THE LESSON OF SURIVAL OF BALTIC ECONOMIC AND FINANCIAL CRISIS

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Abstract

Systematic macroeconomic forecasts and public finance ,the state of convergence and financial markets of EU describe perspectives economies of EU Member States. National economies went through restructuring processes, creating the conditions for further development based on sustainable criteria. Within this study we aimed an analysis of main macroeconomic evolutions in Estonia and Latvia, the causes that have led to deterioration of the economic situation of the two countries as well as measures to counter the real estate crisis, financial and economic crisis lately adopted by the governments of countries.

Keywords: economic increase, gross domestic product, fiscal policy, foreign direct investments

JEL Classification: G, G01, G18.

Introduction

Estonia's main macroeconomic data

Into a Europe that is in full recession, the Baltic countries make a discordant note. In 2012 Estonia reported an economic increase of 2,5% and Latvia of 4,3%.

From 1 January 2013, Latvia has introduced holding type legislation, becoming the first country in Central and Eastern Europe that makes this step, competing with traditional destinations for setting up off-shore companies and holding companies such as, for example, in Europe, the well known Netherlands, Luxembourg and Cyprus. Practically, from this moment revenues from transfers of social parts and dividends are exempted from tax in Latvia and also there is no limitation in respect of the period of holding those social parts in Latvian entity up to which taxpayers may qualify to such a tax regime.

This is not the first time when a Baltic state simply radically change fiscal policy in our region[2].In 1994, Estonia became the first country in the world to introduce the flat tax, a concept previously considered to be utopia domain. Within a decade and a half, this tax system proved so easy to administer and so attractive for business and foreign investors that has been copied by almost all Central and Eastern European states.

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At moment of opening of economic crisis in 2008, the small Baltic economies have been ravaged simply by speculative real estate bubble implosion. But they proceeded immediately to a brutal adjustment of public spending, even with the risk of an explosion of unemployment. The result was that the Baltic states were the only from the region that even registered a crisis in V and economic increase resumed quickly, at relatively high rhythms.

Following the final ECOFIN decision of 13 July 2010 based on the conditions defined in the 'Maastricht' convergence criteria, Estonia adopted the euro on 1 January 2011. As part of the preparations to join the euro area, Estonia was a member of the Exchange Rate Mechanism II (ERM II)[3].

Since the end of 2009, the economic recession in Latvia has stopped and growth has resumed.[4]

2. An overall analysis of the Estonian economy in the current period

Estonia is among the smaller EU countries, with a dynamic economy in full development that was however very strongly affected by real estate crisis, financial and economic crisis lately, both as a result of decreasing corrections of internal demand and as a result of lower external demand that supported so much the economic increase in previous years. Decrease of internal demand was linked to weak economic activity and on the increase, on global market, of prices of energy and food.

In this context, Estonia has made rapid progress in stabilizing and restructuring the economy, and this is rewarded by the high volume of direct foreign investments in this country, especially visible through indicator of direct foreign investments per inhabitant.

GDP growth rate was 3,1% in 2010 and 7,6% in 2011. For 2012 it realized an increase of 2,5%.Labour productivity has increased in recent years, due to the reduction of wage income. This fact has led to the competitiveness improvement of Estonian companies on international markets. Exports have constitute the engine of economic recovery of Estonia, developing with 22% in 2010 and 25% in 2011, as a result of increasing added value in industry.

Causes that have generated the crisis were mainly the following:

- very small dimensions and opening up the economy to the outside;
- disappearance of many export markets;
- decline in household consumption - previously based on lending.

Measures to counteract the economic crisis

To counteract the negative economic and social effects of the economic crisis, initiated in early 2008 due to real estate crisis already appeared in 2007, was adopted on 9 October 2008 an "Action plan for economic growth and insurance of jobs for

[3] http://ec.europa.eu/economy_finance/eu/countries/estonia_en.

[4] Report on Economic Development of Latvia | December | 2012, page 10

2008-2011" based mainly on increasing economic competitiveness.The financial part of this plan is include in the annual budget of the country.

These objectives are:

- increasing labor productivity and achieving a threshold of 80% of the EU average;
- increasing research and development costs and reaching a threshold of 2% of GDP;
- increasing the number of jobs by 70.5%;
- change the system of health insurance benefits through greater responsibility of the employee and the employer;
- reduce the number of people receiving special pensions.

From 9 October 2008 entered into force measures to safeguard up to 50.000 euro limit of all bank deposits.

Estonia has not faced with a financial crisis, banks are well capitalized, so no need to take governmental measures of capitalization of thereof. However, it was decided that from February 2009 to be adopted certain deposit guarantee schemes to prevent the transmission of risks to the real economy.

Credit expansion from years preceding the crisis has generated the creation of a large number of unsustainable jobs and with low productivity in the construction industry and commerce.

In evaluation of the situation should be considered, however, spectacular growth rates recorded by Estonia since the second half of the 90s. Thus, the GDP per inhabitant increased from $ 5,657 in 1993 to 9,200 Euro/person in 2011.

Being a small country with an open economy, Estonia understood from the early 90s that it will not be able to ensure currency stability and capital mobility through an independent monetary policy.

In fiscal policy domain, Estonia has introduced in 1992 a fixed rate income tax of 26%, then decreased to 21%. Since 1999, the reinvested profit is not taxed. In this way, has been simplified tax system and tax collection and were stimulated investments.

Fiscal consolidation measures had cumulated 16% of GDP. Fiscal consolidation works as follows: a reduction of deficit and budgetary expenditures requires in the future lower taxes but leaves more money for current generation consumption in private sector.[5] Two thirds of them looked budgetary expenditures (reduction with 8% of the budget for health insurances, limiting the growth of pensions, reduce administrative costs, those for defense and agricultural subsidies, stop lending to local authorities except co-financing projects with funds EU). The other third of the fiscal consolidation measures has considered the budgetary revenue part (increase contributions for unemployment to 4,2%, increase excise duties on alcohol, tobacco

[5] http://florincitu.wordpress.com/2013/03/08/consolidarea-fiscala-nu-influenteaza-negativ-pib-ul/

and fuel, increase VAT from 18 to 20%, dividends from companies with state capital, sales of their lands, suspension of reduction gradual process of income tax). As a result of these measures, Estonia has managed to reduce public debt at 7% of GDP. The budget deficit was only 1,7% of GDP in 2009 and in 2010 and 2011 Estonia had budget surplus (0,1% in 2010 and 1% in 2011).

During the crisis Estonia did not need the bailout, since reserves created starting from 2001 have covered debts. In 2009 reserves amounted to 11,6% of GDP, and in 2010, 12%. Also, since the major commercial banks in Estonia are with Swedish capital, the answer to the crisis effects has been easier than for countries where state intervention was necessary to save the banking sector.

Besides fiscal consolidation measures, the Estonian government realized public investment projects with structural funds in transport and telecommunications infrastructure and support companies through special programs to create new jobs, stimulation of exports and investments. Moreover, pensions were increased slightly to help the aging population and to stimulate consumption.

Currently privatization process in Estonia is completed, only three major companies in the infrastructure domain remains in state ownership.

Favorable development from Estonian economy continue in 2012, in the third quarter registered a GDP growth rate of 3,4% compared to the corresponding period last year and of 1,7% compared with previous quarter. Activities on internal market constituted the growth engine, the most important areas being construction and IT, and to a lesser extent, transports, commerce and professional or technical services. The European Commission predicted for Estonia growth rates of 2,5% in 2012 (the highest in the EU), 3,1% in 2013 and 4% in 2014. The main factors of growth will be domestic demand and positive developments on the labor force market.

Fiscal reform was carried out in Estonia in the first phase of transition proccess to economy market. Current tax system came into effect in 1994, being updated, during the time, with a series of new laws.

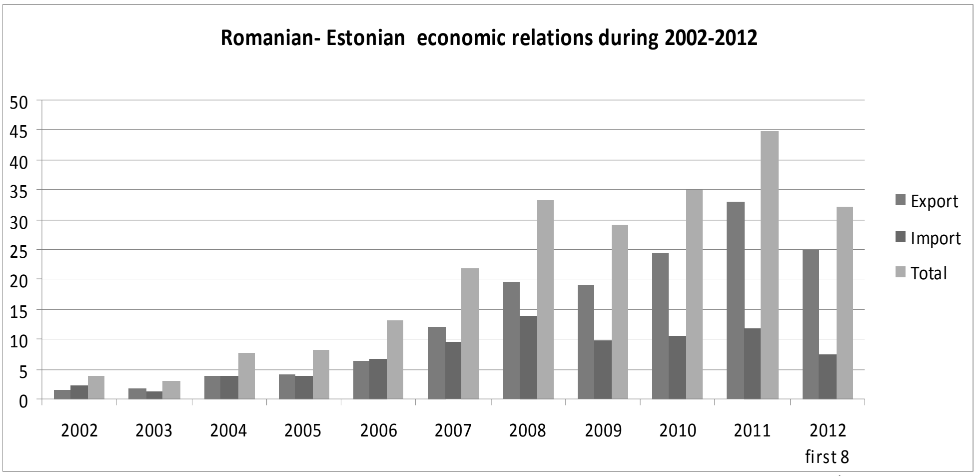
Flat Tax is a system that applies the same tax rate to every taxpayer regardless of income bracket.[6]

The tax system is net and uniformly (**Flat Tax**), which until 2006 was 23%, being reduced in 2007 to 20%,and at present is **21%.** Reinvested profit is not taxed. The most important taxes are the profit tax which has a share of 21% and a VAT rate of 20%.Social security (social insurance contribution - 20%, State insurance for pension and sickness -13%). Contribution unemployment: 0, 5% employer, 1% employee.

[6] http://www.investopedia.com/terms/f/flattax

Table no.1 Romanian-Estonian economic relations[7]

Year	Export	Import	Totals
2002	1.54	2.22	3.76
2003	1.92	1.31	3.07
2004	3.86	3.81	7.67
2005	4.2	3.96	8.16
2006	6.33	6.69	13.02
2007	12.23	9.56	21.79
2008	19.54	13.81	33.36
2009	19.14	9.89	29.03
2010	24.39	10.62	35.01
2011	32.93	11.95	44.88
2012 first eight months	24.89	7.37	32.26



Romanian-Estonian commercial exchanges, although they have an upward evolution, not reflect yet the real possibilities of the economies of the two countries.

In 2011 the total volume of commercial exchanges between Romania and Estonia was 44,88 million EUR, of which 32,93 million EUR exports (ranked 66th in total Romanian exports) and imports 11,95 million EUR (ranks 74), the balance being surplus of 20,98 million EUR in favor of the Romanian side.

In the first eight months of 2012, bilateral trade volume reached a level of 32,26 million EUR (increase of 5,91% compared to the same period of 2011), of which 24,89 million EUR Romanian export (increase of 9,35%, 64th in total Romanian exports) and 7,37 million EUR import from Estonia (decrease of 4,26%,

[7] http://www.mae.ro/bilateral-relations/1697

ranks 77).Trade balance remains favorably to Romanian side, with a surplus of 17,52 million EUR

3. An overall analysis of the Latvian economy in the current period

Exports and imports of goods and services

In 2011, exports of Latvian goods at current prices increased by 28% (14% at constant prices), compared to 2010. Also, in 2012, exports of goods are in continued growth. In January-April 2012, exports increased by 11% in current prices, compared to the four months of 2011.

Like exports, imports of goods increased into a steady rhythm during this period. In 2011, imports of goods in current prices increased by 30% compared to 2010. Also, in early 2012, imports of goods are also increasing. In January-April 2012, imports in current prices exceeded the level in January-April 2011 by 18%.

In the first quarter of 2012, the negative trade balance is less than 10% of foreign trade. In 2007-2008, it was more than 25% of all foreign trade.

Exports to EU countries increased by 29% in 2011, but in January-April 2012 by 10% compared to the four months of 2011. In 2011, the increase in exports of metal products group contributed traditionally the most to this increase, while in the four months of 2012, the group of agricultural products and foodstuffs, have contributed largely to the growth.

Foreign investments in the first quarter of 2012 decreased by 50% compared to the same period last year. In June 2012 the total foreign investment reached 9.497 billion euros.

Latvian **exports** increased in 2011 by 28% compared to 2010. Exports have continued to grow in 2012, in January-April period registering an increase of 11% against the same period of 2011.

In 2011, Latvian **imports** increased by 30% compared to 2010. Import growth continued in 2012, in January-April periods registering a value by +18% against the same period of 2011.

It becomes natural in global economic context that every country to follow the insurance of economic growth, as a source of increasing living standards of the people, and in this sense, the policy of attracting foreign investments becomes a component part of the economic policy of each country[8].

Flows of foreign direct investments (FDI) resumed to be growing in Latvia in 2010, after it in years of crisis have experienced a setback.

Compared to 2010, FDI volume increased, in 2011 by 43,3% in the Baltic States, at the same time is to be noted that in 2011 FDI was higher with 5,4% than in 2012. It should be noted that in 2011, Latvia has attracted half of all FDI in the Baltic States.

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[8] Rodica BURBULEA, Foreign investment and their role in stabilizing and increasing national economy, page 2

According to the balance of international investments in Latvia, **FDI stock** in Latvian economy reached 6,567 billion LVL) 9,344 billion euros) at the end of the first quarter of 2012, which is higher with 10% than at the end of the first quarter of 2011. The share of FDI in the structure of foreign capital stock was 25,4 percent.

Sweden is the largest investor in the economy of Latvia. At the end of March 2012, investments in Sweden constituted almost 25% of total FDI stock. Mainly, these are investments in financial intermediation (85% of total FDI in the sector). Since the end of first quarter of 2011, the Swedish direct investments nearly tripled, mainly due to mutual transactions between Swedish and Estonian owners in banking sector.

Meanwhile, the stock of direct Estonian investments in Latvia fell by 56% and constituted 5,8% of total FDI stock at the end of March 2012. Major investments were also made by entrepreneurs in Denmark, the Netherlands, Germany, Finland, Russia and Cyprus. The volume of investments in these countries, at the end of March 2012 amounted almost 60% of the total stock of FDI in the economy of Latvia.

FDI is concentrated mainly in the service sectors. By 2008, the growth rates of FDI in services sectors were almost one and half times higher than in manufacturing sectors. However, in 2009 and 2010, FDI grew faster in production sectors (by 6,6% and 10,6%), while the stock of FDI in the services sector remained unchanged in 2009, but in 2010 decreased by 5%.

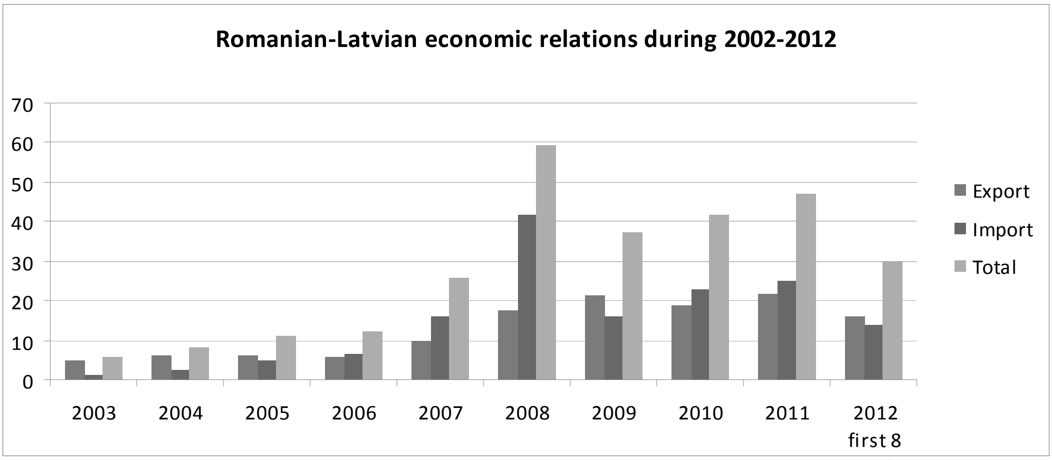
At the end of March 2012, the stock of FDI in services sectors accounted 68,1% of FDI in the economy of Latvia.

The largest investments in the processing industry have been made by investors in Denmark, Finland, Germany, Sweden, Ireland, Estonia, the Netherlands and Cyprus. Investments in the above mentioned countries were 80% of the stock of FDI in manufacturing. Noted that by the end of 2007,none of the countries mentioned has not hold the leading position in the structure of FDI stock in processing industry.

Due to financial crisis, the situation has changed significantly. In late March 2012, the Irish capital was dominant in the structure of FDI, constituting more than one fifth of FDI stock in processing industry. Entrepreneurs in Cyprus and the Netherlands have made, also, major investments in production. Investments in these countries in processing industry increased 3 times compared to the end of 2008. However, the volume of FDI stock from other major countries fell: Germany and Denmark with 7,4% and 8,6%, Finland by 21,6%.Meanwhile, at the end of March 2012, the stock of investments in processing industry increased by 17% in the investments made by businessmen in Russia.

Table no.2 Romanian-Latvian economic relations[9]

Year	Export	Import	Totals
2003	4,8	1,1	5,9
2004	6	2.3	8.3
2005	6.1	5	11.21
2006	5.8	6.5	12.3
2007	10	15.8	25.8
2008	17.63	41.72	59.35
2009	21.14	15.92	37.06
2010	18.67	23.12	41.79
2011	21.9	25.16	47.05
2012 first eight months	16.02	13.77	29.79



The evolution of bilateral trade exchanges:

- In the period 2003-2011, bilateral trade has seen a steady increase, with the exception of the crisis year 2009;
- In 2008, has registered a maximum of almost 60 million euros, 10 times more than in 2003;
- Since 2009, the upward trend was resumed, in 2011 registering a value of bilateral trade of 47 million euros, of which 21,9 million euros Romanian exports (ranked 75 in total Romanian exports) and 25,16 million euros imports (rank 61);
- In the first 8 months of 2012, bilateral trade volume was 29,79 million euros (decrease of 5% compared to the same periods of 2011), of which exports 16,02 million euros (increase of 0,56%, rank 73), and imports 13,77% million

[9] www.dce.gov.ro

euros (decrease of 10,75%, rank 69). Decrease in imports led to obtaining a surplus in bilateral trade balance of 2,25 million euros.

4. Conclusions

Estonian economy recovered quickly after the crisis, at the moment being, according to experts, more powerful than before the crisis and can do better face of shocks on the international markets. It is the only country in the euro area that has budgetary surplus, public debt being only 6% of GDP, compared with 81% in Germany, the largest European economy, or with 163% in Greece, the country most affected by the crisis.

The global financial crisis has not affected the geopolitical structure of the stock of foreign capital in Latvia. Mainly, these are investments of EU Member States. At the end of March 2012, FDI of EU Member States constituted 71.7% of total FDI, a fifth are investments of new EU member states and nearly half are investments of euro zone countries.

Regarding fiscal policy, in 1992 Estonia introduced a flat rate income tax of 26%, then decreased to 21%. Since 1999, reinvested profit is not taxed. In this way, has been simplified the tax system and tax collection and were stimulated investments.

Since 2010 the Latvian economy recession is over and economic growth started again. In 2011 GDP already has exceeded previous year level by 5.5%. In 2012, growth continued at almost the same level as in 2011, forecast growth being 5%.

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