high long-term unemployment of poorly skilled workers, who struggled to find work even during the boom times and were the first to be made redundant after the outbreak of the crisis. As a result, the share of long term unemployment on total unemployment has been growing (see Figure 7.2.). Workers who remain without a job for a prolonged period of time gradually lose their working habits, which further intensifies their social exclusion and increases the difficulty of re-entering the labour market. Young people are also vulnerable to unemployment due to a mismatch between the output of the Slovak education system and the existing demand for skills on the labour market.

Figure 7.2. **Unemployment of different groups (2000 – 2011)**



Source: Eurostat, LSF

Young people unable to find their first job are often the ones who end up leaving their country. The actual number of outward migrants from Slovakia is hard to estimate, because most Slovak migrants choose other EU countries as their destination and in many cases they keep their address of residence in Slovakia and do not inform the authorities of the fact that they migrated. This is particularly true for migrants who intend to return to Slovakia after spending some time abroad. It is clear that there has been an intensive outward migration from Slovakia, in particular since Slovakia joined the EU in 2004.¹⁷ Since the outbreak of the crisis, there has been some return migration caused by the worsening of the situation in the destination countries, although there are no numbers or estimations available detailing the extent of this phenomenon. The increase in unemployment, in particular among young people, is likely to have provided another incentive for young Slovaks to seek employment elsewhere, which can contribute to the 'brain drain' and cause labour shortages in the future.

The rise of political populism and the metamorphosis of the Slovak party system. The crisis has also contributed to shifting political opportunity structures. Slovakia has had three governments since the outbreak of the crisis, each rising to power on a promise to end ineffective policies pursued by its predecessor. In 2012, the left-wing party managed to gain unprecedented support from the population and form the first one-party government since 1989. Meanwhile, the political right remained fragmented and is struggling to retain some degree of relevancy. Populist formations such as the Obyčajní ľudia (Ordinary People) party have taken over an important part of the former electorate of the traditional political parties. In short, the Slovak party system is currently in flux and the window of opportunity remains open for a reorganisation of Slovak politics.

The rise of populist political actors has been connected with the increased sensitivity of society towards the issue of corruption. Corruption scandals have been a part of the everyday reality of Slovak politics since the independence of the country. So far, however, there has not been a single high-ranking politician or civil servant found guilty of corruption-related charges even though all political parties often accuse their opponents of engaging in corrupt practices. This in turn leads to a loss of faith in democratic politics and an increase in support for populist political formations, as well as a mushrooming of social movements formed to fight corruption. Popular support for these movements culminated in the so-called Gorilla case. The uproar was caused by the leak of alleged transcripts of secret debates between a well-known businessman and various politicians, in which the participants discussed how to enrich themselves at the expense of public resources.

Massive demonstrations took place in Bratislava to protest the immoral

¹⁷ Martin Kahanec and Klaus Zimmerman, *EU Labour Markets after Post-Enlargement Migration...*

connections between the business and political spheres, and the subsequent poor performance of the centre-right political parties was blamed on the implication of several key people in the Dzurinda governments in the scandal. Their severe defeat in the 2012 elections radically weakened the position of the former leader of the centre-right forces. Ironically, Fico, whose left wing party gained an absolute majority in the parliament, was also implicated in the scandal. The likely explanation for this divergence of outcomes is that the interaction between the outbreak of the crisis, which erased the apparent success of the Slovak business model put into place by centre-right representatives after the defeat of Mečiar, and the moral outrage over the apparent omnipresence of corruption led to the collapse of popular support in particular for those political forces that represented liberalisation and modernisation tendencies in society. The success of SMER might point to a renewal of the demand for strengthening the role of the state as a guarantor of welfare and law in a society disappointed with the failure of the centre-right forces to deliver the promised material elevation and better governance.

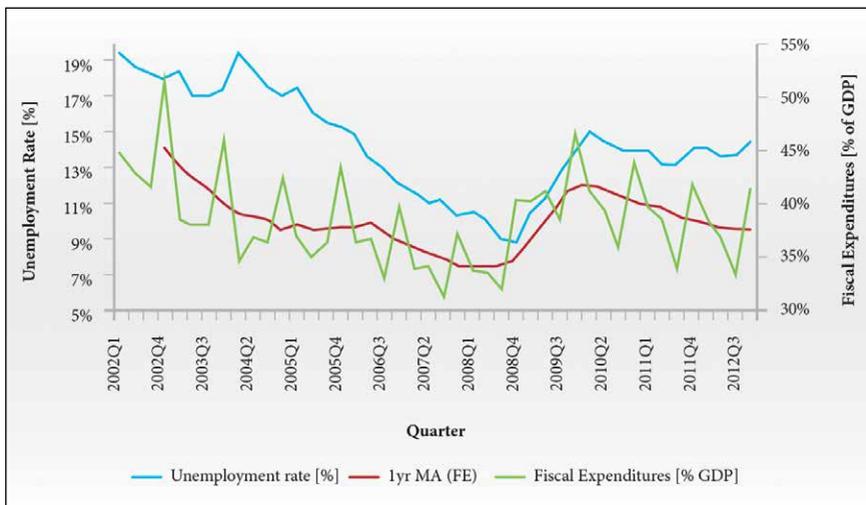
The path forward

Unemployment seems to be the crucial category for understanding the impact of the crisis on Slovak society. Even though Slovakia managed to retain growth and the trust of global financial markets, there appears to be a real risk of a return to the high unemployment equilibrium with all its associated negative consequences for society as well as for the economy and political system. In spite of evidence pointing to the imminent recovery in the eurozone, which should also bring higher growth rates in Slovakia, there seems to be a real danger of a jobless recovery.

It is clear that the austerity policies pursued by the government are a factor that hinders job creation. Therefore, in this section, we would like to explore the relationship between the austerity policies pursued by the government and unemployment. The space allocated for this chapter is not sufficient to discuss the issue in depth – therefore, the following discussion should be seen as an attempt to define the framework for understanding the issue.

What the data show us? The data we use is quarterly-based, ranging from Q1 2002 to Q4 2012, covering the span of the last 11 fiscal years. A first glimpse at the time series of unemployment rates and fiscal expenditures hints at the assumption that these are positively correlated, exhibiting the same trend pattern (at least until the outbreak of the crisis).

Figure 8. Spending and unemployment in Slovakia



Source: Eurostat

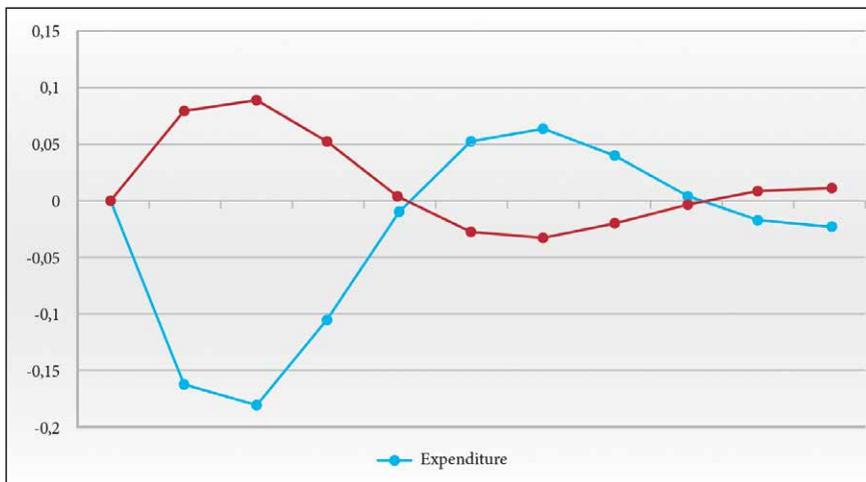
As Figure 8 shows, traditionally the two variables were linked, probably because economic growth led to both job creation and a decrease of the relative share of spending on GDP, while economic contraction led to exactly the opposite scenario. However, the current broader situational context seems to be different – the share of public expenditures on GDP is getting lower, but unemployment is stagnant. This confirms the ‘jobless recovery’ scenario already mentioned in this chapter.

Establishing the relationship. To support our answers with a statistical analysis, we refer to the regression model by Turrini¹⁸, trimmed by country fixed effects used to measure the impact of austerity on unemployment: where denotes the country’s unemployment rate in the -th period, is the amount of government expenditure during that period, are period fixed effects, and is the standard white-noise error. This is an augmented AR2 model, the motivation for its implementation being the regular oscillations of cyclical unemployment around the mean for large data samples.

Based on longitudinal data from 13 European countries, the impact of fiscal adjustment on unemployment seems to be quite clear, at least in the short run.

¹⁸ Alessandro Turrini, “Fiscal Consolidation in Reformed and Unreformed Labour Markets: A Look at EU Countries,” *EU Commission Economic paper* 462 (2012), http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp_462_en.pdf

Figure 9. Changes in unemployment per 1% of GDP fiscal stimulus



Source: Turrini¹⁹

The sample did not include Slovakia; however, the results proved to be quite robust when different degrees of labour market regulation were taken into account.

Implications for Slovakia. In the outlook for Slovakia published by the European Commission, the unemployment rates are poised to decline slowly (see the EU forecast on Table 3). There should be little or no negative pressure on unemployment caused by austerity as the government now seems to be done with cutting spending and does not plan any significant tax increases for the near future. Nevertheless, despite the 2016 elections, there is currently no plan to stimulate the economy in spite of the expected sluggish recovery of the job market.

Meanwhile, the loss of jobs caused by austerity is likely to remain rather sticky and there is no evidence suggesting that a medium-term effect of unemployment rates returning to the original levels following the fiscal adjustments described by Turrini is going to be visible in Slovakia over the course of the coming years.

¹⁹ Alessandro Turrini, “Fiscal Consolidation in Reformed and Unreformed Labour Markets...” 14.

Table 3. Main features of country forecast for Slovakia 2013

	2012			Annual percentage change					
	bn EUR	Curr. prices	%GDP	94-09	2010	2011	2012	2013	2014
GDP	71.1	100	4.5	4.4	3	1.8	0.9	2.1	2.9
Private Consumption	41	57.7	-	-0.7	-0.5	-0.2	0.8	0.9	1.9
Public Consumption	12.5	17.6	2.5	1	-4.3	-1.1	0.1	4.2	2.8
Gross fixed capital formation	14.3	20.1	2.9	6.5	14.2	-10.5	-5.3	1.2	3.7
of which: equipment	6.8	9.6	-	11.7	38.3	-11.5	-6.3	-0.5	4.3
Exports (goods and services)	68.7	96.6	8	16	12.2	9.9	4.6	4.6	6
Imports (goods and services)	65	91.4	6.9	14.9	9.7	3.3	1.9	4.3	5.8
GNI (GDP deflator)	69.4	97.6	4.5	2.6	3.4	1.6	1	2.1	2.9
Contribution to GDP growth:	Domestic demand		3.8	1.1	1.9	-2.7	-0.6	1.5	2.2
	Inventories		0.2	2.6	-0.8	-1.4	-1.2	0	0
	Net exports		0.4	0.7	2	5.9	2.7	0.6	0.7
Employment			0.3	-1.5	1.8	0.7	-0.3	0.3	0.5
Unemployment rate (a)			14.8	14.5	13.7	14	13.9	13.7	13.3
Compensation of employees/head			-	5.1	2	2.8	2	3	3
Unit labour costs whole economy			-	-0.9	0.8	1	0.8	1.3	0.6
Real unit labour cost			-	-1.4	-0.8	-0.2	-0.6	-0.5	-1.2
Saving rate of households (b)			8.9	10.3	9.4	8.2	5.8	6.8	7.2
GDP deflator			5.2	0.5	1.6	1.3	1.5	1.8	1.8
Harmonised index of consumer prices			-	0.7	4.1	3.7	1.7	1.6	1.9
Terms of trade goods			-	-0.8	-1.5	-1.3	0	-0.1	0
Trade balance (c)			-5.2	0.8	1	4.7	7.3	7.6	8
Current-account balance (c)			-5.4	-3.7	-2.6	1.6	4.3	4.3	5.4
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-5.4	-2.1	-0.9	3.1	5.6	5.4	6
General government balance (c)			-5.5	-7.7	-5.1	-4.5	-3	-3.2	-3.8
Cyclically-adjusted budget balance (c)			-5.9	-7.4	-4.6	-3.9	-1.9	-2.1	-2.9
Structural budget balance (c)			-3.8	-7.3	-5	-4	-2.3	-3.1	-2.9
General government gross debt (c)			36.9	41	43.4	52.2	54.3	57.2	58.1

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

Source: European Commission²⁰

The current outlook for the Slovak economy in the medium term can be, therefore, expressed best using the term ‘stagnation’. While the bleeding of the crisis years has largely stopped, there seem to be no reason to expect that the ‘golden years’ of double-digit growth from the pre-crisis era will return in the medium run. The prolonged period of high unemployment could have a negative impact on economic developments in Slovakia in the long run through stimulating brain-drain dynamics. Furthermore it can result in a deepening of distrust in democratic institutions, which will result in increased ex ante constraints on necessary reforms, for example in the healthcare industry.

²⁰ European Commission, „Slovakia”, http://ec.europa.eu/economy_finance/eu/countries/slovakia_en.htm

Conclusions

The Slovak economy did not suffer from the same problems as some Western European economies; the economy was competitive and capable of attracting significant investment, in particular in the manufacturing sector. Furthermore, the banking sector was stable and the authorities were fiscally mostly prudent. On the other hand, dependency on the industrial sector made Slovakia vulnerable to external demand shocks caused by the economic problems of West European countries.

Slovakia's eurozone accession in 2009 has likely also played a role in how the country has fared throughout the crisis; however, as of now it is too early to precisely evaluate whether the effects were positive or negative.

The good shape of the Slovak economy at the outbreak of the crisis made it possible for the government to attempt to counter the destructive effects of the crisis through increased government spending. Nevertheless, this policy failed to protect the country against the external shock and entailed a significant fiscal burden. As a result, the government was forced to embrace austerity to maintain fiscal stability at a time when economy was just coming out of the recession.

In addition to the quickly worsening fiscal position of Slovakia, austerity was also legitimised through moral appeals stressing the virtues of 'living within our means' and European policies aimed at strengthening the commitment of particularly the eurozone countries to decreasing budget deficits.

There was a combination of increased pressure for the implementation of austerity measures in a country that is still among the poorest in the EU and whose citizenry had endured more than their share of austerity and reforms over the course of 2000s, as well as what was often framed as a *loan for fat Greeks*.²¹ In this respect, the crisis poses a challenge for the Slovak political system, which has been traditionally united in support of European integration.

The single biggest social impact of the crisis and austerity has been the fast return of high unemployment rates, which have troubled Slovakia since the beginning of its existence and only disappeared for a short time due to the rapid growth period preceding the crisis. Young people and low-skilled workers were hit the most, and even those who managed to retain their jobs were often pushed into 'alternative' working arrangements, without the security of standard employment. Consequentially, additional outward migration for Slovakia can be expected.

In terms of the impact on the political system, the crisis has played into the general disillusion of the population towards politicians, in particular reformists. This disillusion was further strengthened by anger stemming from the widespread

²¹ "Tatra Tiger on the Ropes", *The Economist*, October 12, 2011, <http://www.economist.com/blogs/eastern-approaches/2011/10/slovakia-and-euro-crisis>

perception of corruption. As a result, the existing cleavage between political left and right ceased to define Slovak politics, because the left gained total domination and the centre-right forces struggle to remain relevant while having to fight back against new populist formations.

Looking into the future, we found that austerity in Slovakia has likely led to job loss, which is not likely to disappear in the medium run. Our expectation is that after the good times of fast economic growth in the mid-2000s and the bad times of the late-2000s and early-2010s crisis, Slovakia is poised to enter a period of stagnation. This development could also pose a threat to the long-term future of Slovakia by providing an additional impetus for young, talented Slovaks to seek their future abroad, or by contributing to the further delay of necessary reforms.

The Czech Republic: From supply-side economics to aggressive deficit-cutting. And now an expansionary turn?

Juraj Draxler

The Czech Republic did not experience a dramatic onset of the crisis. Immediately after the Lehman Brothers collapse in September 2008, the government dismissed the possibility that a US banking crisis could have any impact on the Czech economy. However, by the end of that year the country was facing a sustained reduction of demand for the products of its strongly export-based economy. Also, banks were quickly limiting access to short-term credit.

In response, the government convened a group of experts to suggest crisis-fighting measures. The ensuing official strategy was to fight the downturn with supply-side policies. These included export-boosting steps and some tax relief, for example in the form of faster depreciation schedules. Crucially, the government also introduced sweeping cuts to social security contributions. It argued that the reduction in revenue would be offset by better employment.

This was in line with the fundamental ideological commitments of the ruling coalition. Voted into power in 2006 after eight years of Social Democratic governments, it was dominated by the Civic Democrats. The conservative Christian Democrats were the junior partner. The coalition insisted on catching up with pro-market reforms seen elsewhere in Central and Eastern Europe. In early 2008 the coalition introduced a flat tax, the flagship scheme of post-socialist reformers. It also started preparing a partial privatisation of mandatory pensions. And, as mentioned, it reacted to the unfolding crisis by reducing labour taxes.

The latter measure backfired almost immediately. Supply-side stimuli contributed to widening fiscal deficits. Ironically, this proved politically expedient. Following the Greek bailout, leading politicians on the right warned that the Czech Republic could “go the Greek way” if the Social Democrats took power. When the Civic Democrats found themselves back at the helm in 2010 after a year-long caretaker government, heading a three-party coalition, they vowed now to fight the crisis with austerity policies. As a result, supply-side measures went quietly out the window. The government raised the VAT tax and made income tax slightly more progressive by redefining the tax base. Even so, growth remained sluggish and public debt as a percentage of the gross domestic product (GDP) grew significantly.

In the end, the coalition imploded over a series of corruption and abuse-of-power scandals. The Civic Democrats, the party that dominated the right

wing of Czech politics for more than two decades, barely managed to remain in parliament. In the October 2013 elections it raked in just 7.7% of the vote, an unprecedented debacle. The new coalition is, as of December 2013, not yet fully formed. However, the Social Democrats have managed to pen a draft coalition agreement with ANO, a newly-formed party led by the Czech Republic's second richest man, Andrej Babiš, and a much smaller party, the Christian Democrats, a reduced and reformed version of the party that ruled with the Civic Democrats from 2006-2009. The shift in the political landscape has been truly tectonic. The perception by the public of how the previous two right-wing governments handled the economy throughout the crisis played a big role in this. It was not so much about the economic impact of the crisis, but the reformist chaos that the government unleashed ostensibly to make the economy more competitive. In many ways, the government parties were trapped in the reformist rhetoric that had dominated the political landscape for two decades.

Transition history

Socialist Czechoslovakia had actually ranked among the most nationalised economies in the Soviet bloc. Neighbouring Poland retained a considerable share of small private farming during its own four decades of central planning. Another neighbour, Hungary, allowed small private enterprises to exist some years before the demise of the regime. But in Czechoslovakia, all production of goods and services was controlled by the state.¹ In addition, a very high share of housing stock was either housing collectives or directly state-owned flats.

However, after 1989, the country – which split into the Czech Republic and Slovakia in 1993 – went down the path of radical reforms. Price liberalisation was swift, and by the end of 1991 practically all prices were deregulated.² In parallel, gradual but fast steps toward foreign exchange liberalisation were taking place. At the same time, “small privatisation” went ahead in 1991/1992. This was the process of selling off retail units such as cafes, supermarkets, restaurants, hairdressers, and so on.

By January 1, 1993, when the Czech Republic became independent, most of these early transition measures were completed or at a very advanced stage. By the end of that year, more than half of employment was in the private sector.³ The country was also quickly opening up to trade, withdrawing technical restrictions such as quotas and permissions, and lowering import duties fast. By 1995, average

¹ The few negligible exceptions to this included the possibility to sell off surpluses from one's own garden.

² Patricia McGrath, “Impact of Financial Deregulation on Monetary and Economic Policy in the Czech Republic, Hungary and Poland: 1990-2003”, William Davidson Institute Working Paper Number 1049 (May 2013).

³ Patricia McGrath, “Impact of Financial Deregulation on Monetary and Economic Policy...”, 4.

import duties were at 8-10% for manufactured products and 19% for foodstuffs and agricultural products.⁴ In that year, the country also joined the World Trade Organization (WTO).

In sum, in its early stages of transition, just like Poland but unlike Hungary, where privatisation was much slower, the Czech Republic chose a radical approach. Also, in contrast to Poland or Hungary, which both experienced hyperinflation in the 1980s and high inflation in the early 1990s, the Czechs did not experience prolonged phases of high inflation. This had positive and negative consequences. On the one hand, low inflation made it difficult for large enterprises to get rid of debt. This not only accrued in the transition period; in many cases companies remained saddled with high real debt dating back to the socialist period. The debt made life difficult for the companies and ultimately also for the banks. In the end, the Social Democratic government of 1998-2002 moved the bad debt off the banks' balance sheets into a special vehicle and privatised the financial institutions. But in late 1990s, the credit crunch resulting from tighter monetary conditions and from banks refusing to lend more to indebted companies had created some serious difficulties.

On the other hand, this monetary stability meant Czech and Slovak citizens have retained confidence in their own currency. There was never the kind of parallel economy using Western money that sprang up in many other post-Socialist countries. In addition, even though there were some bank bankruptcies in the second half of 1990s when monetary policy was tight, the banking sector remained fairly stable. As a result, the population trusted the local banks and the Czech crown. There was no inclination to take out loans in anything other than the home currency.

Following early price and trade deregulation and small privatisation, the second reform wave started – the privatisation of large state enterprises. Here again the government opted for a fast and radical solution. Back in 1990, influential groups of industry leaders, politicians and civil servants argued for the selective sale of enterprises to strategic investors who would provide capital, access to markets and technological know-how. In this spirit, Škoda Auto, the traditional car manufacturer, was sold to Volkswagen in 1990. Nevertheless, after the first free elections in June 1990 the political group led by Finance Minister (and soon Prime Minister) Václav Klaus prevailed. This group argued not only for a generally fast, “shock” approach to transformation, but also for the use of the voucher method of privatisation. Every adult citizen of what was then still Czechoslovakia received a book with 1,000 points and could allocate those to

⁴ World Trade Organization (WTO), “Trade Policy Reviews: Czech Republic March 1996,” http://www.wto.org/english/tratop_e/tptr_e/tp29_e.htm

companies of his or her choice. In several rounds of bidding, companies were sold off to citizens.

The twist in the whole story was the appearance of investment funds. These offered to take over citizen's privatisation vouchers and invest points on their behalf. Afterwards they would take over the shares in the company and pay cash in return. Unfortunately, in most cases the funds just stripped companies of assets, leaving empty shells and not even paying the promised cash to the small investors.

So, in many ways, the road to stock exchange-based, popular capitalism was closed by the end of the 1990s. Stock-exchange capitalisation was low and citizens did not trust the capital market. However, just like in many other new member states, reformers changed their narrative to argue that the economy must be kick-started by social security and healthcare reforms. Soon, a new idea of how to make people stakeholders in capitalism surfaced – a partial privatisation of the mandatory pension system. This emerged, together with the flat tax, as the reform beacon that the pro-market political forces clung to with increasing persistence.

By early 2000s, all of the manufacturing industry as well as services were private and the banks were owned by large European banking groups. The Czech Republic emerged as one of the globally most open economies. Ranked by simple ratios of gross exports to GDP, the country is the 17th most open in the world.⁵

The country therefore entered the global slump as a small, FDI-driven economy highly dependent on external demand. But pro-market politicians believed that the country needed more headline-grabbing reforms, such as pension privatisation and the introduction of a flat rate income tax. This was the ideological backbone of the government at the helm as the country entered the crisis in 2008.

Macroeconomic overview

In terms of macroeconomic performance, even though the onset of the crisis was not anywhere as bad as in the Baltic States or Greece, over the course of the entire 2008-2013 period the Czech Republic has been affected slightly more than its immediate neighbours. As we see from Figure 1, it has fared worse than Germany and Slovakia, its two biggest trading partners. What is particularly interesting is the downturn in 2012 and the projected slump for 2013.

⁵ According to the World Bank World Development Indicators database, accessed December 10, 2013. <http://data.worldbank.org/data-catalog/world-development-indicators>

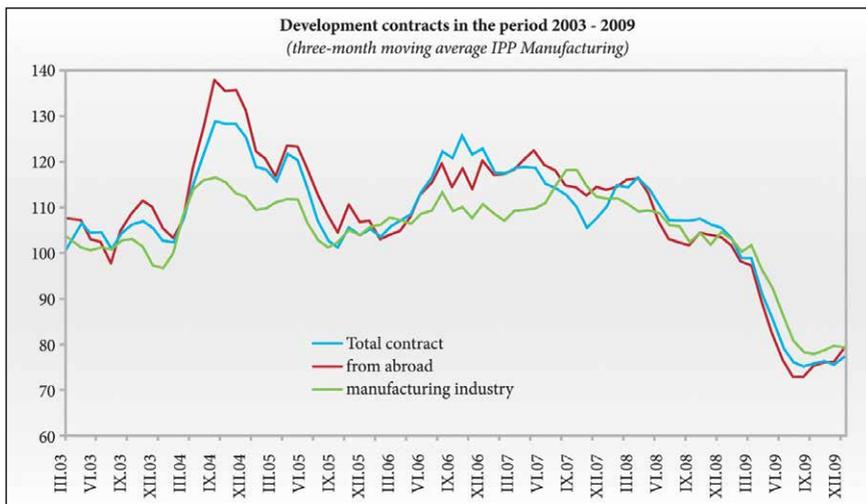
Figure 1. Annual gross domestic product (GDP) growth

	2007	2008	2009	2010	2011	2012	2013
Czech Republic	5.7	3.1	-4.5	2.5	1.8	-1.0	-0.4
Germany	3.3	1.1	-5.1	4.0	3.3	0.7	0.4
Slovakia	10.5	5.8	-4.9	4.4	3.2	2.0	1.0
EU 27	3.2	0.4	-4.5	2.0	1.7	-0.4	-0.1

Source: Eurostat

To look at what precisely happened, let us go back to 2008. In September, the outlook was still relatively positive. However, in October orders in the economy started a freefall (Figure 2).

Figure 2. Orders in the years 2003-2009

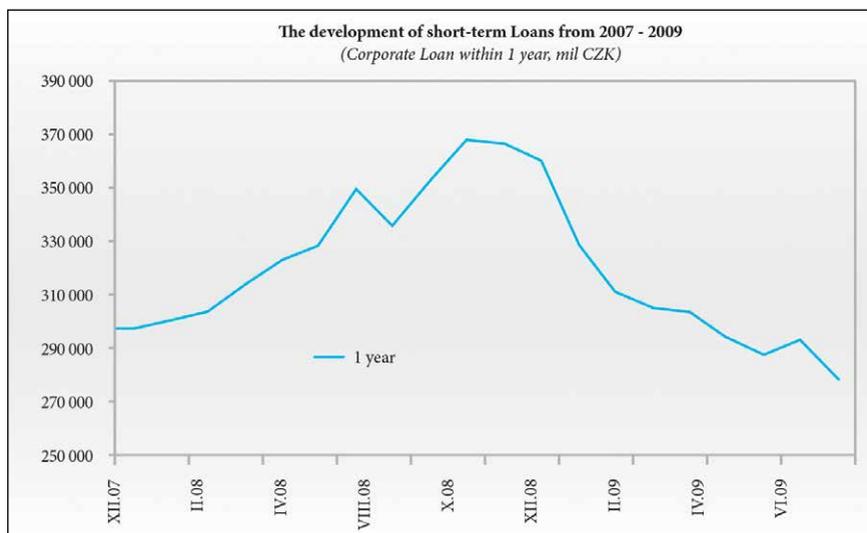


Source: Czech and Moravian Confederacy of Trade Union⁶

This was also the month that short term credit peaked. However, with orders falling, the banking sector started restructuring its credit lines towards longer term credit (Figure 3).

⁶ Českomoravská konfederace odborových svazů, “Ekonomická krize – pohled odborů III” (Czech and Moravian Confederacy of Trade Union, “Economic Crisis – the Union View III”), March 9, 2009, <http://www.cmkos.cz/studie-ekonomicke-analyzy-prognozy/1694-3/ekonomicka-krize-pohled-odboru-iii>

Figure 3. Short-term (up to one year) credit, in millions of Czech crowns⁷



Source: Czech and Moravian Confederacy of Trade Union⁸

So by mid-2009 the total amount of credit given had not changed much, but there was a clear reduction in short-term credit, as seen in Figure 4 (below). Short term credit, however, is vital for supporting the cash flow of many enterprises, especially smaller ones unable to tap other types of credit markets (such as issuing bonds or money market instruments).

Figure 4. Changes in credit structure (quarter-on-quarter, indexed)

	Total credits	Up to 1 year	1-5 years	Over 5 years
4Q/3Q 2007	100.76	103.71	92.82	102.69
4Q/3Q 2008	100.18	89.47	104.6	110.33

Source: Czech and Moravian Confederacy of Trade Union⁹

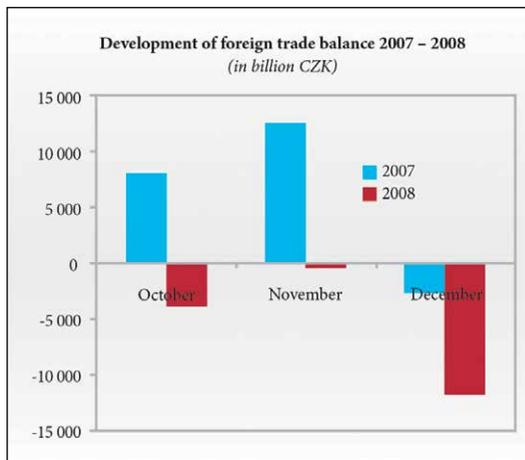
With a fall in orders, by the end of 2008 the country was also experiencing a deepening trade deficit.

⁷ The exchange rate is approximately 1 euro to 27 Czech crowns.

⁸ Českomoravská konfederace odborových svazů, “Ekonomická krize – pohled odborů III”.

⁹ Českomoravská konfederace odborových svazů, “Ekonomická krize – pohled odborů III”.

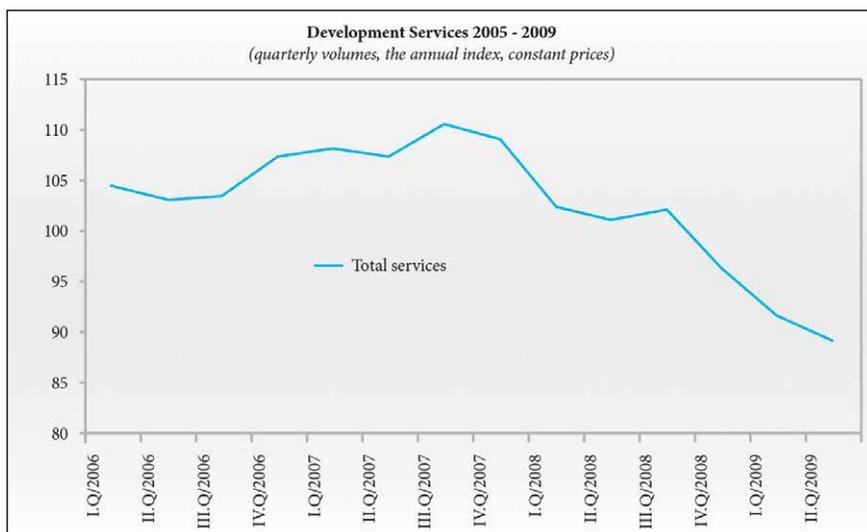
Figure 5. Changes in the trade balance, 2007-2008 (in billions of Czech crowns)



Source: Czech and Moravian Confederacy of Trade Union¹⁰

Services were sliding, too (Figure 6).

Figure 6. Quarterly volume of services from 2005-2009, year-on-year index, constant prices



Source: Czech and Moravian Confederacy of Trade Union¹¹

¹⁰ Českomoravská konfederace odborových svazů, “Ekonomická krize – pohled odborů III”.

¹¹ Českomoravská konfederace odborových svazů, “Ekonomická krize – pohled odborů III”.

Nevertheless, even despite an increase in unemployment, the Czech labour market was actually holding up fairly well.

Figure 7. Semi-annual figures for the year-on-year harmonised (not seasonally adjusted) unemployment rate in the Czech Republic (%)

	06/08	12/08	06/09	12/09	06/10	12/10	06/11	12/11	06/12	12/12
Czech Republic	5.9	6.4	7.3	7.9	8.1	7.8	7.8	7.7	7.9	8.1

Source: Eurostat

The underlying fundamentals also remained good. The Czech Republic had a fairly consolidated banking sector and an export-oriented economy strongly tied to Germany. It also had none of the weaknesses that accounted for early collapses in the region. There were no domestic loans in foreign currencies, as was the case in Hungary and Latvia. The debt, which according to Eurostat stood at 28.7% at the end of 2008¹², was among the lowest in the EU. Therefore, the government would not need to fear a panicky reaction in bond markets.

Nevertheless, it chose to react to the crisis with more pro-market reforms. It was very open and ideological in its commitment. The National Anti-Crisis Plan, introduced in February 2009, opens with statements such as “this plan is based on the principle of more freedom, not more of the state”. It also directly refused to entertain any notion of implementing solutions along Keynesian lines (“Instead of populist fiscal stimulation measures, we have focussed here on supply-side reforms.”)¹³.

The plan came following suggestions by a group of experts that the government had convened in early 2009. Called the National Economic Council of the Government (NERV), it was a mixture of experts from CERGE-EI, the respected economics graduate school and research institute in Prague, and analysts from banks and brokerages.

The plan featured a list of ongoing reforms, i.e. those that the government had already planned before the crisis and now insisted on with even more urgency. There was also a list of completely new measures.

¹² Eurostat database, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde410&plugin=1>

¹³ Národní ekonomická rada vlády (NERV), “Představujeme národní protikrizový plán“ (National Economic Council of the Government, “Introducing the National Anti-crisis Plan”), presented in February 2013, <http://www.vlada.cz/assets/media-centrum/predstavujeme/narodni-protikrizovy-plan.pdf>

Ongoing:

- Lower corporate income tax from 24% to 21% as of January 2008, with a planned further decrease to 20% as of January 2009, and 19% as of January 2010. Also lower withholding taxes.
- Better financing for SMEs by providing loan guarantees through the country's development bank, and better financing for agriculture and forestry businesses through special guarantee instruments.
- A slight increase in infrastructure financing. This mostly consisted of financing for a large university cluster project in Moravia.
- Increase in the salaries of civil servants.
- Better capitalisation for the export-import bank and a range of new financial instruments to help exporters. As we will see later, strong pro-export policies have remained a priority to this day. This is one area where parties across the political spectrum have tended to agree.
- A small increase in R&D spending.

Newly-proposed measures:

- Cuts to social security contributions. These were regressive in the sense that employers were entitled to bigger discounts on lower-paid employees. This turned out to be the most expensive of the proposed measures. With a rising hole in public finances, the government quickly stopped advertising this as a success story.
- Sweeping withholding tax holidays.
- Faster depreciation schedules.
- Faster reimbursement of VAT.
- Increased funding for green initiatives, especially subsidies for insulating blocks of flats to make them more energy efficient. Like pro-export policies, this was a non-controversial measure. It was supported across the political spectrum and in line with the commitment to cut emissions of greenhouse gases.
- Mass-transportation subsidies (especially for short-distance bus lines) to facilitate labour mobility.

The trade unions criticised the crisis plan both in terms of its contents as well as the policy process. The plan was formally presented to the national tripartite council on February 16. Two days later, on February 18, the plan was already put to vote in parliament. The unions, and the public in general, had practically no time to analyse and discuss the measures.

In terms of the contents of the plan, economic commentary by the main union body in the Czech Republic, the Czech and Moravian Confederacy of Trade Unions (ČMKOS), immediately attacked the plan as wrong in its diagnosis and wrong

in the measures prescribed.¹⁴ The unions warned that there was the danger of a protracted economic slump and pointed out that this is how Western governments viewed the situation. The government's plan, on the other hand, talks of "a cyclical downturn".¹⁵ The unions were urging the government to take both broader and better targeted measures. They were especially critical of the planned cuts to social contributions inasmuch as they were not targeted and were regressive. The union commentary thus insisted that the whole idea of trying to incentivise by giving bigger contribution discounts on lower-paid employees was bad economics. "The salary generally reflects how much an employee contributes to the firm and how much the firm values him or her. It is not likely that companies fighting for survival will opt to lay off their highly qualified employees and keep the less qualified. They are not going to let the engineers go and keep the cleaning staff".¹⁶ The measure, therefore, was badly designed. Even worse, since it would still cover a large part of the workforce, it would create a big hole in public finance.

Instead, in contrast to the government plan, the unions urged tax relief, more bank guarantees and other instruments that would be especially tailored to keep viable but temporarily struggling companies afloat. The unions also urged a recourse to fiscal stimulus.

The unions certainly had a point. In view of a deficit that really was getting out of hand, the next pro-market government, from 2010-2013, backtracked on supply-side measures and instead prescribed austerity policies. Yet the economy contracted again, and government's critics, such as the unions, pointed to a lack of internal demand caused by poorly designed austerity measures as the main cause.

Regulatory and governance effects

Since the government was committed to making life easier for businesses, it continued to introduce earlier-than-planned reforms aimed at keeping red tape under control. The government made it much easier to set up small businesses by easing the bureaucracy that this involved. It also introduced a system of Regulatory Impact Assessments (RIA).¹⁷

In this spirit, in 2007, the Czech government passed rules binding the government

¹⁴ Českomoravská konfederace odborových svazů, "Ekonomická krize – pohled odborů II" (Czech and Moravian Confederacy of Trade Union, "Economic Crisis – the Union View II"), March 9, 2009, <http://www.cmkos.cz/studie-ekonomicke-analyzy-prognozy/1387-3/ekonomicka-krize-pohled-odboru-ii>

¹⁵ Národní ekonomická rada vlády (NERV), "Představujeme...", 3.

¹⁶ Českomoravská konfederace odborových svazů, "Ekonomická krize – pohled odborů II", 5.

¹⁷ RIAs are part of a general insistence on evidence-based policy-making and are recommended by international organisations such as the OECD. The idea behind RIAs is that governments should not only prepare analyses of their reforms' macroeconomic impacts or the impact on the suggested target group. Instead, there should be an analysis of how a piece of regulation might affect businesses, e.g. by increasing their compliance costs, as well as wider stakeholder groups and relations.

to submit all of its legislative proposals to RIAs. This was the first attempt in any of the new member states to create a comprehensive RIA framework. All pieces of legislation originating with the government now have to be accompanied either by a “small RIA” (which is largely qualitative) or a “large RIA” (where the financial impact of legislation is supposed to be sizeable, and in these there should be a proper quantitative analysis provided as well).¹⁸ However, the evidence that this has improved policy-making is not overwhelmingly positive. The government sometimes introduces legislation via individual members of parliament, thus bypassing this requirement.¹⁹ Or it simply ignores it, as was the case with a lot of the legislation rushed through as part of the anti-crisis package – a fact that the trade unions bitterly complained about.

The Nečas government, which came into power in 2010, also rolled out several large-scale IT reforms. Practically all of these proved controversial. After the Ministry of Social Affairs introduced a new system to help pay out social security benefits, systems kept crashing and the government was humiliated by having to keep staff on long hours in order to pay benefits on time. The whole story remained headline news for many weeks. Later, the same ministry introduced a debit card for benefit claimants, insisting it would stop the paying out of benefits by postal orders and that every claimant had to use the card. This proved controversial as well. The government changed its position several times, while the courts ruled against the exclusive use of accounts and cards prescribed by the government. In the end, the whole project was discontinued. In the summer of 2012, the government introduced a new IT solution for car registrations, which resulted in chaos lasting for months.

In the health sector, the government had been trying to introduce electronic patient records since 2002. However, the company implementing this had anonymous owners and the costs over the years snowballed. The system was not much used and in the end, and the public General Health Insurance Agency discontinued it.

In fact, especially the Ministry of Social Affairs’ IT tenders were hugely controversial, and towards the end of the government’s lifetime the junior minister responsible for them was led away from his office by the police, in handcuffs.

This was ironic. The 2010-2013 government of Petr Nečas had two overriding policy agendas when entering office – fiscal responsibility and the fight against corruption. Unlike many other politicians, the Catholic Nečas lived modestly and was dubbed “Mr Clean” by journalists. The second party in the coalition was TOP09, led by Karel Schwarzenberg, an aristocrat with a Swiss passport, but really

¹⁸ “Hodnocení dopadů regulace”, Ministerstvo vnitra ČR (“Regulatory Impact Assessment”, Interior Ministry of the Czech Republic), <http://www.mvcr.cz/clanek/hodnoceni-dopadu-regulace-ria.aspx>

¹⁹ Centre for European Policy Studies & The Evaluation Partnership, Study on Social Impact Assessment, Study for DG Employment and Social Affairs of the European Commission (June 2010).

managed by Miroslav Kalousek, the finance minister. The third party was Public Affairs (VV), an upstart headed by a popular anti-corruption journalist crusader Radek John.

The government introduced an anti-corruption manual for bureaucrats. It also introduced property declarations for a wide range of elected public officials. This had long been touted as an effective anti-corruption measure. However, it proved to be a toothless instrument. Just like other new member states, the Czech Republic never introduced a system of wealth taxation that would serve both the purpose of effectively taxing wealthy individuals and being a register of acquired wealth, against which the illegal income of anybody, not just politicians, could be checked. In a similar vein, the country never introduced any checks on residency for wealthy individuals. It is therefore fairly unproblematic for the rich to register as tax residents in a tax haven while still being active and physically present in the Czech Republic.

From almost the beginning, the coalition was rocked by infighting. As a by-product of jostling for positions of power, more and more details of corruption were leaked to the press. Very early on, Prime Minister Nečas refused to intervene in cases where his party faithful were implicated in shady dealings, some of which were even taped.²⁰

In spite of prosecutors' bold action against Nečas, the public does not feel that much has been done to root out corruption and nepotism. Powerful lobbyists continue to enjoy power and ostentatious wealth. The widespread feeling that all Czech politics is hopelessly dirty is probably the biggest legacy of Nečas's government.²¹

Fiscal policy and taxation

Besides being corruption fighters, the government that started in 2010 also declared itself "the government of fiscal responsibility". With moribund growth trends, it soon needed recourse to higher taxes. Being ideologically committed to low taxation, it decided not to start by raising the rates of direct taxes. Instead, it redefined the tax base for personal income tax, making it slightly broader and more progressive. The government also raised the lower VAT band from 10% to 14%. This

²⁰ Nevertheless, the newly-encouraged prosecution service acted against him in the summer of 2013. The head of his cabinet, with whom Nečas was having an affair, had instructed the military intelligence service to spy on Nečas's wife. She was also involved in negotiations to give certain MPs who threatened to topple the government highly paid jobs in state controlled firms as compensation for their resignation. This classification of pork barrel politics as corruption was legally controversial. Nevertheless, Nečas, his reputation damaged beyond repair and now generally disliked by the public, resigned, bringing the government down with him.

²¹ For a brief summary of the economic policies and corruption cases of Nečas's government, see, for example, the following article by the economist for the Czech-Moravian Confederation of Trade Unions: Jaroslav Ungerma, "The Legacy of Petr Nečas: Erosion of Public Confidence in Politics," V4 Revue, September 12, 2013, <http://visegradrevue.eu/?p=1788>

was a risky measure. The finance ministry argued that the tax increase would be absorbed by retailers and would not result in higher prices. However, this proved to be wrong. By the end of the year, headline inflation stood at 3.3%, while prices of foodstuffs rose by 5.0% on a year-on-year basis. Retail sales dropped by 2.5%.²²

Changes to the tax system left many unhappy. For example, businesses were left on edge in October 2012 as the government tried to introduce a VAT increase for the next year. In addition to rushing this through parliament without almost any forewarning, the process got stuck and the parliament did not approve the increase until mid-December. This meant the private sector had only two weeks to prepare for the change (changing computer software, product labels, and so on).

The government also had to act against over-generous support for solar power stations. This was introduced in the 2006-2010 legislative term and was extremely badly designed. In order to counter the generosity of subsidies and stable purchasing prices for solar energy, the government introduced a special, very steep solar surcharge. This became a symbol of how politicians check their bad decisions with equally egregious measures. The owners of the solar stations started a series of arbitrage proceedings against the Czech Republic and it is expected that they will at least partly win.

In general, however, the government's declaration of its firm commitment to low-deficit policies probably contributed to relatively favourable conditions in the bond markets, where yields on Czech bonds remained among the lowest in the CEE region. In addition, the government decided to issue retail bonds. This is something it has never done in the past. In fact, it is a relatively rare practice in Europe nowadays. Governments prefer to raise money by pitching bonds to large institutional investors through auctions. A bond can be bought on a secondary market by any physical person, of course, but the relatively high face value and occasional registration conditions make this impractical. However, in October 2011 the Czech government went ahead and issued 20 billion Czech crowns worth of bonds to the public (about 800 million euro at the exchange rate at the time).

The reasons for this are not entirely clear. The bonds issued were costlier for the government than wholesale finance. In theory, this is offset by the fact that private individuals are much more stable holders. They buy the bonds to hold them, not speculate on them, and at any rate there is no real secondary market where panic could play out.²³ And since the demand exceeded general expectations, the whole operation was considered a political success for the government. Two more issues followed the same year. The government continued with two issues in 2013.²⁴ Both

²² Jaroslav Ungerma, "The Legacy of Petr Nečas...".

²³ The government of Italy issued 19 billion euros worth of retail bonds in October 2012, the biggest ever single bond issue by an EU government. In this case, the issue could be said to have clearly demonstrated to the financial markets that Italy has enough financing to rely on and eased pressure on its wholesale bonds.

²⁴ *sporcidluhopisy.cz*. 2013, government website for retail bonds, <http://www.sporcidluhopisy.cz/>

quickly sold out. The autumn issue actually sold out in four days despite the fact that originally the government was planning to allow the whole month of November for registering demand.²⁵ The government also took some aggressive measures to improve VAT collection. Most notably it introduced shared VAT tax liability – if a company registers VAT-bound transactions improperly and its partner does not pay the VAT to the government, the company must pay instead. As of January 2014 there will officially be a black list of “unreliable” companies (i.e. those that have improperly paid VAT in the past) – trading with them will automatically create a liability for VAT payment in case the blacklisted company does not pay. This is similar to measures introduced in other countries in the region, e.g. neighbouring Hungary and Slovakia.²⁶

The Czech Republic does not fare nearly as badly as many other new member states in terms of tax collection effectiveness. Nevertheless, the tax gap (the difference between tax that should theoretically be paid to the government and tax really paid) remains higher than in Western European nations. When we look at the study released by the European Commission in September 2013 on the VAT gap, the numbers clearly demonstrate this (Figure 8).

Figure 8. The VAT gap in the Czech Republic vs. other countries in the Visegrad Group and the EU

	VAT gap as % of GDP 2011	VAT gap as % of GDP 2000-2011
Czech Republic	2.7	2.1
Hungary	3.7	3.0
Poland	1.5	1.1
Slovakia	4.0	2.9
EU 26 total	1.5	1.2
EU 26 average	2.1	1.6

Source: European Commission²⁷

Nevertheless, the government steadfastly refused to introduce cash registers with fiscal memory, even though this is generally accepted as a very effective way of countering VAT avoidance at the retail level. Politicians considered this too costly for businesses.

In the meantime, the Czech Republic has been a relatively unproblematic EU member in the latest initiatives against tax fraud, such as the amendments to

²⁵ “Ukončen úpis vánočních dluhopisů”, investia.cz, <http://www.investia.cz/ukoncen-upis-vanocnich-dluhopisu-2013>

²⁶ Juraj Draxler, “Bleeding Central Europe through VAT scams”, *V4 Revue*, December 9, 2013, <http://visegradrevue.eu/?p=2004>

²⁷ From European Commission, “Fight Against Fraud: New Study Confirms Billions Lost in VAT Gap”, September 19, 2013, http://europa.eu/rapid/press-release_IP-13-844_en.htm.

the Withholding Tax Directive or the improvements to data sharing across fiscal jurisdictions.

On the other hand, the government has dragged its feet on another solution that would make life much easier for enterprises: single collection points for taxes as well as social security and healthcare contributions. This has been in the national reform plans for years, yet its practical application is still a long way off.

Similarly, though it has been considering it for many years, the Czech government has still not implemented a single treasury system (a uniform system of accounts for the government). This would potentially greatly improve control over the flow of public finance, yet is opposed by entrenched interests within the individual ministries and public agencies. Nor did the government seriously consider implementing a click-through budget²⁸, despite some discussion among economists on this issue.

In 2012, the government, again in keeping with its self-declared mission to improve the health of public finance, started drawing up a plan to introduce a constitutional fiscal brake and set up a fiscal council. This despite the fact that the Czech Republic, along with the UK, has famously not joined the EU Fiscal Treaty. Nevertheless, the government fell apart before any serious steps in this direction could be taken.

In general, it could be said that the crisis was thus not used as a springboard to increase the efficiency and transparency of public finance. The management of public finance remained as it was, without a centralised treasury system. The collection of taxes has not improved either – a single collection point for income tax, healthcare and social contributions will be implemented later. And the government also balked at implementing key measures against tax evasion, such as universal cash registers.

The welfare state and social reverberations

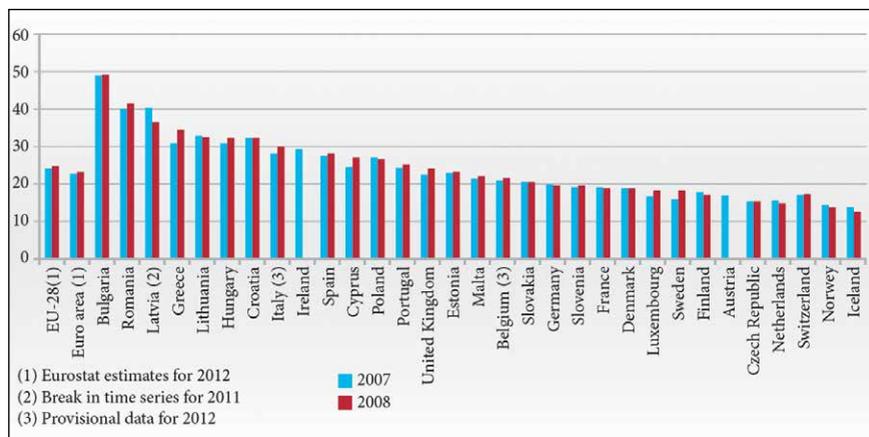
The Czech Republic remains a welfare state partly based on the Continental (mostly German) model, but with much less generosity, which prompts some authors to cluster it with a separate Eastern European social model.²⁹

At the same time, the Czech Republic has best preserved the egalitarian tendencies of the former socialist welfare models. It has the second lowest poverty level in the EU, behind the Netherlands, when measured according to Eurostat's poverty definition (Figure 9).

²⁸ Click-through budgeting provides means presenting public expenditure figures in an easily accessible, hierarchically structured form, so that when published online, it is possible to go through layers and items in a click of a computer mouse.

²⁹ Juraj Draxler and Olaf van Vliet, "European Social Model: No Convergence From the East," *Journal of European Integration*, 32 Iss. 1 (2010), 115-135.

Figure 9. At-risk-of poverty rate in the EU plus Switzerland, Norway and Iceland



Source: Eurostat

At the onset of the crisis, the relatively dense social security net provided an effective intervention tool. However, this naturally led to increasing deficits while at the same time the government undercut social security funding in order to stimulate growth. An all-out attack on the social security system would probably not have been politically possible. Nevertheless, the government did try to trim social expenditure. This took place through creating tougher requirements for disability benefits, for example.

The government failed to reform the governance structure of its social security system. The Social Security Agency continues to be part of the state budget, even though many successive governments have pledged to make it a completely independent public agency, like it is in Germany and other countries where the German model of social security was adopted.

The Nečas government introduced one change in January 2013 that created a crack in the traditional Czech welfare state system: a partial opt-out from the public pension system. This was a relatively mild reform in light of the fact that it previously considered making the partial privatisation mandatory, not as an opt-out option, and the fact that the scale of funds to be diverted from the public system was to be bigger. In the end, workers simply got the option of diverting 3% of their mandatory pension contributions into a private fund. If they choose to do so, two additional percentage points are diverted to the fund. The government did this so that a contribution to the private fund is large enough to be economically viable for the fund, but to avoid diverting too much away from the public pension system. Ironically, the government introduced this reform at a time when it was being

partly rolled back elsewhere in the region.³⁰ The reform did not prove popular, with only 75,000 people joining by mid-2013, while the government and the pension funds had been estimating demand in the hundreds of thousands.

In addition to being relatively socially generous, the Czech Republic, while traditionally very ethnically homogeneous, is the most welcoming to foreigners of all the new member states. The inflow of immigrants is relatively socially stratified. The highest immigrant group in the broad sense are the Slovaks, with whom the Czechs shared the same state until 1993. Tens of thousands of Slovaks study at Czech universities. There is sizeable migration from poorer Slovak regions by workers who end up in the lowest paid jobs. At the same time, Slovaks also occupy many highly qualified positions, including the top echelons of business. In contrast, the second biggest group are the Ukrainians, who predominantly fill low-skilled jobs. They are followed by two Asian communities, the Chinese and the Vietnamese. Most of the recent migrants from these two communities work in manufacturing, especially in Plzen, an industrial city in the west of the country. The Chinese and the Vietnamese are also very active in retail, owning many small grocery shops. Prague especially has a large community of Russian expatriates as well.

Perhaps surprisingly, in a wider European context this influx of foreigners has barely led to any tension. This is partly due to the make-up of the immigrants. Slovaks are still considered almost as co-citizens, given the shared history of the two countries and the fact that the two languages are mutually intelligible. Ukrainians mostly take menial jobs where there is shortage of local labour, and at any rate they are perceived as temporary help who want to return to their own country as soon as they have saved enough money. The Chinese and the Vietnamese communities are relatively scattered and (at least on the level of language) well-integrated. Czechs have a more ambivalent relationship with Russians – memories of the 1968 occupation are still lingering and Russia as a nation is routinely vilified. However, given that the Russian émigré community in Prague consists of relatively wealthy and highly-educated middle class individuals, who significantly prop up the local property market, there are no problems on this front either.

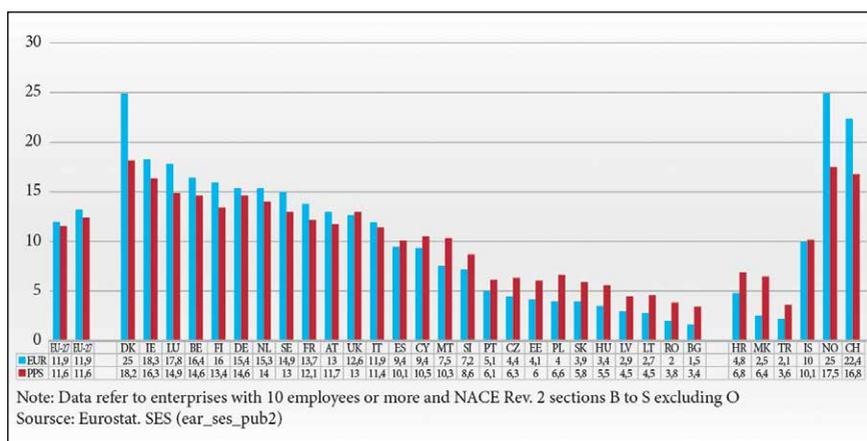
The only type of racial tension thus arises with the Roma community. Here, the country faces some serious problems. In the past few years there have been attempted pogroms against the Roma, and last summer saw large-scale street protests against the Roma in major cities outside of Prague (where the problem is not felt, since many Roma were effectively removed from the city in the 1990s).

³⁰ Juraj Draxler, “World Bank-Inspired Pension Systems are Rolled Back Across the Region,” *V4 Revue*, August 31, 2012, <http://visegradrevue.eu/?p=1080>

Labour market policies

As with other transition economies, wage convergence in the Czech Republic has somewhat lagged behind GDP convergence. In purchasing power standards (PPS), the Czech GDP is about 80% of the EU average. On the other hand, the average wage in the Czech Republic is much lower than in the old member states. The median hourly private sector wage in PPS is only 6.6 euros, compared to 14.6 in France or 12.1 in Germany. The EU average is EU 11.6 euros (Figure 10).

Figure 10. Median private sector hourly wages in the EU (nominal and in PPS)

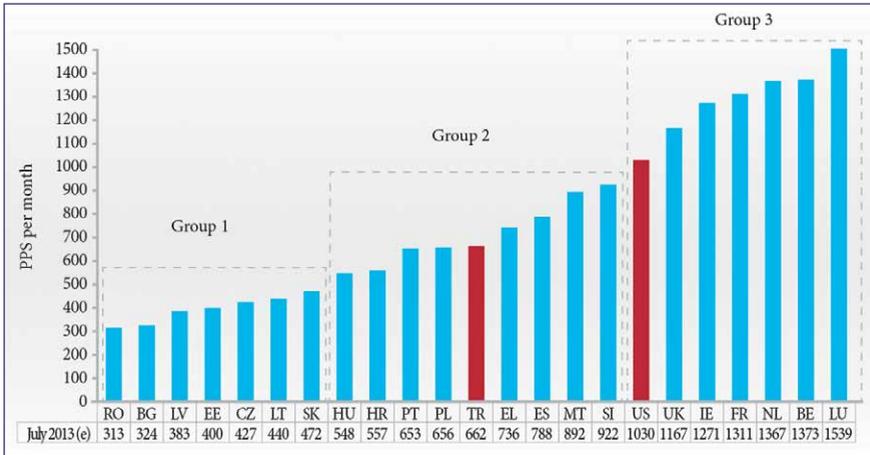


Source: Eurostat³¹

The Czech Republic has a statutory minimum wage. In PPS, this is currently 427 euros a month and is significantly lower than in those old member states that have a statutory minimum wage (Figure 11). The minimum wage does not play a large role in the economy, as it is so low that only some 3-4% of workers actually get it.

³¹ Eurostat, "Earnings Statistics, 2010," May 2013, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Earnings_statistics

Figure 11. Monthly minimum wage in EU member states, PPS



Source: Eurostat

In its early stages of transition, the Czech Republic adopted many features of the German tripartite model.³² In principle, the government consults employers as well as the main umbrella organisation for the unions, the Czech-Moravian Trade Union Confederacy (ČMKOS), over the main social and labour market laws. In practice, the government is not required by law to heed the trade unions' views.³³

The trade unions do have some clout, though. Although industrial action is scarce by Western European standards, in contrast to many other EU new member states the Czech unions are capable of mounting the occasional show of force. The last such occurred in 2011, when the transport unions in Prague stopped traffic for a whole day. This was the first time the well-run Prague metro was out of action in its entire history. The unions have had a few strong leaders, who often cooperated with the Social Democrats and later entered the European Parliament and the Czech Senate on a social democratic ticket. The unions also have a small but productive economic analytical unit that provides timely critiques of government policy.

Still, strikes are infrequent. And at least in the past 10 years there has not been any attempt at solidarity strikes (strikes called in solidarity with another sector or company's workforce demands).³⁴ This means that the unions do remain a relatively weak force compared to Western European standards.

The Czech labour market has a strong two-tiered structure. Regular jobs are relatively well protected. Unemployment benefits have recently become much more insurance based, i.e. they reflect how much a person has been paying in premiums and for how long.³⁵

³² Juraj Draxler, "Is the Age of Radical Reforms Over?" *V4 Revue*, September 20, 2012, accessed December 10, 2013. <http://visegradrevue.eu/?p=1135>

³³ For details and an international comparison, see Miroslav Beblavý, Jan Drahokoupil, Juraj Draxler and Martin Myant, *Labour Relations in Central and Eastern Europe*, Neujobs Report 3 (Brussels: Centre for European Policy Studies, November 2011).

³⁴ Miroslav Beblavý et al., *Labour Relations in Central and Eastern Europe*.

³⁵ Miroslav Beblavý et al., *Labour Relations in Central and Eastern Europe*.

Besides regular employment, there exist easy options for more flexible arrangements. There are two types of irregular contracts that can be used for temporary or one-off work. In addition to these, it is possible to give someone work that's invoiced on the basis of a small business licence. The Czechs call employment on the basis of any type of irregular contract "Švarc systém".³⁶ The authorities would nowadays not allow more extreme cases, such as employing someone in an assembly line job on the basis of an irregular contract. However, all kinds of manual and office work are contracted out like this. Craftsmen, builders, and also university teachers are widely paid on the basis of an invoice or a series of temporary, creatively written contracts.

There was a sweeping reform of social security as well as labour market laws that came into force on 1 January 2012. The new labour code re-introduced some stronger wording aimed against "Švarc systém", which had been missing since 2006. Nevertheless, in practice the government has not done anything to monitor and sanction it. For example, despite promises from the government, the authorities have not implemented checks at workplaces to find out whether employers were cheating the system by substituting regular employment contracts with irregular arrangements.

This kind of lax attitude to using loopholes and taking advantage of irregular employment persists in the wider society. In spring 2013, Jan Mládek, the then shadow minister of finance for the Social Democrats, publicly called for changes to the two-tiered labour market, which would also mean that people doing work on a small business license would have to pay higher social and healthcare contributions. The media then organised a witch-hunt against this, in their wording, "anti-entrepreneurial" attitude.

The Czech Republic spends much less on active labour market policies (ALMP) than the old member states.³⁷ However, as mentioned above, the general labour market situation remains relatively favourable, especially compared to other new member states, where unemployment is usually in double-digit numbers.

Industrial and long-term growth policies

The Czech Republic remains one of the most industrialised nations in Europe. When measuring value-added manufacturing as a percentage of GDP, in 2010 the figure was 24% in the Czech Republic, compared to 21% in Germany, 11% in the UK and 11% in France (2009) (World Bank World Development Indicators database).

³⁶ This refers to one Miroslav Švarc, the proprietor of a construction company in 1990s, who was the first to start the large-scale employment of people through irregular contracts, thus saving on social and healthcare contributions. He was later personally vilified (and, for unrelated reasons, went bankrupt). Nevertheless, his legacy has, so to speak, lived on. Irregular contracts are widely used.

³⁷ Jaroslav Ungerma, "The Legacy of Petr Nečas..."

Much of the country's transition strategy rested on inserting itself into Western manufacturing value chains, utilising the relatively skilled labour force provided at low labour unit costs. The country is today one of the biggest car producers in Europe, making around a million light passenger vehicles a year (compared to the UK's 1.3 million and France's 2 million). In per capita terms, the country is the second biggest car producer in the world, behind neighbouring Slovakia.³⁸

Besides manufactured goods, the Czech Republic is also an important energy exporter. In the future, the country could increase this role if current plans for the enlargement of the newer of its two nuclear power stations (Temelín) go ahead. Currently, the energy company ČEZ has already opened a tender for the construction. ČEZ, majority-owned by the government with a minority stake floated on the stock exchange, has over the past few years emerged as one of the key energy players in Central and Eastern Europe, with extensive operations also in Bulgaria, Romania and Albania.

The country's exports have been hurt by the relative strength of the Czech crown. The currency has been seen as a safe haven for investors, and as a consequence it saw appreciation in the early months of the economic crisis. The government's policy of advertising fiscal responsibility has also had the perverse effect of supporting the crown. All this at the time when neighbouring Germany and other strong eurozone exporters could rely on the relative weakness of the single currency's periphery to ease pressure for appreciation. The central bank did ease monetary policy throughout the crisis – nevertheless, with other central banks aggressively cutting rates, this did not provide a real stimulus.

It was only in November 2013 that the Czech National Bank (ČNB) changed its policy. It entered the foreign exchange market to aggressively weaken the exchange rate (in one day, the Czech crown dropped from 25 crowns to the euro to 27). This was the first intervention by the ČNB in 11 years. It was met with some confusion, as the bank did not clearly state its policy objectives. It did say, vaguely, that the crown had to be weakened to help meet the bank's inflation target, but there was no forward guidance on how the bank would like to apply forex interventions in the future.

In terms of export policy, the government has recently pursued an explicit strategy of diversifying away from the eurozone towards emerging markets³⁹, also beefing up its well-funded export-financing institutions.⁴⁰

At the moment, a new ruling coalition is being formed. On the one hand, it does not want to engage in pronounced fiscal expansionism. Nevertheless, the draft

³⁸ Stela Pencheva, "How Effective is Visegrad's Export Promotion?," *V4 Revue*, December 6, 2013, <http://visegradrevue.eu/?p=1978>

³⁹ Stela Pencheva, "Czechs Successfully Diversify Outside the Eurozone," *V4 Revue*, October 20, 2012, <http://visegradrevue.eu/?p=1181>

⁴⁰ Stela Pencheva, "How Effective is Visegrad's Export Promotion?."

coalition agreement states that the government will want to use export-promotion even more aggressively than before.⁴¹

It remains to be seen whether the new government will also try to implement more expansionary policies. This has been the wish of the president Miloš Zeman, who from 1998-2002 was the social democratic prime minister. Nevertheless, the president does not have executive powers.

The three parties that will form the ruling coalition have been more cautious: they have supported more infrastructure investment in principle, saying they want to be bolder than the previous government, but have not endorsed any specific plans. However, it is true that the country would need more investment. In fact, cuts to infrastructure spending constituted one of the biggest initiatives of fiscal consolidation from 2008-2013.⁴² In order to reverse this, the government will have to tap more effectively into EU structural aid and possibly have recourse to public-private projects (PPP). In the past, Czech governments have flirted with the idea of PPP-procured highway construction, but none of the projects came to fruition.

Czech EU membership and the response to the crisis

In many aspects, the Czech Republic has remained one of the more “eurosceptic” new member states. In 2009, then-President Vaclav Klaus unconstitutionally refused to ratify the Lisbon Treaty. In 2012, the Czech Republic was the only country in the EU (except the UK) that did not sign the EU Fiscal Compact. In the meantime, since 2006, all Czech governments have been relatively lukewarm about the prospect of joining the common currency. This despite the fact that the manufacturing industry, which continues to be the country’s economic backbone, would more than welcome the opportunity to decrease its transaction costs and exposure risk.

This state of affairs is to a very large degree determined by personal politics. Václav Klaus, the dominant figure during the 1990s transition, became country’s president in 2002. Klaus is a self-avowed Thatcherite – a free marketer and a nationalist. He has always been critical of any aspect of European integration beyond the common market. As president, he nominated the board of the central bank, which subsequently also took a more eurosceptic stance.

The Czech Republic never came close to needing an EU bailout. On the contrary, the press has revelled in stories about “lazy Greeks” and president Klaus himself dropped a remark about Greeks being fit for drinking some ouzo in the shade, but not for a project like the euro.⁴³ Also, Czechs, particularly the young

⁴¹ “Text koaliční smlouvy” (The Text of the Coalition Agreement), idnes.cz, December 13, 2013, http://zpravy.idnes.cz/text-koalicioni-smlouvy-06h-/domaci.aspx?c=A131213_100441_domaci_hv

⁴² Juraj Draxler, “How to Increase Infrastructure Investment in the East,” *V4 Revue*, August 3, 2013, <http://visegradrevue.eu/?p=1733>

⁴³ “Czech President Defends Himself over Ouzo Remarks,” *Česká pozice*, September 2, 2011, <http://www.ceskapozice.cz/en/news/foreign-affairs/czech-president-defends-himself-over-ouzo-remarks>

ones, do leave the country in search of work⁴⁴, but this labour migration is quite small compared to the levels seen in other new member states. The Czech Republic thus plays the role of a relatively confident EU member.

Nevertheless, the country is highly dependent on EU money in the form of structural funds. There have been many scandals involving EU aid, which is often squandered on overpriced or dubious projects. The Czech press consequently revels in stories about wealthy hotel owners in privileged locations such as Karlovy Vary, the country's premier spa, tapping EU funds. Or funds being given to Prague dentists, hardly a struggling group, to improve their equipment. It is probably safe to say that such stories take the spotlight away from more honest projects and the generally positive impact that EU structural aid has on the country. They contribute to the general feeling that EU money is there for the rich. And even though the Czech government did divert some money to active labour market policies to combat unemployment, this was on a limited scale and not advertised as EU help. The general public does not connect the EU with positive crisis-fighting measures and in fact remains hostile to the EU, which is almost universally portrayed in the press as an overbearing, bureaucratic, imperialistic entity run by super-privileged elites at the expense of the hard-working common man in the nation states.

The attitude of the political leadership is changing, however. Václav Klaus left office in early 2013 and was replaced by a more EU-friendly Miloš Zeman. Also, the Civic Democrats are now much weakened, and practically every other relevant party is much more pro-EU. Also, the political newcomer, ANO, which will be included in the new coalition, is run by a tycoon who over the summer bought two of the most widely read dailies. His businesses crucially depends on international cooperation (he owns one of the largest bakeries in Germany, Lieken), direct EU subsidies (agriculture), as well as subsidies based on EU law (bio-fuels).

At the same time, the Social Democrats have, due to their ideological integration into international social democracy, always been antithetical to the Margaret Thatcher-inspired euroscepticism of Václav Klaus. The latter ideology has been based on the belief that European integration should have stopped with creating the common market. Many Social Democrat leaders also seem to simply personally believe in the European project. It is not unreasonable to expect that the new political constellation in the country will influence public debates in a more pro-EU direction.

⁴⁴ Within-EU migration data are notoriously unreliable and for the New Member States sometimes any data are difficult to come by. The best source is Labour Force Survey (particularly from 2008 which had several questions aimed at migration), but the dataset is not publicly available. In the Czech Republic, there is no applied administrative penalty for those who stay out of the country for prolonged periods, and, anecdotally, many choose to work abroad without de-registering at home. The Czech Statistical Office does not publish any data on outward migration. By way of perspective, the UK Office of National Statistics estimates that up to 40,000 Czech citizens could have been living in the UK in 2011, which is considerably less than the number of the neighbouring Poles or Slovaks. See Office for National Statistics, <http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Population+by+Nationality+and+Country+of+Birth#tab-data-tables>

Conclusions

The Czechs have been able to ride out the tumultuous crisis years in relative comfort, mostly thanks to a long-established, well-diversified manufacturing base and a healthy banking sector. Unemployment did rise. In June 2008, it was 5.9%; by the end of the next year, it reached 7.9% and has remained in the interval of 7.9-8.1 % ever since. This was against an economic contraction that reached 4.5% in 2009. There was recession again in 2012, when the economy shrunk by 1%. This was of course relatively painful, but still mild in comparison to many other EU member states.⁴⁵

Nevertheless, the government did react to the crisis, very much in the spirit of two decades of radical reform-making. Since 1989, economic reforms in the Czech Republic have tended to be strongly driven by the political cycle. Parties would implement policies according to their ideological preference, even at very short notice. This has resulted in considerable legislative uncertainty.⁴⁶

Ideological preferences also informed the crisis responses of the two right-wing governments that ruled from 2006-2009 and, interrupted by a caretaker government, from 2010-2013. This happened, however, in two different ways. In 2009, the National Anti-Crisis Plan came with strong and explicit supply-side rhetoric. The most tangible results were blanket reductions in social security contributions to stimulate economic activity.

The second right-wing government, however, put fiscal consolidation at the centre of its attention. Instead of cutting, it now raised taxes. The most notable tax hikes were the VAT increase and a stealthy increase in the personal income tax, which came about through a change in the tax base definition. And rather than providing more public money for investment, expenditure into fixed assets was cut.

When the second government was ousted, it was ostensibly on the back of corruption scandals. However, the public's exasperation with the government was also due to the fact that the governance processes had been erratic and unpredictable. As mentioned earlier, this manifested itself in the government suddenly heavily taxing solar power generation, which before it had generously subsidised. Even more frustrating was for businesses not to know in early December what the VAT would be in January, as happened in 2012.

Little wonder, then, that the real winner of the parliamentary election in October was ANO. Set up in 2011, the party scored just under 18.5%. This was only marginally less than the well-established Social Democrats with 20.5%. ANO is led by Andrej Babiš, a tycoon who is the biggest private employer in

⁴⁵ Eurostat database, <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115>

⁴⁶ Juraj Draxler, "Is the Age of Radical Reforms Over?"

the Czech Republic, controlling most of the traditional domestic chemical and food processing industries. Babiš said he wanted to end political corruption and promised to run the country “like a company”. Naive as that may sound, the prospect of stability brought about by a manager tried and tested through years of building his corporate empire proved too irresistible for the voters.

The Social Democrats, ANO, and the Christian Democrats have promised their government will be broadly fiscally responsible, keeping the public deficit under 3% of GDP. But they also promised to be more interventionist. The coalition wants better assistance for exporters and it promises to prepare some large scale infrastructure projects. It may also be speculated that the change in the balance of party politics was the final tipping point for the unexpected interventions of the Czech central bank in November of 2013, even though the rationale for these (sluggish growth and central bank rates so low they lost effectiveness as a monetary policy instrument) had persisted for a few months already.

Among the first issues to be dealt with is reforming the labour code to bring an end to the two-tier labour market, which is unfair and inefficient. Instead, regular employment should be made more flexible, and at the same time irregular contracts that provide no job security and often lead to tax avoidance should be cracked down on. The government should also increase infrastructure spending. Some Czech roads and trains look positively shambolic compared to what one sees to the west of the country. At the same time, it is probably true that a lot of money is lost through corruption and mismanagement. Measures such as introducing a centralised treasury system for public finance and a click-through budget could help. In general, however, it’s all about human resources and appointing competent people to key positions. The Czech civil service tends to have very clever and committed people in the lower ranks, but inefficient, old-style bureaucratic power cliques higher up the ladder.

Thus one can argue that the future looks promising. For the first time since 1989, none of the major political parties tried to steal the election with a grand reform package. The public clearly no longer wants to hear about how a tweak in taxes or social security reform will bring more investment and prosperity. The main legacy of the crisis is that the public has simply tired of incessant reformist narratives. Instead of more headline-grabbing reforms, the people now want a well-run state. As simple as that sounds, it probably perfectly sums up what the Czech Republic needs.

Poland – a “Not-So-Complete” Success

Michal Rot, Ryszard Petru

Poland in the pre-crisis period

The macroeconomic environment in the pre-crisis period. Poland enjoyed fairly fast economic growth after its accession to the European Union. The customs union, accompanied by EU-wide free movement of capital (and, to some extent, labour) as well as the inflow of EU structural funds, resulted in GDP growth rates reaching (and temporarily exceeding) the level of 6%. The average growth rate from 2004 till 2012 was 4.3%.

The fast growth of the real economy was accompanied by the rising role of the financial sector. The economic development model Poland pursued throughout the transition period was based on a broadly unchanged set of factors:

- (1) Cost advantages – the difference in labour costs compared to developed countries, esp. Germany, acted as an attractor for foreign investors and led to a significant flow of foreign direct investment;
- (2) Favourable demography – the rising population, esp. the baby-boom of the late 1970s/early 1980s entering the labour market, resulted in a boost to domestic demand, esp. consumption;
- (3) A change in lifestyle – the adaptation of consumption and a Western lifestyle also triggered a shift in demand, esp. on durable goods, leading to the growing role of credit consumption.

As a result, growth in Poland was based on foreign savings, i.e., the current account balance was negative since the data were recorded by the NBP (with the exception of the second quarter of 2013, when the first surplus for the current account balance of the country was recorded). The savings shortage was offset by the increasing share of Polish exports in global trade and the incorporation of Poland into global production chains, as well as by sustainable sources of financing for the current account deficit: FDIs and EU fund inflows. The fiscal policy also contributed to the shortage of savings in the economy. Economic growth was accompanied by structural deficit and rising debt through the whole transition period. A pro-cyclical deficit created substantial pressure on public finance, especially during slowdown periods. Although Poland managed to implement a significant structural reform of the pension system in the late 1990s and created the multi-pillar, partially privately managed pension system, the reform has never been finalised. Similarly, the structural reforms of public finances have never been fully implemented (in 2004 the so called ‘prof. Hausner’s plan’ for a deep and

revolutionary change¹ of the fiscal regime in Poland failed as there was neither the political will nor the support for reform). Thus, the fiscal policy (no matter what political party was ruling) led to the increase of public debt. Increasing debt (both domestic, esp. public sector debt, and foreign debt) has been one of the most important factors driving growth and development throughout the transition period. These developments in the real economy were partially reflected in the financial (esp. banking) sector.

The financial sector in the pre-crisis period. According to Financial Supervisory Authority (FSA) data, Poland has 42 commercial banks, of which 38 are foreign owned and four have a majority public interest. In addition, there are 572 cooperative banks and 55 credit unions. Poland's banking sector is relatively concentrated, but less so than other comparable countries in the region, with the largest three banks and the 10 largest banks controlling about one-third and two-thirds of total bank assets, respectively. The share in total bank assets of the five largest banks in Poland was 45% in 2008, compared to 62% and 72% for the Czech Republic and Hungary, respectively. Poland's banking concentration has been lower on average than for countries in the eurozone (57%) and countries in Central and Eastern Europe (58.3%). After the privatisation of the banking sector, the share of foreign-owned banks in total assets of the banking sector reached the level of about two-thirds in 2008 and remained so throughout the crisis.²

However, it is noticeable that the pace of financial catching-up with the mature economies was much slower in Poland than in the region. The period of rapid growth in the 1990s was followed by a period of standstill at the turn of a century, leading to a structural change in the financing of investment by the corporate sector (accompanied by high productivity and liquidity gains due to labour productivity improvements – the official unemployment rate exceeded 20% at that time). Moreover, according to Polish StatOffice data, investment in Poland is financed mainly (about three-quarters) by the resources of enterprises. The traditional measures of financial catch-up used by central bankers and policymakers (the stock of banks' assets or liabilities as a percentage of GDP) may not fully reflect the current issues behind financial intermediation development as they are distorted by time and an accumulation bias.³ Having removed time and the accumulation bias

¹ The reforms planned by prof. Hausner were to generate savings of about 30 billion PLN (3% of GDP) and a decrease in government borrowing needs by 50 billion PLN in the 2004-2007 period. The reforms envisaged in the plan were concentrated on the restructuring of loss generating sectors of the economy (e.g., railways, coal mining), a reduction of public administration, savings in the public pillar of the pension system (e.g., farmers whose pension scheme was subsidised from the state budget were to be included into the common multipillar system introduced in 1999).

² The extensive structural/financial statistics on banking sector can be found at the Financial Supervisory Authority of Poland website, http://www.knf.gov.pl/en/about_the_market/Banking/data/mdata.html

³ Markus Arpa, Reiniger Thomas, and Walko Zoltan, "Can Banking Intermediation in the Central and Eastern European Countries Ever Catch up with the Euro Area?", *Focus on European Economic Integration 2* (Oesterreichische Nationalbank, 2005), 112.

from the financial catch-up measure, Arpa et.al. (2005) identified the sustainability problems of credit growth in the CEE long before the crisis onset. However, Poland was among the regional players with the lowest levels of tension. Factors on the supply side also might have contributed to the unwillingness of banks to lend to enterprises. According to EBRD research, Poland scored in last place among the new member states in the enforcement of pledges and collateral.⁴ However, the housing loans market was buoyant at the onset of the crisis, with the yearly growth rates exceeding 40%. High demand for flats was reinforced by the above-mentioned demographic factor (the peak of the late 1970s/early 1980s baby boom entering the labour market), as well as by falling interest rates (a strong disinflationary processes – in 2006 Poland had one of the lowest CPI inflation rates in the EU). Empirical research conducted by the NBP indicates that the competition level in the banking sector in the period between 1997-2007 followed a slight upward trend (the results have been confirmed by both the Panzar and Rosse model and the Lerner index)⁵ The transmission mechanism of the competition (M&A activity and the regulatory framework), according to the study, was similar both before and during the crisis, and was also similar to the one present in the eurozone banking sector. This may also imply that growing competition among banks in Poland mirrored growing competition on the domestic market between the foreign banks involved in Poland.⁶

As competition in the banking sector intensified and new banks entered the market (the vast majority foreign owned), the margins charged on mortgage loans were also falling. Foreign currency loans dominated mortgage lending, as the inflow of capital and interest rate disparity with the core markets led to a significant cost advantage of FX lending at the time. The academic research is concentrated mainly on the seven most common determinants of the housing credit boom: inflation and exchange rate levels, the volatility of these rates, foreign currency deposits, the interest rate differential, the ratio of inflation, and exchange rate volatility referring to the Minimum Variance Portfolio theory of dollarisation. However, the results reported in the literature are systematically influenced by model specification, the econometric methodology applied and the country samples included in the papers.⁷ Although regular, long series of housing prices in Poland are not accessible, the existing evidence (prices from the 10 biggest cities – the largest housing markets – collected by the National Bank of Poland⁸) suggests

⁴ See Frédérique Dahan, Eliska Kutenicová, and John Simpson, “Enforcing Secured Transactions in Central and Eastern Europe: an Empirical Study”, *Law in Transition* (European Bank for Reconstruction and Development, 2004).

⁵ Malgorzata Pawlowska, “Competition, Concentration and Foreign Capital in the Polish Banking Sector (Prior and During the Financial Crisis)”, *NBP Working Paper* 130 (2012), 23-27.

⁶ Malgorzata Pawlowska, “Competition, Concentration and Foreign Capital in the Polish Banking Sector...”, 32.

⁷ For an extensive review of the academic literature on the topic see Jesús Crespo Cuaresma, Fidrmuc Jarko, and Hake Mariya, “Determinants of Foreign Currency Loans in CESEE Countries: A Meta-Analysis”, *Focus on European Economic Integration* 4 (Oesterreichische Nationalbank, 2011).

⁸ The National Bank of Poland started publishing regular reports on the real estate market in Q2 2010. Reports in Polish are available via http://www.nbp.pl/home.aspx?f=/publikacje/rynek_nieruchomosci/index2.html

the prices have risen steadily since the turn of the century and reached a peak in 2007, when the financial turmoil in the USA began. Later on the pressure on prices was milder as the supply side adjustments (a significant increase of new dwellings on the primary market) led (only) to the gradual satisfaction of housing needs, esp. of the baby boom generation.

The debt of households was growing steadily, esp. after EU accession. However, the microdata from the Household Budget Survey point at a pretty healthy balance sheet of households in Poland. Although the loan burden kept increasing very fast (due to the low base), esp. in the 1998-2005 period, the ability of households to service their debt improved. Non-performing loans ratios remained under control, esp. in the mortgage loans segments.⁹ The results of stress tests pointed to Polish households' resilience as far as the interest rate and exchange rate shocks are concerned. The scale of the indebtedness of the households was far from the dangerous levels that could trigger a financial stability 'event'.

While large banks used their deposit base as the main source of financing, the smaller players were substantially involved in short-term liquidity funding, esp. short-term currency swaps on the interbank market.¹⁰ The structure of meeting liquidity needs in the banking sector was leading to a growing concern for the NBP (being responsible for banking sector supervision at the time).

To sum up, Poland's opening balance during the financial crisis was pretty much positive. Output growth averaged about 6% from 2006–08 and was supported by the EU as it reinforced business confidence and triggered new investments. Private consumption growth was also buoyant, driven by strongly rising real wages, an increase in employment, and record-high credit growth. Moreover, inflationary pressure remained under control. Despite a booming economy, the current account deficit has remained relatively (compared to regional peers) low and the external position remained sustainable. The credit and depth of financial penetration of the economy grew rapidly, but the banking sector as a whole remained in good condition (record high profits in 2008 and high ratios of capital adequacy, including tier 1 capital). Household credit (primarily FX-denominated mortgages) exhibited fast growth, albeit from a small base (in 2000 mortgage lending was almost non-existent). Corporate lending growth was moderate. The funding of the credit expansion by foreign-owned banks was supplied by the parent banks from abroad. Capital-adequacy ratios have declined, but the banking system remained well-capitalised, with a high ratio of tier 1 capital and record profits in 2008.

⁹ Sławomir Zajaczkowski and Dawid Zochowski, "Obciążenia gospodarstw domowych spłatami długu: rozkłady i stress testy – na podstawie badań budżetów gospodarstw domowych GUS" („The debt service burden of Polish households: distributions and stress-tests – based on the Households Budget Survey of the StatOffice”), *Materialy i Studia NBP* (2007), 32.

¹⁰ The importance of the liquidity gap was underlined by the National Bank of Poland in June 2008. See the chapter on liquidity risk in the National Bank of Poland, “Financial Stability Report”, June 2008.

The 2009 crisis in Poland

The macroeconomic implications of the crisis. Although Poland enjoyed strong fundamentals and broadly balanced economic growth (the size of internal and external imbalances was moderate), the GDP growth rate was severely hit by the spillover of the crisis from the developed world. Spillovers reached Poland both from real and financial sector channels. IMF research suggest that spillovers from outside of the country are responsible for 50% of the variance of the output in Poland.¹¹ Both exports and imports contracted deeply at the beginning of 2009, which reflected the global trade collapse. The position of Poland in global trade was closely connected to German producers of final goods. Direct spillovers from Germany to the CEE4 region, including Poland, are still quite small (implicating that domestic demand in Germany is not a driver of the growth of foreign trade in the CEE4 region).¹² As the IMF research also points out, this fact is has an important policy implication: Germany plays the role of a regional anchor of stability. The German economy is capable of absorbing shocks and serving as a cushion for the region, including Poland, mainly due to its sound macroeconomic situation (the relatively low level of leverage, esp. in the public sector) and its safe heaven role.¹³

Although the share of exports in the total economy of Poland was moderate (compared to regional peers Poland seems to be a pretty closed economy, which is chiefly a result of the size of the Polish internal market), the weaker activity was reflected in the industrial output decline and the increasing unemployment rate. However, Poland's institutional features helped to cushion the foreign trade shock. The most important among these was the independent monetary policy.

Poland pursued a direct inflation targeting regime accompanied by a flexible exchange rate. In the wake of the crisis, exchange rate depreciation reinforced the price competitiveness of Polish exports and resulted in a milder decline in exports than would be in the case with another FX regime. Moreover, the depreciation of Polish zloty against the US dollar (almost twofold within the six months from mid-2008 till February 2009) sustained the imported inflation (mainly in the form of energy commodities traded in US dollars) at the elevated level and kept CPI inflation far from deflationary spirals.

The financial sector under impact of the 2009 crisis. The financial sector was also of importance as foreign-owned banks imposed their parent banks' lending policy (which was stricter than the situation in the real economy might have suggested, reflecting a group-wide risk management policy). The flow of funding from the

¹¹ Michal Andrie, Garcia-Saltos Roberto, and Ho Giang, "The Role of Domestic and External Shocks in Poland: Results from an Agnostic Estimation Procedure", *IMF Working Paper* 13/220 (October 2013), 18.

¹² Selim Elekdag and Dirk Muir, "Trade Linkages, Balance Sheets, and Spillovers: The Germany-Central European Supply Chain", *IMF Working Paper* 13/210, 15.

¹³ Selim Elekdag and Dirk Muir, "Trade Linkages, Balance Sheets, and Spillovers...", 20.

parent banks was also restricted (and this was one of the main contributors to the currency depreciation, as the outflows of the equity and debt investments in the financial account of the balance of payments were moderate and the shares of foreign investors in T-bonds and stock exchange markets were well anchored). The financial interlinkages in 2008 pointed at the moderate risk of a contagion effect in Poland, and the exposure (the strongest interconnections in the banking system were with Germany and Austria) was not posing significant stability risks compared to regional peers.¹⁴

The funding for foreign-owned banks in Poland didn't evaporate completely, partly due to impact of international consensus reached under the Vienna Initiative. This is an important political factor contributing indirectly to the stability of the banking system in Poland, which is often neglected in analyses. The key focus of the Initiative, undertaken by a couple of banking groups from Western Europe and later supported by the European Commission and the IMF, was on the prevention of a large withdrawal of cross-border banking groups from the emerging Europe. What's more, research found no empirical evidence of the Vienna Initiative banks withdrawing from non-initiative countries to the countries where they signed the agreement.¹⁵

At the same time, the interbank market was partially frozen as trust evaporated and internal risk criteria limited the exposure of banks on the interbank market. Empirical evidence, however, suggests that the Polish interbank market was relatively resilient to impulses stemming from the subprime crisis in the USA and later on from the real economy crisis. Except for the most common response – an increase in uncertainty – the most important factors impinging upon the liquidity of the domestic interbank market were tied to the local situation.¹⁶ The interbank market was contaminated via the following channels, according to the NBP¹⁷:

- (1) the owners' channel – the credit policy of the foreign owners of Polish banks was transmitted directly from the origin country to Poland; their credit policies, esp. towards the enterprise sector, resulted in a deterioration of the credit supply;
- (2) the macroeconomic channel – a collapse of global trade and external demand resulted in the deterioration of macroeconomic conditions, resulting in a decrease of banking portfolio quality;
- (3) the trust channel – as trust on the interbank market evaporated and

¹⁴ See Zsófia Árvai, Driessen Karl, and Ötker-Robe İnci, "Regional Financial Interlinkages and Financial Contagion Within Europe", *IMF Working Paper* 09/6 (2009).

¹⁵ Ralph De Haas et.al., "Foreign Banks and the Vienna Initiative: Turning Sinners into Saints?", *IMF Working Paper* WP/12/117 (2012), 25.

¹⁶ Piotr Płuciennik et.al. „Wpływ światowego kryzysu gospodarczego 2007–2009 na rynek międzybankowy w Polsce” (The impact of the global crisis 2007-2009 on the interbank market in Poland), *Materiały i Studia NBP* (2012), 44.

¹⁷ See "Polska wobec kryzysu światowego" (Poland and the Global Crisis), National Bank of Poland (Warsaw, 2009).

uncertainty increased, banks increased their internal limits of exposure on their peers.

Thus, the main consequence of the global crisis was a liquidity shortage in the banking sector in Poland. Polish banks had no exposure to the US real estate market, bad banks or toxic assets. Thus, external impulses such as the collapse of the Lehman Brothers have limited influence on the NBP repo-POLONIA spread (the spread between the policy intervention rate and the overnight rate of the Warsaw interbank market), indicating the current liquidity of the banking sector.¹⁸

The halt of GDP growth in Q1 2009 notwithstanding, Poland retained access to the international financial markets and the spread of T-bond yields from German Bunds, reflecting inter alia that risk remained fairly stable.

After the 2009 crisis: the 2010-2013 business cycle

Having weathered the first stage of the global financial crisis well, Poland experienced a significant recovery in 2010 and 2011. The 4%+ real GDP growth rates were closely tied to fiscal stimulus, which started in 2009 and was closely tied to EU funds absorption. However, the pace of fiscal stimulation significantly decreased in the second half of 2012. The quick deterioration of GDP growth was a combination of both cyclical and structural factors. The recession in the eurozone impinged on business and consumer confidence, leading to a halt of both private investment and consumption (real individual consumption stalled in the second half of 2012 – the first time since quarterly data on GDP and its components were compiled). Another side effect of the eurozone recession was subdued external demand. The export growth rates remained positive the whole time, the eurozone situation notwithstanding. This time it's the flexibility of Polish (and German) exporters that proved to be decisive in terms of the geographical diversification of exports: the south-east Asian countries gained a share in the exports of Poland at the expense of eurozone countries. Public investment fell by 20% in Q4 2012, a major structural factor contributing to the deterioration of the situation in the construction sector in Poland, leading to bankruptcies, an unemployment increase and bank losses. The public investment drop was closely tied to the end of the EU financial perspective 2007-2013. The draft of a new perspective stretching from 2014-2020 assumes additional funds on public investment outlays, but these may be spent in Q2 2014 at the earliest (initially fully funded from domestic sources, later refinanced by the EU, based on the 'ex ante conditionality' rule). The further decline of public investment and further fiscal consolidation led to further GDP growth moderation: growth rates below 1% in the first half of 2013 were maintained only due to positive net exports contribution. The domestic demand decline led to

¹⁸ Piotr Płuciennik et al., „Wpływ światowego kryzysu gospodarczego 2007–2009...”, 84.

an imports squeeze, improving the trade balance significantly. At the same time, relatively good exports performance led the trade balance to the record high levels (and the first surplus of the current account balance).

As far as the monetary policy is concerned, the central bank (NBP) continued its business as usual: responding to subpar GDP growth and the sharp fall of CPI inflation to record low levels, it cut interest rates accordingly to the historically lowest level (setting the intervention rate at 2.5%). The novel feature of the monetary policy was a swift intervention on the currency markets, which was repeated a couple of times when financial market tensions associated with, for example, uncertainty regarding the eurozone future, occurred, frequently impinging upon the volatility of the zloty exchange rate. As the NBP stated many times, it didn't target any specific level for the exchange rate. The interventions most probably slashed the speculative positions of some FX market participants, leading to lower volatility of the zloty exchange rate.

As opposed to the first stage of the crisis, the financial system remained resilient throughout 2012 and 2013 and posted no significant losses or liquidity shortages. The risks remained contained and under control. The challenge for the regulatory policy would be the integration of the institutional framework in order to create a domestic macroprudential framework integrated EU-wide.

The fiscal policy stance is the main difference with the first stage of the crisis. The pace of fiscal consolidation from 2012 (the consolidation resulted in a decline in the public deficit from 7.9% of GDP in 2010 to 3.9% of GDP in 2012, according to ESA95 methodology) eased significantly in 2013, mainly due to the threat of the recession. The fall of revenues made the government once again (after the 2009 episode) update the budget bill. However, the fiscal space was very limited and without further changes in the law on public finance an amendment to the budget would not be possible at all. The changes in the budget bill resulted in a deficit that was larger by 1% of GDP. However, room for a further move in the fiscal policy was very much limited by the public debt precautionary threshold of 55% of GDP. The threshold would in practice limit further spending tied to the upcoming EU multiyear financial framework 2014-2020 (as domestic sources must be engaged at the beginning of projects).

Anti-crisis policy response measures

Anti-crisis measures of international scope in 2009. Poland enjoyed the favourable coincidence of a couple of factors which helped to curtail the scope and depth of the crisis. The inflow of EU funds, the IMF's flexible credit line and the economy's structural dependence on German production chains are of vital importance. These anti-crisis measures are merely policy response measures,

but, as was mentioned, a coincidence of favourable factors turned out to play a significant role as the crisis broke out.

Large inflows of EU funds since EU accession significantly impacted macroeconomic outcomes. These flows, in case of Poland, amounted to about 3-4% of GDP per year and constituted a significant fiscal impulse supporting both consumption and investment. The impact of EU funds on total well-being, esp. in the long term, is still debated. Research offers tentative support for the impact of EU funds on growth. General studies based generally on cross-country panel regression find both positive¹⁹ and inconclusive results.²⁰ As the impact of the EU funds shock is a multichannel one, measuring it seems to be unbiased (or less biased) when a complete model of the economy is used. The IMF's estimates²¹ point at the difference between the funds allocated for consumption and investment purposes. Similar effects are estimated by the NBP.²² The above mentioned research found that for Poland it is of a crucial importance how much of the aid is spent on productive investment in the public sector (mainly into infrastructure). As Poland has been lagging behind the developed world in terms of infrastructure development²³ (e.g., the fast roads network was practically non-existent at the point of EU entry), the majority of funds was directed to infrastructural and environmental issues. There was a broad agreement among politicians that this was an unprecedented chance in the modern history of Poland to speed up the process of catching-up with the developed world. The organisation of the EURO2012 football championship also contributed to the better absorption of infrastructure funds, acting as an additional motivating factor.

The IMF conclusions from its research regarding EU funds absorption are the following²⁴:

- (1) The New Member States, including Poland, benefit greatly from the inflow of EU funds, substantially accelerating convergence;
- (2) The EU funds should be directed mainly to public investment rather than to income support, as it is a prerequisite for an enhancement in overall productivity to speed up the convergence process;

¹⁹ See Jose Garcia Solanes and Maria Dolores Ramon, "The Impact of European Structural Funds on Economic Convergence in European Countries and Regions", *Discussion Paper del CELPE* (Salerno: Università di Salerno, 2001).

²⁰ Aadne Cappelen et al., "The Impact of EU Regional Support on Growth and Convergence in the European Union," *Journal of Common Market Studies* 41, No. 4 (2003), 639-640.

²¹ Christoph B. Rosenberg and Sierhej Robert, "Interpreting EU Funds Data for Macroeconomic Analysis in the New Member States," *IMF Working Paper 07/77* (2007), 17-18.

²² Katarzyna B. Budnik et al., "The New Macroeconometric Model of the Polish Economy", *NBP Working Paper 62* (2009), 45.

²³ See e.g. Klaus Schwab, ed., *Global Competitiveness Report 2013-2014*, (Geneva: World Economic Forum, 2013).

²⁴ See Céline Allard et al., "Macroeconomic Effects of EU Transfers in New Member States", *IMF Working Paper 08/223*.

- (3) Except for demand side effects (when the infrastructure begins to be constructed), an additional focus on the supply side should guarantee that additional side effects would be prevented;
- (4) The effect of funds directed to income support would be short-lived and would fail to deliver benefits in terms of additional convergence;
- (5) The inflow of EU funds should lead to a depreciation of the real equilibrium exchange rate in the medium-term, if funds are used to enhance the supply side of the economy (the accumulation of infrastructural capital), and the real interest rate would increase during the period of inflows;
- (6) Should the funds be directed for consumption purposes, overheating pressures would emerge, leading to a real appreciation of the equilibrium exchange rate, thus impinging negatively upon the international competitiveness of a country;
- (7) The monetary and fiscal policy should also be tuned to EU funds inflows. According to the IMF, the policy mix should combine counter-cyclical fiscal policy and a strong commitment to the monetary policy regime.²⁵

Poland seemed to fulfil all of the above mentioned prerequisites in 2009 for the most influential impact of EU funds. The historically largest infrastructure construction programme was in its buoyant phase in 2009, and there was no austerity in terms of the fiscal stance. Instead, the government enacted a fully countercyclical fiscal policy, whereas the monetary policy was adjusted only to the extent that it reflected the current state of inflation and growth without additional unconventional measures, including quantitative easing.

The high degree of integration into the global production chain via the German economy (mentioned above) was the second feature that helped to cushion the crisis in Poland. This integration is the result of a couple of characteristics: geographical and cultural proximity, the production cost advantages of emerging markets over mature economies, and the similar structure of the economies in terms of broad economic sectors. The index of industrial proximity reveals that the CEE4 (Poland, the Czech Republic, Slovakia and Hungary) have the closest ties with Germany, and had these ties even before the EU integration.²⁶ Thus FDI inflows have been generating positive spillovers to the CEE4 economies, including Poland. Research on integration with Germany points to two important issues:

- (1) FDI inflows from Germany generated a medium-term growth enhancing shock, mainly via technology transfers: the expansion of exports was mainly driven by higher knowledge intensive sectors, financed as greenfield investments.²⁷

²⁵ Céline Allard et al., "Macroeconomic Effects of EU Transfers in New Member States", 31.

²⁶ Jesmin Rahman and Zhao Tianli, "Export Performance in Europe: What Do We Know from Supply Links?", *IMF Working Paper* 13/62, 17.

²⁷ Shekhar Aiyar et al., "German-Central European Supply Chain – cluster report", *IMF Country Report* 13/263, 8.

- (2) Only some demand for durable goods in Poland after the crisis broke out can be attributed to German fiscal stimulus (i.e., the ‘cash for clunkers’ programme, which supported the demand for new cars in Germany, increasing the demand in car factories located in Poland)

However, as was mentioned above, domestic demand in Germany is a minor factor impinging on trade for the Polish economy – the small fiscal impact of Germany on the CEE4 region, including Poland, can be attributed to supply chain connections and the major role of the intermediate goods trade in the linkages between Germany and Poland.

Thus, the performance of Polish exports relies to a significant extent on the wellbeing of German exporters and their ability to increase their exports volumes. As it turned out, after the initial trade shock German exporters found their way on the global markets, esp. when the eurozone ran into fiscal trouble and the deepest recession in its history. The shift in the geographical orientation of German exports (and Polish as well) helped to maintain the good results of Polish subcontractors in the later stages of the crisis (since 2011).

The third international measure used by the Polish government to counteract the crisis was the IMF’s flexible credit line. Poland, after Mexico, became the second country which gained access to a new credit facility from the IMF. The first credit line in 2009 amounted to 20.5 billion US dollars and was opened as a precautionary measure. As the IMF pointed out, the new instrument was intended to bolster international confidence in the public debt market in a country. The flexible credit line was a type of an insurance policy – i.e., the country has to pay an initial premium for access to the credit line. The entrance criteria for applicants were strict: a country, to be granted access to an FCL, must have strong economic fundamentals. The FCL could be granted to a country after a specific review by IMF staff. However, once the decision was a ‘green light’, the credit line was open up to its limit without further application needs. Poland has been granted with an FCL every year since 2009, but it has never drawn any credit from it. As the government has already underlined, it is a precautionary measure only. The FCL helped to maintain the confidence of the financial markets and international investors towards Polish public debt. The prerequisites for granting the FCL were the following:

- (1) sound macroeconomic policy before the crisis:
 - a. a determined anti-inflationary focus, facilitated by a long-standing and effective inflation-targeting regime and a freely floating exchange rate, which helped build confidence,
 - b. the government’s commitment to adopt the euro provided a strong anchor for fiscal policy, with the deficit being reduced to 2% of GDP in 2007 – i.e., below the Maastricht criterion of 3% of GDP

- c. banking supervision was strengthened to be in full compliance with EU laws and directives; moreover, as FX-loans gained pace, the government acted to slow lending in foreign currency via regulatory measures;

(2) a sound domestic crisis response.

The FCL agreement is still in place and will expire in January 2015.

Anti-crisis response of the domestic policy in 2009. The response to the crisis in Poland was a combination of policy actions determining the outcome of the monetary, fiscal and institutional framework. In the field of monetary policy, the independent monetary authority started an easing cycle, with a reduction of the main policy rate by 250 basis points to a level of 3.5% in June 2009 (the lowest in history). The authorities went into action to protect the financial stability of the banking and financial system of the country. Moreover, there were changes in the regulations surrounding public sector accounts, which had an impact on the liquidity of the banking sector. The imposition of deposit limits on the Ministry of Finance helped decrease the share of term deposits in overall state deposits and reduced the volatility of budget deposits at the NBP, which impinged upon the stabilisation of the liquidity and the POLONIA rate on the interbank market.²⁸

The NBP also arranged additional liquidity measures for the banking system: the additional swap arrangements with core central banks enabled liquidity support in dollars, euros and Swiss francs. The NBP widened the collateral to be used in its discount operations, as well as extended the maturity of the repo transactions. The FSA also increased the frequency of the monitoring of banks in Poland, with on-site inspections as well as stress testing. Additional measures applicable to the financial sector included actions regarding capital buffers for banks, the liquidity of the whole banking system, including foreign currency liquidity, the improvement of risk monitoring within banks, the enhancement of deposit guarantees, and filling the credit supply gap for enterprises with the state development bank (BGK). It must be noted however, that some of the above mentioned measures, esp. in the banking regulatory/institutional framework, may generate new type of risk connected to the misbehaviour of some banks. The broadening of the safety net may have stable, adverse effects on individual bank risk levels in the CE region.²⁹ The moral hazard behaviour associated with a broader safety net may decrease, however, in times of crisis, as the risk levels of individual banks depend less on safety net arrangements. The effects may also be delayed and long-lasting (up to three years). Financial institutions owned by banks also are prone to a moral hazard consideration and the risk associated with their misbehaviour may be even larger than in the case of banks themselves.³⁰ The introduction/development of the financial sector safety net may increase costs for banks and may result in an aggressive reaction depending on the shareholders' structure. Thus, considerations

²⁸ Piotr Pluciennik et al., „Wpływ światowego kryzysu gospodarczego 2007–2009...”, 85.

²⁹ Dorota Skala, “The Influence of Regulatory and Institutional Framework and Shareholder Structure upon Risk of Financial Institutions in Central Europe”, *NBP Working Paper* 149 (2013), 37.

³⁰ Dorota Skala, “The Influence of Regulatory and Institutional Framework...”, 38.

on financial safety must take into account the following:

- (1) Financial sector-wide stakeholders' interests (both banks' shareholders as well as clients and taxpayers);
- (2) Moral hazard considerations ('too big to fail', an implicit rule accompanied by pressure on banks' profits, resulted in excessive risk taking and the whole crisis, which started in the USA);
- (3) The safety net enhancements must either be explicitly temporary or accompanied by additional market watchdog guidance as far as risk taking by banks is concerned.

A survey conducted at the headquarters of banks registered in Poland indicated that the monetary policy measures undertaken by the NBP at the onset of the crisis were positively evaluated by the banks' management. The most important conclusions from the survey were the following:

- (1) The impact of the interest rates cuts in 2008/2009 was definitely positive, as well as being in pace with the NBP intervention;
- (2) The steps stymying the negative outcomes of the evaporation of trust that were undertaken by the NBP were welcomed by the headquarters of banks (above all, the three month repo operations);
- (3) The headquarters pointed to the temporarily limited central bank's power to regulate the overnight market and POLONIA rate;
- (4) However, the fiscal crisis in Greece had no major influence on the NBP's ability to steer interbank liquidity.³¹

As far as the fiscal policy is concerned, there was an initial commitment by the government to stick to the euro adoption calendar – however, the depth of the crisis caused the initial fiscal discipline to be abandoned. Thus the austerity measures must have been put on hold for some time, as the adherence to discipline could be highly procyclical and Poland could have stepped into the first recession since the transition had begun. As time went by the original budget plan collapsed and there were significant changes in the fiscal framework, including not only the new budget bill, but also changes in the law on public finance. Already in 2009 a shift in domestic methodology was made in order to create fiscal space, as the public debt was exceeding the limits of precautionary levels and was approaching the constitutional limits of 60% of GDP. Thus, a change in the scope of public entities which were included into the calculation of the public deficit and debt was made. The special purpose fund operated by the state-owned bank BGK was created in order to finance road infrastructure projects (co-financed with EU funds). Moreover, the EU fund inflows and outflows were taken out of the central budget plan and put into separate frames in order to relax the surveillance rules

³¹ Piotr Płuciennik et al., „Wpływ światowego kryzysu gospodarczego 2007–2009...”, 105.

which restricted the government's ability to enhance the relationship between the central budget deficit and the projected revenues (this is one of the punishments for the public debt exceeding 50% of GDP – the first precautionary level). Thus, changes in the institutional framework created a fiscal space that enabled the government to stimulate the economy from the expenditure side, esp. in 2009, when the global environment was fairly unfavourable. Domestic framework changes notwithstanding, the EU wide definition of the general government sector and ESA95 rules still applied to the whole of the revenues and expenditures of general government units; the ESA95 deficit quickly exceeded the Maastricht criteria leading to the growth of ESA95 debt and the imposition of the Excessive Deficit Procedure on Poland. It must be also mentioned that at the end of 2008 limited employment subsidies and mortgage support for the unemployed were introduced – however, the size and impact of these measures was limited (less than 0.1% of GDP).

Policy measures in the post-crisis period, 2010-2013. There were also other reforms which give some relief to enterprises; they are not so closely tied to the crisis itself, but the crisis might have contributed to the acceleration of their implementation:

- (1) The government introduced an electronic system of property rights registration, which eased a process of property sale and registration.
- (2) The building law evolved towards less administrative procedures in terms of issuing building permits.
- (3) There were also (unsuccessful) attempts to improve company registration; however, the single-window registration process is still lacking efficiency as it is not followed by a broad administrative easing of doing business in Poland.
- (4) The same applies to the tax system, which requires reform and simplification – reform could bolster the productivity of companies and mitigate many risks in conducting a business. However, there was some degree of improvement as the electronic system of invoicing received a legal framework in 2011.
- (5) The government prepared a de-regulation package which should open access to many regulated professions in Poland.

The privatisation process was also accelerated in the years following the outbreak of the crisis. Privatisation accelerated in 2010, and the revenue flows from the sale of stakes in state-owned companies tripled in 2010, but in many cases (esp. in the so called 'strategic sectors' of the economy) the government sold only minority stakes and retained control over the company and its dividend policy. The dividends paid by the state-owned/state-controlled enterprises are one of the major non-tax revenue sources of the central budget.

As privatisation is expected to limit borrowing needs in the short-term, it is

only a limited source of stable financing for the state coffins. The privatisation goal is to attract foreign capital along with new technology and to induce efficiency gains from the transfer of know-how and restructuring. In the case of Poland's privatisation, the motivation was pretty much limited in the crisis to filling in the revenue gap, as there were extreme cases when the state-owned enterprise bought shares of another privatised company (in the energy sector).

The labour market reforms evolve mainly towards more labour participation in the market. The changes implemented in the crisis period accompany and complement direct crisis measures. The most important challenge is the low participation rate. The reforms include:

- (1) increased flexibility for temporary employment: an unlimited number of temporary contracts between an employee and employer was allowed so long as their total duration does not exceed two years;
- (2) degressive unemployment benefits: benefits are higher in the first months of being unemployed and lower in subsequent periods, which should motivate to job seeking;
- (3) deeper pension reform in the early stage of the crisis (however, the situation turned drastically in the first half 2013 as the government decided to *de facto* nationalise T-bonds in the portfolio of the pension funds): the government decided to gradually increase and equalise the retirement age for men and women to 67 years (men reach target level in 2020, women in 2040).

The fiscal measures already identified/implemented as a response to the deterioration of the country's fiscal position in 2012/2013 include a series of a small steps improving both the revenue and the expenditure positions. These include maintaining the current VAT rates till the end of 2016 (instead of planned lower VAT rates to be implemented earlier) and limits on discretionary expenditures tied to the temporary fiscal rule – expenditure growth was limited by CPI inflation plus one percentage point. However, the implemented fiscal measures are not sufficient to bolster GDP growth quickly in the coming election cycle. Thus the government is pushing ahead with changes to the pension system, which should curb the size and role of the private pension pillar. This is the most controversial policy measure undertaken throughout the whole crisis and post-crisis period. The public seems not to enjoy the economic policy measures as much as previously, when additional non-economic debates (including the Smolensk catastrophe) painted the picture of the elections in 2011.

To briefly summarise the pension system: Poland adopted a multi-pillar pension system in 1999, replacing the previous (defined) benefit system. The new scheme distinguished between different age groups: the old system remained for people born in 1948 or earlier, while people born in the period 1949-1968 could choose the old or the new system, and people born after 1969 must joined the new system. The new system is based on three pillars:

- (1) The first pillar is a mandatory public scheme with individual accounts, where

all contributions are recorded on the individual accounts of prospective pensioners – however, the whole cash flow is spent on the actual pensions. The virtual records are indexed annually.

- (2) The second pillar is an obligatory privately managed scheme, with pension funds as legal entities represented by private companies managing the investment portfolio of the funds.
- (3) The third pillar, still in its infancy, is constituted by voluntary retirement schemes.

In the system reforms from 1999 the retirement age remained unchanged: 60 years for women and 65 years for men. However, exceptions leading to the possibility to retire earlier have been introduced many times by many mighty lobby groups as time has gone by, largely because subsequent governments used this issue in their search for popularity. Early retirement was partially abolished in 2008.

The new system created an additional burden for fiscal policy (at the same time limiting future social security obligations) as the contributions made by employees in the new system must also finance pensions in the old system. The costs of the intermediate/transition period, when the two systems coexist, were to be covered by privatisation. However, the pace of privatisation at the beginning of 2000s fell drastically, leading to growing pressure on the fiscal stance of the country. The privatisation income was not enough to cover the costs of the transition period as well as the lack of previously envisaged structural and savings reforms made by the government in 2011, which lowered the contribution transferred to the pension funds. This implied lower current borrowing needs, alongside rising future obligations. Additionally, the changes in the system involved the equalisation of the retirement age for women and men (67 years) introduced gradually (for men till 2020, for women till 2040). However this was not enough to create a fiscal space that enables the government to stimulate the economy quickly. Instead of structural and fiscal reforms, the government pursues additional revolutionary changes that will practically eliminate the second pillar from the system: the planned changes for 2014 include the transfer of bonds (and other papers that are included in the public debt) from private pension funds to the public pillar. This transfer and the annihilation of the transferred bonds will decrease the public debt by the amount of transferred assets (currently estimated at about 8% of GDP). Additionally, people will have a choice: stay with the private system or move (with their remaining assets) to the public one.

The most important effect of the planned changes to the system would be a decrease of the public debt by about 8% of GDP. The government often uses the argument that private pension funds were one of the reasons for higher deficits and debt accumulation, and the pursued changes should reverse that situation. However, it is likely that without the pension reform deficits and debt would be the

same as (or similar to) the potential savings of ‘not having’ the private pillar, which could have been consumed by different political groups/lobbies.

The political aspects of the crisis measures

The reaction of the public to the reforms must be analysed via the lens of the political preferences of the society. Political popularity polls quite often publish their methodology, and especially the sample size surveyed leaves some room for improvement and can generate significant bias. Thus, further on we will address the political aspect of the economic policy through the lens of a research project named ‘The Diagnosis.’³² This political preferences survey was last conducted in 2011. The results of “The Diagnosis” point at a couple of important characteristics: the citizens who identify themselves with the ruling (since 2007) Civic Platform (PO) party are often people living in the bigger cities, well educated, with an income above the average, and are the most entrepreneurial and the most satisfied with the situation in the country. They also have a very positive attitude towards the democratic system. The ruling coalition (PO with the agrarian Polish People’s Party [PSL], which protects farmers’ interests) seems to have adopted a successful political strategy since they won the elections in 2007; this strategy can be described as ‘minimising the political costs of decision taken’. Having an educated electorate, the PO managed to convince voters to accept potentially unpopular decisions, as each controversial political reform or initiative (including changes in the pension system) was preceded by a substantial informational campaign supporting the government position towards a particular problem. Moreover, the actions taken when the crisis broke out in the global economy were also supported by the followers of the PO. As young people in bigger cities with income above average are most likely to be engaged in one or more banking products (including a mortgage), the stability of the banking system was one of the most important focus points of the anti-crisis measures. Additionally, Poland was the only country in the EU to avoid a recession in 2009, which implied that the increase in unemployment was at most moderate (and unemployment was rising mainly outside the metropolitan areas). This economic achievement was at the same time a stabilisation factor for government popularity. The tax hikes or changes in the pension system seemed to have been understood by the voters as a sine qua non of the record high public investment programme, which was in its buoyant phase in 2011. The PO won the parliamentary elections under the campaign slogan ‘Poland under construction’,

³² “The Diagnosis” is to our best knowledge the most comprehensive, coherent and methodologically sound survey of Polish society, conducted every two years, encompassing very different areas of life such as living conditions, happiness, social capital, and political preferences. The survey has been conducted since the mid-1990s and complete materials (in Polish and English), including Databases, is available via the webpage www.diagnoza.com.

referring to the public spending on infrastructure that was financed partly by EU structural funds.

The planned changes to the pension system (*de facto* an annihilation of the second pillar of the system) are a good example of the sacrifice of long-term societal goals for short-term political needs. The planned changes also point at the quality of the democratic process, which was put into question. These questions surrounded the social 'contract', including intergenerational agreements, which was 'signed' in 1999 will most likely be changed drastically in 2014 at the expense of some of society's members (particularly the younger generation). The PO voters (its electorate is substantially younger) seem to be disappointed and no longer identify themselves with the ruling party. It is notable that in 'The Diagnosis' the fall in PO popularity (understood as identification with the party) is not accompanied by a rise of popularity for another party. The voters probably have joined the most numerous 'indecisive' group.

Moreover, the short-term political goals don't tackle the problem of boosting potential growth. Poland's development model, based on the three factors mentioned at the beginning of the chapter, will become obsolete in the coming 10 years. New problems should arise, including dissipating cost advantages and dramatic changes in the demographic structure of society. In order to reverse the unfavourable long-term trend there must be a wide political agreement lasting more than one election cycle.

The most notable result of the economic anti-crisis measures is that the coalition – composed of the Civic Platform with the agrarian Polish People's Party – has governed since 2007, winning the elections again in 2011. Thus, the government was re-elected, with the prime minister and the minister of finance retaining their posts being a notable example of political success. The main implication stemming from the Polish policy response in the crisis can be summed up as follows:

- (1) The government must tackle the imbalances in the economy – sooner or later they will impinge on economic performance. In the long term they are unsustainable, leading to stagnation/recession followed by a rise of unemployment and a fall of popularity in the polls;
- (2) Once in crisis, the government must act according to an expectation of crisis durability: the Polish government assumed that the crisis was a temporary shock and bet on fiscal expansion (and not on austerity). In general all these measures led to a temporary demand increase; however, the permanent effect of the supply side reforms, in general less popular and socially more sensitive, may not be visible soon enough for a party to be re-elected;
- (3) The long term economic goals, which exceed the traditional election cycle, were negligible so far as the current economic development model is concerned, and worked without any particular political need or will – this

will change in the future;

- (4) Thus, the government has been able to conduct an economic policy which minimised the political costs of decisions taken since 2007;
- (5) However, the government can't follow the above mentioned policy strategy forever. The economic development model has its boundaries. Poland seems to be approaching the limits of the current development model based on its favourable demography, cost advantages and changes in the lifestyle. Should these limits be reached they would make any prospective government face (unpopular) structural reforms which should aim to boost the supply side of the economy (mainly the labour supply);
- (6) The labour supply will be one of the focal points in the coming future, as after 2004 (the EU enlargement) about 2 million Poles (according to StatOffice estimates) emigrated. On the other hand, the population of Poland will grow older and less numerous and the unfavourable demographic processes should speed-up in the decade after 2020. The politicians should face up to the challenge of attracting immigrants (which can be unpopular) or try to change the unfavourable demography with more active policies supporting more births;
- (7) However, boosting the birth rate should be started as soon as possible as the effects of such a policy can only be visible after one generation. Such a policy is less likely nowadays as funding for it is limited (the EU 2014-2020 multiyear financial framework is focussed on infrastructure and innovations).

Concluding Remarks: Stabilisation Lessons and Their Sustainability

Karlis Bukovskis

Regardless of the differences and specifics of the countries analysed, one definite conclusion that arises from this book is that all of the Baltic and Visegrad countries had to go through a stabilisation phase in the context of the European economic crisis. All of the countries faced adjustments, whether those involved external bailouts (as in the situation of Latvia and Hungary) or the application of domestic economic instruments. Poland tends to stand out when compared to the other observed countries during the first years of the economic problems in Europe. At the same time, 2012 and 2013 austerity measures, including pension system reform, demonstrate the fact that no country in Baltics and Visegrad has been left unaffected. It has been a long time since the so-called HELL (Hungary, Estonia, Latvia and Lithuania) countries (occasionally used next to another infamous abbreviation – PIIGS) proved that they can successfully manage macroeconomic instabilities without becoming a long term burden for the rest of the European Union. Many significant decisions have been made that influenced the current economic and political structures of the Baltic and Visegrad countries. This concluding chapter will try to provide a general overview of the economic and political struggles of the last few years and the lessons that can be learned.

To HELL and back

The Central and Eastern European countries traditionally are perceived as laggards in economic development because of their relatively recent and bumpy transition to capitalism. At the same time, they have proven themselves to be dedicated and predictable countries by successfully joining the European Union and implementing structural reforms. Moreover, along with the somewhat phony “Baltic Tigers”, the Visegrad countries demonstrated remarkable growth as well. But that growth, especially in Hungary and the Baltics (HELL), ended in a harsh landing. Attempts to “get rich fast” may work on an individual level, but it rarely works on a state level in a sustainable way. The sharp decline in domestic consumption, banking sector shortcomings, foreign currency denominated loans, real estate bubbles, shrinking export volumes and permanently negative trade balances in general, low levels of productivity, outward migration and many other characteristics that can be read about in the respective country chapters in this book defined the fall of the Baltic and most of the Visegrad economies.

The articles demonstrate that each country chose its own path to cope with the economic problems they were facing. No two similar approaches, no two similar situations existed. Even among the Baltic States differences are clearly visible, although the Baltic States stand out as more similar because of their generally similar starting point and political and economic developments and ideologies. Hungarian problems can easily be compared to the Baltic ones, but nonetheless, the true high level of pre-accumulated government debt, forint depreciation and taxes and political controls limiting the independence of the Central Bank of Hungary are obstacles that the Baltic States did not experience. The Czech and Slovak cases have similarities, including some of the main causes for the economic problems (like falling exports) in addition to somewhat more preparedness for economic problems.

Although in most of the observed countries the economic problems were self-inflicted, in some cases the European dimension of the economic crisis did the most damage. For instance, unlike the Czech Republic where Juraj Draxler stresses out that “The Czechs have been able to ride out the tumultuous crisis years in relative comfort, mostly thanks to a long-established, well-diversified manufacturing base and a healthy banking sector”, the Slovak authors Brian Fabo and Michal Mudroň must conclude that “The good shape of the Slovak economy at the outbreak of the crisis made it possible for the government to attempt to counter the destructive effects of the crisis through increased government spending. Nevertheless, this policy failed to protect the country against the external shock and entailed a significant fiscal burden”. The very external shock came from the solidarity mechanisms installed to assist more failing countries in the eurozone and the eurozone itself. The first attempts to regulate the economic problems in the southern parts of the eurozone were hectic and threw countries like Slovakia and Estonia into turmoil that the eurozone is more institutionally and politically prepared to cope with today. Poland is also an example of relative preparedness for economic problems. According to Michal Rot and Ryszard Petru, “Based on its favourable demography, cost advantages and changes in the lifestyle”, together with the application of monetary mechanisms and a stable banking system, Poland was more prepared for the potential problems.

Of course, the European dimension of the economic crisis cannot be reduced only to the negative influences of the initial unpreparedness of eurozone. Both the economic and political dimensions of the EU in the observed countries must be indicated. Firstly, there is the essential structural role and investment opportunities provided by EU funds. While the national budgets and public projects experienced austerity measures, the availability of external finances allowed private and public projects to acquire the much needed resources for development. Of course, experiences with the absorption of the funds may differ and had additional political

effects as well. The second aspect is the strategic role and external discipline of the eurozone in the economic stabilisation of both Estonia and Latvia: "(...) the goal to join the eurozone was seen as a priority at any cost and fulfilling the Maastricht criteria seemed possible only through austerity and budget cuts," stresses Estonian researcher Viljar Veebel. Naturally the logic behind this strategy, among all the others, was to mobilise resources around one particular goal, provide the society with a practical result of the austerity measures, and convince foreign partners of the countries' pro-European stance and trustworthiness.

The other conclusions that can be drawn from the authors' contributions allow for identifying other structural economical, psychological and political arguments in the context of the Baltic and Visegrad responses to the European economic crisis. These further highlighted aspects can be easily attributed to all of the Baltic and Visegrad countries. For instance, in the case of the Baltic States and Hungary the conclusion by Aldis Austers in his article can be generalised rather easily: "Yet the scars of the financial crisis and recession are still being felt and will haunt Latvia's economy and society for years to come, posing a considerable challenge to the sustainability of Latvia's economic growth." The macroeconomic stabilisation programmes have proven to be successful, but the price is still being paid by high unemployment figures, increasing income inequality, and reduced investments in human capital, including healthcare and education. The logical steps of stabilisation choices have caused structural social problems that manifest themselves not only in social problems and a significant emigration wave, but also in the sustainability of the achieved post-crisis growth. However, A. Auster's observation that "Latvia's economy is becoming 'smarter'", together with positive economic indicators, currently raises hopes that the speculation and credit boom based "wild capitalism" days are over not only for Latvia, but for the rest of the Baltic and Visegrad countries as well.

A number of conceptual lessons can be learned from the European economic crisis. Not only will fiscal prudence apparently remain among the central economic principles of several consequent governments in Baltic and Visegrad countries, but also the avoidance of pro-cyclical economic policies should be the basis for sustainable further development. A conclusion by Zoltán Pogátsa that "It can be hoped with a degree of realism that the Hungarian political elite has learned from the experience and has accepted the need for fiscal prudence" can be attributed to all of the observed countries – although the Baltics and Hungary are among the countries that learned the lesson the hardest way. The necessity to balance both the national and municipal expenses to revenues must be seen as systemic.

Ramūnas Vilpišauskas, Vitalis Nakrošis and Vytautas Kuokštis in commenting on the Lithuanian economic outlook are sceptical, stating that "It is not clear whether it will manage to accumulate a surplus if the economy continues growing.

Therefore, there might be a painful repetition of the same pro-cyclical story again when the next economic decline unravels.” The authors tend to doubt the economic wisdom and political will of monitoring and adjusting the economy permanently to avoid overheating again. Moreover, the fear that pro-cyclical policies or even excessive government spending could return is politically present. In spite of the fact that, except for the Czech Republic, the rest of the observed countries are parties to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, populist policies on a municipal or even national level aimed solely at political gains could distort the achieved relative macroeconomic stability and promises of sustainable further development.

At the same time, almost all of the observed countries face the same problem as Hungary, where the “already accumulated FX [foreign exchange] loan stock is likely to burden economic policy making for a long time to come”. The availability of foreign bank issued loans is a characteristic of all of the observed countries. The cheap credit-fuelled growth in internal consumption was dictated by logic – populations of the countries wanted to improve their living conditions as the first change in the economy, in the form of easy credit, appeared. Thus, the countries and their populations have accumulated rather substantial external debts, the interest payments for which will keep public investments limited for years to come, especially in case of Latvia and Hungary with over 100% of GDP. The accumulation and management of private debt and, depending on the country, some public debt is very much tied to the continuous presence of foreign banks in the observed countries. Although the institutional lending programmes are finished in both Latvia and Hungary, the only two countries that borrowed from the International Monetary Fund and its associates, the government debts will function as breaks for increased investments, including into research, development and innovations. Although Viljar Veebel indicates that “Being motivated only by their own economic interests and assets, foreign banks had low motivation to contribute to the general socio-economic stabilisation in the countries”, in many countries the banks engaged in negotiations with both the government and mortgage holders on measures for containing the spread of unrecoverable loans and thus sustainable stabilisation.

Economic problems and the need for reforms, and the very principle of austerity itself, in many countries and in many sectors were very much used as an argument for democratic legitimation of spending cuts. The cuts in many cases were performed in short periods of time without proper evaluation of the effects in the longer term. Many, although not all, of the cuts were performed mechanically without proper attachment to sectorial reforms. This is also concluded by the Lithuanian authors in this book: “Although its guiding principle was using the crisis as a window of opportunity for reform, it did not really succeed in connecting the

fiscal consolidation and structural reform processes”. The stabilisation had to be performed in due time and a scientific, detailed analysis was not always a possibility. Juraj Draxler, while commenting on the Czech experience, even more clearly states the psychological and political effects of the government activities: “(...) the public’s exasperation with the government was also due to the fact that the governance processes had been erratic and unpredictable”. Therefore, the reforms remained in the hands of the top decision makers of particular sectors. The structural reforms need to be continued to make the lagging sectors more resource efficient and based upon long term development and investment perspectives. Slovak authors Brian Fabo and Michal Mudroň conclude that “In terms of the impact on the political system, the crisis has played into the general disillusion of the population towards politicians, in particular reformists. This disillusion was further strengthened by anger stemming from the widespread perception of corruption”.

B. Fabo and M. Mudroň point out yet another aspect of the stabilisation results – a jobless growth that is again visible in all of the Baltic and Visegrad countries. In spite of the fact that economies demonstrate increasing economic activity, the unemployment figures remain high and structural unemployment is becoming an increasing economic as well as social and political problem. Companies are in need of hiring specifically skilled workers, while the available labour pool does not fit the demand and features many potential workers that have not found permanent employment for some time. The return to growth is very much related to increasing efficiency and the modernisation of production, a more active search for export markets, and the unused production capacities because of crisis-reduced internal consumption.

Moreover, the other growing and immediately solvable problem is related to economic growth and demographics in the observed countries. Not only have countries experienced a mass exodus of their population before and during the crisis, but also the aging problem comes on the agenda increasingly quickly. “New problems should arise, including dissipating cost advantages and dramatic changes in the demographic structure of society. In order to reverse the unfavourable long-term trend there must be a wide political agreement lasting more than one election cycle,” warn M. Rot and R. Petru.

In Pursuit of the “European Dream”

Evidently the pursuit of the “European Dream” – stability and sustainability of personal income and societal welfare – has been the driving force behind the economic turmoil in Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia and Hungary. Both on the state level and the personal level the attempts to reduce the income gap between the observed countries and the Western

European states has been an important objective. The clash between the state and personal welfare, of course, has tended to distinguish and decide the paths taken and instruments used on the national level. The “European Dream” is deeply rooted in the very “promise” of economic benefits from EU membership that were widely used during the pre-accession campaigns. The European Union is seen as a source of prosperity not only in the member states that joined the bloc after 2004, but also to the ones still outside and willing to enter. Therefore, both the practical need to improve the living conditions together with the permanent reminders of failures and the low rankings of the former “new member states” in various spheres drove the psychological and political need to make economic decisions that facilitated the birth of unsustainable economic action.

The economic crisis demonstrated the unsustainability of “credited growth” in the observed countries. The stabilisation measures in each country, depending on the depth of the economic problems, were still based upon adjustments to immediate problems. Although general macroeconomic stabilisation for no reason should be attributed to unsustainable measures, the lack of implemented structural reforms in many sectors and the collateral damage done by austerity measures are the issues that create an unstable basis for sustainable development. Not only have countries learned from their own economic circumstances and experiences, but the evidence also demonstrates the learning process on the basis of comparative analysis among the observed member states. The decision makers of the Baltic States have not only learnt from each other, but also from Visegrad countries and vice versa. The difference is that some of the countries fell into economic problems later or for different reasons, which also caused the differences in their economic approaches. Moreover, often the countries because of mutual competition tended to copy not only unsustainable policies, but also policies that are based in incomparable data.

Thus, when answering the question whether the Baltic and Visegrad countries had a “politics of economic sustainability”, and whether the stabilisation measures in the observed countries have made them economically sustainable, one must conclude that the answer is yes. The economic crisis made national economic development more sustainable than before the crisis, in spite of the fact that many of the immediate problems have not yet been solved and the stabilisation measures may have inflated many additional social problems. The macroeconomic stabilisation made the bubbles burst and reduced the volume of unsustainable economic activities. But this came at the expense of increasing social problems, a lack of investments in human resources, including the basic healthcare and children, as well as shrinking populations and domestic unemployment. The short term approach, where the political cycles are incompatible with decisive long term sustainable economic action, is the main worry.

J. Draxler in his chapter positively concludes that “The main legacy of the crisis is that the public has simply tired of incessant reformist narratives. Instead of more headline-grabbing reforms, the people now want a well-run state”. There is a substantiated hope that the societies will remember the hardships brought by the austerity and stabilisation measures and will remember the causes of the problems. This brings hope that the political maturation process of the democratic Baltic and Visegrad countries will limit political populism and increase the quality of decision makers, the “piecemeal engineers”, and the decisions they will make.

Division of labour is the final aspect that must be mentioned in these concluding remarks. As the authors of this book divided the burden of analysis so that the reader would be provided with country specifics and detailed conclusions in the respective country chapters, the hope remains that the Baltic and Visegrad countries will more actively pursue the economic division of labour in the region and in the European Union and thus move to increase their relative advantage in a few sectors instead of continuing the unsustainable and indecisive politics of mutual competition in every sphere.

Selected Further Reading

- Austers, Aldis, and Karlis Bukovskis. "Latvia's Socio-Economic and Political-Institutional Challenges in the Context of the Eurozone Accession." In: *Baltic-German Strategic Engagement: Realignment after the Eurocrisis?* Riga: Latvian Institute of International Affairs, 2013. pp. 15-37. –http://liia.lv/site/docs/StrategyTalks2013_A5_GALA.pdf
- Beblavý, Miroslav. „Why Has the Crisis Been Bad for Private Pensions, But Good for the Flat Tax? The Sustainability of ‘Neoliberal’ Reforms in the New EU Member States“. CEPS Working paper 356. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1996467
- Bukovskis, Karlis. "Latvia's Austerity Model in the Context of European Austerity versus Growth Debate." In: *The Riga Conference Papers 2012*. Riga: Latvian Institute of International Affairs, Latvian Transatlantic Organization, 2012. pp. 10-15. http://liia.lv/site/docs/The_Riga_Conference_Papers_20121.pdf
- Cerami, Alfio, and Pieter Vanhuysse, eds. *Post-Communist Welfare Pathways: Theorizing Social Policy Transformations in Central and Eastern Europe*. Basingstoke: Palgrave Macmillan, 2009.
- Drahekoupil, Jan. *Globalization and the State in Central and Eastern Europe: The Politics of Foreign Direct Investment*. London: Routledge, 2009.
- Dušek, Libor, and Lubomír Lízal. *CERGE-EI Tackles Transition*. Prague: CERGE-EI, 2011.
- Haggard, Stephan, and Steven B. Webb. "What Do We Know About the Political Economy of Economic Policy Reform?." *The World Bank Research Observer* 8, Iss. 2 (1993): 143–168.
- Hall, Robert E., and Alvin Rabushka. *The Flat Tax*. Stanford: Hoover Institution Press, 1985.
- Kahancová, Marta. "The demise of Social Partnership or a Balanced Recovery? The Crisis and Collective Bargaining in Slovakia". *Transfer* 2 (2013): 171-183.
- Kahanec, Martin, and Michael Fertig. "Mobility in an Enlarging European Union: Projections of Potential Flows from EU's Eastern Neighbors and Croatia". CELSI Discussion Paper 18 (2013). <http://celsi.sk/en/publication/paper-details/28/mobility-in-an-enlarging-european-union-projections-of-potential-flows-from-eu-s-eastern-neighbors-and-croatia/>
- Krastev, Ivan. "The Strange Death of the Liberal Consensus." *Journal of Democracy* 4 (2007): 48-67.
- Krueger, Anne O., ed. *Political Economy of Policy Reforms in Developing Countries*. London: MIT Press, 1993.
- Kuodis, Raimondas. "Fiskalinės politikos taisyklės valdžioms žaboti." *Pranešimas Atviros Lietuvos fondo organizuotoje apskrito stalo diskusijoje: www.ekonomika.org*. 2005.
- Kuokštis, Vytautas. "Baltic Variety of Capitalism as an Explanation to the Success of Internal Devaluation." In: *Governance Failure and Reform Attempts after the Global Economic Crisis of 2008/2009. Case Studies from Central and Eastern Europe*, eds. Leonid Kosals and Heiko Pleines. *Changing Europe Book Series 9*. Stuttgart: Ibidem Publishers, 2012. 13-28.
- Kusá, Zuzana. "Diskurz a zmeny sociálneho štátu" (Discourse and Changes of the Welfare State). *Slovak Sociological Review* 1 (2008): 5-33.
- Lainela, Seija, and Pekka Sutela. *The Baltic Economies in Transition*. Helsinki: Bank of Finland, 1994.
- Lane, Jan-Erik, ed. *Public Sector Reform. Rationale, Trends and Problems*. London: Sage, 1997.
- Lietuvos Respublikos Seimas (LRS). "Dėl penkioliktosios Lietuvos Respublikos Vyriausybės veiklos programos" (2008 12 09 Nr. XI-52). *Valstybės žinios* 146-5870 (2008).
- Lietuvos Respublikos Seimas (LRS). "Lietuvos Respublikos fiskalinės drausmės ástatymas" (2007 11 08 Nr. X-1316). *Valstybės žinios* 120-4881 (2007).

- Maniakas, Klaudijus. "Lithuania's European Policy and its Coordination." In: Lithuania's Road to the European Union. Unification of Europe and Lithuania's EU Accession Negotiations, eds. Klaudijus Maniakas, Ramūnas Vilpišauskas, and Darius Žeruolis. Vilnius: Eugrimas, 2005. 439–465.
- Myant, Martin, and Jan Drahokoupil. "International Integration, Varieties of Capitalism and Resilience to Crisis in Transition Economies". *Europe-Asia Studies* 64 (2012).
- Myant, Martin, and Jan Drahokoupil. *Transition Economies: Political Economy in Russia, Eastern Europe and Central Asia*. Chichester: John Wiley, 2011.
- Nakrošis, Vitalis, and Ramūnas Vilpišauskas. *Country Report: Lithuania: Unfinished Business of the Fifth Enlargement*. Sofia: OSI, 2009.
- O'Dwyer, Conor, and Kovalčik, Branislav. "And the Last Shall Be First: Party System Institutionalization and Second-Generation Economic Reform in Postcommunist Europe". *Studies in Comparative International Development* 4 (2009): 3-26.
- Ost, David. „The Consequences of Postcommunism." *East European Politics and Society* 1 (2009): 13-33.
- Pollitt, Christopher, and Geert Bouckaert. *Public Management Reform: A Comparative Analysis*. Oxford: Oxford University Press, 2000.
- Queensland Government. "Framework for Self-Management 2008–2015." 2009.
- Rodrik, Dani. "Understanding Economic Policy Reform: A Comparative Analysis." *Journal of Economic Literature* 34, Iss. 1 (1996): 9–41.
- Tompson, William. *The Political Economy of Reform. Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*. Paris: OECD, 2009.
- Vilpišauskas, Ramūnas. "Eurozone Crisis and European Integration: Functional Spillover, Political Spillover?". *The Journal of European Integration* 35, no. 3 (2013): 361-373.
- Vilpišauskas, Ramūnas. "The Political Economy of Baltic States' Accession into the EU: The Impact on the Role of States." In: *Towards the Completion of Europe. Analysis and Perspectives of the European Union Enlargement*, eds. Joaquín Roy and Roberto Domínguez. Miami: University of Miami, 2006. 209–221.
- Vilpišauskas, Ramūnas. "The Regulatory Alignment in the Context of EU Accession and its Impact on the Functioning of Lithuanian Economy." In: *Lithuania: Country Economic Memorandum, Vol. II, Technical Papers*, ed. Ana Revenga. Washington DC: World Bank, 2002. 205–246.
- Vilpišauskas, Ramūnas. *Economic and Political Challenges of Acceding to the Euro Area in the Post-Lehman Brothers' World. Country Report Lithuania*. European Policies Initiative. Sofia: Open Society Institute, 2009.
- Williamson, John, ed. *The Political Economy of Policy Reform*. Washington DC: Institute for International Economics, 1994.
- World Bank. "Doing Business. Measuring Business Regulations." <http://www.doingbusiness.org/customquery>
- World Bank. "World Development Report: From Plan to Market." 2006.
- World Health Organisation (WHO) Regional Office for Europe. *European Health for All Database*. Copenhagen, 2009. <http://www.euro.who.int/hfadl>
- Zemplerinová, Alena. *Effects of Foreign Direct Investment: the Case of the Czech Economy*. Prague: CERGE-EI, 2012.

Notes on Authors



Kārlis Bukovskis is the Deputy Director and a researcher at the Latvian Institute of International Affairs (LIIA). He is also a guest lecturer on the global political economy and the economic diplomacy of the EU at universities in Latvia. He acquired master's degrees from the University of Latvia and the University of Helsinki, and has been a student at the University of Trier and Riga Stradiņš University. Bukovskis has also served as a senior desk officer at the Ministry of Foreign Affairs of Latvia, dealing with European Union institutional affairs and cooperation with the European Parliament. Currently he is also engaged in the preparation of the Latvian presidency of the Council of the European Union, where he deals with the ECOFIN and institutional changes in the EU. His main points of interest are the international political economy, the international financial system, and European Union institutional affairs.



Aldis Austers has studied economics at Riga Technical University and international relations at the Vienna Diplomatic Academy. He has worked for an extended period of time in Latvia's Foreign Affairs Ministry and the Bank of Latvia. Currently Aldis Austers is a researcher at Latvia's Institute of International Affairs and a part time lecturer at Riga Stradiņš University. His fields of interest include monetary economics, political economics, the migration of people, and European integration.



Vitalis Nakrošis was awarded a Master's degree in the Political Economy of Transition from the London School of Economics (in 1998) and a PhD in social sciences from Vilnius University (in 2004). Vitalis is a professor in public administration in the Institute of International Relations and Political Science (Vilnius University). His main research interests include public management reforms, public sector organisations, performance management, policy implementation and evaluation, EU public policies and programmes. Vitalis has published a number of books, book chapters and articles on various public policy and administration subjects. The work of Vitalis appeared in, or was accepted by, International Journal of Public Administration, Evaluation, NISPACEE Journal of Public Administration and Policy, the Transylvanian Review of Administrative Sciences, the Journal of

Baltic Studies and a few Lithuanian academic journals (Politologija, Viešojo politika ir administravimas). His most recent co-edited book is *Lithuanian Agencies and Other Public Sector Organisations: Organisation, Autonomy, Control and Performance*, Vilnius: Vilnius University, 2011. Vitalis is also actively involved in the work of various commissions and working groups, especially in the governmental “Sunset” Commission responsible for improving public administration in Lithuania.



Ramūnas Vilpišauskas is a Director and Professor of the Institute of International Relations and Political Science, Vilnius University. He is a graduate of Vilnius University and Lancaster University (UK) (in 1995 and 1996 respectively, both with distinctions). His main research interests included the political economy of European integration, policy analysis of reforms, and international political economy. Ramūnas has been a visiting fellow at several universities in the USA (Syracuse University) and Canada (Carleton University), has been a Fulbright scholar at Columbia University, and conducted research at a number of European institutions including the European University Institute (Florence). He has graduated from the International Trade and Commercial Diplomacy programme at Carleton University (Ottawa) and the Swedish Institute Management Programme (Stockholm). He has worked as a Chief Economic Policy Advisor to President of Lithuania V. Adamkus and the Head of Economic and Social Policy Group (2004-2009), and he has also been appointed to coordinate the team of advisors to the President (2006-2009). He has an extensive list of publications on EU enlargement, transition reforms, policy analysis and European integration policies.



Vytautas Kuokštis is a lecturer at the Institute of International Relations and Political Science of Vilnius University and a postdoctoral researcher at the Faculty of Philosophy of Vilnius University. He holds a BSc degree in Economics from the Stockholm School of Economics in Riga (SSE Riga) as well as an MA in Comparative Politics and a PhD in Political Science (both from Vilnius University). His main research interests are comparative and international political economy with a special emphasis on the political economy of Baltic countries and financial crises. Vytautas's doctoral dissertation focused on the adjustment to the crisis in the Estonia, Latvia and Lithuania during the Great Recession. Vytautas has had research stays at the University of Bristol, Creighton University, Central European University, Tartu University and Tallinn Technical University.



Viljar Veebel is a researcher who has been researching in the University of Tartu, the Estonian School of Diplomacy and the Tallinn Technological University. He defended his Ph.D. in 2012 at the University of Tartu, focusing on the European Union pre-accession policy and the European Neighbourhood Policy. Since 2013 he has been working at the Estonian National Defence Academy as Associate Professor of Social Sciences. Viljar Veebel is also actively participating as a consultant in European Union related projects in Moldova, Georgia, Ukraine and the Balkan area in development cooperation projects in cooperation with the Estonian Ministry of Foreign Affairs, the Estonian School of Diplomacy and the Swedish International Development Agency. He is also participating in an active media debate on European Union enlargement and the relations of the Baltic States with Russia and the European Union.



Zoltán Pogátsa, PhD, is an international political economist working on questions related to development, public policy, the economics and politics of European integration, as well as issues related to Central Europe and the Balkans. His home institution is the Faculty of Economics at the University of Western Hungary, where he is in charge of the MA Programme on International Economics and Business. Pogátsa also carries out research for the Hungarian Academy of Sciences and has lectured at various universities in Slovakia, the Czech Republic, Austria, Germany, France, the UK, Italy and Ireland.



Brian Fabo is a data analyst and researcher at the Central European Labor Studies Institute (CELSI) in Bratislava, Slovakia, and has participated in several international research projects on various labour market-relevant issues. Recently, he has contributed to a policy paper on the employment position of low-educated individuals in Eastern Europe, published inside the framework of the EU-funded FP 7 project 'NEUJOBS', an upcoming book on labour relations prepared by the International Organization of Labour. A paper co-authored by Brian, titled "Migration strategies of crisis-stricken youth in an enlarged European Union" was published in the August 2013 edition of *Transfer: European Review of Labour and Research*. In September 2013, Brian spent a month working at the Amsterdam Institute for the Advanced Study of Labour on a project aimed to improve the measurement of tasks performed in different occupations. His current research

focuses on labor market developments in Central and Eastern Europe's post-Fordist knowledge economy as well as methodological aspects of online and mobile data collection. In addition to academic work, Brian is responsible for data collection, processing and analysis at the global WageIndicator Foundation, which runs voluntary web-based surveys, as well as representative face-to-face surveys on various labour market issues in over 80 countries worldwide.



Michal Mudroň is a data analyst at the Central European Labour Studies Institute (CELSI) in Bratislava, Slovakia. He holds an Mgr. in Economic and Financial Mathematics of the Faculty of Mathematics, Physics and Informatics of Comenius University. His working experience includes private finance and portfolio management, investment consulting, data collection and management, database administration, webdesign and website administration, search engine optimisation and content management systems. He has a passion for dynamic technology solutions, such as mobile applications and data collection systems combined with statistical analysis and interactive visualisation platforms. Currently, he is cooperating with the WageIndicator Foundation, headquartered in Amsterdam, as a member of a global initiative to provide the most reliable wage information for any specific occupation and worker profile. WageIndicator, in partnership with CELSI, collects labour market data by means of voluntary online and offline surveys available at national WageIndicator sites. Michal's responsibility in the project is to co-manage the data collection and survey modeling in over 80 countries around the globe.



Juraj Draxler, MA, is Associate Research Fellow at the Centre for European Policy Studies (CEPS). Before moving to Germany and the UK for university studies, in late 1990s he worked in his native Slovakia as a spokesman for a state-owned industrial holdings company and later as a journalist for Reuters news agency. Since 2005, he has been associated with the Centre for European Policy Studies (CEPS), a Brussels-based think-tank. He coordinated a 3-year EU-funded research project titled Adequacy and Sustainability of Old-Age Income (AIM). He is the co-author of "Is Social Europe Fit for Globalisation?", the background document for a high-level conference on globalisation's impact on the European Union organised by the European Commission in spring 2008. He still occasionally contributes to CEPS's work as an Associate Fellow. Juraj Draxler's journal publications, book chapters and policy briefs mostly focus on the

development of specific social policies and the welfare state in general in the EU, but he has also published analyses looking more narrowly at welfare and labour market policies in EU's new member states. He also regularly writes for the mass media. He has a weekly column in a Slovak daily paper, but often publishes comments in other media in Slovakia, the Czech Republic and elsewhere. In 2010-13, he was lecturing at the University of New York in Prague (UNYP) and the Anglo-American University. He continues to be active in both Slovakia and the Czech Republic, as advisor to private companies and government institutions.



Michal Rot, PhD, currently holds an expert position at the Economic Analyses Department in PKO Bank Polski (the largest commercial bank in Poland). He has been involved in economic research and forecasting for more than seven years, both within commercial institutions as well as at the central bank. He contributed to the monetary policy analyses by supporting the Polish central bank with the development of tools and scenario analyses suitable for monetary policy decision process. Currently his research focuses inter alia on the fiscal policy in Poland and its implications for the real economy. Before switching to the macroeconomic research he also gathered experience as a management consultant developing strategies, business plans and business cases for Deloitte Warsaw office's clients.



Ryszard Petru, Partner at PwC office as well as President of the Association of Polish Economists. Until recently he was Head of Analysis, Strategy and Investor Relations at PKO Bank Polski after a serving as Chief Economist and Head of Strategy at BRE Bank SA. From 2004-2008 he was Chief Economist at BPH Bank (research and macroeconomic analysis). From 2001 to 2004, he covered macroeconomic policy issues affecting Poland and Hungary at the World Bank, specifically addressing the reform of public finances, regional policy and the investment climate, while advising on pension reform and public finances in central and Eastern Europe and central Asia. From 1997 - 2000 he was advisor to prof. Leszek Balcerowicz (Deputy Prime Minister and Finance minister), focusing on pension reforms and the creation of a new system of retirement pensions.

The Latvian Institute of International Affairs (LIIA) was established in May 1992 in Riga as a non-profit foundation charged with the task of providing Latvia's decision-makers, experts, and the wider public with analysis, recommendations, and information about international developments, regional security issues, and foreign policy strategy and choices. It is an independent research institute that conducts research, publishes publications, as well as organizes lectures, seminars and conferences related to international affairs. Among Latvian think tanks, the LIIA is the oldest and one of the most well-known and internationally recognized institutions, especially as the leading think tank that specializes in international affairs.

Latvian Institute of International Affairs

Address: 21 Pils street, Riga, LV-1050, Republic of Latvia

www.lai.lv, <http://liia.lv>, liia@liia.lv

