

# The Economic Crisis and its Aftermath in the Nordic and Baltic Countries

Do As We Say and Not As We Do

Hilmar Þór Hilmarsson  
Professor University of Akureyri

## The Economic Crisis and its Aftermath in the Nordic and Baltic Countries

The Nordic-Baltic region has become highly integrated. The Nordic countries have been successful in balancing competitiveness and economic growth with social inclusiveness, while the Baltic States have grown economically but remain vulnerable with weak social systems and highly unequal income distribution. European Union (EU) membership and inter-linkages with the continental Nordic banking systems appear to have affected the 2008/09 crisis response of the Baltic States.

In spite of their strengths, including their social systems, continental Nordic states are faced with a challenging mix of large, cross-border banks and highly indebted households at a time of rather weak global growth. The Baltic States are challenged by slow economic growth post-crisis, security concerns, and large-scale outward migration of the youngest and most highly educated people.

It is now a decade since the Baltic States were hit by the global crisis. It is time to take stock of their progress and assess their relations with other countries in the region and with the EU. This book focuses on the Baltics and their Nordic partners pre- and post-crisis: successes, failures, lessons learned, and future challenges, examining and comparing the crisis response of these various small states that enjoy different income levels, operate different welfare and tax systems, and seek different levels of integration with the EU.

**Hilmar Þór Hilmarsson** is a Professor at the University of Akureyri, School of Business and Science, Iceland, where he teaches courses on international business and macroeconomics. He received his degree in Economics from the University of Iceland in 1987, an MA in Economics from New York University in 1989, and a PhD in public administration and economic development from the American University in Washington, DC in 1992. He served as a Specialist and Co-ordinator with the World Bank Group in Washington, DC from 1990 to 1995, at the World Bank office in Riga, Latvia from 1999 to 2003 and the World Bank office in Hanoi, Vietnam from 2003 to 2006. From 1995 to 1999 he served as a Special Advisor to the Minister for Foreign Affairs in Iceland.

ECONOMICS, EUROPE, BALTIC STATES, FISCAL POLICY

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## Iceland alone and Latvia captured: The role of Sweden in the Icelandic and Latvian financial crises



Both Iceland and Latvia were severely hit by the late 2000s financial crisis. However, as **Hilmar Þór Hilmarsson** writes, Sweden did not suffer as serious a crisis despite its extensive banking interconnections in other Nordic and Baltic countries. He argues that Sweden effectively managed to 'export' its crisis to other states, and that given the continued vulnerability of the Swedish banking system, the lessons from the first crisis have still to be learned.

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# Dienas brīvdienas DIZNES



pēc krīzes. Ja tā turpināsies, tās bagātāko ES dalībvalstu ekonomiskās attīstības līmeni tuvākajā nākotnē tālāk nesasnies. Bet Baltijas valstīm vēl ir iespēja mainīties. Tās var kļūt konkurētspējīgākas, ieguldot vairāk resursus izglītībā, zinātnē, pētniecībā un infrastruktūrā.» akts ekonomikas un starptautiskās vadībzinātnes profesors no Islandes Hilmar Hilmarsons.

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EKSPERTA VIEDOKLIS

## Baltijas valstīm vēl ir iespēja mainīties



Hilmar Hilmarsons,  
ekonomikas un starptautiskās  
zinātnes profesors Akureiri  
universitātē Islandē,  
Igaunijas Universitātes viesprofesors,  
Bankas pārstāvis Rīgā  
1999-2003. g.

pirms Baltijas valstu iea-  
šanās Eiropas Savienībā  
), es dzīvoju Rīgā. Visap-  
jūtu optimismu un cerī-  
ka pavisam drīz Baltijas  
stis sasnies ES 15 valstu  
ekonomiskās attīstības līme-

katrā no trijām valstīm vis-  
maz vienu gadu izaugsmes  
rādītājs pārsniedza šo atzī-  
mi. Protams, ka pie šādiem  
tempiem, ekonomikas apmērs  
desmit gadu laikā divkār-  
šojās. Arī bezdarba līmenis  
ievērojami kritās.

Taču jau 2008./2009. gadā  
Baltijas reģionu iedragāja  
globālā finanšu krīze. Īpaši  
smagi tā skāra tieši Latviju.  
Bija nepieciešams pieņemt  
svarīgus lēmumus, un visas  
trīs Baltijas valstis izlēma  
ieviešot fiksētā valūtas kursa  
politiku. ES šo apņemšanos  
atbalstīja, un tā tika izvirzīta  
par nosacījumu eiro ieviešanai.  
Šī politika paredzēja bāru  
taupības pasākumu uzsāk-  
šanu. Tika samazināts darba-  
vietu skaits, algas, kā arī iz-  
devumi sociālajām, izglītības  
un veselības programmām.

Laikā palielinātu Latvijas eko-  
nomiskā konkurētspēju, ce-  
ribā uz ātrāku ekonomikas  
atveseļošanas Starptautiskais  
Valūtas fonds ieteica Latvijas

to, ka devalvācija ietekmēs  
to portfeli; daudzi šo banku  
klienti bija veikuši aizpēmu  
eiro valūtā. Arī ES pau-  
da bažas par lata devalvāci-  
jas ietekmi uz Latvijas eko-  
nomiku.

Būsim atklāti – 2005. līdz  
2007. gadā Baltijas valstu  
IKP izaugsmes pamatā nebi-

kas izpratne. Bankas pie at-  
bīdības tā arī netika sauktas.  
Tā vietā visās trijās Baltijas  
valstīs, kurās ir viens no vis-  
augstākajiem nabadzības, so-  
ciālās atstumtības un ienāku-  
mu nevienlīdzības riskam pa-  
kļauto cilvēku skaits ES, tika  
īstenoti taupības pasākumi.  
Vairāk uzmanības tika pie-

” Kā pētnieks esmu  
mēģinājis izprast, kā  
Baltijas valstis pēkšņi  
kļuva tik neoliberalas, kādēļ tās  
pieņēma tik ekstrēmu brīvā tirgus  
filozofiju?!

ja fiskālās nelīdzsvarotības;  
Igaunijas budžetā šajā pe-  
riodā tika reģistrēts pārli-  
kums, bet Latvijas un Lietu-  
vas budžeti bija gandrīz līdz-  
svaroti. Ekonomikas strauju

vērsts banku glābšanai, nevis  
maznodrošināto personu lab-  
klājības veicināšanai. Kā pē-  
tnieks esmu mēģinājis izprast,  
kā Baltijas valstis pēkšņi kļu-  
va tik neoliberalas, kādēļ tās

Lārs, kurš 1992. gadā (neilgi  
pēc valstiskuma atjaunoša-  
nas) tika ievēlēts par Igauni-  
jas premjerministru, atklāja:  
«Par laimi, es nebiju ekono-  
mists. [...] Biju izlasījis tikai  
vienu grāmatu par ekono-  
mikas zinātni – Miltona Frīd-  
mana izvēles brīvību (*Free  
to Choose*). Tolaik es par to  
neko nesaprātu, tādēļ domā-  
ju, ka Rietumos īstenotās  
ekonomiskās reformas spēj  
izskaidrot Frīdmana rakstīto  
par guvumiem no privatizāci-  
jas, vienotiem nodokļiem un  
muitas tiesību atcelšanas.»  
Un Lārs Igaunijā īstenoja  
Frīdmana politiku: politiku,  
kas nekad iepriekš nebija ti-  
kusi ieviesta nevienā citā pa-  
saulas valstī, pat ne Frīdmana  
dzimtenē ASV.

Pēdējo desmit gadu laikā es-  
mu pasniedzis lekcijas visu  
trīs Baltijas valstu univer-  
sitatēs. Esmu runājis ar stu-  
dentiem. Daudzi no viņiem  
pametuši dzimteni un devu-  
šies uz kādu bagātāku valsti

Latvijā un Lietuvā emigrā-  
cijas līmenis ir jo sevišķi  
augsts. Ir skumji noskatīties  
cik lēni Baltijas valstis at-  
kājas pēc krīzes. Ja tā turpinā-  
sies, tās bagātāko ES dalīb-  
valstu ekonomiskās attīsti-  
bas līmeni tuvākajā nāko-  
nē tā arī nesasnies. Baltij-  
valstu jaunieši, kas dzimte-  
pametuši, visticamāk, nev-  
lēšies atgriezties mājās, ko-  
tos sagaida zemas darba al-  
gu un vājas sociālās labklāji-  
sistēmas.

Bet Baltijas valstīm vēl ir  
iespēja mainīties. Tās var kļūt  
konkurētspējīgākas, iegul-  
dot vairāk resursus izglītī-  
bā, zinātnē, pētniecībā un infr-  
struktūrā. Baltijas valstis v-  
pāļņveidot nodokļu sistēmas  
ieviešot progresīvā nodok-  
ļu likmi un paaugstinot i-  
enākuma, zemes un kapitā-  
nodokli. Tās var pamazām  
uzlabot labklājības un ve-  
selības aprūpes sistēmas  
Latvijā, Lietuvā un Igauni-  
jā ir modernas valstis

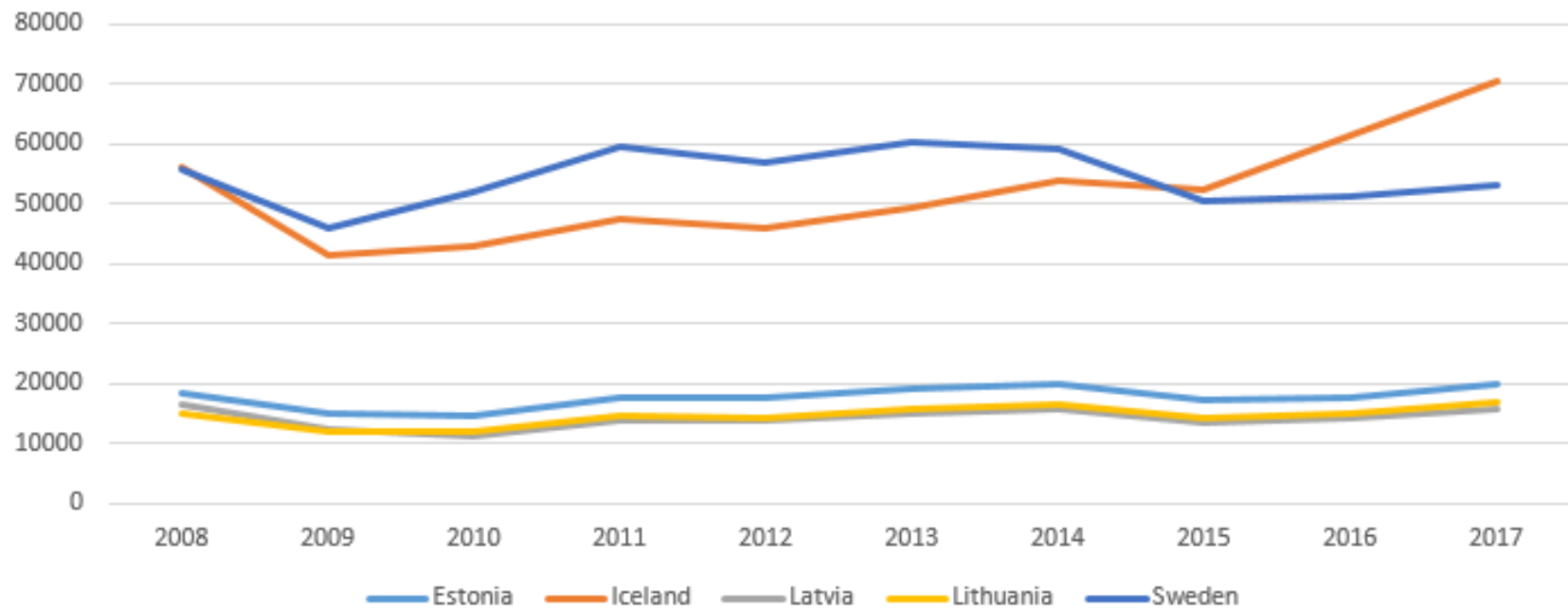
# Nordic Countries and Baltic States

## Baltic and Finnish proximity with Russia

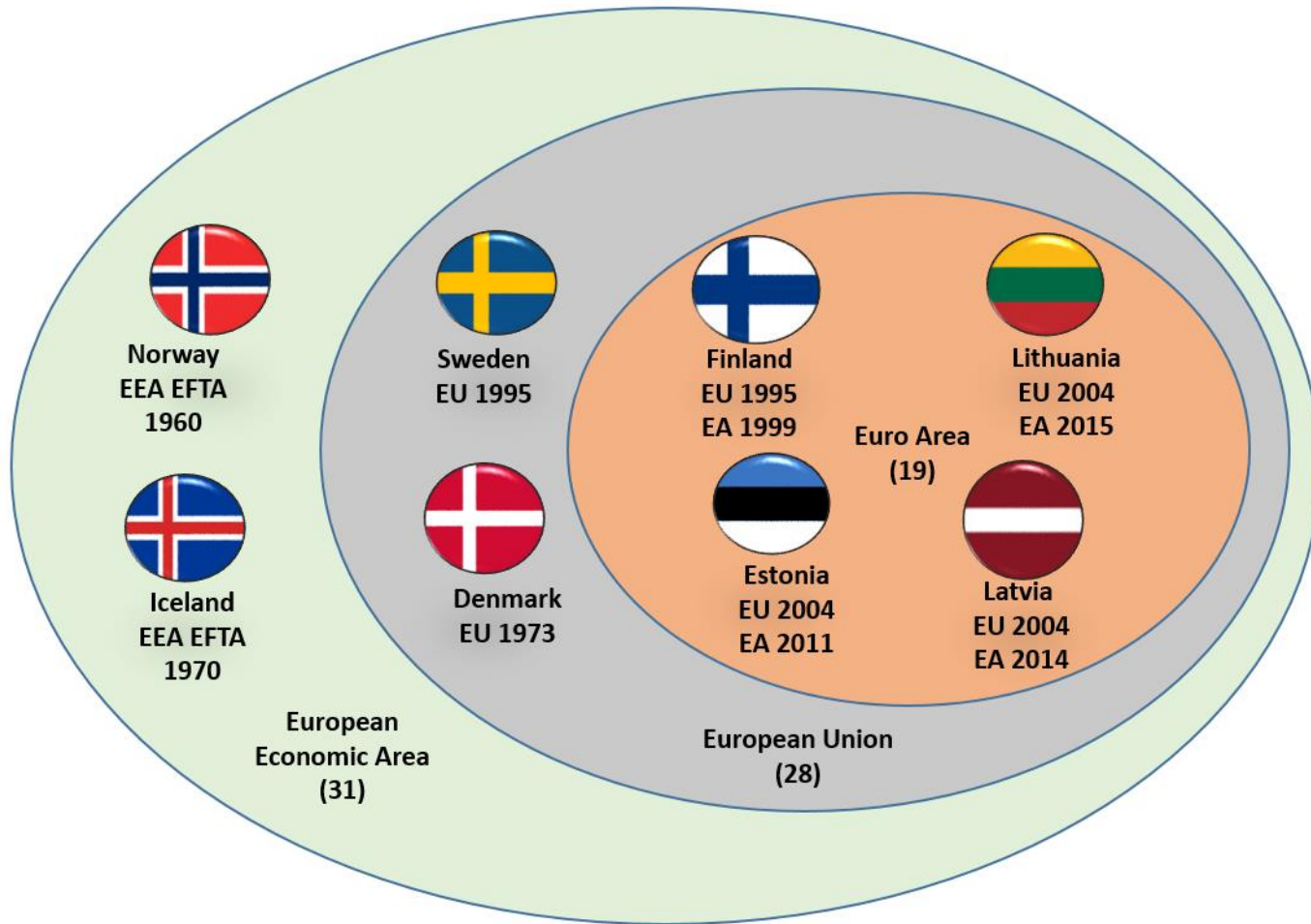
### Prisoners of geography?



# Gross domestic product per capita, current prices - U.S. dollars.



# Level of European Integration



# Nordic welfare model

- Holmström, et al. argue that the Nordics have embraced both globalization and the welfare state, and that the security offered by collective mechanisms for sharing risks has been instrumental in enhancing a favorable attitude to globalization and competition (See Holmström, et al. 2007, p. 12).
- Professional economists have often been puzzled by the relatively good economic performance of the Nordic model, given its high taxes and its generous social protection systems as well as the role of strong labour unions and wage coordination (See, Holmström, et al. 2007, p. 16).



# Mart Laar Prime Minister of Estonia

## Waking on Water

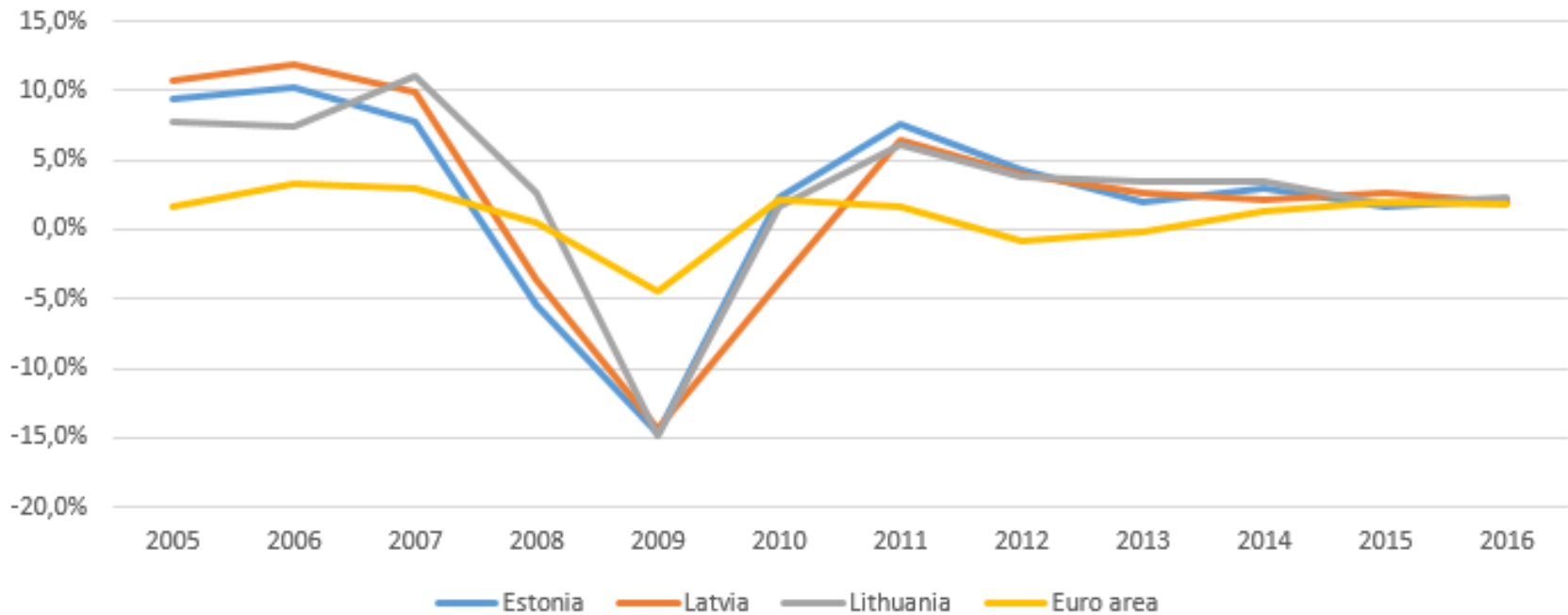
- “It is very fortunate that I was not an economist,” he says. “I had read only one book on economics – Milton Friedman’s “Free to Choose.” I was so ignorant at the time that I thought that what Friedman wrote about the benefits of privatisation, the flat tax and the abolition of all customs rights, was the result of economic reforms that had been put into practice in the West. It seemed common sense to me and, as I thought it had already been done everywhere, I simply introduced it in Estonia, despite warnings from Estonian economists that it could not be done. They said it was as impossible as walking on water. We did it: we just walked on the water because we did not know that it was impossible” (The Brussels Journal, 2005).

# Mart Laar Waking on Wather

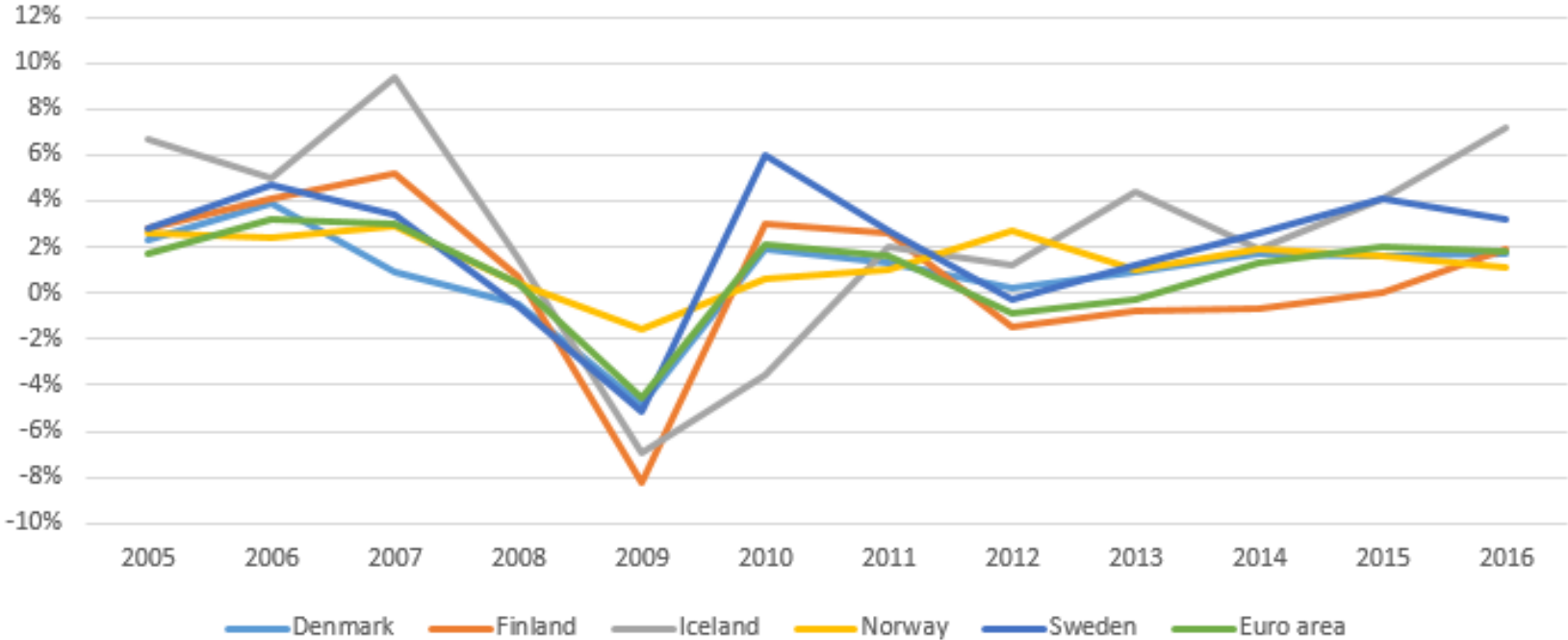
- The Cato Institute awarded Laar the Milton Friedman Prize for Advancing Liberty in 2006.



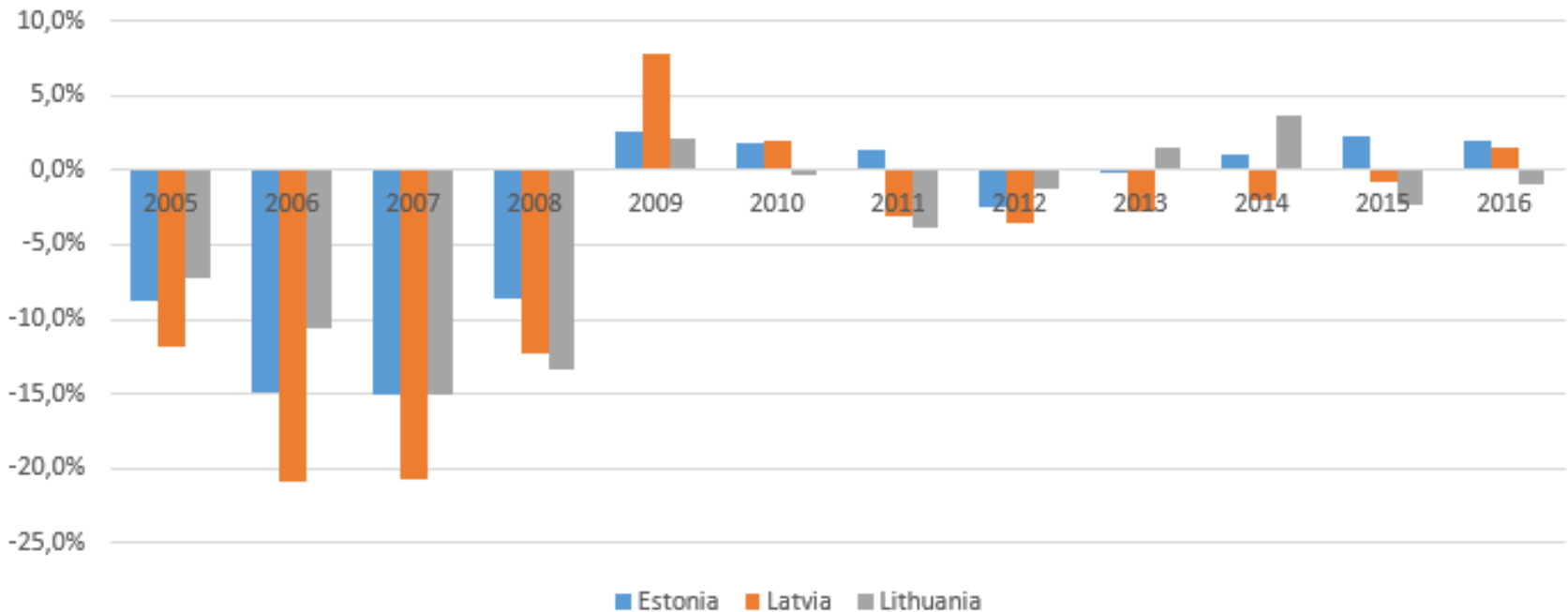
# Baltic States and Euro Area. Gross Domestic Product, constant prices. Percent change.



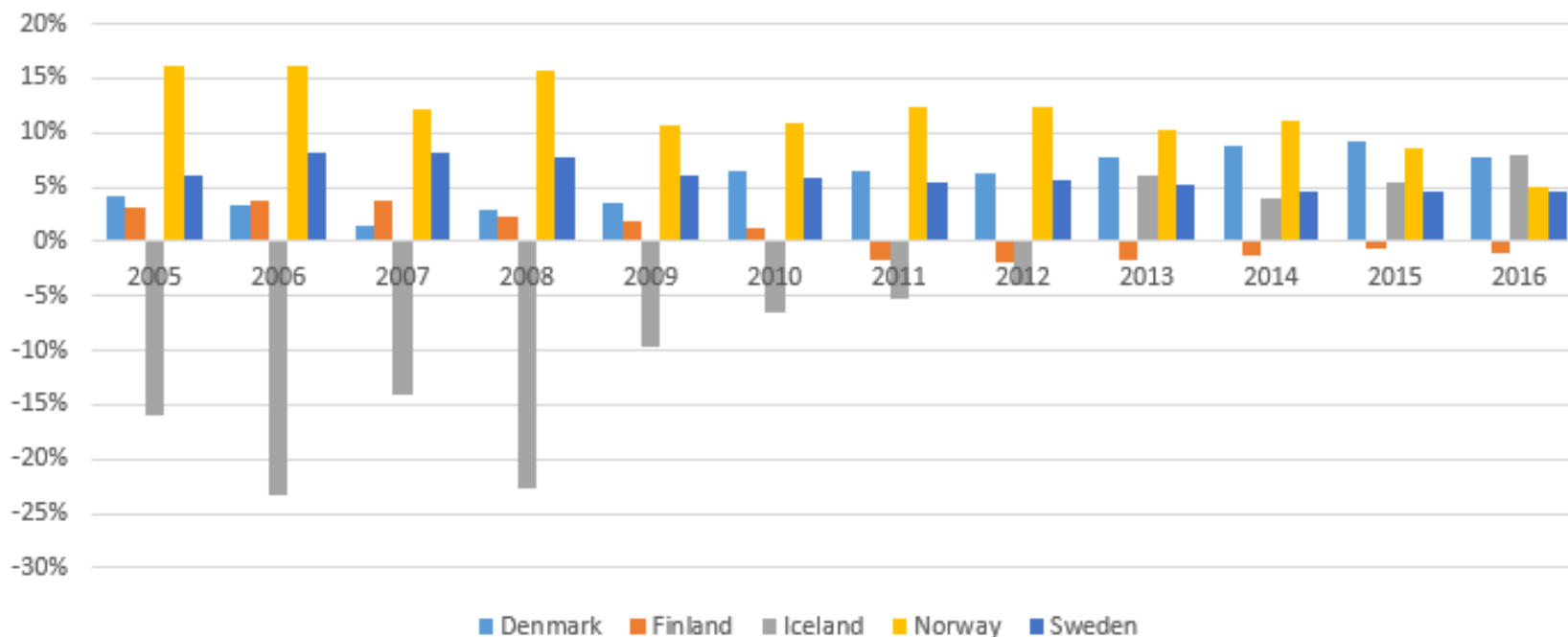
# Nordic Countries and Euro Area. Gross Domestic Product, constant prices. Percent change.



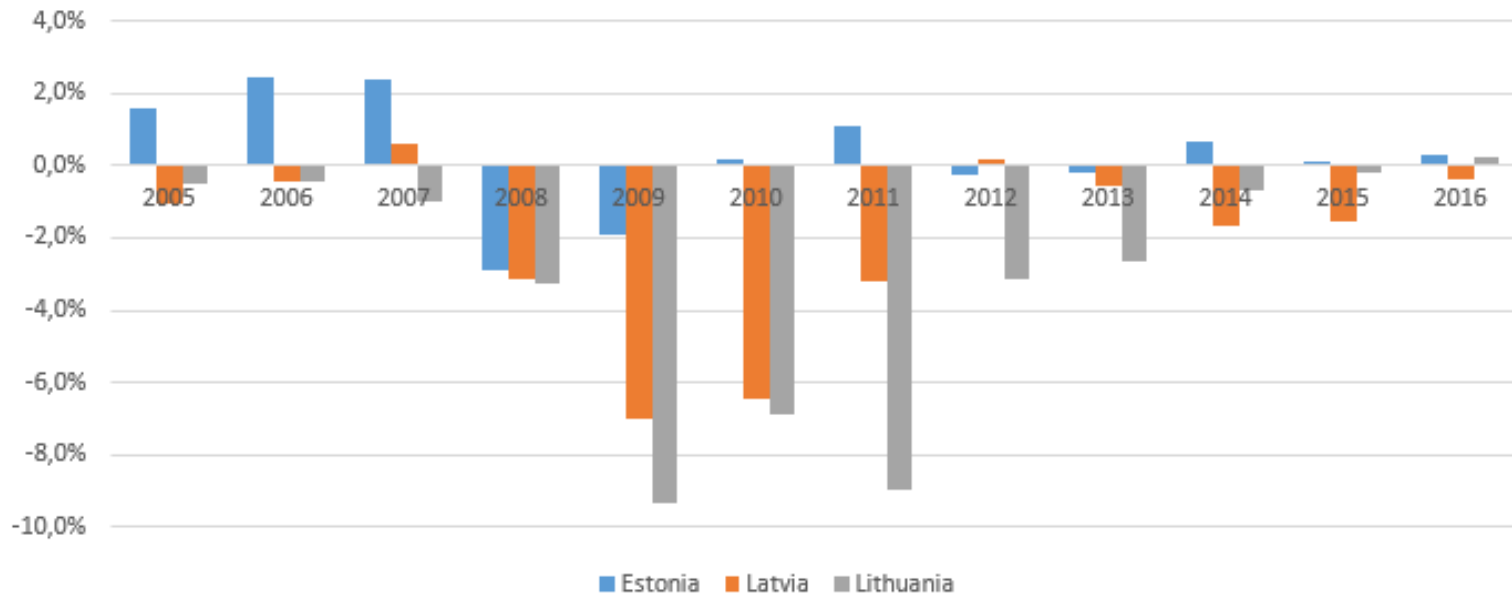
# Baltic States. Current account balance. Percent of GDP.



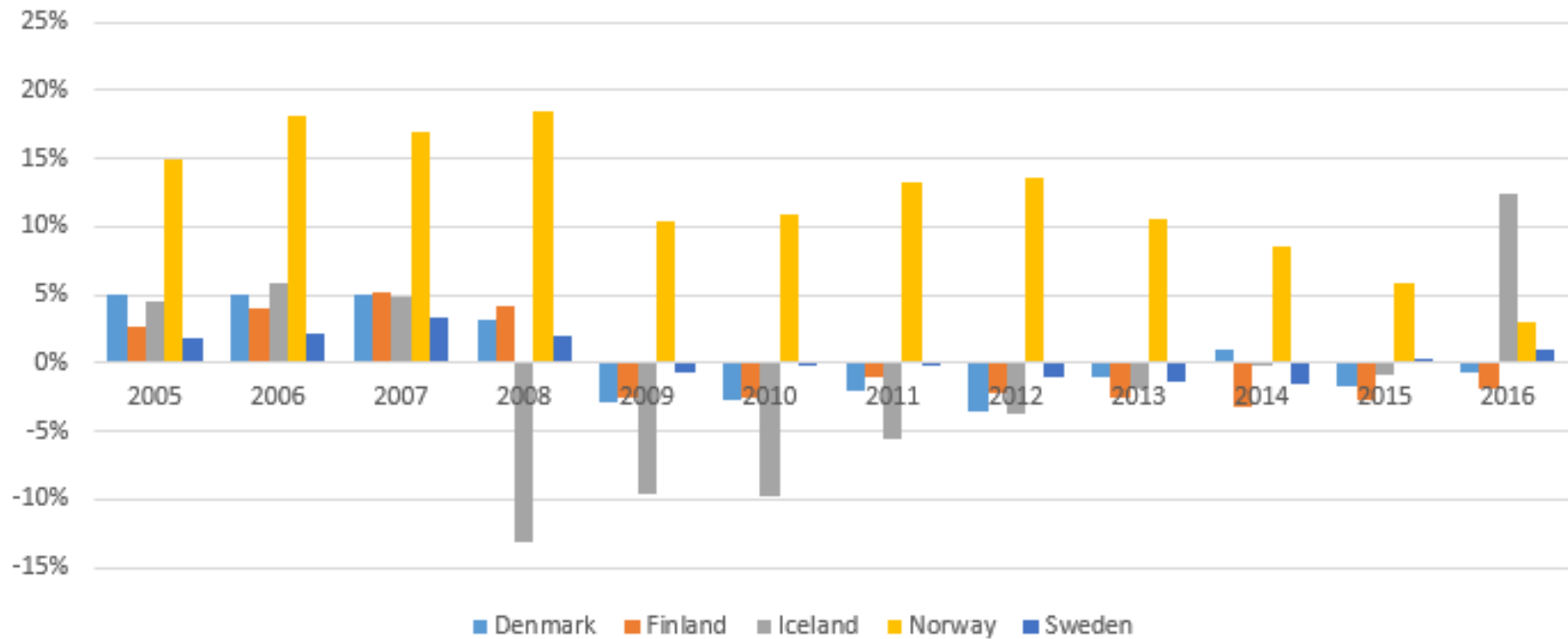
# Nordic countries. Current account balance. Percent of GDP.



# Baltic States. Headline deficit. Percent of GDP.

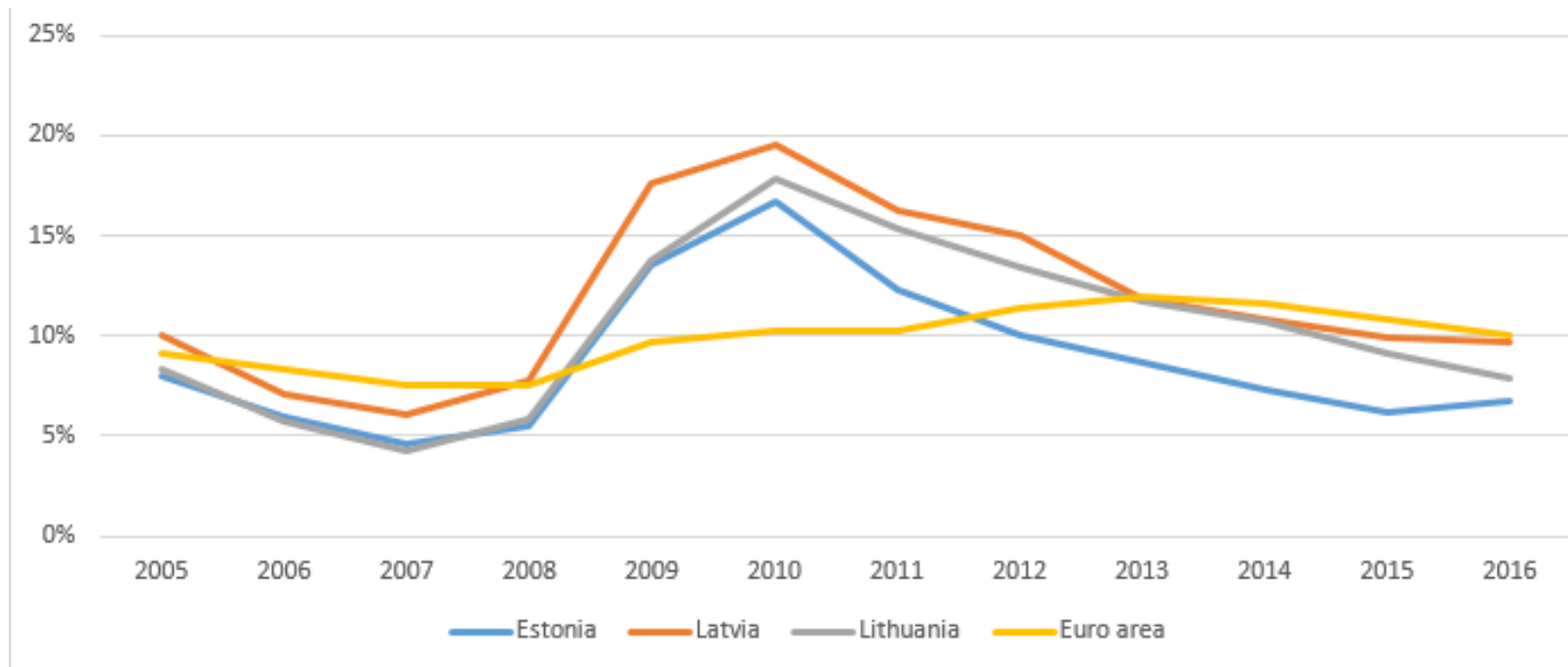


# Nordic countries. Headline deficit. Percent of GDP.

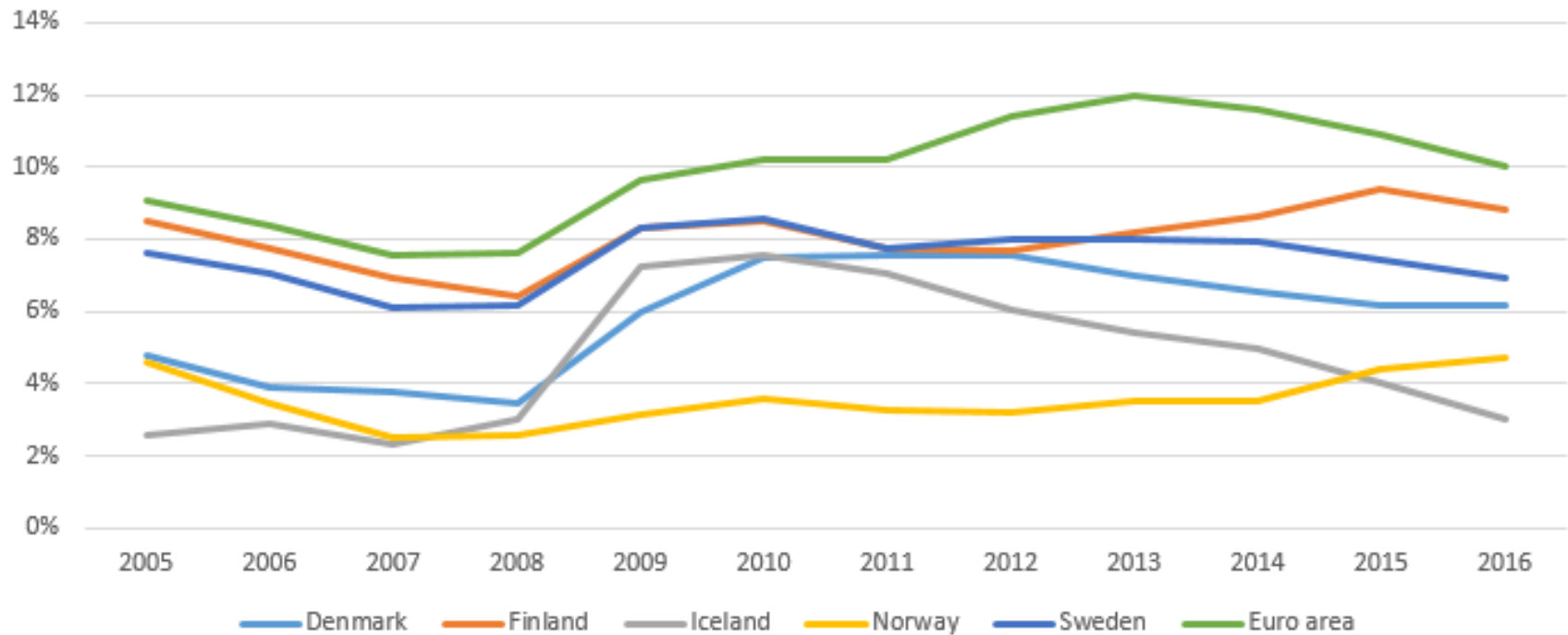




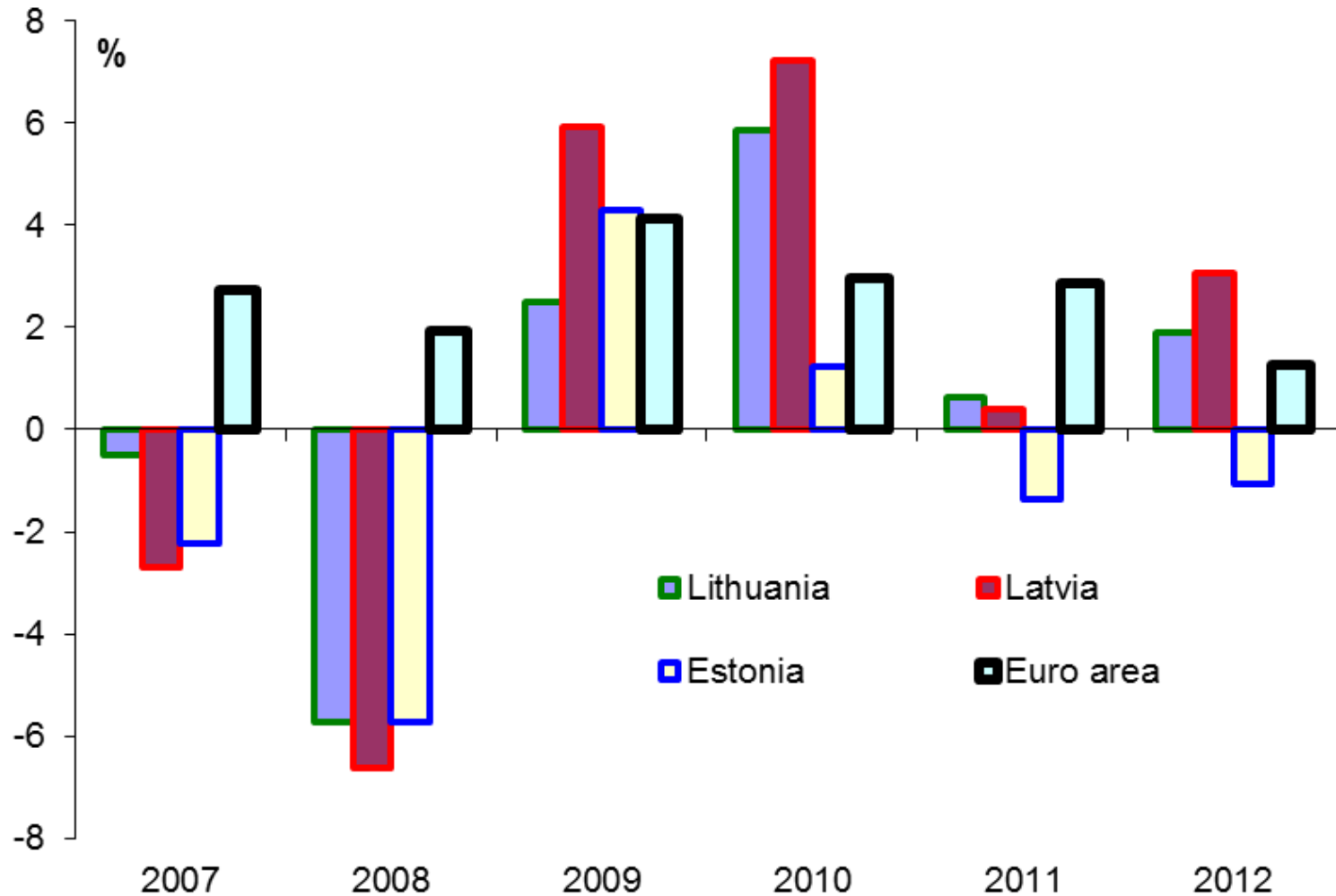
# Baltic States and Euro Area. Unemployment rate. Percent of total labor force.



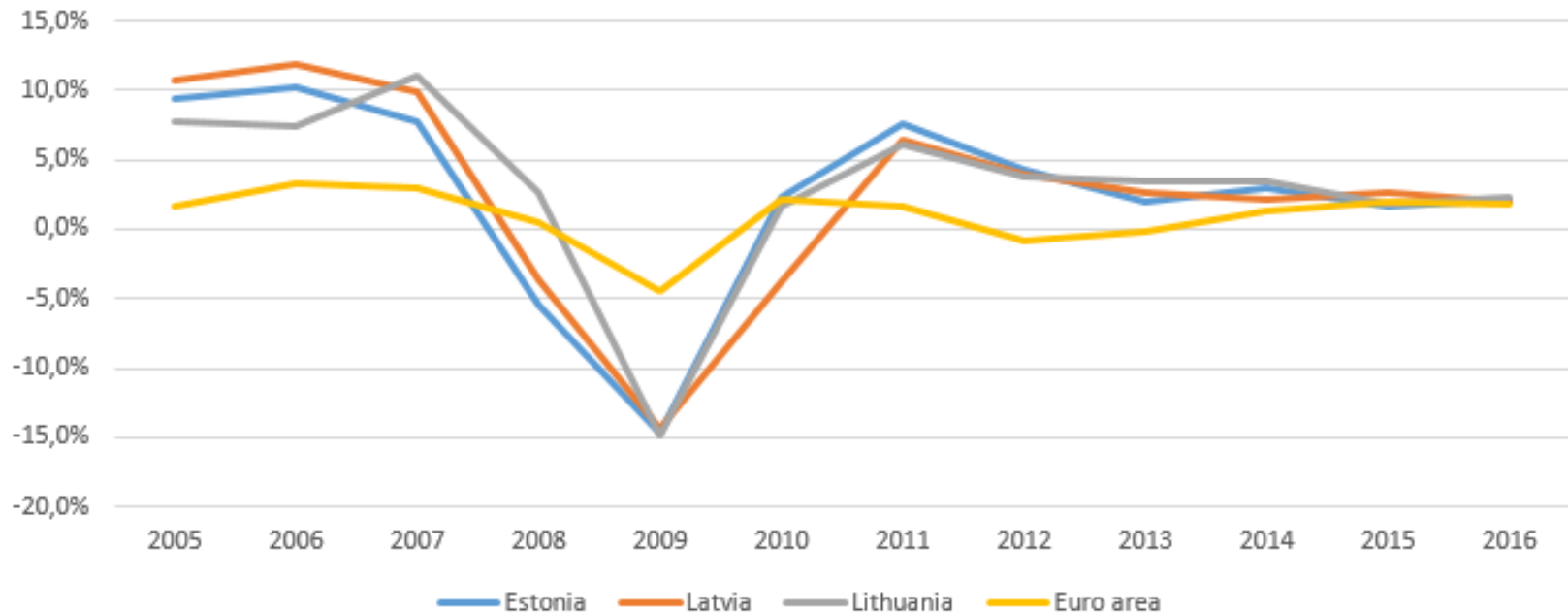
# Nordic countries and Euro Area. Unemployment rate. Percent of total labor force.



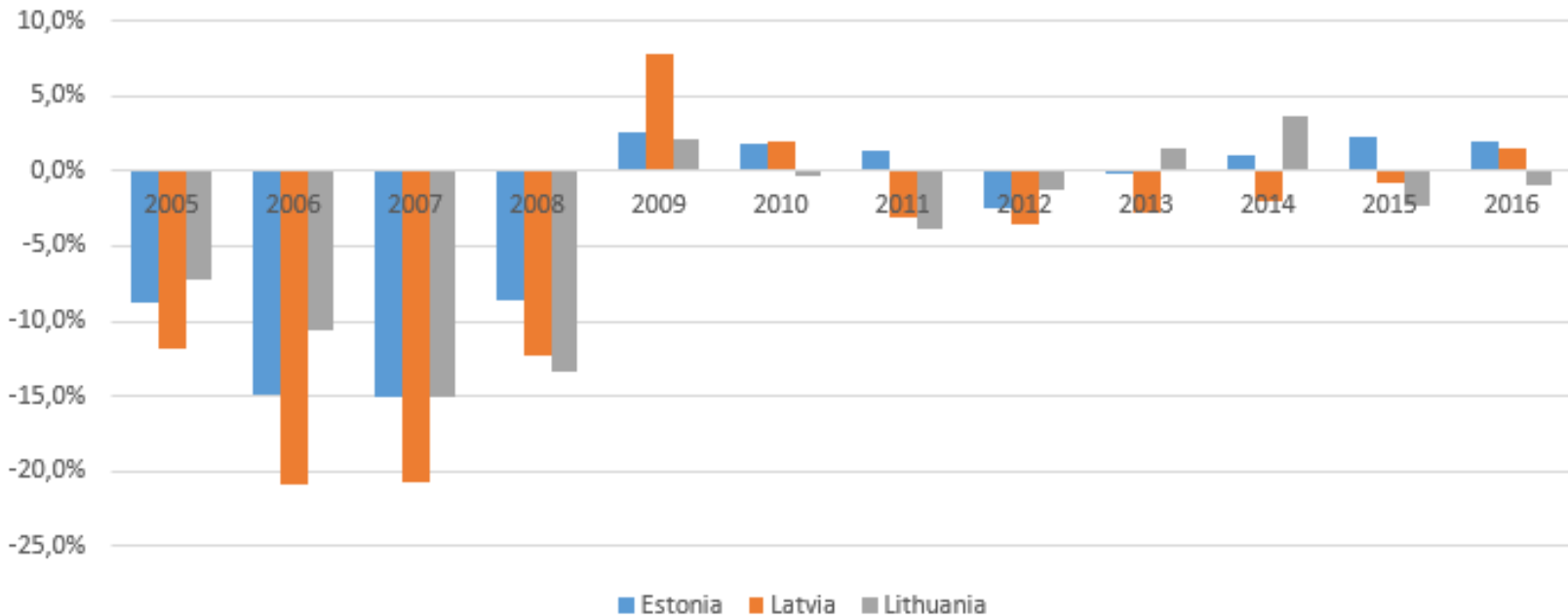
# Real interest rates on lending for house purchases, original maturity over 10 years



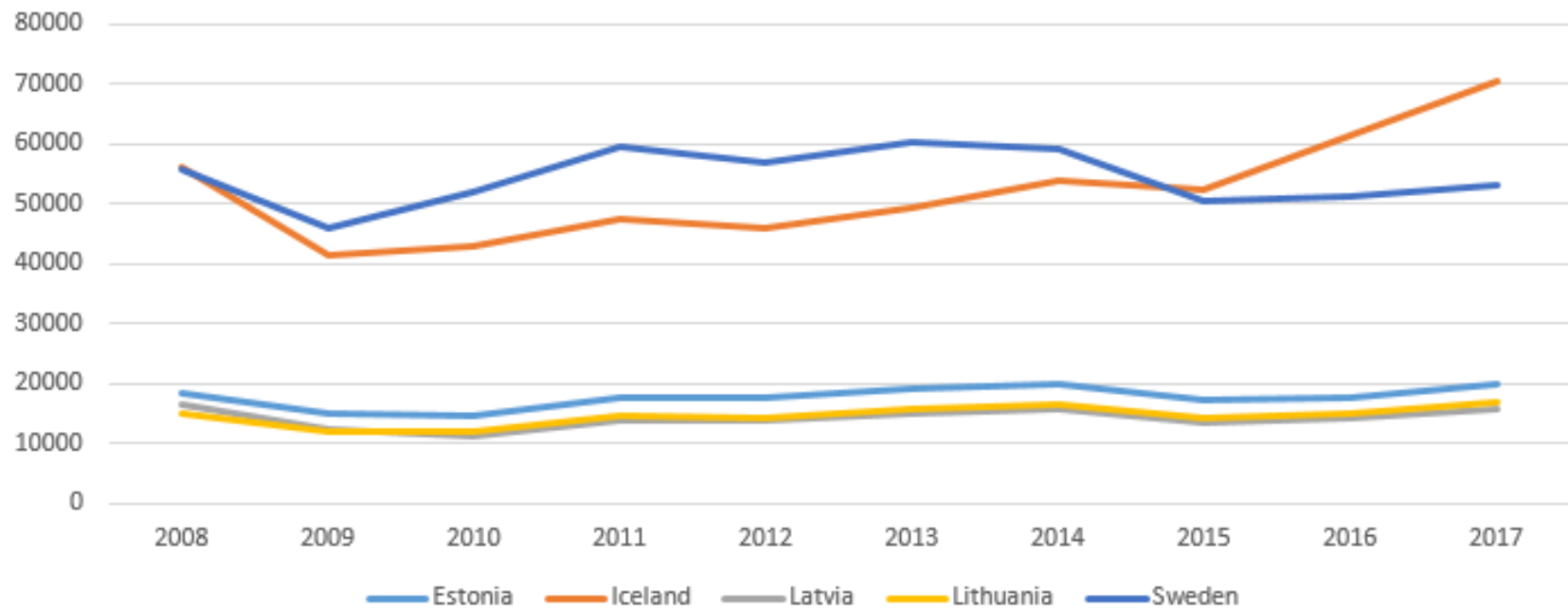
# Baltic States and Euro Area. Gross Domestic Product, constant prices. Percent change.



# Baltic States. Current account balance. Percent of GDP.



# Gross domestic product per capita, current prices - U.S. dollars.



# Latvia: Devaluation

- The big issue was the exchange rate policy
- Adoption of the euro could have been stalled for years to come if depreciation
  - External forces
    - European Union/Euro Area
    - Nordic/Swedish banking interests
    - International Monetary Fund (Mission in November, 2008)

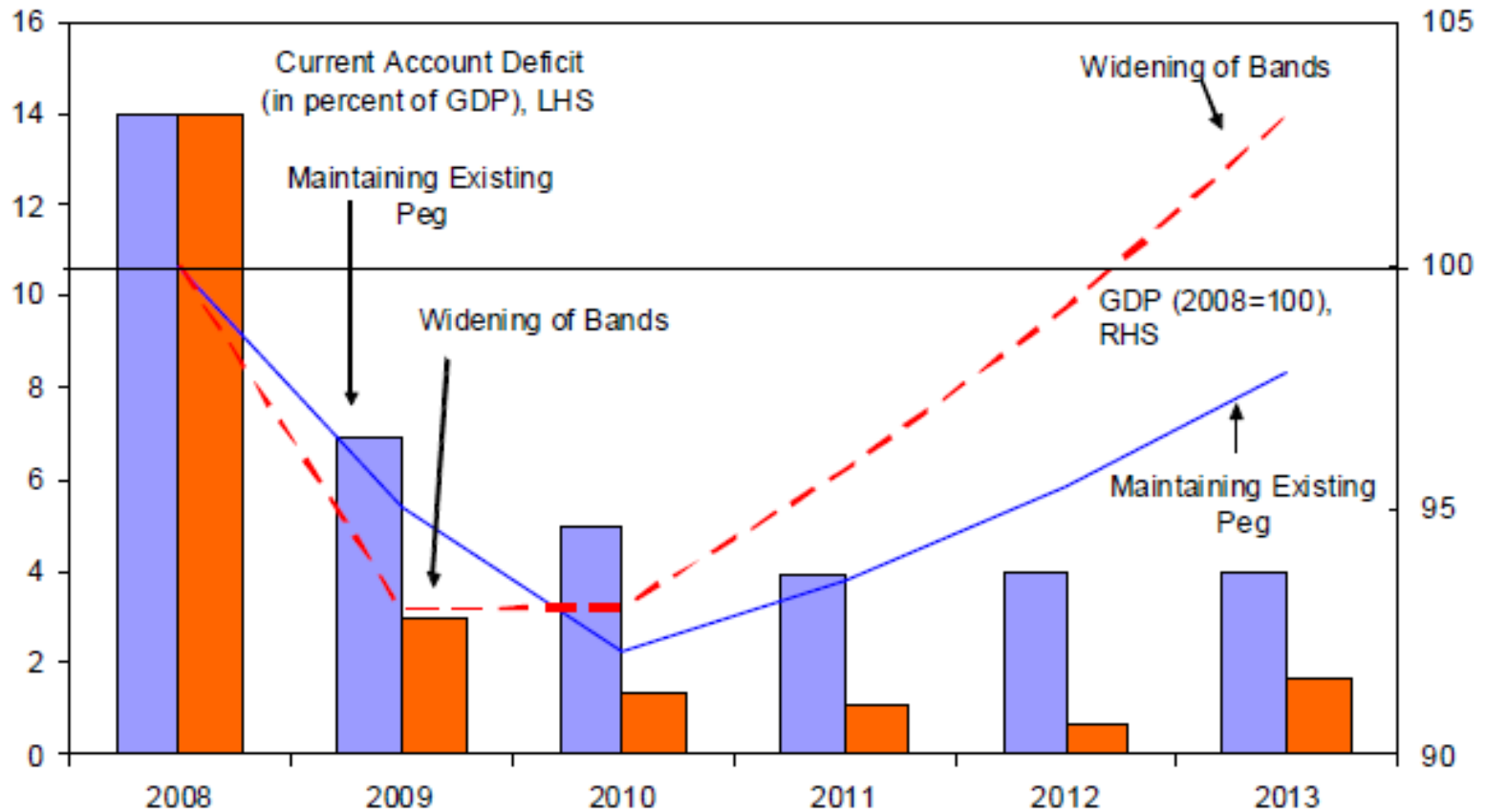
# Devaluation

- IMF says YES -> Widening the exchange rate band to the full 15 percent
  - Improve competitiveness
    - Faster economic recovery



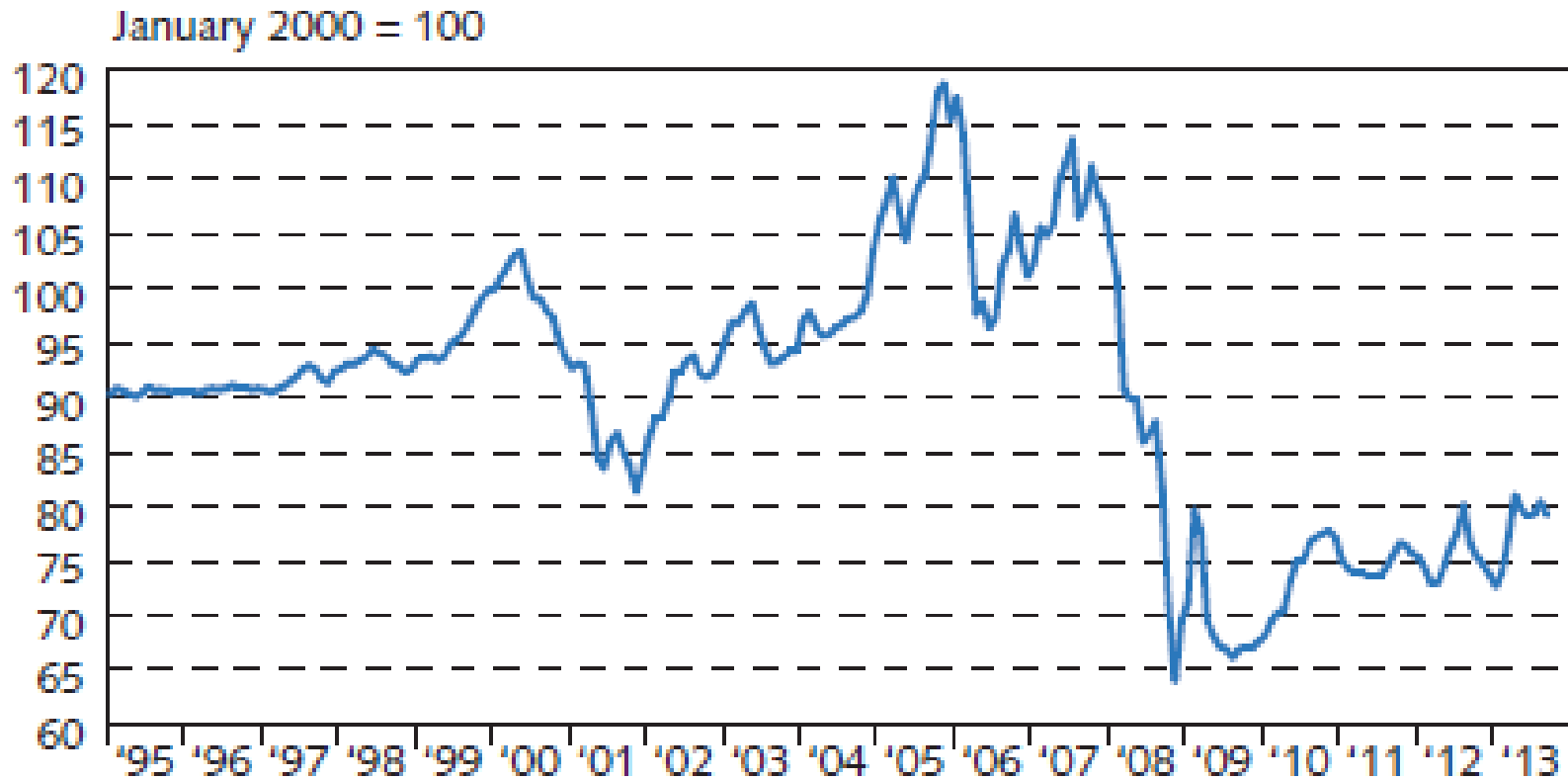
# Latvia: Devaluation 15 percent

Latvia: Alternative Exchange Rate Options Compared



Source: Latvian Authorities, Fund Staff Projections

# Iceland: Real exchange rate



Monthly data relative to consumer prices.  
Source: Central Bank of Iceland.

# Devaluation: IMF, banks in Latvia and the EU

- IMF says YES -> Widening the exchange rate band to the full 15 percent
  - Improve competitiveness
    - Faster economic recovery
- Banks say NO -> Concern over the impact of a devaluation on banks and their clients
- EU says NO -> Concern over potential regional spillover effects of a devaluation

# Nordic-Baltic banking interlinkages

*Table 7.1* Liabilities of the Nordic and Baltic Banking Systems to the Nordic Countries 1999–2006 (% of total foreign liabilities)

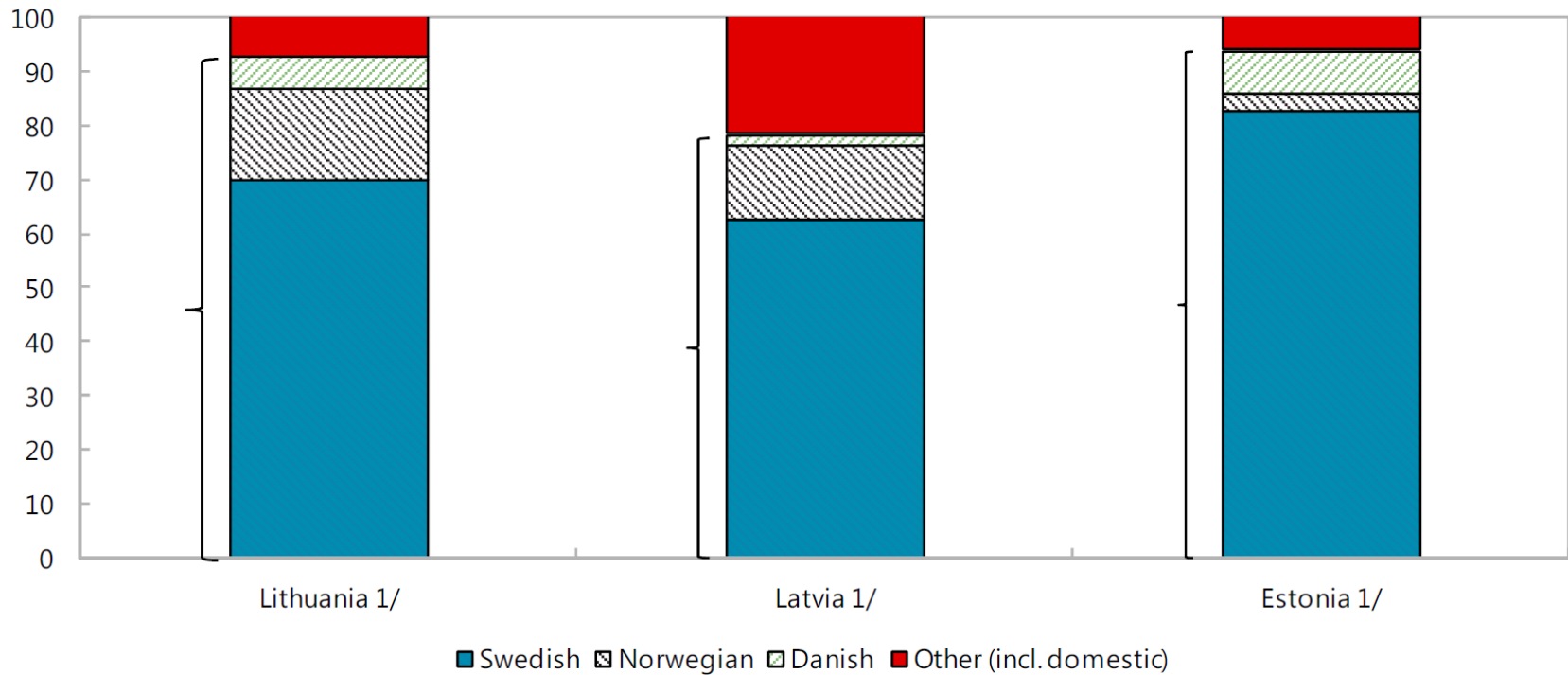
	<i>Liabilities to Denmark</i>		<i>Liabilities to Finland</i>		<i>Liabilities to Norway</i>		<i>Liabilities to Sweden</i>		<i>Liabilities to all Nordics</i>	
	<i>Q4 1999</i>	<i>Q3 2006</i>	<i>Q4 1999</i>	<i>Q3 2006</i>	<i>Q4 1999</i>	<i>Q1 2004</i>	<i>Q4 1999</i>	<i>Q3 2006</i>	<i>Q4 1999</i>	<i>Q3 2006</i>
<b>Nordic Countries</b>	<b>3.9</b>	<b>7.9</b>	<b>3.7</b>	<b>5.2</b>	<b>0.1</b>	<b>0.5</b>	<b>10.8</b>	<b>27.9</b>	<b>18.5</b>	<b>41.4</b>
Denmark	-	-	1.2	6.4	0.0	0.5	9.9	33.5	11.1	40.5
Finland	3.3	1.8	-	-	-	0.1	23.3	60.2	26.6	62.1
Iceland	1.5	-	0.8	0.1	3.0	0.4	3.5	0.8	8.8	1.3
Norway	4.2	10.4	2.0	4.1	-	-	23.6	31.9	29.8	46.3
Sweden	7.0	19.3	8.3	8.9	-	1.1	-	-	15.3	29.3
<b>Baltic States</b>	<b>0.0</b>	<b>0.0</b>	<b>8.7</b>	<b>11.1</b>	<b>0.0</b>	<b>0.0</b>	<b>42.6</b>	<b>70.9</b>	<b>51.3</b>	<b>82.1</b>
Estonia	-	-	10.9	13.2	-	-	59.8	78.8	70.6	92.0
Latvia	-	-	9.6	8.8	-	-	45.0	67.9	54.5	76.7
Lithuania	-	-	4.2	11.3	-	-	10.3	65.5	14.5	76.7

Source: Bank for International Settlements Consolidated Banking Statistics and International Monetary Fund (2007).

Notes: Liabilities on immediate borrowers basis; data for liabilities to Norway not publicly available after March 2004.

# Ownership Structure of the Baltic Banking System (IMF, 2014)

Ownership Structure of the Baltic Banking System  
(Percent)



# Devaluation of the Lat

- Devaluation would have broken the Latvian banking system and caused mass bankruptcies because of currency mismatches. Disorderly devaluation would presumably have spread to Lithuania and Estonia, as well as caused a Swedish banking crisis (Åslund and Dombrovskis, 2011, p. 116)
- Baltic crisis -> Swedish crisis -> Scandinavian crisis -> EU/Eurozone crisis

# Latvia Rescue Package

*Table 11.1* Latvia's 2008 rescue package—Burden sharing

	<i>Value (million euro)</i>	<i>% of total</i>
EU	3,100	41.3
Nordic countries	1,800	24.0
IMF	1,700	22.7
World Bank and EBRD	500	6.7
Czech Republic, Poland and Estonia	400	5.3
Total	7,500	100.0

Source: International Monetary Fund (2013b).

Note: In Hungary the IMF provided 63% of the 2008 rescue package, and in Romania 65 %.

# Latvia: Government ownership?

- Swedish Minister of Finance called the closest friends of Latvia to an emergency meeting at Arlanda airport in Stockholm on December 10, 2008 (Åslund and Dombrovskis, 2011, p. 45-46)
  - Government ownership?
- A representative of the Swedish Ministry of Finance (a key partner given the significant importance of Swedish banks in Latvia) also regularly joined program missions (IMF, 2013b, p. 7)
  - Unusual third country involvement



# Latvia: Government ownership?

- The European Commission was heavily involved in the program design, especially in the fiscal and financial sectors (IMF, 2013b, p. 7)
  - Unusually strong IMF language
- Latvia's Prime Minister "Reform starts where the money ends" (Åslund and Dombrovskis, 2011, p. 73)
  - Reform imposed
- "If your financial sector is largely composed of foreign subsidiaries, it is a good idea to be friends with the parent banks" (Blanchard, et al., 2013, p. 33)
  - Dependency

# Government ownership

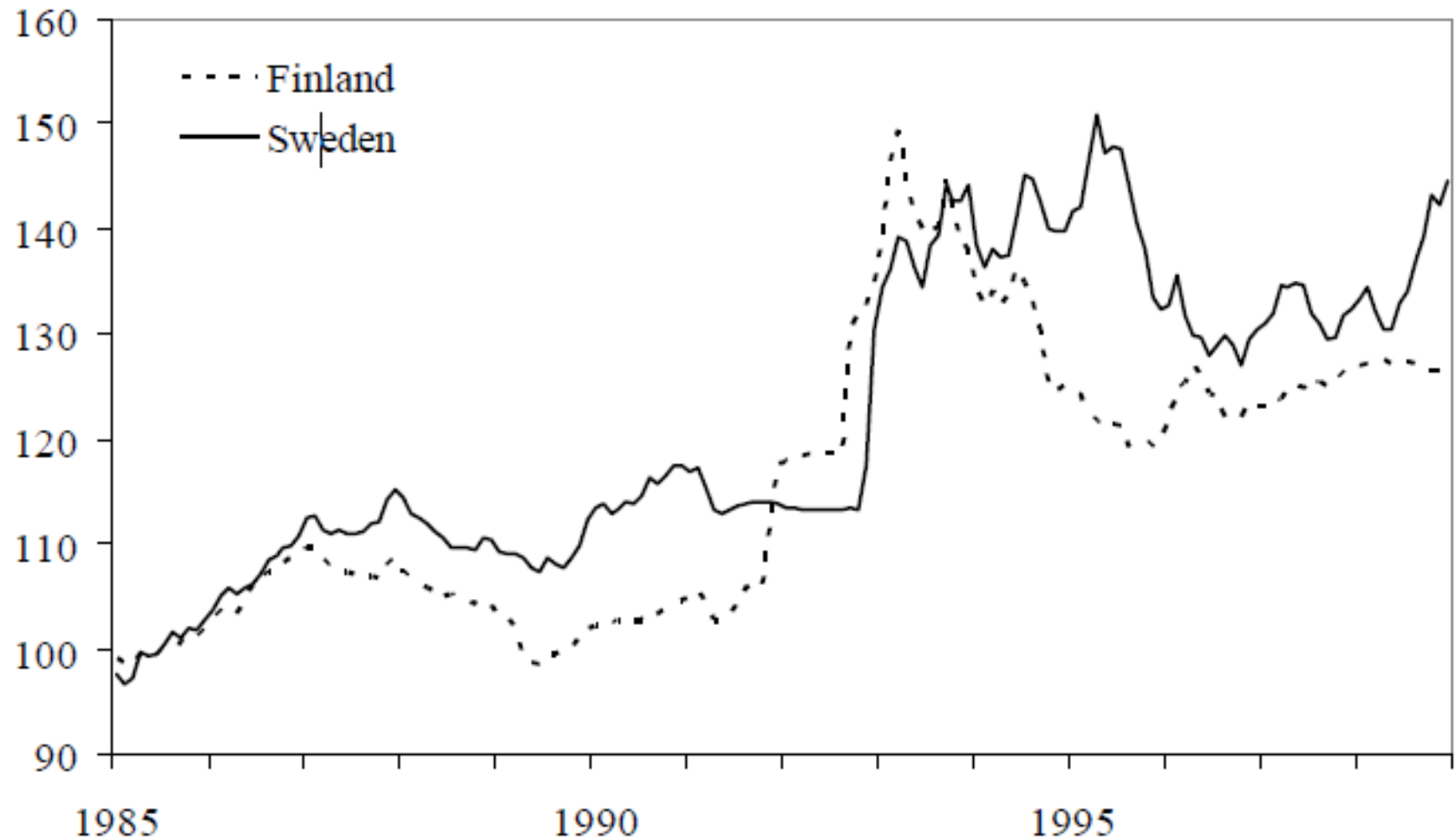
- Arguably, Sweden could have also blocked both IMF and EC funds if necessary, as was the case with the UK and the Netherlands when these countries blocked an IMF rescue package for Iceland (Boyes 2009; Cepilovs and Muizniece 2016).

# Sweden and Finland

- Latvia also learned from the Swedish and Finnish banking and devaluation crisis in the early 1990s that banking collapses and devaluation should have been avoided if possible (Åslund and Dombrovskis, 2011, p. 117)

# The Finnish and Swedish exchange rate against the ECU-basket 1985-99.

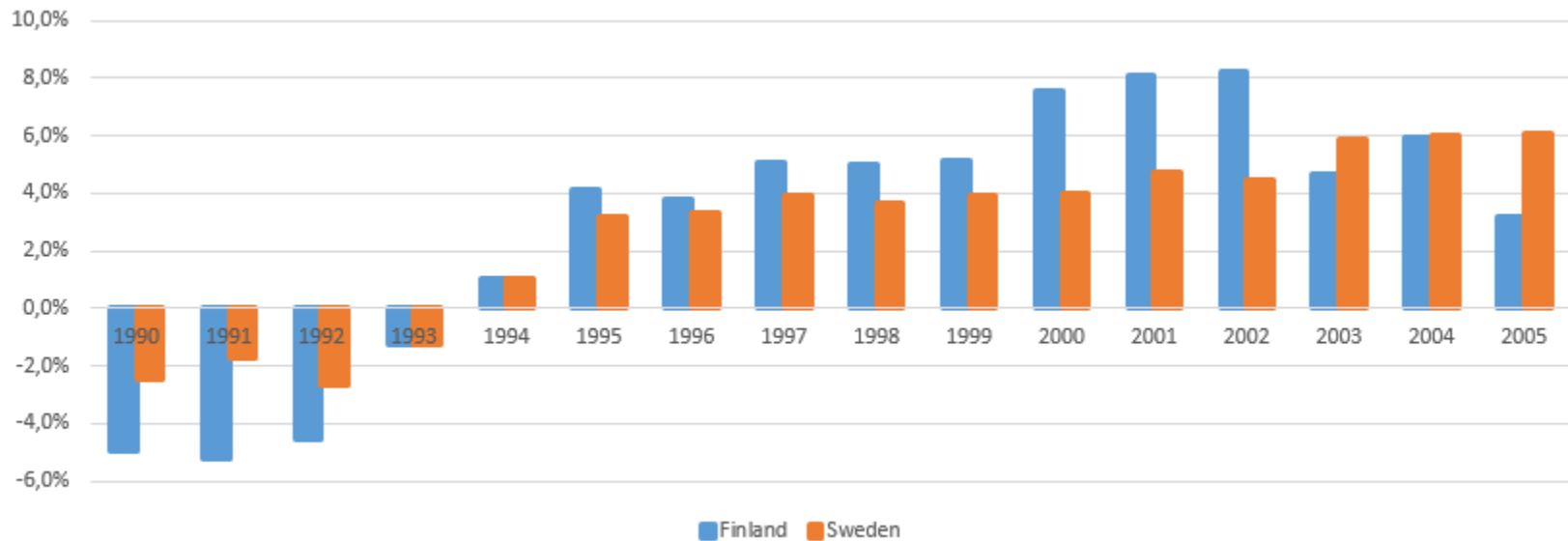
(1985=100)



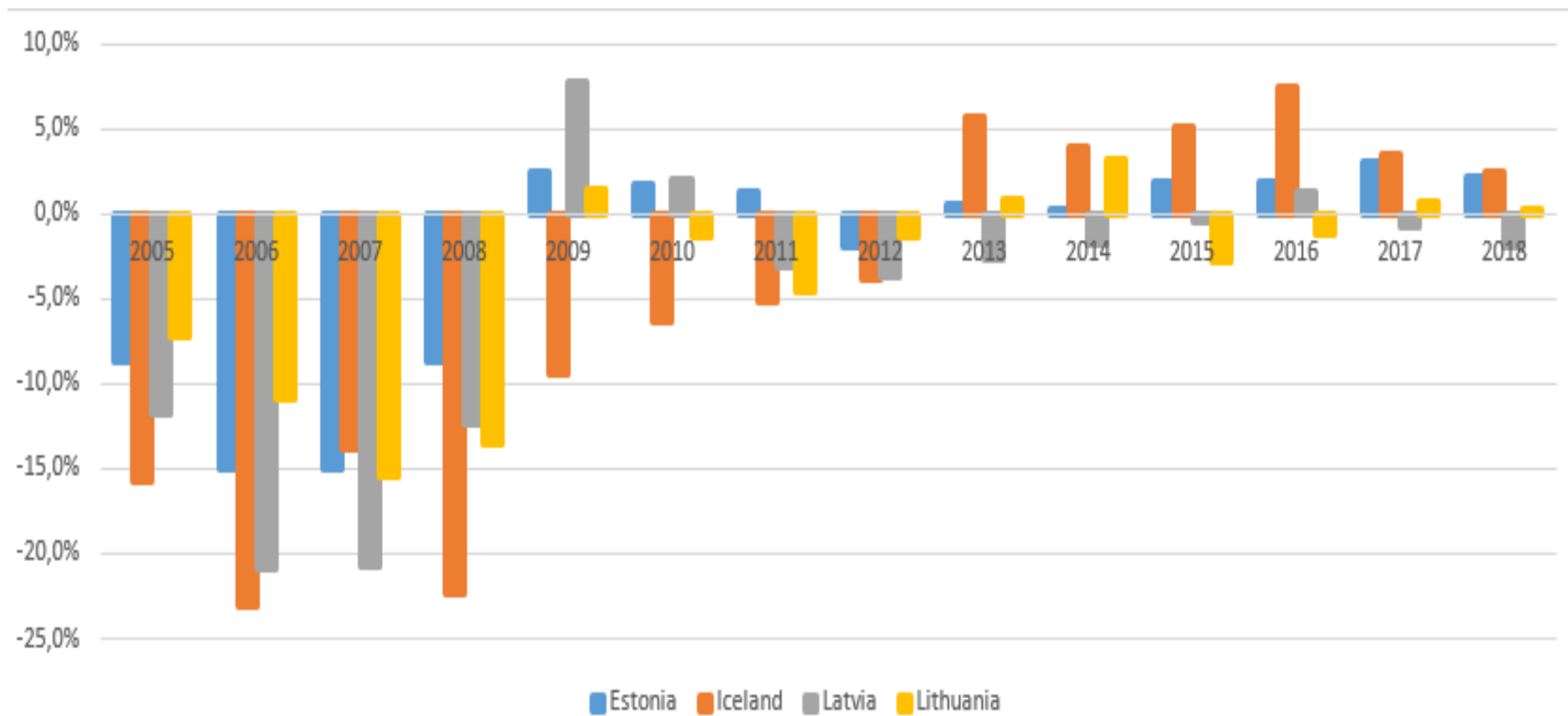
# Depreciation in Sweden and Finland

- “the biggest macroeconomic change contributing to the recovery was the loosening of monetary policy, including the currency depreciation in the aftermath of the 1992 EMS crisis” (Jonung et al., 2008, p. 31).
- “The depreciation of the krona in November 1992 marked the culmination of the crisis and the beginning of the recovery in Sweden” (Jonung et al., 2008, p. 36).
- “As in Finland, exports were the major driving force behind the Swedish recovery, growing strongly and increasing as a share of GDP” (Jonung et al., 2008, p. 36).
- Lars Jonung was chief economic advisor to Prime Minister Carl Bildt in 1992-94.

# Current account balance. Percent of GDP.



# Current account balance. Percent of GDP.



# Depreciation in Sweden

- The success of the floating regime with an independent central bank geared to price stability can serve as one of the explanations of Sweden's reluctance to join the euro (Holmström, et al. 2010, p. 112-113)



# Going „beyond“ GDP

- Gini coefficient
- Income quintile share ratio
- At risk of poverty rate
- Proportion of people at risk of poverty or social exclusion

Table 9.1 Gross domestic product (GDP) per capita (current prices, US \$ at purchasing-power parity) and selected social indicators 2015

	<i>GDP per capita (US \$)</i>	<i>Proportion of population at risk of poverty or social exclusion</i>	<i>At-risk-of-poverty rate (%)</i>	<i>Gini coefficient/index</i>	<i>Income quintile share ratio</i>
<b>Baltics</b>					
Estonia	28,685	24.2	21.6	34.8	6.2
Latvia	24,678	30.9	22.5	35.4	6.5
Lithuania	28,591	29.3	22.2	37.9	7.5
<b>Nordics</b>					
Denmark	47,229	17.7	12.2	27.4	4.1
Finland	41,055	16.8	12.4	25.2	3.6
Iceland	45,746	13.0	9.6	23.6	3.4
Norway	68,410	15.0	11.9	23.9	3.5
Sweden	48,315	18.6	16.3	26.7	4.1
<b>Anglo-Saxon</b>					
Ireland	65,679	26.0	16.3	29.8	4.5
UK	41,482	23.5	16.6	32.4	5.2
<b>Central Europe</b>					
Czech Republic	32,317	14.0	9.7	25.0	3.5
Hungary	26,539	28.2	14.9	28.2	4.3
Poland	26,612	23.4	17.6	30.6	4.9
Slovakia	28,591	18.4	12.3	23.7	3.5
Slovenia	29,879	19.2	14.3	24.5	3.6
<b>South-Eastern Europe</b>					
Bulgaria	19,288	41.3	22.0	37.0	7.1
Romania	20,936	37.4	25.4	37.4	8.3
<b>EU-28</b>		<b>23.8</b>	<b>17.3</b>	<b>31.0</b>	<b>5.2</b>
<b>EUR-19</b>		<b>23.1</b>	<b>17.2</b>	<b>30.8</b>	<b>5.2</b>

Source: International Monetary Fund (2017) and Eurostat (2017).

Note: EUR-19: the 19 countries of the euro area.

# Exit or Voice



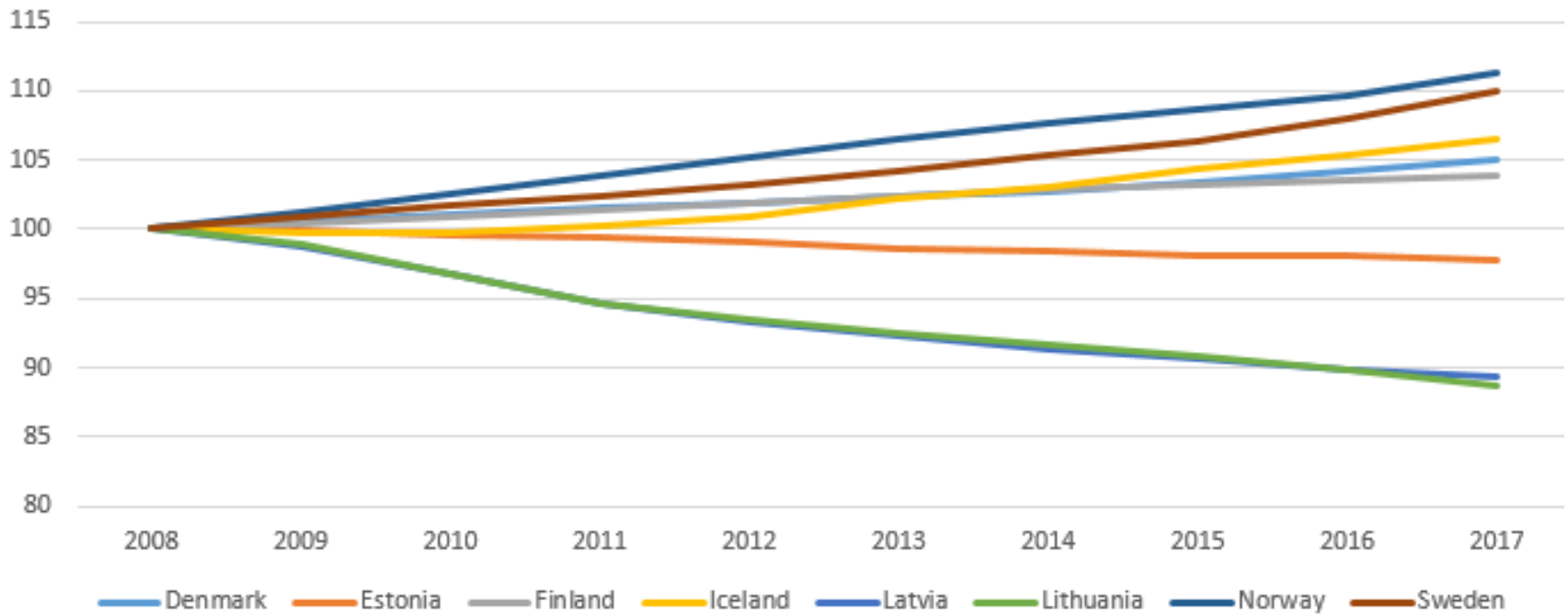
January 2019

# Exit

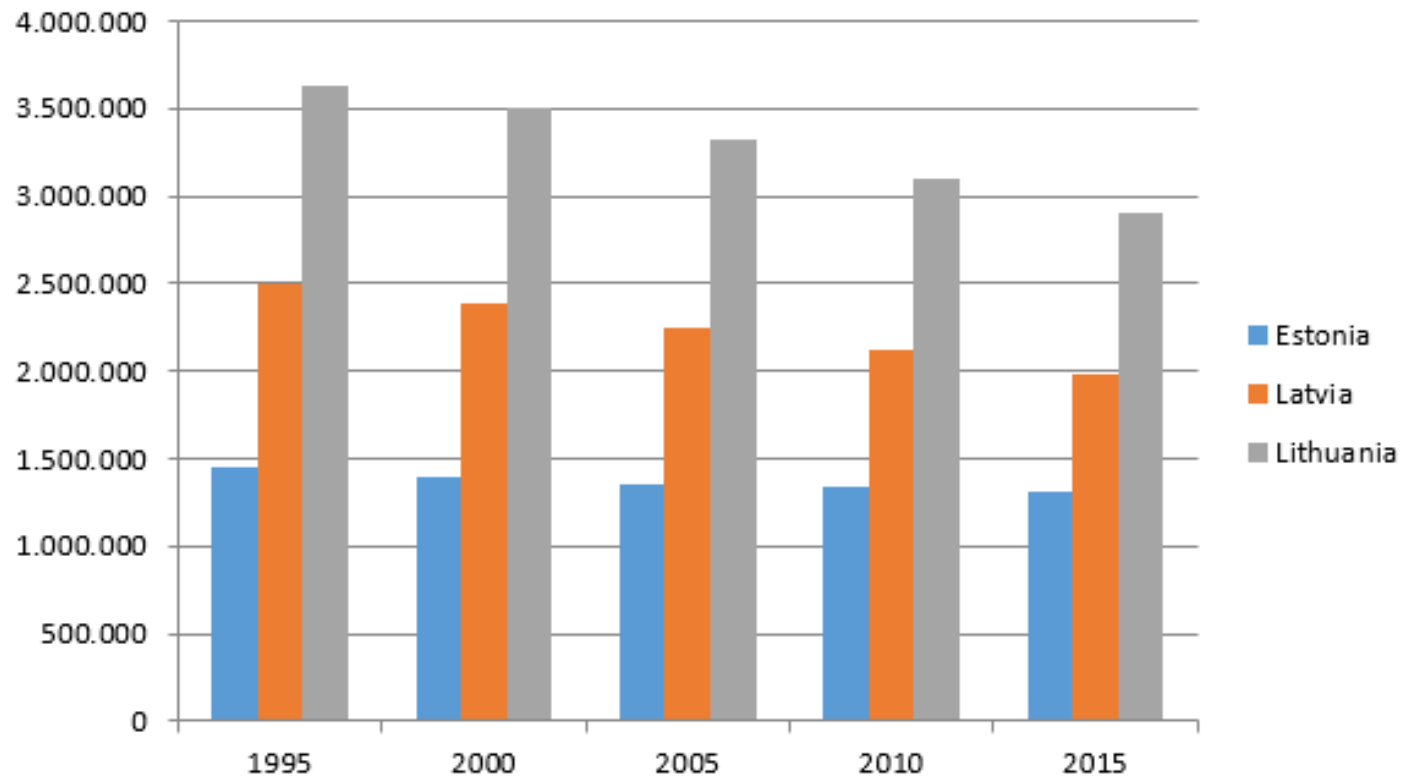
**Net migration during 2008-2011 (i.e. change in population not due to death or birth), percent of the 1 January 2008 number of people in the age cohort (Darvas 2013)**



# Population Nordics and Baltics (2008 = 100)



# Population Baltics



# Lessons learned

- Need for more balanced and sustainable economic growth—not asset bubbles driven by cross-border capital inflows. Need to strengthen the tradable sector.
- Take measures to limit credit growth.
- The fixed exchange-rate policy implemented in the Baltics has not served them well: the Nordics, except Finland, keep their own currency.

# Lessons learned

- Take measures to discourage lending in foreign currencies.
- Fiscal austerity during the 2008/09 crisis and the post-crisis period was damaging for long-term growth and has contributed to massive and largely permanent outbound migration of skilled young people from the Baltic States.



# Challenges

- Policies to contain domestic consumption, strengthen domestic saving, scale-up government revenues and invest in human capital.
- Policies to discourage foreign debt in favour of foreign investment.
- Action to reduce dependence on foreign banks and avoid excessive cross-border banking interlinkages.

# Challenges

- Measures to support broader-based, more shared growth and inclusive societies.
- The Baltic States must be more independent and firmer in their dealings with international organizations, especially the EU as well as larger countries.
- More independence in security, improved relations with Russia and strong Nordic-Baltic co-operation.

# Challenges – EU, Euro area membership

- Flaws in the Stability and Growth Pact (SGP).
- A common currency without a fiscal union and banking union.
- The European Central Bank and the narrow policy target.