

Estonia: a new model for the euro zone?

By [Sandrine Levasseur](#)

In the wake of the Swedish and German models, should Europe now adopt the Estonian model? Despite Estonia's *success story*, the answer is no. Here's why.

Estonia has been a source of continuous surprise in recent years. First, it wrong-footed those who, in the autumn of 2008, thought the country had no alternative but to abandon its [currency board](#) and massively devalue its currency. However, Estonia chose a different path, as it strengthened its monetary anchor by adopting the euro on 1st January 2011. The winter of 2008 saw another surprise when the country decided on a significant reduction in civil servant salaries in the hope of creating a “demonstration effect” for the private sector, particularly for businesses exposed to international competition. The government's objective was clearly to help the economy to become more competitive. This strategy, called an “internal devaluation”, worked in the sense that the total wage bill actually declined, with wage losses that could reach up to 10% to 15% at the peak of the crisis. Surprisingly, this decline in wages, which affected every sector of the economy, was relatively well accepted by the population. It was met by only a few strikes and demonstrations, even when the government decided to introduce more flexibility into the labour market (easier redundancy procedures, lifting administrative authorization for the reduction of working time, etc.). Finally, [the ultimate surprise](#) was undoubtedly GDP growth of around 8% in 2011, a fall in the unemployment rate to less than 11%, and a trade deficit of only 2% of GDP (versus 16% before the crisis). Estonia's public debt was contained at 15.5% of GDP, and for

2011 the country even recorded a budget surplus of 0.3% of GDP! This is the stuff of dreams for the other euro zone countries!

Despite all this, the strategy adopted by Estonia cannot be turned into a model for the other euro zone countries. In fact, Estonia's success story is due to a convergence of favourable factors, with two conditions being critical:

1. A strategy of lowering wages makes it possible to become more competitive relative to a country's main partners only if it is conducted in isolation. If in Europe, particularly in the euro zone, every country were to lower its wage bill, the result would simply be sluggish domestic demand, with no positive impact on the countries' exports. To date, among the members of the euro zone, only Estonia and Ireland (two "small" countries) have played the card of lowering wages in the context of the crisis. We can scarcely imagine the impact on the euro zone if Germany or France ("large" countries) had drastically lowered wages at the height of the crisis. In addition to weak demand, this would have inevitably led to a trade war between the countries, which ultimately would not have benefited anyone.

2. A strategy of lowering wages is good for the country that implements it only so long as its major trading partners are on a trajectory of growth. In this regard, the upturn in Sweden and Finland partly explains Estonia's good export performance. In 2011, GDP increased by 4.1% in Sweden and 3% in Finland (against "only" 1.6% in the euro zone). We might expect that exports from Estonia would have been less dynamic (+33% in 2011!) if the growth rate of its two major trading partners had been lower, since between them Finland and Sweden represent 33% of Estonia's export markets.

But does this mean that a slowdown in activity in [Sweden](#) and [Finland](#) – as can be anticipated for 2012 or 2013 – would negate the efforts made by Estonia's workers in terms of pay

concessions? In other words, with respect to the long-term prospects of Estonia's economy, has the reduction in wages been in vain? The answer is no, it hasn't. In Estonia (as well as in the other Baltic states), the decline in wages was in fact necessary to offset the strong wage hikes granted before the crisis, which were largely disconnected from any gains in productivity. The loss of competitiveness of the Estonian economy that resulted could be seen in the winter of 2007, when GDP decelerated significantly and the trade deficit reached an abysmal level. By the spring of 2008, it had become clear that the growth model of Estonia (and of the other Baltic states), based on the equation "consumption + credit + greatly expanded construction", was [unsustainable](#) and that "adjustments" were inevitable in order to reorient the economy towards exports.

A detailed analysis of the adjustments made in the Estonian labour market during the economic crisis (see [here](#)) helps to measure the impact on business competitiveness of the pay cuts, the reduction in working time and the massive layoffs. Overall, the [real effective exchange rate](#) (measured by the unit labour costs of Estonia relative to those of its trading partners) has depreciated by some 23% since 2009. The loss of purchasing power suffered by Estonia's workers is estimated at 9% (in real terms) since 2009, or even at 20% of the gains in purchasing power obtained in 2004-2008. Among the institutional and societal factors that led Estonians to accept the wage cuts and a more flexible labour market, the absence of strong union representation seems to be an important explanatory factor. For example, in Estonia, fewer than 10% of employees are covered by collective bargaining agreements (against 67% in France). The other key explanatory factor seems to have been the desire to join the euro zone. In these difficult times for the single currency, if this willingness seems surprising, it is nevertheless still [relevant for a certain number of EU countries](#) that have not yet adopted the euro.