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Budgetary Discipline and Internal Devaluation – Estonian Method to Overcome the Crisis

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Abstract: *The purpose of this article is to outline the main reasons and effects of the Estonian adjustments in response to the global financial and economic crisis. Estonia chose significant budgetary savings, in contrast with most other countries stimulating their economies by expansionary fiscal policy and leading to fiscal imbalances and growing public debts. Estonia did not carry out a devaluation of its currency, but restored competitiveness through internal devaluation. This strategy allowed Estonia to maintain a fixed exchange rate, fulfill the Maastricht criteria and adopt the single currency. As a result, Estonia has increased the stability of its economy, restoring and enhancing confidence among investors. At the same time, the Estonian strategy confirmed the existence of non-Keynesian effects – the positive economic results of public spending reduction.*

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Introduction

The article aims to outline the key circumstances and effects of the adjustment actions undertaken by Estonia in response to the global financial and economic crisis based on budgetary savings and internal devaluation.

Estonia was one of the economies which were most severely affected by the global crisis. In response to the recession, it opted for significant budgetary savings, which contrasted with the actions undertaken by most other countries boosting their expansive fiscal policies and increasing their budgetary imbalance and public debt in this manner. It did not devaluate its currency, but took the challenge to restore competitiveness through internal devaluation. This strategy enabled to maintain a fixed exchange rate, fulfil the Maastricht criteria and to adopt the single currency. As a result, Estonia increased the stability of its economy, restored and strengthened confidence among investors. Fiscal discipline and internal devaluation are the basic elements of the strategy by Estonia applied to restore stability and competitiveness of its economy.

Methodology of the research

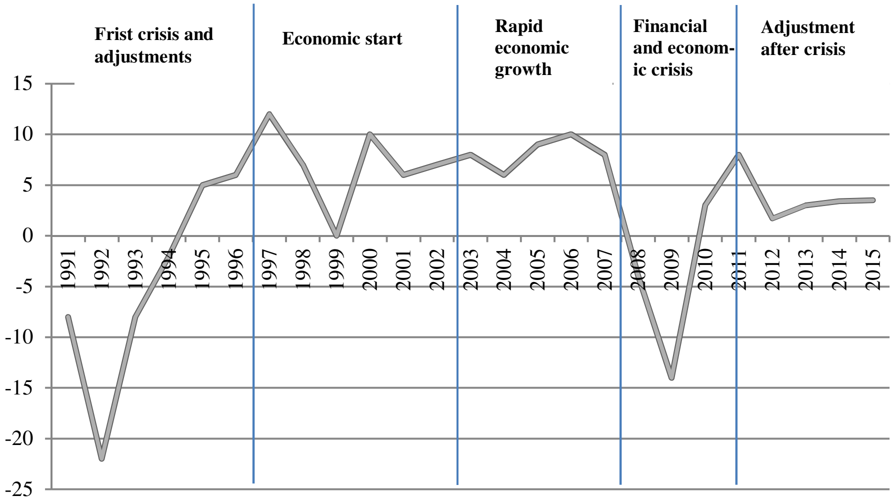
The basis for the discussion is an analysis of the economic and political nature of the decision of Estonia. The analyzed period (1991-2012) was divided into 5 phases. The first section of the article will present the main assumptions of the economic policies implemented by Estonia and specify the characteristics of its economy. Then, the sources of internal imbalances and the effects of the global financial and economic crisis will be discussed. The last section of the analysis will cover the causes and effects of the strategy applied by Estonia based on budgetary savings and internal devaluation. The article is a review based on an analysis of financial and economic results in Estonia since 1991 (data come from EUROSTAT and OECD). It refers to the economic theory on the impact of tightening fiscal policy, and aims to prove its effectiveness in conditions of significant deterioration of the fiscal position.

Nature and objectives of the economic policy of Estonia in the 90s.

Estonia, a federal republic within the USSR till 1991, for the last two decades has undergone a radical transformation from a centrally planned economy to a liberal country, with a vast degree of openness, stable democratic institutions and integrated with international political and economic organisations. The following 5 phases can be distinguished within its short period of the most recent economic history:

1. 1991-1994 – the years of crisis upon regaining its independence and adaptation to the new market conditions;
2. 1995-1999 – the years of its economic recovery and first recession;
3. 2000-2007 – the period of its very high economic growth;
4. 2008-2009 – its economic collapse due to the global financial and economic crisis;
5. since 2010 – the stabilisation of its economy and continuation of its growth.

Figure 1. Economic growth in Estonia since 1991 (together with 2012-2014 forecasts)



Source: own study based on ECB (Statistical Data Warehouse).

Estonia struggled with the most severe – so far – economic collapse in the first few years upon gaining its independence. The crisis epicentre was located in Russia, its cause was the crisis and the system transformation process in Russia being the largest trading partner of Estonia at that time, and the legacy of solutions being characteristic to centrally planned economies. The demise of the USSR disturbed or cut economic and spatial links between these two organisms. It should be noted that at the moment of regaining its independence, in practical terms, Estonia had no experience of its operation as a state (it was a union entity within the USSR) and had no such basic attributes of independence like its own army or currency. The country

had to thoroughly rebuild its economy and adapt all the solutions governing its economic, political and social fields. The first steps were aimed at:
- cessation of government control over means of production and price-setting;
- getting out of the ruble (RUB) zone and introduction of its own exchangeable currency;
- introduction of free trade based on economic relations with international entities;
- privatisation of state enterprises;
- reduction of inflation (which reached the level of 211% in 1991, 1069% in 1992 and 85% in 1993);
- limitation of budgetary expenditure and reconstruction of its tax system (Bauc, 1995).

As Kosiedowski noted (1996), the range of political and economic problems in Estonia was much more complicated than the one in other countries of Central and Eastern Europe, e.g. Poland. However, just in 1994, it managed to overcome the transformation recession and the adopted solutions being favourable to foreign investments promptly attracted attention to this small, peripheral country.[1]

The government made a far-reaching decision in the scope of the national economic policies by bounding the Estonian kroon with the deutsche mark (1992) and then with the euro (1999) on the basis of the currency board. On the one hand, this solution enabled to stabilise the currency and to bring hyperinflation under control, but on the other hand significantly determined the character of economic policies implemented in this country. The application of the fixed exchange rate regime prevented the Estonian monetary authorities to run autonomous monetary policies and freely react to economic changes, especially when under crisis. Then this strategy stood for a need to make the economy more flexible and to maintain stable public finance to ensure effective responding to possible economic shocks (further: IMF, 2002). Decisions (and effects) in the area of budgetary policies were then linked with liberal approach to the market (e.g. low taxes entailed lower budgetary income therefore it was required to reduce social spending or subsidies for enterprises).

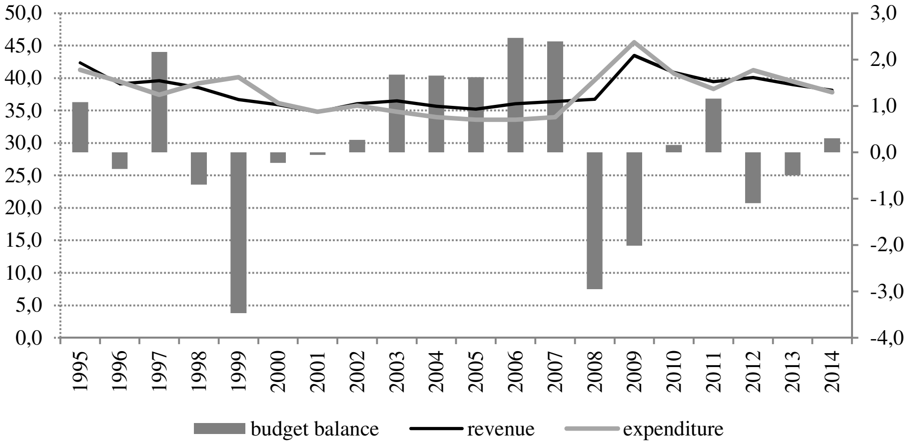
In 1994, the Estonian budget showed a surplus and one of the most significant objectives of its economic policies was to keep it at that level (Pautola, 1997). For the sake of discipline and reliability, Estonia introduced the rule of budgetary balance at the central level and the principle of requiring

[1] Foreigners are allowed to buy properties for production purposes and establish, buy and possess companies on the same basis as Estonians do. 3-year exemption from taxes is provided for investments over $1 million. Within further 5 years investors pay low (5%) income tax (Kuczyński, 2003).

the government to establish a budgetary surplus in "good times". Despite they had no binding legal basis, since then they have become an important determinant of decisions in the scope of economic policies (compare European Commission, 2012).

In 1996, the Estonian budget recorded a short-term deterioration (as a result of a drop in income, the budgetary deficit reached 0.4% of GDP) but one year later – at the economic prosperity – (the growth of GDP at the level of 12% in 1997), the government reduced spending by 2 percentage points. In 1997, Estonia generated a surplus once again and introduced a new element of fiscal policy – the stabilisation reserve fund. Its purpose has been to invest the means derived from the budgetary surpluses and partly from privatisation to prevent their spending on a current basis and assist in stabilising the economy at crisis times (Erixon, 2010).

Figure 2. Level of budgetary income and expenditure (% of GDP, left scale) and the budgetary balance (right scale) in Estonia (in % of GDP) in 1995-2011 (together with forecast)



Source: own based on (European Commission, 2012a).

A subsequent – upon the transformation recession – serious challenge for Estonia referred to a decline of its economic conditions in 1998 and then a severe decrease of production in 1999 as a result of the financial crisis in Russia. Its effects significantly affected the budget (the deficit reached 3.2 % of GDP). Therefore – in order to restore the balance – the government decided to undertake restrictive measures. The main efforts were focused on the reduction of public expenditure from the level of 40% of GDP in 1999 down to 34.8% of PKB in 2001. Consumption, investment and social expenditure together with wages and employment in the public sector was considerably lowered. At the same time, harsh conditions at the labour market facilitated to keep the wage discipline in private enterprises, which in conjunction with the governmental savings led to a decline in the growth rate of wages – it tripled in 2001 compared to 2000. As a result, in 2001 Estonia almost balanced its budget, in 2002 it generated a minor surplus, and in subsequent years this surplus was steadily increased (to 2.4 % in 2007). In view of the determination to keep the exchange rate regime, Estonia did not decide to devaluate its currency and the competitiveness of its economy was restored only through internal adjustments.

"Baltic tiger"

After overcoming the crisis Estonia continued the process of building its image as a liberal economy. The rapid development (within 2000-2007 its average economic growth rate at the level of 8%) was favoured by its friendly business environment. The high standing in the economic freedom rank was (and has been) the effect of running the neo-liberal approach. In 2010 it took the 14th position in the general classification and the 3rd one in the EU (Economic Freedom, 2012). Estonia is also high in terms of the ease of doing business – the 21st position globally and 7th position among the EU countries (Doing Business, 2013). The country has thus been characterised by a high degree of economic freedom, taking into consideration of all the post-socialist countries. The following definitions (which have long been its "slogan" to encourage investments) are applied to specify the character of the Estonian economy: liberal trade regime, transparent law and favourable attitude of the authorities to running business. In Estonia there is one rate of income tax (21%), value-added tax (20%) and enterprises do not pay tax on reinvested income (Estonian Investment Agency). Transparency, simplicity and stability of legal regulations were strengthened by the fixed exchange rate regime, as demonstrated by increased influxes of foreign capital (further: Sepp et al. 2002). The country – as a place of investment – primarily attracted the attention of Sweden (37% of all its foreign direct investment FDI) and Finland (24%). Apart from its friendly business environment, these countries found the following factors attractive: low labour costs, geographical proximity and high level of education of work forces (and also cultural and linguistic proximity for Finland). In 2008 enterprises owned by foreigners (in part or in whole) produced one third of the Estonian GDP and generated approximately 50% of its export. At the same time, nearly 14% of foreign direct investments was concentrated in traditional manufacturing industries and 13% – in trade, accommodation and catering business fields. As much as 36% of foreign direct investments got concentrated in the financial intermediation sector and 25% – in the construction sector and business activities related to real estate and rental services[2] (OECD, 2011). Strong links of the Estonian economy with the Scandinavian countries can be perceived in particular in the banking sector in which – out of six banks in operation at the market – three ones coming from Scandinavia focus 96% of all the assets with just 2 Swedish ones – 68% (IMF, 2009).

All these factors contributed to the development of the Estonian economy. Thanks to its impressive successes Estonia (like Lithuania and Latvia) has become known as the "Baltic tiger" and for eight years (2000-2007) its GDP per capita increased from 45% up to 71% of the EU average. However, within the last pre-crisis years the boom was driven primarily by domestic demand – its fast-growing consumption and boomed real estate market. Estonians willingly financed their expenditure by means of credits granted almost exclusively by banks with foreign capital (in 2006 the level of credits granted to individuals accounted for almost 1/3 of the Estonian GDP). Its vast domestic demand was satisfied by the rapid growth of its import, resulting in a significant level of its economic imbalance in the current account (in 2007 the deficit accounted for 18% of the Estonian GDP). In addition, labour shortages contributed to a spiral growth of wages and prices. Wages grew faster than productivity which led to a decrease in cost competitiveness (IMF, 2009). Symptoms of overheating of the economy could be perceived prior to the onset of the global recession.

In connection with the crisis at the global financial market, Estonia suffered primarily due to reduced external crediting (which significantly influenced its demand). Then, very quickly it underwent economic difficulties of its trading partners which resulted in a strong decline in export and reduced capital inflows. The specificity of the Estonian economy (its minor size and high degree of opening) makes it very susceptible to external shocks, which affect it very severely (Blanchard, 2010). Therefore, already in 2008, it suffered a negative rate of its economic growth (-4%) and one year later – a decline of its production at the level of -14% was the third lowest indicator in the EU (just behind Latvia and Lithuania). Such a strong collapse led to a rapid increase of its unemployment (from 4.7% in 2007 up to 16.9% in 2010) and a substantial budgetary imbalance in 2008. 2002 was the year when its budget deficit was recorded for the first time (2.7% of GDP).

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[2] For comparison, the figures in the Czech Republic are as follows: industry – 35%, trade, accommodation and restaurants – 9%, financial intermediation – 19%, construction sector, real estate and rental services – 16%.

Response of Estonia to the financial and economic crisis

The manner of response to the crisis was determined by four characteristics of the Estonian economy:

1. a size and openness of its economy – in 2011 the Estonian GDP accounted for only 0.13% of EU GDP and the relation of export and import with GDP stood at 180% (the EU average is 86%);
2. a strong dependence of the Estonian economy from foreign demand (in 2011 its export accounted for almost 91.5% of generated production);
3. the exchange rate regime based on the currency board system;
4. the final stage of its preparations for the adoption of the single currency (the government's determination to meet the fiscal criterion);
5. public attitude (consent to the budget restrictions) and "tradition" of sound public finance.

Estonia is a country which – as one of the few ones – chosen to undertake very restrictive measures to restore the stability of its budget and the competitiveness of its economy. Similarly as during the 1998-1999 crisis, its major efforts were concentrated on reducing spending (among others: a reduction of staff wages in the public sector by 10%, limitation of indexation of pension benefits and sickness allowances, current and investment expenditure in the state administration). The following was raised at the income side: VAT rate (by 2 percentage points), excise duty (for natural gas, gasoline, diesel, alcohol and cigarettes) and contributions to the fund paying out unemployment benefits. There were also some one-off measures undertaken (among others: increased proceeds from dividends and temporary suspension of the transfer of contributions by the state to the capital-based pension system). In total, in 2010-2011, the budgetary expenditure was reduced by 7.2% of GDP, 40% of which stood for structural changes (Convergence Programme, 2010). As a result, the budgetary deficit in 2008-2009 turned into its surplus just in 2010. These responses to the global financial and economic crisis were very similar to the ones undertaken by Estonia during the 1998-1999 recession.

Table 1. Changes of the budget items in the savings packages (% of GDP)

Year	Change of income level	Change of expenditure level	Change of wage expenditure level	Change of budget balance
1997	+ 0.5	- 2	- 0.6	+ 2.6
2000-2001	- 2	- 5.4	- 1.6	+ 3.4
2009-2010	- 4.1	- 7.3	- 1.8	+ 3.2

Source: European Commission (2012a).

The success in the field of public finance contributed to the improvement of economic (managing) conditions derived from the range and manner of conducting its budgetary adjustments. As numerous studies show it is the reduction in expenditure and in particular employment and wages in the state sector is a powerful driver. A decrease in the growth rate of real wages affects the ease of wage pressure across the economy thus contributing to its competitiveness and volume of production (Giavazzi, 2000). Once again this mechanism was applied in Estonia. The combination of wage discipline in the administration sector[3] and private enterprises led to an abrupt slowdown in the growth of wages (in so far nominal wages increased by 25% compared to the previous year, by only 9.7% in 2008, and their growth rate was negative one year later). As a result, unit labour costs decreased significantly as well (see: Table 2). These actions based on the recovery of its competitiveness as a result of a fall in wages and prices are referred to as internal devaluation. This method of adjustments is certainly much more difficult, more expensive and less predictable in its consequences than currency devaluation (although in case of Estonia it would involve a modification of the exchange rate regime, significant loss of confidence at the market and postponement of adoption of the common currency). Firstly, internal devaluation is linked with a change of many prices in this country – not only one price is changed – its currency price (the so-called menu costs). Secondly, it is much easier to raise prices and wages than reduce them. Thirdly, savings and cuts are very severe for indebted societies (both for business entities and households). As people incur the highest costs (as they get lower wages, social benefits or lose jobs), therefore these measures are socially and politically unpopular, and very rarely applied in business practice. However, the attitude of the Estonians demonstrates that it is possible to undertake such actions. No demonstrations directed against such savings policies took place. Even more, the governing party bearing the responsibility for them was re-elected at the parliamentary elections (Siarkiewicz, 2011). It can be explained by cultural

[3] According to the estimates made by the European Federation of Public Service Unions, wages in the public sector in Estonia decreased in 2009 by about 16% on average.

conditioning at different levels, among others through the impact of the Protestant ethics, attitude toward work, respect for public institutions manifested in the ethos of work, efficiency and economy (Lipset, 2003). In addition, the Estonians already experienced the effects of similar actions, therefore they expressed their support for such measures and trust for the authorities.

Table 2. Potential impact of budgetary changes onto economic activities

Traditional Keynesian approach	**Increase in expenditure (or reduction of taxes) leads to increased production —> Multiplier exceeding 1**
Neo-Keynesian economics	The multiplier is limited in relation to the partial effect of ejection —> Multiplier between 1 and 0
Ricardian equivalence	Fiscal changes are fully compensated by means of preventive behaviours of market participants —> Multiplier equal to 0
Non-Keynesian effects	Credible fiscal consolidation plans impact the improvement of market participants' expectations and contribute to the increase in competitiveness of the economy —> Multiplier is negative or close to 0

Source: own study.

Thus the Estonian strategy based on savings provided evidence to the operation of non-Keynesian effects of budgetary restrictions. Their impact on aggregate demand in medium and short terms has been long and thoroughly discussed (theorists of economics agree only in terms of their positive impact in long period). The strength and direction of interactions depend on the adopted model: on one hand the traditional Keynesian approach emphasizes the importance of a public expenditure multiplier and highlights the negative implications of restrictive fiscal policies for economic growth, on the other hand – it proves the existence of positive effects of the tightening of budgetary policies in medium – or even short-terms.

Table 2. Selected economic indicators for Estonia in 1996-2012

	1996	**1997**	1998	1999	**2000**	**2001**	2002	2002 -06	2007	2008	**2009**	**2010**	2011	2012
Total employ-ment*	-2.4	**0**	-1.9	-4.5	**-1.5**	**-3.7**	0.8	2.0	0.8	0.2	**-10.0**	**-4.8**	7.0	0.6
Unemployment rate	10	**9.6**	9.2	11.3	**13.7**	**12.6**	10.3	8.8	4.7	5.5	**13.8**	**16.9**	12.5	11.6
PCE *	12.3	**11.9**	5.3	0.9	**7.8**	**7**	9.5	9.9	8.8	-6.1	**-15.6**	**-1.7**	4.2	2.8
GCE *	-2.9	**-1.9**	2.2	-0.2	**-2.1**	**2.7**	3.4	3.8	6.6	5.0	**-1.6**	**- 1.1**	1.6	1.0
Public invest-ment *	18.2	**23.6**	21.4	15.5	**16.7**	**13.1**	24.2	16.8	9.3	-15.1	**-37.9**	**-9.1**	26.8	8.3
Deflator of GDP	24.1	**10.2**	5.2	6.8	**4.8**	**6.5**	4.7	5.6	11.6	5.3	**-1.0**	**1.1**	3.7	2.9
Labour costs *	28.7	**20.2**	13.6	8.5	**14.6**	**9.6**	9.1	11.6	25.0	9.7	**-3.4**	**1.4**	1.4	4.0
Real labour costs *	3.6	**9**	8.1	1.7	**9.3**	**3**	4.2	7.8	15.8	1.1	**- 2.5**	**-0.8**	-3.2	0.4
Unit labour costs*	10.6	**5**	3.2	3	**2.3**	**3.2**	3.2	5.5	17.2	14.1	**1.4**	**-5.6**	0.8	3.0
Real unit labour costs*	-5.1	**-2.7**	-0.8	-2.8	**-1.9**	**-2.4**	-0.8	-0.1	5.0	8.3	**2.4**	**-6.6**	-2.8	0.0
Gross National Saving (% of GDP)	20.7	**20.3**	21.7	20.6	**23.1**	**22.9**	21.9	22.4	22.9	21.6	**23.2**	**23.9**	25.3	24.9
Export	0.3	**26.4**	13.4	0.4	**27.4**	**4**	-2.7	8.6	3.7	0.6	**-18.6**	**22.5**	24.9	1.4
Import	8.5	**28.6**	12.5	-5.9	**27.1**	**4.8**	7.2	13.1	6.3	-6.3	**-32.4**	**20.6**	27.0	2.3
Wages in public sector (% of GDP)	11.3	**10.5**	10.5	11.8	10.8	10.2	10.3	10	9.5	11.3	12.9	11.9	11.1	no data

* Annual change, in %, PCE - Private consumption expenditure; GCE - Government consumption expenditure

Source: ECB Statistical Data Warehouse, Economic databases and indicators

Rzońca and Ciżkowicz (2005) draw attention to the two main channels of positive impacts of fiscal restrictions in short terms. The first group include changes in market participants' expectations in response to the consolidation of public finance (business entities expecting the ease of tax burdens in the near future increase the level of their spending which balances negative impacts of fiscal changes in aggregate demand). The dependency occurs at the considerable level of budgetary imbalance and high debt[4], therefore the mechanism was not observed in Estonia. According to the second group, non-Keynesian effects are the result of positive supply shocks induced by fiscal impulses. In this case, its force and direction does not depend on the level of its budgetary deficit or public debt, but it does on the manner of "tightening" of fiscal policies. The best results are brought by limiting spending, in particular in the field of employment and wages in the public sector as it eases wage pressure and reduce costs[5]. This is the path of interactions which was observed in Estonia during the period of fiscal consolidations in 2000-2001 and 2009-2010.

It would seem that the positive effects of savings and internal devaluation (in 2011 the economic growth reached the level of 8% of GDP) should prove the validity of the measures taken. However, they were quite critically referred to by P. Krugman, a well-known economist and Nobel laureate in economics. He stated that such measures doom the country to pointless suffering and that in this situation he would recommend the currency devaluation (rather sarcastically he called the country another “hero of austerity”). His comment on the low effectiveness of such solutions posted in the internet was responded by Toomas Hendrik Ilves, the President of Estonia. Deeply outraged by Krugman’s entry, he made a statement pointing his lack of knowledge on the characteristics of Estonia and pondering the reason for the criticism of his country when it (as one of the few countries in the EU) fulfils fiscal obligations and meets the requirements of international institutions (Greeley, 2012)[6]. It must be also noted that the decisions made by the Estonian government introducing savings packages were largely determined by the need to complete the process of accession to the euro zone. It should not be surprising that Estonia has strongly aspired to the adoption of the single currency, in spite of the ongoing economic crisis and concerns on the future of the monetary union among others due to the debt crisis in Greece). As rightly argued by the Prime Minister of Estonia, foreign investments are

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[4] Non-Keynesian effects in short and medium terms are proven by, among others, Bhattacharya (1999) – when the level of public debt is high; Giavazzi, Jappelli and Pagano (2000) – when the level of public debt significantly increases.

[5] The two approaches are not mutually exclusive. In addition, fiscal impulses may lead to non-Keynesian effects by affecting the level of interest rates (reduction of risk premium as a result of considerable reduction of budgetary imbalances).

[6] The President's response was not officially commented on by Krugman.

"everything" for a small, open country with little capital. Therefore, the adoption of the single currency was aimed at recovering and strengthening confidence among investors. In addition, since 2007, the Estonian kroon has been subjected to speculative pressures, hence the introduction of the single currency (euro) would effectively solve the problem (Roman, 2007; IMF, 2010). Krugman disagreed in this case as well, stating that the Estonian development strategy based on investments reaching the country only because it is safe requires serious thinking-over. He also compared Estonia to Spain, where the adoption of the single currency in combination with low labour costs actually encouraged business entities to invest, however, there were no solid foundations for the economic growth (Greeley, 2012)[7]. The fact is that the impressive economic performance of Estonia (in particularly since 2000) have been the result of cheaper labour force, inflows of foreign capital and expansive monetary conditions. This analogue seems to be inadequate due to completely different conditions, variances of socio-economic models and economic objectives and results (including budgetary ones) of these two countries. The crisis experienced by Estonia was similar in its sources to the one suffered by Spain, however in spite of similar restrictions on the application of economic policy instruments (it did not implement its currency devaluation), it very quickly and efficiently managed difficulties. Moreover, the force of the economic collapse which affected Estonia was significantly more severe than in case of other EU countries, and yet it reached impressive results just 2 years later – in 2010 its economic growth rate amounted to 3% and in 2011 it reached its pre-crisis level placing the country at the forefront of the fastest growing economies. The growth was contributed mainly by its domestic demand (generated by the high dynamics of household consumption and significant increase of investments), otherwise than before the crisis, it occurred at the period of stagnation at the credit market. The economy is also favourably affected by the high dynamics of export - triple higher than the average in 2002-2006. Obviously prosperity at its major trading partners was an important favouring factor but it is due to the mentioned internal devaluation and fiscal consolidation, Estonia rigidly kept its exchange rate, fulfilled the Maastricht criteria, adopted the single currency, increased stability of its economy and investor confidence (S&P Agency raised its credit rating in August 2011 which additionally improved its image and increased attractiveness for foreign direct investment) (NBP, 2012).

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[7] Although FDI reached mainly the service sector, which may suggest a low degree of absorption of innovations, Estonia made used of foreign investments and invested in its economy. The statistics provide evidence on the dynamic growth of innovation among small and medium-sized enterprises, export activities of innovative companies (annually by 20-25%) or spending on R&D (23% annually, which – next to Malta – stood for the highest dynamics in the EU as a whole). Within 2000-2006 the share of spending on R&D increased from the level of 0,61% up o 1,15% of GDP and thus doubled (Action Plan, 2008).

Conclusions

Fiscal discipline and internal devaluation are the basic elements of the strategy by Estonia applied to restore stability and competitiveness of its economy. The placement of strong emphasis on sound public finance constitutes its consistent implementation of the budgetary principle requiring the government to settle the balance at the central level (which at the same time it gave rise to its long-term stability and reference to the currency board mechanism). Prompt response to the deterioration in the budget balance as a result of the recession focused every time on the reduction of budget expenditures, including in particular, wages and employment in the public sector. Once again internal devaluation proved to be successful and allowed Estonia to quickly regain competitiveness. Thus three very important factors determining its success can be pointed out. Firstly, it is necessary to ensure a high degree of flexibility of the economy, allowing its reaction to change. Secondly, it is very important to provide transparency of economic policies and consistency in the implementation of their objectives. Thirdly, it is essential to build trust and public support for such measures. Since the start of the process of transformation, Estonia has focused on building a liberal and open economy. It has also run prudent budgetary policies based on neo-classical patterns. Although its specificity makes the country extremely vulnerable to severe economic shocks, once again it has proven that they can be successfully overcome by the application of methods so rarely used in business.

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