# "Success Stories" Differ: Latvian and Estonian Austerity Models

by Martins Vargulis

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<u>*Introduction*</u>

The Baltic States experienced a troubled transition period from the communist planned economy to an open market liberal economy through the 1990s, and successfully acceded to the common market of the European Union (EU) in May 2004. The aftermath of EU accession has demonstrated economic developments worthy of both criticism and acclaim. The trajectory of economic developments have taken the countries from being called the 'Baltic Economic Tigers' to becoming fastest falling economies in the world, and then again to being the fastest growing economies in the EU, within little more than seven years. Nevertheless, there are some obvious differences – in addition to the similarities – in the policies that were implemented by both the Latvian and Estonian governments. These differences determined the unequal readiness of the countries to overcame challenges that were presented by the global financial crisis.

Estonia and Latvia are presently perceived by various representatives of international institutions and economists as success stories, thanks to their specific approach to overcoming the economic crisis. For instance, IMF Managing Director Christine Lagarde recently announced that the Latvian government's economic policy is a "success story", and that it "could serve as an inspiration for European leaders grappling with the euro crisis".[1] Moreover, from the perspective of foreign investors the Estonian approach has also been evaluated as successful and quite attractive for investing in the country.[2] Although economic indicators from both countries over the last two years have significantly improved, the approach used by the Latvian government in many ways differs from Estonian policies.

Therefore, among other questions raised in this article, there is an analysis of Latvian and Estonian economic development up to the global financial crisis in 2008, a look at the countries' experiences, an analysis of the economic challenges during the recession, an overview of adopted policies and solutions, as well as an exploration of opportunities for further development, which from the perspective of some well known economists – like, for instance, Paul Krugman – has been questionable.[3]

<u>*Estonia and its policies of avoiding economic recession*</u>

Estonian economic indicators like GDP, the unemployment rate, wages, and others from the period after Estonia joined the EU until the eve of the crisis in late-2008 obviously improved. Estonia was a very dynamic economy, with a GDP growth rate of 8.2% per year on average from 2004 to 2007. The unemployment rate decreased continuously throughout this period to reach 4.7% in 2007, its lowest level since the transition to a market economy in Estonia[4].

1 Mark Wesbort, *IMF Chief Praises Latvian "Success Story" -- A Scary Speech for the Eurozone*, http://www.huffingtonpost.com/mark-weisbrot/imf-chief-praises-latvia_b_1587723.html, 13.06.2012,12:40 pm.

2 Edition.cnn.com, March 29, 2012, Estonia's success: Liberal regulation, strong work ethic, http://edition.cnn.com/2012/03/29/business/marketplace-europe-estonia-quest/index.html

3 Investors.com, *Baltic Tiger Takes A Bite Out of Paul Krugman*, http://news.investors.com/ibdeditorials/060812-614335-estonia-teaches-paul-krugman-a-lesson.htm#ixzz27wjDs3E5, 08.06.2012.

4 Levasseur, S. *Labour market adjustments in Estonia during the global crisis*. – OFCE, December 2011. - p.2. - http://www.ofce.sciences-po.fr/pdf/dtravail/WP2011-25.pdf

However, as was found during the crisis, these indicators weren't based on a stable framework. An economic breakthrough similar to that of Latvian was built on the basis of widespread credit for households and very high wages, which were the main contributing factors to GDP from 2004 till 2007. Estonia's very rapid economic growth and large investment volumes were supported by both an increase of loans issued by the banking sector and the active operation of foreign investors in reinvesting profits earned in Estonia.[5] At the same time, many factors that supported the country's development have had a fairly short impact and there was reason to doubt their sustainability. This raises the question of why Estonia stepped into economic recession and what guaranteed Estonia's successful way of overcoming the crisis.

The economic development of Estonia from 2004 to 2007 could be described by the five main pillars upon which the Estonian economy was built: increase of the demand, increase of the government sector, active FDI, export growth, and the impact of accession to the EU. The strength/weakness or sustainability/unbalance of these pillars set the future direction of the country's economic policy. First of all, accession to the EU in 2004 decreased the level of risk premium, which obviously stimulated the process whereby Estonia received an influx of cheap money. Finland and other Scandinavian countries were eager to offer cut-rate mortgages and build new homes. The result was a real estate bubble, artificially stimulated economic growth, and malinvestment.[6]

Secondly, the increase of demand in the government sector contributed to the extremely high speed of growth in the state budget, which was funded through the taxation of domestic demand as a result of the loan boom. FDI in Estonia was an econmic pillar that not only contributed to the economic growth of the pre-crisis period, but could also protect Estonia from deeper recession during the crisis by improving the balance of payments. The fourth aspect of the Estonia's economic development was related to it's export growth, which was based on financial flows rather than on real production. One of the major stumbling blocks for the Estonian economy in the pre-crisis period was low competitiveness. For instance, in 2007, the manufacturing sector contributed only 9% to GDP growth, while construction, wholesale & retail trade, financial intermediation, and real estate contributed a total of 63%[7]. Last but not least, the Estonian economy was positively stimulated by the benefits of EU membership: various funds, the elimination of trade restrictions, a bigger trade market, attractiveness for investors, foreign tourists, etc.

Except FDI, and to some extent the benefits from the EU, all other aspects that contributed to the development of Estonia's economy were artificially created without a stable base and resulted in other economic problems. For instance, after joining the EU there were widespread legitimate concerns among entrepreneurs about the migration of skilled workers to other EU countries. To retain highly skilled employees, most companies significantly increased wages. From 2004 – 2007, the average salary was increased by 64%. This high growth of wages exceeded the increase of labor competitiveness and productivity. For example, in 2006 the Estonian GDP per capita amounted to only 22% of the relevant indicators of the five wealthiest European Union states (42% if considering the level of prices).[8] The low level of productivity affected the competitiveness of Estonian companies in the region, whose price of goods and services increased.

5 Urmas Varblane, *The Estonian Economy Current Status of Competitiveness and Future Outlooks*, Eesti Arengufond, Tallinn, 2008, http://www.arengufond.ee/upload/Editor/English/ty_raport_eng.pdf, p.13.

6 The WealthCycles Staff, Estonian Austerity Models Healthy Economic Correction, July 27, 2012, http://wealthcycles.com/blog/2012/07/27/estonian-austerity-models-healthy-economic-correction

7 Levasseur, S. *Labour market adjustments in Estonia during the global crisis*. – OFCE, December 2011. - p.2. - http://www.ofce.sciences-po.fr/pdf/dtravail/WP2011-25.pdf

8 Urmas Varblane, *The Estonian Economy Current Status of Competitiveness and Future Outlooks*, Eesti Arengufond, Tallinn, 2008, http://www.arengufond.ee/upload/Editor/English/ty_raport_eng.pdf, p.11.

When the bubble burst in 2008, in order to continue the successful development that Estonia had implemented after its accession to the EU the Estonian government was forced to choose between two main options – austerity versus a devaluation of the national currency; a hard decision that has been made by many countries during the crisis. Instead of devaluation the Estonian government chose austerity and developed policies. Rather than attempting to reflate its economic bubble via a flood of new, unbacked kroon and massive spending packages, the Estonia's government slashed spending sharply. It froze pensions, cut government salaries by 10% (and ministers' salaries by 20%), and raised the value-added tax by 2%.[9] The Estonian government stuck with its 10 year plan to join the eurozone, which pegged the kroon first to the German mark, then to the euro.

The result of these reforms was painful. There were plant closings, layoffs, and building project shut-downs. Unemployment rose to 16%; gross domestic product (GDP) fell by 14%.[10] Many skilled workers left the country for jobs elsewhere. The annual average unemployment rate in Estonia reached 16.9% in 2010, but already dropped to 12.5% in 2011[11]. Overall, wages fell slightly in 2009 and 2010.

Nevertheless, while most European Union countries are still suffering from the economic crisis Estonia is going in the opposite direction. Estonia demonstrated the fastest growth rate in the EU in 2011 at 8.3%[12]. There are several factors that promoted economic growth. One of the main keys to success in economic stabilization was policies adopted by the Estonian government to facilitate the creation of domestic and international companies. The Estonian government provided an opportunity for companies to report their taxes online to minimize time consumption and procedures. The main goal was to provide an easy, understandable, and competitive business field. And obviously the Estonian government has succeeded in this. At the worst point of the crisis, in 2009, Estonia was ranked 22nd out of 183 countries on the World Bank's Ease of Doing Business Index[13]. It held the highest position of all three Baltic States.

In 2010 Estonia became the 17th member of the eurozone – the first ex-Soviet state to adopt the EU single currency. The greatest advantage that countries hope to obtain as a member of the eurozone is an increase in FDI. Compared to the pre-crisis period of early 2008, foreign direct investments had increased by 15% by mid-2011. According to the data, the export of Estonian goods was 47% higher during the first nine months of 2011 than during the same time the year before. More than 70% of Estonian exports go to other member states of the European Union, and therefore it is important that foreign investors are not threatened by exchange risks. The euro has given Estonia[14] reliability.

In 2009 Estonia's main export commodity was machinery and appliances at almost 20% of the total.[15] Goods and services in this particular field have already found their place on the international market. Moreover, investors from around the world already appreciate Estonian IT products and specialists, whose goods and services have provided a significant input to Estonian development. Most investors who actively operate in Estonia have a positive attitude toward operation in Estonia. For instance, general manager Vesa Kandell of a local plant for ABB, a Swiss industrial group that is one of Estonia's biggest investors and

9 The WealthCycles Staff, Estonian Austerity Models Healthy Economic Correction, July 27, 2012, http://wealthcycles.com/blog/2012/07/27/estonian-austerity-models-healthy-economic-correction

10 The WealthCycles Staff, Estonian Austerity Models Healthy Economic Correction, July 27, 2012, http://wealthcycles.com/blog/2012/07/27/estonian-austerity-models-healthy-economic-correction

11 Statistics Estonia, Real GDP per capita, growth rate and totals, http://www.stat.ee/29958

12 Statistics Estonia, Real GDP per capita, growth rate and totals, http://www.stat.ee/29958; date of publication?

13 The World Bank, International Finance Coorporation, Ease of doing business in Estonia, http://www.doingbusiness.org/data/exploreeconomies/estonia

14 Andrus Ansip at Estonian Export Directory, http://www.estonianexport.ee

15 Estonian Export Directory, http://www.estonianexport.ee/?page=b6&lang=eng

operates four factories employing 1,000 people, argues that Estonia has become an important high-tech production hub for ABB during its two decades in the country. Mr. Kandell explains that in Estonia there is a well-educated engineering workforce as well as well-educated hard working people for factory operations. He adds that the business environment in Estonia is very modern and liberal. It's not as cumbersome as many other countries.[16] These and similar ideas that can be heard from a number of investors who operates in Estonia, and such attitudes would not be possible if the Estonian government were not oriented toward business development and viability.

Estonian economic sustainability relies on tight ties with other Scandinavian countries, mainly Sweden and Finland, which combined make up one third of Estonian exports. Moreover, the main foreign investors into Estonia are Finland and Sweden. Nearly half of foreign investment in 2012, for example, came from Finland[17]. During the crisis exports to Sweden and Finland didn't change significantly due to stable demand from the Scandinavian countries. Estonia's economic strength to some extent is determined by the economic strength and sustainability of its partner countries. Estonian exports during the crises didn't change dramatically because the main destination countries didn't experience economic problems.

Last but not least, the final aspect that prompted the downturn of the Estonian economy was it economic connections with Latvia. After Finland, Sweden, and Russia, Latvia is the fourth largest foreign trade partner. During crisis, Estonian exports to Latvia significantly reduced. In 2009, for instance, exports to Latvia were reduced by 17%. The decrease of demand for Estonian goods and services in Latvia played, and still plays, a significant role in the Estonian economy. To fully understand Latvian-Estonian ties during the economic crisis, the next chapter will evaluate Latvia's economic position in the pre-crisis period and analyze the policies adopted and implemented by the Latvian government during the crisis.

*Latvia, the 'Fat Years' and Austerity Burden*

Just as a feast usually requires dieting afterward, the Latvian economy needed austerity to balance its economic excesses. Prime Minister Aigars Kalvītis (2004-2007) infamously promised the biblical 'seven fat years' for the Latvian people during his reign. At the end of the day there were only three years with economic increases and poverty afterward. After the difficult experience of the 1990s, Latvian society was looking for possibilities to improve living conditions as quick as possible. Hence, slight euphoria about the newly achieved EU membership, an inflow of financial assistance from EU funds, and most importantly the growing availability of lending from resident banks enhanced the rapid growth of GDP and economic activity. The economic situation after Latvia joined the EU was marked by positive and rapid growth in economic activity, internal consumption, and income, as well as falling unemployment numbers. Annual GDP growth was averaging 10%. The main contributor to GDP, however, was the rapidly growing internal consumption – mainly in the construction sector, retail trade, and distribution, due to government expenditure and the inflow of money from various sources outside.

The unemployment figures were falling. As the economy expanded, people were able to find a second or third job, while others entered the job market for the first time. Unemployment figures were dropping not only because of increasing economic activity and an increasing number of businesses (from 46,634 in 2004 to 63,741 in 2008[18]), but also because of workforce

16 Edition.cnn.com, March 29, 2012, Estonia's success: Liberal regulation, strong work ethic, http://edition.cnn.com/2012/03/29/business/marketplace-europe-estonia-quest/index.html

17 Enterprise Estonia, Last year foreign investments in Estonia grew, February 15, 2012, http://www.eas.ee/en/eas/news?option=com_content&view=article&id=4327

18 Ekonomiski aktīvās statistikas vienības statistiskajos reģionos, republikas pilsētās un rajonos, 2004. - 2008.g. – Riga: Central Statistical Bureau of Latvia, 2012. - http://data.csb.gov.lv/Dialog/SaveShow.asp

emigration trends. After Latvia joined the EU, 'old member-states' that immediately opened their labor market – like Ireland or the United Kingdom – became very attractive destinations for Latvian workers. The main reason for leaving was wage differences, and the emigrants left available workplaces for the remaining workers in Latvia. Among the many sectors that demonstrated growth and an increased shortage of labor, the construction sector stood out as the most attractive one. The reason for this, of course, was the high demand for modern houses and apartments, which ultimately resulted from the promise of rapidly increasing wages.

Wages grew on average by 15-20% in all sectors. Encouraged by growing wages and the ability to find additional income through another job, the people of Latvia became economically more self-aware. Hearing the promises and encouragements of politicians, media, leading experts and officials, and most importantly the banks, people increased their consumption rates. Domestic demand grew faster than in other countries in the region before quickly collapsing in 2009. Purchasing power, though, was not fueled only by increasing wages. A large proportion was contributed by emigrant workers sending capital to relatives in Latvia. Some polls found that 68% of income earned while working abroad was spent in Latvia, mostly on housing[19].

The second and more influential aspect was the expansion and increased exposure of the banking sector in Latvia. In particular, Sweden's SEB and Swedbank, along with the local PAREX bank, became notoriously aggressive in their marketing policies and competition. A lack of political will among the elite and economic sense among banking officials in limiting excessive crediting to private businesses and individuals led to the creation of a real estate bubble and net external debt that reached 165.4% of GDP in 2010[20]. The banking sector was enticing the population into borrowing, and approximately 158,000 households[21] had mortgages or other loans with the banks.

Growing internal consumption, increasing real estate prices, and growing wages naturally accelerated the inflation rate. The inflation rate was considered by some to be a normal characteristic of a growing economy and was not seen as an immediately solvable problem. In 2008 alone the inflation rate reached 15.4%. By the end, the high inflation rate not only reduced the relative growth in income, but also temporarily closed the door for Latvia's entrance into the eurozone. The high inflation rate and the pegged exchange rate made it possible to preserve the competitiveness of Latvian goods on the EU and world markets.

At the same time, the external trade deficit of Latvia over the 2004-2008 period averaged 15%. Latvia was importing a significant number of consumer goods from countries like Germany, Estonia, Lithuania, Sweden, Finland, and, of course, energy resources and raw materials from Russia. Rapidly growing internal consumption, facilitated by necessity and a willingness to improve the conditions and achieve the 'promised' average Western living standard, made demand for car and construction material imports more keen. The current account balance, however, did demonstrate some trends of improvement, which was bolstered by the export of services.

This unbalanced economic structure in Latvia gradually led to a situation where it collapsed. As with all economic bubbles, this situation was not sustainable and eventually had to burst. The unwillingness of the Latvian government to apply fiscal and monetary principles and the populist-driven misuse of public revenues led to the deepest economic crisis in the world in

19 Pētījums: Īrijā strādājošie lielāko daļu naudas tērē Latvijā// Apollo.lv, 19.09.2007. - http://www.apollo.lv/zinas/petijums-irija-stradajosie-lielako-dalu-naudas-tere-latvija/364515

20 Pastušenko, J. Explaining the difference between Latvia's gross and net external debt.// macroeconomics.lv, 28.02.2012. - http://www.macroeconomics.lv/explaining-difference-between-latvias-gross-and-net-external-debt

21 Mājsaimniecību finanšu apskats. – Riga: SEB, 2010. – p. 8.

2009. Liberalization and deregulation principles were followed by the government, which maintained budget deficits (approx. -0.6% of GDP[22]) even during the accelerated growth years 2004-2007.State revenues were not only spent on increasing social benefits (including maternity benefits). The state budget was spent on the expansion of the bureaucratic sector as well. Increasing employment possibilities along with growing wages and social benefits encouraged the population to consume more and borrow more from the banks. Mortgages concluded for 30-40 years became a new trend in the Latvian economy and society. Many people could use the opportunities to try out their business idea or to buy an apartment, which would be almost unimaginable in different conditions.

In spite of an active and capable workforce in which having two or even three different jobs became a norm, productivity did not grow as fast as wages did. It balanced out at around 50% of the EU average. Imported products dominated the market and the exporting industries produced less capital intensive, and thus less expensive, products. Instead of turning to innovation, future planning, and increasing efficiency, many companies satisfied themselves with growing internal demand and the possibility to increase prices on their products. Some even turned to the real estate business or started trading property as one of their business segments.

The banking sector grew. Not only had the Swedish banks accumulated more and more loans, Latvian local banks did the same. The infamous PAREX was the first of the Baltic banks that was able to borrow a syndicated loan within international financial markets. This was the same loan that it was not able to repay, and as a result had to be nationalized to save the country's financial system from a bank run. After the financial problems started, other smaller banks mostly survived or experienced a wave of mergers. More and more experts started to stress that the financial sector in Latvia exceeds the capacity of the real economy. The dream to become the financial center of the Baltic region was not achievable without a strong export and production based real economy.

Growing budget expenses, the volatility of the financial sector, dependence on foreign banking capital, the real estate bubble, an increasingly emigrating workforce, low productivity, a loss of competitiveness, and permanent trade deficits led to the crisis that Latvia experienced at the end of 2008. The decision to bail out PAREX was the last drop in the ocean of unsustainability that the Baltic Tiger had turned into.

Austerity was the first and most obvious choice for Latvian politicians. Reforming the tax system, healthcare and educational systems, the state apparatus, and many other sectors that had become large and inefficient became the central political argument of the forthcoming governments led by Valdis Dombrovskis. The main goal of all these reforms was to consolidate state budget expenses, and from 2008-2011 this goal was achieved in the amount of 16.6% of GDP.

The first round of consolidation touched on the reorganization of the state apparatus. A number of subordinated agencies dealing with limited and specific issues under the ministries were reduced from 138 to 80. A similar reduction of the number of institutions was performed in the case of ministries themselves – the number was decreased from 17 to 12. Moreover, a large number of vacant and filled places in the public sector were liquidated altogether. Around 17,000 (25%) of public sector jobs were terminated in the years 2008-2011[23]. This left many public sector workers jobless,

22 Vispārējās valdības sektora galvenie rādītāji. – Riga: Central Statistical Bureau of Latvia, 2012. - http://data.csb.gov.lv/Dialog/Saveshow.asp

23 The number of officials working in the central government institutions was estimated around 68 thousand people in 2011. For more please see Pašlaik valsts pārvaldē mazākais nodarbināto skaits pēdējos 12 gados. – Riga: State Chancellery of the Republic of Latvia, 26.08.2011. - http://www.mk.gov.lv/lv/aktuali/zinas/2011gads/08/260811-vk-02/

and many of these found jobs in the private sector. Some of them retired, some ended up back in other state institutions and are dealing with similar issues as they did before.

In order to save money, the government reduced pensions and managed to stop their indexation, but after the Constitutional Court ruled in favor of pensioners the decision was reversed and the money reimbursed. Similarly, 'more successful' attempts were made in the case of unemployment benefits and maternity benefits. Instead of six months of full wage unemployment payments, this was reduced to one month full, followed by two months at three-quarters wages and then by 45 Lats for the next six months. After some research, 'ceilings' were introduced to maternity benefits, thus reducing the benefits for young moms and dads who had received around the full net wage for a year after the child was born. Additionally, several other tax rebates were suspended or abolished, while value added tax and personal income taxes increased and the tax base, in general, broadened.

Reform plans were introduced in the healthcare system and the educational system. Like other spheres, both these faced a consolidation of expenses, in many cases mechanically rather than in accordance with an outlined plan. Naturally, the government's desire to limit social and political protests during the consolidation period affected the way that cutting expenses was performed. Much of the consolidation was done by limiting available resources while leaving the sector generally unreformed. This reduced resistance from professionals, especially the high-ranking ones, and gave the ministers the necessary stability to perform cuts that later appeared in the macroeconomic situation of the state.

Macroeconomic indicators and the stability of the financial system were the central goals pursued by the multiple governments of Valdis Dombrovskis. The implementation of the Maastricht criteria and eurozone membership in 2014 was set as the central political and economic goal for the state. Because the goals were so clear, they were attractive to general public[24]. Among the first steps to stabilize the financial system was borrowing from the International Monetary Fund (1.1 billion EUR), the European Commission (2.04 billion EUR), the World Bank (400 million EUR), and The European Reconstruction and Development Bank (100 million EUR)[25]. As is traditional, the lending came with secret conditionality principles. The conditions not only affected decisions made by the Latvian authorities and approved by 'the Lenders', but also provided the government with 'a scapegoat figure' in their communication with society.

Stabilization of the financial system through the injection of borrowed money into the banking sector, as well as overall government expenses, allowed the government to regain trust within international financial markets, and later to refinance some portion of the debt by issuing government bonds. Stabilization of the financial system and core economic indicators was seen as the prime necessity during the economic crisis. 'Macroeconomic stability first', became one of the main characteristics of the Latvian Austerity Model (LAM). The second feature of LAM is an 'internal devaluation', which involved wage flexibility instead of mechanical devaluation of the national currency. This naturally allowed the state to preserve its competitiveness.

To preserve and increase competitiveness, several sectors were liberated or supported by tax incentives. Among these were the forest industry and exports of raw wood, the financial and banking sector, and most importantly the industrial sector and exporting businesses. The prioritization of the exporting industries – like food

24 Bukovskis, K. Latvia's Austerity Model in the Context of European Austerity versus Growth Debate//The Rīga Conference Papers 2012. Collection of essays and articles. – Riga: Latvian Institute of International Affairs, Latvian Transatlantic Organization, 2012. – p. 14.

25 Latvija šogad SVF atmaksājusi 112 miljonus latu. – LETA, 09.09.2012. -http://www.leta.lv/news/latvia/0D19FE17-DB61-4EF4-99BE-172C462DFD18/

production, the timber industry, and the metal industry – went hand in hand with a dynamically growing pharmaceutical industry and the value of producers of electronic and optical goods. The exporting industries became the driving force of the Latvian recovery, but their stability and capacity, again, is strictly tied to demand on the international market. Nevertheless, exports were able to substitute falling tax revenues, which were hurt by decreasing internal consumption. As a result, the real estate market and domestic service sectors, including retailers, were among the most hurt industries by the crisis. The banking sector experienced losses in 2009-2011 in the amount of 1.868 billion EUR. But the data shows a return to profits of 128 million EUR during the first seven months of 2012[26]. Thus, it can be concluded that hesitancy with the implementation of necessary fiscal and monetary policy led to the unavoidable austerity measures and the damage to some of the industries that were mainly responsible for causing the structural economic unbalances in the first place. The real estate sector, banking, and the construction sector, as well as everyone employed in those sectors and their clients, were hit the most severely and directly or indirectly dragged the whole country and its population down with them.

## CONCLUSIONS

On the eve of the global financial crisis, neither Latvia nor Estonia were ready for the economic turbulence that prompted them to take tough decisions during peak hours of the global crisis. The implemented economic policy of the Estonian government after EU accession until the eve of the global financial crisis is quite similar to the policy provided by the Latvian government. After accession to the EU, both countries enjoyed obvious economic growth. But this economic growth in both countries was more stimulated by the real estate boom than by real and competitive production. The level of imported goods and services was higher than exports. The increase of GDP was based on construction, wholesale & retail trade, financial intermediation, and real estate. These are the areas that contributed to the bubble, which collapsed and caused the economic crisis in both countries. The Estonian and Latvian economical models were unable to face the challenges of the global crisis, which led to the need for strict austerity policies.

From 2008 till 2011, both Latvia and Estonia experienced a significant economic recession and implemented a list of economic policies to develop their economies. In contrast with Latvia, during the crisis Estonia paid more attention to promoting production rather than reducing social payments. The tax system remained unchanged and the government adopted amendments in legislation that promoted the development of business in Estonia. The percentage of FDI in Estonia from 2008 - 2011 didn't decrease significantly. For foreign businessmen, Estonia was still quite attractive.

One of the main factors that put Estonia in a more favorable position than Latvia was the banking bail out factor. There wasn't any bank in Estonia during the period of global financial crisis that experienced bankruptcy and demanded additional funds from the Estonian government. The Latvian bank Parex, which announced its bankruptcy in 2008, was the main factor that distorted the Latvian budget, causing the economic crisis and forcing the country to borrow money from the International Monetary Fund and European Commission. The rescue of Parex directly and indirectly (through government deposits, guarantees, and investment in the bank's capital) cost more than 1 billion lats, or 20% of its annual budget. This situation forced the country to adopt more strict austerity measures than Estonia.

26 FKTK: Komercbanku kopējā peļņa šogad pārsniegs 100 miljonus latu. – LETA, 06.09.2012.