

Two years ago, the eyes of the financial world were not on Europe's Western periphery but on its North-Eastern corner. The three Baltic states—Estonia, Latvia and Lithuania—were among the first victims of the global financial crisis, the International Monetary Fund said.

- [Carl Bildt: 'The sacrifices were not in vain'](#)

After a spectacular boom, with several years of Chinese-style growth rates, these small and open economies faced an equally spectacular bust. Credit—and with it property prices, consumption, and investment—collapsed. Exports were hit by the global depression. And the financial sector came under severe stress. Indeed, Latvia was forced to nationalize its largest domestic bank and had to ask for a bailout from the European Union and the IMF.

The conventional wisdom at the time was that these three countries would have to give up their long-standing currency pegs against the euro and devalue. After all, this is what countries facing a trade and financial shock most often choose to do.

But the Baltic governments begged to differ. They opted to maintain their currency pegs and instead let their economies adjust through “internal devaluation”: a mix of budget and wage cuts, supported by financial and structural reforms.

Meltdown avoided

It is too early to pass final judgment on the success of the Baltic strategy. Adjustment is still far from complete, and the current problems in the eurozone may yet complicate recovery. What is clear, however, is that the most dire predictions have not come true. Despite an unprecedented economic downturn—cumulatively, GDP has shrunk by about a quarter—devaluation and banking crises have been avoided.

Impressed by the authorities' determination and mindful of the regional implications of a potential devaluation, [we at the IMF](#) supported Latvia with a [€1.7 billion loan](#) as part of an international rescue package of €7.5 billion. The financing provided to Latvia also boosted confidence that Lithuania and Estonia would weather the storm.

How the Baltics Defied Predictions: Video

Written by Johan Nylander

Monday, 17 January 2011 07:49 - Last Updated Monday, 17 January 2011 07:58

In a recent [paper](#) , my colleague Catriona Purfield and I take a closer look at how the authorities' policies played out as the crisis evolved in 2008-09. We also highlight differences between the three countries, which are often overlooked by outside observers.

Even though the initial adjustment was rapid, the crisis has left a severe legacy. Unemployment remains high, public finances still pose a challenge, competitiveness needs a further boost, and the banking system is still being repaired. That said, all three countries have recently started growing again, helped by a pick-up in external demand.

How it worked

How were the Baltics able to achieve such large-scale adjustment under a currency peg?

- First, their economic structures, having undergone fundamental changes in the past two decades, proved **relatively flexible**. There is early evidence that companies and workers are adapting quickly to the post-boom environment.
- Second, small foreign currency markets, dominated by a few domestic players, made it **virtually impossible** for outsiders to take speculative positions against the three currencies.
- Third, **close integration** with Nordic neighbors, especially foreign bank ownership, added to stability as deep-pocketed parents (backstopped by their home country governments) were willing and able to absorb losses rather than pulling out.
- Finally, fiscal belt-tightening, including necessary, but painful measures to reduce wages, pensions, and social benefits, were **broadly supported** by the population. Such determination is rooted in strong social cohesion and a shared desire to maintain stability and eventually adopt the euro, a symbol of the three countries' membership of the European Union and their ties to the West.

Different starting points, different outcomes

Differences between the three countries also hold lessons. The crisis was deepest in **Latvia**, probably because imbalances during the boom were the largest there. The banking system, which is partly domestically-owned, proved particularly vulnerable to a sudden stop and capital outflows.

Estonia, in contrast, contained pressures on its public finances and financial system better than its neighbors and has just succeeded in adopting the euro, becoming the 17th member of the euro area on January 1, 2011. This remarkable achievement was due to three factors:

- **Timing** – the recession started earlier in Estonia and the government moved quickly to adjust policies.
- **Institutions** – sizeable fiscal reserves were built up during the boom and Estonia has a tradition of strong tax compliance.
- A fully foreign-owned banking system – Estonia's banks received **strong capital and liquidity support from abroad**, further boosted by a precautionary swap line between Swedish and Estonian central banks.

Estonia's experience shows that prudent policies during the boom may not avoid a bust, but they can put the country into a better position to deal with shocks. The size of imbalances also matters. In **Lithuania**, a delayed (and smaller) boom may now make it easier to regain competitiveness.

The Baltic experience demonstrates that large economic adjustment, including nominal wage and benefit cuts, is indeed possible under a currency peg (or, for that matter, in a currency union). What it takes, however, is both grit and flexibility.

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Source: [*IMF Direct*](#)