Madis Müller: New models in Northern Europe?

Speech by Mr Madis Müller, Deputy Governor of the Bank of Estonia (Eesti Pank), at a symposium organised by the Konrad-Adenauer-Stiftung, Berlin, 28 November 2012.

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Ladies and gentlemen,

Thank you for this excellent opportunity to discuss together with colleagues from Latvia and Lithuania the experience of the three Baltic countries during the financial crisis. While the situation of each country is undoubtedly different, we can still consider if there are any lessons one could learn from the Baltic cases.

In my opening comments, I would like to address specifically the question of what is the best pace for economic adjustments once a country has been hit by a crisis. We hear today many suggestions that austerity requirements have gone too far and that we should allow more time for implementing difficult reforms.

First, let me start by saying that in more open economies, the crisis was felt almost instantly. In small and open countries such as the Baltic countries, there was no domestic demand to substitute for the lost export income. The economic reality had changed very suddenly.

The EU countries could be divided into two groups. The countries that had a higher export dependence had to react fast to the changed economic environment. This applies especially to smaller countries, including the Baltic States, although Germany's economy is also heavily reliant on exports. Those small countries in particular had to accept the new economic reality of lower demand, higher unemployment and forced fiscal consolidation due to a fall in tax income or borrowing difficulties.

The other group consists of bigger or more closed economies that were relying on domestic demand. They were able to smooth the initial impact of the crisis with more extensive government support measures. There was also the expectation that the crisis would be temporary. With the benefit of hindsight we know that we were not facing a temporary bump on the road, but a more fundamental need for adjustment. The initial smoothing of the shock may have been even more costly as it resulted in a higher level of public debt.

Secondly, the required policy adjustment involves a dimension which we now consider critical: the speed of reacting and the decisiveness of policy actions. The Baltic countries have learned it firsthand through their experience, which of course is the hard way.

There are few economists today that would fundamentally question the need for fiscal consolidation and structural reforms in Europe, as the crisis has clearly turned out not to be temporary. However, we all know it is politically difficult to cut government spending and implement reforms fast. The natural tendency for most politicians is to favour gradual adjustment. "Gradualists" say that in case of fast changes the risk of possible policy mistakes is higher, leading to losses in physical and human capital. Opponents of that view, including myself, certainly acknowledge those risks. But we feel that the costs of delayed action may sometimes outweigh its benefits, as postponing the inevitable and failing to accept the changed reality will lead to additional unnecessary costs. One should not want to keep alive old structures that clearly cannot be sustainable in the changed world for longer than necessary. This is a waste of limited resources and reduces long-term productivity. There is a saying that "a crisis should not be wasted" – negative shocks to an economy should lead to productivity gains.

Our experience shows that quick decision-making and decisive policy actions can shorten the period of uncertainty that also weighs on economic activity. People and entrepreneurs in countries with delayed reforms overreact, leading to a higher level of risk aversion than necessary. Overshooting in risk aversion results in lost jobs and postponed investments.

Estonia, for example, lost almost 20% of its GDP during the crisis. By now we have regained the pre-crisis level, contrary to many countries that preferred to delay the necessary reforms. Some of them still face years of decreasing economic output.

In summary, I would like to stress that prolonged fiscal consolidation and structural reforms can lead to unnecessary costs to the society. Some countries have chosen to delay the pain and take only gradual steps with their structural reforms, but this has in fact resulted in a reduction of the overall economic activity to the extent that might be no less than the short-term cost of a quicker adjustment. The difference is that they are still not done and cannot hope for a rebound that might otherwise be there.