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Limiting one's policy choices through a currency board: a rewarding shock therapy approach for Estonia?

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LIMITING ONE'S POLICY CHOICES THROUGH A CURRENCY BOARD -
A REWARDING SHOCK THERAPY APPROACH FOR ESTONIA?

A Thesis Presented
by
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University of Massachusetts Amherst in partial fulfillment
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LIMITING ONE’S POLICY CHOICES THROUGH A CURRENCY BOARD -
A REWARDING SHOCK THERAPY APPROACH FOR ESTONIA?

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<tr>
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<th>Full Form</th>
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<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<td>CSCE</td>
<td>Conference on Security and Cooperation in Europe</td>
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<td>DEM</td>
<td>Deutsche Mark</td>
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<td>ECU</td>
<td>European Currency Unit</td>
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<td>EEK</td>
<td>Eesti Kroon</td>
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<tr>
<td>Eesti Pank</td>
<td>Bank of Estonia, the Estonian central bank</td>
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<tr>
<td>EIU</td>
<td>Economist Intelligence Unit</td>
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<tr>
<td>EMS</td>
<td>European Monetary System</td>
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<td>ESSR</td>
<td>Estonian Soviet Socialist Republic</td>
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<td>EU</td>
<td>European Union</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GDR</td>
<td>German Democratic Republic</td>
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<td>KMÜ</td>
<td>Estonian Coalition Party and Rural Union</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>NATO</td>
<td>North Atlantic Treaty Organization</td>
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<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>SDR</td>
<td>Special Drawing Rights</td>
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<td>US</td>
<td>United States of America</td>
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<td>Abbreviation</td>
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<td>USD</td>
<td>US - Dollar</td>
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<td>USSR</td>
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<td>VAT</td>
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CHAPTER I
INTRODUCTION

Market Reforms in Eastern Europe and the Former Soviet Union

After the hold of the communist ideology among both elites and the population at large had gradually weakened to an extent that the people of the former Eastern bloc could finally remove the communist regimes from power, plans were made to reorganize the economies that had been nearly completely ruined by decades of communist management.

The Leninist economic framework was thoroughly discredited, but it was not clear how the transformation to a market economy should be made. The theoretical conception of how to accomplish such a transition and how to revive the Eastern national economies that received the most attention demanded radical economic reforms. It has subsequently become generally known as ‘shock therapy’ or ‘big bang’, and was summarized in a 1990 article in The Economist by Jeffrey Sachs, professor at Harvard University and then economic adviser to the governments of Poland and Yugoslavia.¹ He denounced any ‘“third way’, such as a chimerical ‘market socialism’,”² which several Eastern states had embarked on at that time only to see their economic instability increase, and he proposed instead a four-part transformation program that he claimed would yield the greatest success. First, establishment of real, market-clearing prices, second, liberalization of private

² Ibid., p. 21.
economic activity, third, privatization of state enterprises, or at least their subjection to market discipline, and fourth, macroeconomic stability through low inflation and a balanced budget. With this concept, he was arguing against the proponents of a more gradual change. While both parties have the same outcome in mind, that is the creation of capitalist and democratic institutions, the 'gradualists' prefer a slower pace of change and reforms, on the ground that the transformation process in Eastern Europe is unprecedented and without a sufficiently established conceptual framework. In their eyes, rapid change will then lead only to the destruction of national economies, and while the old system is quickly destroyed, efficient democratic structures will fail to emerge, simply because this is a process which takes time. A likely consequence would be the coming to power of political forces which abandon reforms, and maybe even the commitment to democracy, endangering thereby the transformation process as a whole.

The shock therapy approach has profoundly influenced the reform policy decisions of Eastern European states. Now, after several years of transition, the effects of the economic, social and political change can be observed. As a consequence, the radical reformers have to deal with critics who claim that the fall of the Eastern economies, expressed in an unprecedented decline of the GNP, has been higher than necessary, because shock therapy demanded, for example, the breakup of the old Comecon markets, and it thus pitted one country against the other in a race for integration into the Western European markets. In the critics' view, declaring that radical reforms were the only way to enter the world markets has allowed the governments to "legitimiz[e] privatization, unemployment, social differentiation and the impoverishment of large sections of the
While progress, at least in the way that is quantifiable in statistic economic data, can be presented, the GDP growth is rather small, so that a return to the ‘pre-shock’ living standards appears to be unlikely within the next decade. Moreover, increasing income and wealth differentials threaten to destabilize the civil society. Instead of meeting human needs and shifting the focus of attention to the development of employment and social welfare policies, the countries’ economic and social structures are resolutely prepared to come up to Western requirements in order to attract investments — “the inculcation of the neoclassical paradigm is pervasive”.

The advocates of rapid reforms never denied the fact that the process of rapid transformation is a painful one, but they discounted these costs in favor of the benefits of the quick and successful recovery that these countries would undergo in the following. Moreover, they do not claim that shock therapy is supposed to shape domestic policies forever. At a certain moment during the transition process, a moment which was, however, not exactly determined by the theorists, market economy will be established, and the country will be able to adjust the socio-political framework according to its wishes and needs.

**A Test Case for Shock Therapy: The ‘Estonian Way’**

The Baltic states, Estonia, Latvia and Lithuania, were three of the republics that emerged as independent nations as the Soviet Union collapsed. Like all former states

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with a centrally planned economy, they were willing to face the hardship of the transition to an economy determined by market forces. Unlike the Eastern European countries, they were also faced with the additional challenge of re-establishing a separate economy after almost fifty years of complete integration into the economic system of the Soviet Union. This meant a reorientation of trade, at least partially, from the former Soviet republics towards the West. The main feature of this second challenge, however, was the introduction of a national currency, a milestone both economically as a step to de-link from the Russian ruble-zone and psychologically as a significant symbol of national sovereignty and independence. However, a new currency is generally prone to instability, due to its lack of reputation in the financial markets, which is largely due to uncertainty about the new government’s ability to successfully manage the exchange rate in an environment of rapid and erratic political and economical change.

Estonia serves as a prominent example of a country in which the shock therapy paradigm for the formulation of economic policies for transition countries profoundly influenced the way reforms were approached. The country implemented liberalization, privatization and stabilization measures in all fields of economic activity, and it implemented them rather quickly. Most of all, it established a currency board as a device to ensure currency stability, a policy which leaves little room for deviations from the radical path through its restrictive impact on almost all fields of economic decision making. The ‘Estonian Way’, as I will call the country’s approach to reforms, therefore includes not only the radicality and speed of shock therapy, but also its ‘institutionalization’ in the form of a currency board. The result has been a largely painful process of adjustment to
the new economic reality. The country can therefore serve as a ‘test case’ for the shock therapy approach. As I will show in this paper, the Estonian reform measures, spearheaded by the currency board, are likely to remain in place until the transition process has come to a point where shock therapy can be replaced by ‘fine tuning’, because shock therapy has succeeded well enough to prevent the formation of a strong coalition of opponents.

**The Currency Board as the Epitome of the ‘Estonian Way’**

The government of Estonia decided to peg its national currency, the kroon (crown), to the German deutschmark. To shield it from inflation and devaluation, and to avoid the detrimental effects that a weak currency would have on Estonia’s plans to develop into an open economy linked to the world markets, the viability of this peg was reinforced through the restrictive mechanism of a currency board. This rather unusual method of exchange-rate management, which has mainly been used by Hong Kong and a number of other British colonies, epitomizes the very firm approach to reform which Estonia had chosen, along the lines of the shock therapy theory. Its rigidity sets Estonia apart from other states, including its Baltic neighbors. While Lithuania and Latvia have recently pegged their currencies to the US dollar and the SDR of the International Monetary Fund, respectively, neither the process of currency reform itself nor the political approach to market reforms were as radical and drastic as in Estonia, nor have the other former Soviet republics adopted such a radical approach. Thus, the ‘Estonian Way’ provides a particu-
larly clear case, permitting for an assessment of how successful the radical reforms approach, the shock therapy, is.

The major political goal for Estonia is integration into the Western European world. A ‘Return to Europe’ is vital to this country in light of statements about the reconstruction of the old Russian empire issued by certain political factions in Moscow. The fact that Russian troops continued to be stationed on Estonian territory until the last units were finally withdrawn on August 31st, 1994, did not help to put the minds of the Estonians at ease. Integration, however, requires the adoption of the rules and norms of the international trade regime and thus a degree of economic openness that makes it impossible to impose tight restrictions on trade and capital flows to create exchange rate stability.

The decision to adopt a fixed exchange rate and the currency board demonstrates that the Estonian government chose to use the exchange rate as a ‘nominal anchor’. This is the academic term for an approach to exchange rate policy in which the exchange rate is primarily used to tie domestic inflation to the inflation rate of another country, most likely an important trading partner. This means that the Estonian government regards its exchange rate policy as an instrument for avoiding the hyper-inflationary tendencies that broke loose in many of the other former Soviet republics after 1991. Next to this stabilization effect, it is also supporting liberalization by importing the world market prices as the basis of calculation for the domestic production. As the domestic monetary policy is under this regime exogeneously given, it serves as a credible signal for domestic price

5 In the case of Estonia, the choice fell on the deutschmark because of its stability, the trade links to Germany, the high volatility of the dollar, and because it was better to understand for the population than a basket, such as the ECU. See Rudnick (1993), p.160.
The nominal anchor approach is also a deliberate constraint of the domestic policy choices. The scope of monetary and fiscal policies is limited, because deficit spending is not possible if the peg be maintained. Unable to borrow from the currency board to balance its budget, the Estonian government could pursue fiscal policies in two ways. It could either impose tight restraints on imports, which would not be compatible with its goal to establish an open economy, or it could borrow money, which would crowd out private borrowing and therefore seriously hamper economic development. As a consequence, the government has to remain committed to a balanced budget. The nominal anchor approach, especially since it is strongly backed by the currency board mechanism, also influences the actions of the private sector. It lends credibility to governmental stability policies, which induces private agents to adjust their price and wage settings, which is in turn an important prerequisite for every successful stabilization program. Credibility is achieved by the fact that a currency board is not able to finance budget deficits of the government, a procedure that is widely regarded as the main cause of inflation and currency instability. The currency board of Estonia provides the country with a kroon as stable and reliable as the currency it is pegged to, the deutschmark. The stability of the kroon has proven to be a major asset for the economic transformation of the former Soviet republic, as well as for its ability to attract investment and to establish new links and patterns of production and trade with the world.

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6 As opposed to the 'real targets' approach, in which the nominal exchange rate, along with other policy instruments, serves as a tool for the government to actively pursue internal and external equilibria.

7 Especially since access to capital is very limited in an underdeveloped domestic capital market such as Estonia’s.
Yet, the 'price' of this success is high. Since having a currency board leaves the government with very few and restricted policy instruments for steering the economy, adopting this approach basically means giving up one of the central features of national sovereignty. As the economic history of a vast number of newly emerged states of the last thirty years shows, governments have generally been very unwilling to relinquish this power. As a result, they sooner or later used the central bank to ‘run the press’ and finance the deficit, which caused inflation, loss of credibility, and with it the loss of low-cost access to international financial markets.

Viability of the Estonian Way

Since the currency board is one expression of the Estonian shock therapy approach, it is not meant to be in place for eternity. This was indeed stated at several occasions both by the economists who proposed it⁸ and by the Estonian government that implemented it. The success of the currency board, and with it the success of the Estonian Way, can therefore be assessed by the circumstances under which it will be abandoned. Two different scenarios are imaginable. First, the currency board is dropped under the pressure of those who have suffered from the transition process, and the resulting policy changes are a backlash against shock therapy. Second, the currency board is dropped because the government no longer regards it as necessary for the transition, and the resulting policy is not a radical change, but rather still a commitment to the principles of a market economy. The first case might be accompanied by the rise of a large oppositional movement, which

⁸ See, for example, Hanke, Jonung and Schuler (1992).
is maybe even directed against the democratic principles, some degree of public unrest, and the demise of the governing party or coalition. The Estonian Way would then have failed to bring the economic stability predicted by the underlying macroeconomic theories, and it would have failed to support the development of democratic structures the political stability, as it was expected to come with positive economic development. In the second case, it would be a success, because it actually did support the creation of a democratic framework within which the market economy can be formed according to the political will of the Estonian people. The governing party or coalition may lose its power and have to go into opposition, but it will not be profoundly discredited.

An assessment of the viability of the Estonian Way must therefore be extended to include the political repercussions of the economic development of the last years in transition.

According to the statistics published by Estonian authorities as well as international institutions, and according to the laudeats issued by the international economic press, the Estonian Way seems to be working out so far. Economic development is indeed astonishing, and the currency remains stable. The currency board as a device for monetary stability is working the way it was conceptualized. However, even though reforms have already come a long way, the country is still not at a point where the transition period can be considered complete.

The introduction of a currency board in 1992 met little opposition, apparently because of a general consensus brought about by both the fear of a devastating hyper-inflation and the desire to get rid of the ‘occupation currency’, the Russian ruble. Estonian economic
planners were expecting that the maintenance of a stable and reliable currency would be well worth the sacrifices, since it will foster economic development, and this will in turn deliver economic benefits to the majority of Estonians. However, an economic policy which stresses efficiency nevertheless has distributional effects, which will almost certainly leave particular social groups dissatisfied, to say the least. Four years of economic transition have definitely yielded different gains - or losses - for different social groups. Gains of wealth are recently indicated by the statistics, but they have surely not been evenly distributed. The strong commitment to a balanced budget leaves little room for appropriate social security and welfare institutions.

So far, the widespread consent in the Estonian society that economic hardship has to be endured to keep the currency stable and the economy recovering, has survived even the dramatic decrease of the economy that followed immediately after the currency reform. However, different gains and losses can be reasonably expected, and thus the economic conditions of different social groups have to be taken into consideration. Political tensions are most likely to arise out of the situation of people who either fear to slide down the social ladder or see no chance to climb up. People who depend on social benefits, such as the unemployed, or whose only income is a pension, such as the elderly, are suffering from an insufficient social security net, which can only pay little money if the government is forced to balance the budget and to closely monitor its expenditures. In the case of Estonia, a ‘derelict’ of the Soviet era, a large group of ethnic Russians which is a generally highly skilled work force but yet without Estonian passports, deserves special attention, because economic aspects become mixed with nationalistic ones in this con-
text. If the ‘losers’ of the reforms seek to improve their condition, they might eventually demand that the existing policy be abandoned as a whole, if government measures to ameliorate their situation that are compatible with the economic reforms prove to be ineffective or insufficient. The broad coalition of consensus that supported the establishment of the currency board would then break apart. This might in turn lead to a break with the strict policies of the currency board approach and the path of monetary austerity, which in turn might endanger the reform process in general.

Scope of This Study

In the following chapters, I will show that the Estonian Way and its distributive effects have not given rise to a coalition of economically disadvantaged groups that might topple the arrangement before the transition is perfect and before Estonia could drop the currency board. If no unexpected external shocks make all economic calculations and predictions obsolete, the country is likely to continue with its present policies. This means that the government will be able to reap the outcome it expected from voluntarily limiting its policy choices through the adaptation of a currency board - a stable currency and with it positive economic development, which is undoubtedly one of the pillars of a politically stable society. The Estonian Way will find its way into the history books as a success, and with it all the economic theorists that have advised the currency board approach will have reason to rejoice.

As this thesis discusses the implications and results of the shock therapy approach in the case of one small country, it is as much a case study as it deals with a general model
of economic theory. The mechanisms specified in a model, and the propositions for policy formulation derived from it, may apply to all Eastern economies, the results, on the other hand, depend on the special circumstances under which each country finds itself. Chapter II will introduce the reader to Estonia, its history, and the economic and social conditions under which it had to operate after it regained independence in 1991. Chapter III begins with a description of the main reform measures that are part of the Estonian Way, and it will discuss the economic and security considerations that stand behind Estonia's decision to turn to the West and the open liberal markets of the world trade regime. This is followed by an introduction to the economic theory behind the central feature of the Estonian Way, currency stability. A discussion of the importance of a stable currency and the role of the exchange rate regime as an instrument in the battle against inflation is followed by a comparison of the general features of a central bank and a currency board as two institutions that can back an exchange rate regime. Chapter IV will then introduce the Estonian currency board, beginning with the events that led to the currency reform in 1992. The institutional set-up of the board will be explained, I will show where the Estonian board corresponds or deviates from the theoretical model. This is followed by a short report on how the new currency was introduced. The chapter concludes with a discussion of the performance of the Estonian currency board from 1992 until today. In chapter V, the results of the reform measures will be presented through a review of the overall economic performance of the Estonian economy. I use selected economic indicators: the development of the GNP, the inflation rate, the employment situation, the development of international trade, and the development of foreign direct
investment. In chapter VI I will discuss the shadow economy and its effects on the reliability of the figures presented in the chapter before, and with it its effects on the possible level of dissatisfaction within the Estonian society. This is followed by a presentation of the various groups that have been hit the hardest by unemployment. Then the situation of Estonia’s largest foreign ethnic group, the Russians, is presented. How little the dissatisfaction in Estonia has transferred into political pressure is shown in section VI.D, when the development of the political landscape is reviewed. That quick and radical reforms can also be well conceptualized, which can only bolster the support for them, is shown in the last paragraph on banking reform. The paper is concluded with an argument to be cautious. Even if the Estonian Way turns out to be a success, it does not yield satisfaction. Shock therapy promises to lead a country to the Western economic world. As glamorous as it might appear, and even if one considers it to be better than the alternatives, it is still not paradise.
CHAPTER II
HISTORICAL AND ECONOMIC OUTLOOK

A. A Brief History of Estonia

Estonia, the northernmost of the three Baltic states, has not always been as removed from the European stage as it was during its decades as a republic of the Soviet Union. When the country was annexed by Joseph Stalin in 1940, it was in fact “stolen or kidnapped from the European family” of which it had been a sovereign member since its independence after World War I.

The native tribes of the Baltic region were invaded and colonized by German and Scandinavian crusaders in the 12th and 13th century, and the region was then subject to a wide variety of rulers. The Danes, the Teutonic Order and the Swedes were ultimately followed by the Russians under tsar Peter I (the Great) in the 17th century. In the late 18th century, Russification policies employed by the rulers in Moscow turned against the social structure of the German-speaking landowner class and, less successfully, against the awakening of a cultural national identity of the Estonians. In the beginning, it was mainly the urban intellectuals who showed increasing interest in the special features of Estonian culture, such as the language, folk songs and costumes, but towards the end of the century, these activities found their expression more and more in political demands and popular agitation. This gradual development of a national consciousness finally re-

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sulted in a strong movement for independence that stepped forth during the Russian
revolution of 1905. It was violently repressed by the tsarist forces, however, and it was
not until the Wilsonian ideal of the right of self-determination of the people became an
international norm, and both the German and Soviet Russian occupation forces were
sufficiently weakened after World War I, that Estonia reached sovereignty and state-
hood, along with the other Baltic states, Latvia and Lithuania.

Due to its geographical location, the region had served as a trading post for the east-
west routes as well as for the north-south trade as early as the 13th and 14th century. The
Order of the Teutonic Knights was a member of the Hanseatic League, to the profit of
the merchants of the main Estonian seaports. At the same time, however, the German
knights established serfdom and maintained a feudal system in the rural parts, which ex-
cluded large parts of the native population from the beneficial trade of the urban areas.
The Russians kept this system under their rule, which ensured them the loyalty of the
landed German gentry of the region. After the peasantry received personal emancipation
between 1816 and 1819, the way was open for industrial capitalism to develop. By the
end of the 19th century, Estonia had become most heavily industrialized province of the
Russian empire.

In the years following its independence, Estonia introduced a democratic constitution
and was admitted into the League of Nations together with its Baltic neighbors. The na-
tional currency, the kroon, was introduced for the first time. Even though the democratic
history of Estonia became tainted after growing political instability in the 1930s led to
the suspension of the parliament and the introduction of an authoritarian regime that
ruled by decree until 1940, it was this period of the ‘First Republic’, the only period of political self-determination in the history of Estonia, that the separation movement of the late 1980s would refer to in its quest for the restoration of independence.

In 1939, Nazi Germany and Russia signed the Molotov-Ribbentrop pact, which assigned Estonia, Latvia and Lithuania to the Soviet sphere of influence. In 1940, the Red Army entered the Baltic territories, dissolved the governments, secretly deported or killed their leaders, and created a pro-Soviet government after an election in which only the Estonian Communist Party was allowed to run. Following a formal request of this puppet regime, Estonia was admitted as a republic into the Soviet Union on August 6, 1940.¹⁰ While the country came under German Nazi rule from 1941 to 1944, the Red Army regained possession of the country at the end of World War II, and the Soviet era continued.

Economically, the era of independence brought a quick recovery from the devastation of World War I. A land reform was carried out which broke up the large estates of the Baltic German nobility and increased the number of small farms by about 100 percent. As a result, almost one half of the population was employed in the agricultural sector. The industrial sector showed significant progress as well, and doubled its production in the late 1930s. Both Estonia’s economic development and its situation equaled that of its Scandinavian neighbors at that time.

Soviet rule drastically changed the economic structure of Estonia. Not only were the Bolsheviks quick to nationalize the Estonian economy after their takeover in 1940, they

also tore down large parts of the already war-ravaged industrial facilities to reconstruct them in Russia. The country also suffered significant losses of population, especially of its educated upper classes, which emigrated in large numbers. 10,000 Estonians were deported by the Russians in 1941. Between 1941 and 1944, the Nazis persecuted Communists and the Jewish population. When the Russians returned in 1944, about 70,000 Estonians fled into exile to Sweden, Great Britain, the United States and Australia, setting up communities that lobbied on behalf of their mother country in the following decades.\textsuperscript{11} Another 25,000 people were deported in the wake of the agricultural collectivization of the late 1940s. Between 1940 and 1950, a total of over than 200,000 people were killed, deported, forcefully conscripted into the Russian army, or went into exile, out of a population of slightly more than one million.\textsuperscript{12} A shortage of labor force was the consequence, especially since the Soviet Union pushed the development of industrial production facilities. In the following decades, many people from other Soviet republics, mainly from Russia, would be settled in Estonia, a policy that profoundly altered the ethnic composition of the country.

With the ultimate decay of the Soviet Union, the forces of independence came forth again. Estonia’s statehood had remained being recognized by the Western world. What appeared as an insignificant act of formality in the face of the reality of Russian dominance, gained momentum when the rallies for independence started. It gave the movement a legitimacy that went beyond secessionism to the restitution of an independent

\textsuperscript{12} Van Arkadie and Karlsson (1992), p. 91.
statehood which had never ceased to exist not only in the minds of the Estonian people, but also in the eyes of major foreign powers.

The drive for independence developed out of ecological protest movements which were made possible by the era of liberalization that had arrived through the introduction of Michail Gorbachev’s policies of glasnost\(^\text{13}\) and perestroika\(^\text{14}\) in the second half of the 1980s. Further autonomous political actions followed. Estonian liberal economists published a plan for economic autonomy. Peaceful demonstrations, accompanied by the singing of traditional Estonian folk songs, took place in the streets. The publication of the secret protocols of the Molotov-Ribbentrop pact in 1989 revealed the illegitimacy of Soviet rule over Estonia and fueled further protests. In 1990, radical groups started to register citizens of the pre-war republic and their descendants, declaring that this was the only electorate that could legitimately decide about Estonia’s future. In February 1990, the ‘Congress of Estonia’ was elected as a counter-parliament to spearhead the struggle for independence. The importance of the Congress, however, was limited by the fact that one month later elections for the ‘official’ parliament, the Supreme Soviet,\(^\text{15}\) gave a decisive 70 percent majority to pro-independence forces, even though the electorate included also residents that were not ethnic Estonians.

Although there were no events in Estonia similar to the crackdown on civilians by Soviet Union military forces in Vilnius and Riga in January 1991, the acceptance of Russian rule and the Soviet regime further deteriorated. The culmination point came with

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\(^{13}\) "Russian term for public discussion of issues; accession of information..." Glossary (1996), p. 283.

\(^{14}\) "Literally, restructuring. [The] campaign in the Soviet Union in the middle to late 1980s to revitalize the economy, communist party, and society by adjusting political, social, and economic mechanisms" Glossary (1996), p. 284.

\(^{15}\) The Supreme Soviet was later renamed the Supreme Council.
the coup in Moscow on August 19, 1991, and the declaration of support for it by the Baltic Soviet military command. While Soviet troops were on the march towards Tallinn, the Supreme Council declared full independence on August 20 and asked for international recognition. The coup collapsed within a few days, and Estonia was recognized internationally in the following weeks. The USSR itself accepted Estonian independence on September 6. Shortly thereafter, it declared its own dissolution and ceased to exist on December 31, 1991.

B. The Social and Economic Structure of Estonia at the Outset of Independence

1. The New Country

Estonia has a land area of about 43,200 square kilometers, which includes 1,520 islands in the Baltic sea.\(^\text{16}\) While the lower parts of the country are marshy, the upper regions possess fertile soils. The highest elevation is 318 meters above sea level. About 40 percent of the country consists of forests, twenty percent of the area is covered by marshlands. In the northern parts, eastward of Tallinn, oil shale is mined, which is, however, of rather low quality. Other significant natural reserves are phosphorites, limestone and dolomites.

The population in 1989 was 1.565 million. The extreme change of the ethnic composition of the country is illustrated by the following figures.\(^\text{17}\) In 1939, 88.2 per cent of

\(^{16}\) Total size 45,226 square kilometers, “slightly larger than Vermont and New Hampshire combined”. Pettai (1996), p. 3.

\(^{17}\) For the figures on the ethnic composition of Estonia, see Brawer (1994), p. 63.
the population, about 1,000,000 people, were Estonian. As mentioned above, from 1945 on people from other parts of the Soviet Union were sent to Estonia to work in oil-shale mining and the developing heavy industry. The census of 1989 showed that only 61.5 per cent of the citizens of the ESSR were ethnic Estonians, while ethnic Russians, Belorussians and Ukrainians constituted 36 percent. By 1994, these relations had not significantly changed.\textsuperscript{18} About 70 percent of the population lives in urban areas. The major cities are the capital, Tallinn, with 500,000 inhabitants, and Tartu, with 110,000 inhabitants and a university that was founded in 1632 by the Swedish rulers. Other major towns are Narva, with 82,000 and Kohtla-Järve with 77,000 residents. The non-Estonian population is very unequally distributed over the country. As the immigrants were predominantly employed in the heavy industry, they were settled in the highly industrialized region in the north-east, where Estonians became the minority. Only 47 percent of the inhabitants of Tallinn, for example, are Estonians, and so are only a minority of 4 percent of the residents of Narva. The rural parts, on the other hand, remained rather homogeneously Estonian.

2. Estonia’s Economy at Independence

At the outset of independence in 1991, the new Estonian state had to deal with the legacy of fifty years of Soviet Russian annexation, a period in which not only the ethnic composition of the population was altered immensely. Soviet rule also affected the

\textsuperscript{18} See the 1994 estimates in Pettai (1996), p. 4.
structure of the Estonian economy and the minds of the individuals. Since Estonia had already been one of the more industrialized regions of the USSR, the central planners turned the region into a ‘production facility’ of the Union. Large state enterprises manufactured all kinds of goods, while they procured the raw materials from other parts of the Union. Facilities for military production and the exploitation of the natural resources of the oil shale region were also set up. The small farms were collectivized, that is, combined to gigantic agricultural production facilities, a policy which profoundly transformed the rural regions. As a result, entrepreneurship largely disappeared both in the industrial and in the agricultural sector. Individual economic activity was replaced by the collective goal of plan fulfillment.

When Estonia was incorporated into the system of centralized planning of the USSR, the old pre-war trade patterns were disrupted, and the country became dependent on the demand and supply markets of the other Soviet republics, most prominently those of Soviet Russia. Estonia changed from its predominantly agrarian structure to one of the leading industrial regions of the USSR. The nationalization of enterprises destroyed the economic basis of the local capitalist and the middle class. Expansion under the Soviet regime led the industrial sector to account for 50 percent of the net material production by the end of the 1980s. 33 percent of the workforce was employed in industry, with an average number of employees per enterprise of 792.19 The concentration of industrial production in the oil-shale region in the North-East led to new centers of industrialization and a clear distinction from the agrarian south. Though oil-shale as a source of en-

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19 As a comparison, the average for the European Community is 160 employees per enterprise. See World Bank (1993), p. 86.
ergy is not an economical input factor at world prices because of its costliness, it constitutes one of the few energy sources of the region. The textile production sector, already strong in the pre-war republic, was also heavily dependent on imports of raw materials, such as cotton, from Russia, and its future comparative advantage was questionable after the break with the Soviet Union. Estonia’s industrial strongholds were a relatively diversified sector of machine-building and metallurgy and the food products industry, which employed about thirteen per cent of the industrial labor force, as table 1 shows. With the shortages of raw material from Russia, the sector had already suffered a severe decline of production during the final days of the Soviet era, a situation which would continue after economic independence was established and makes short-term adjustment problematic.

The many small farmers had to give up their piece of land, people and property were collectivized in huge agricultural enterprises. By 1990 only 12 per cent of the labor force were employed in the agrarian sector, which accounted for about 22 per cent of national production, the most important products being meat and dairy products. The agricultural sector also provided the major share of the input of the food industry, which accounted for another 24 percent of the total net material production. Yet, Estonian agriculture depended heavily on input imports from other Soviet republics, especially fertilizer and feed grains for the large collective farms. Along with all other sectors of the industry, fuel shortages caused significant problems for agriculture. The multi-faceted task the

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21 Ibid., p. 100.  
agrarian sector faced at the outset of independence was the restitution of property rights that date back to the pre-war republic, the introduction of a pricing system for input and output, and the establishment of a support system that would be able to provide the technological assistance and information processing necessary for a market-oriented agricultural production.

Table 1: Industrial Structure of Estonia in 1989

<table>
<thead>
<tr>
<th></th>
<th>Share of Industrial Production (in %)</th>
<th>Employees (in 1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electrical Energy</td>
<td>6.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Fuel Industry</td>
<td>2.6</td>
<td>11.3</td>
</tr>
<tr>
<td>Chemicals</td>
<td>9.2</td>
<td>16.2</td>
</tr>
<tr>
<td>Machinery / Metalwork</td>
<td>14.4</td>
<td>58.2</td>
</tr>
<tr>
<td>Timber, Pulp, Paper</td>
<td>9.1</td>
<td>28.0</td>
</tr>
<tr>
<td>Building Materials</td>
<td>3.6</td>
<td>14.3</td>
</tr>
<tr>
<td>Light Industry</td>
<td>26.4</td>
<td>43.3</td>
</tr>
<tr>
<td>Food Industry</td>
<td>23.9</td>
<td>28.2</td>
</tr>
<tr>
<td>Others</td>
<td>4.8</td>
<td>14.6</td>
</tr>
<tr>
<td>All Enterprises</td>
<td>100</td>
<td>221.3</td>
</tr>
</tbody>
</table>

It was obvious that the Soviet policy of establishing gigantic industrial and agronomic enterprises had to be radically reversed, because with independence, the input supply channels were now transnational, the Eastern markets were lost, and the products had to be priced at real market levels. However, even though the industrial structure was so completely out of line with the demands of the international markets, the chances for small Estonia to successfully adjust to open market conditions were still conceived to be better than those of most other republics. The import and export share of the total production of Estonia was notably higher than the average Soviet Union rate. In 1990, the ESSR exported about 42 percent of its output. However, about 90 to 95 per cent of these exports went to other Soviet republics, and about one half of the remainder to other Socialist states. New markets and trade connections had to be established. In the course of the Gorbachev reforms, all Soviet republics and state enterprises were granted the right to negotiate trade agreements directly in 1989. As a consequence, the number of Estonian economic institutions with direct foreign-trading rights - and connections - had risen to 3,200 by 1991.24

One of the sectors that has been attributed the best chances for future development is the services sector, mainly the tourism industry. The old towns, the shores, islands and numerous inland lakes of Estonia had already been the source of streams of tourists, mostly from the Eastern world. With the end of this low value mass tourism, the country has now the unique chance to upgrade this sector and to move to higher standards. While this promises more economic benefits, it will, on the other hand, put less strains on the

The development of the following years showed that day-visitors from the northern neighbor Finland who make use of the price differences between the two countries, account for most of the tourists. While they contribute considerably to the foreign currency earnings of the Estonian economy, they are surely not clients on which a flourishing tourism industry can be founded.\textsuperscript{26}

The results of 50 years of socialist regimes were discernible not only in the material condition of the country, but also in the psychological condition of its people. Like individuals in all former socialist countries, regardless of their ethnic background, Estonians were psychologically affected by the centralized system. The country was pervaded by a lack of incentives and motivation for economic activity, created by the absence of economic freedom. These effects were most visible in the agricultural sector. The farmers had been taken from their own piece of land and transferred to large state cooperatives, and the decaying remnants of their houses can still be spotted in the landscape today. The effects of this agrarian reorganization were so extensive that the abandoning of fields, which were subsequently reclaimed by the forest, led to a phenomenon very unusual for Europe - the woodlands in Estonia nearly doubled over the decades of Soviet rule.\textsuperscript{27} The land reform that followed independence left numerous highly specialized ‘workers of the agrarian industry’ with their own share of the land and, if lucky, with their own share of the production facilities. The new independent farmer, maybe a for-

\textsuperscript{26} See Jaakson (1996), pp. 625-26
\textsuperscript{27} See Lieven (1993), p. 3.
mer tractor repair technician, was now suddenly challenged with the task of mastering all activities related to farming, such as financing, input procuring, planting, harvesting, and product marketing. Success will therefore depend on the farmers’ ability to quickly adapt and to gain knowledge.

The industrial workers experienced for decades that a system in which minimal personal effort would get them just as far as tireless labor and enthusiasm, which left them with a passivity that especially older workers are unlikely to be able to overcome very soon. Most of all, the managerial class worked on an incentive basis that left them rather helpless when the markets were opened. Rewards, which were hardly ever monetary, were given for plan fulfillment, a rather static goal compared to the dynamic management processes of the competitive Western markets. Therefore it was seen that the “aggregate effect of industrial managers’ lack of adaptability to the new economic order poses more than an obstacle to reform efforts” as they could endanger the reform effort as a whole as they cannot lead their enterprises effectively into the new era. The only group of economic subjects that should easily be able, as a whole, to profit from the new arrangements, are the entrepreneurs. First, even the Soviet system provided some limited opportunities for entrepreneurial activities, which were rewarded, for example, by political influence or a permission to travel abroad. Second, entrepreneurial spirit was never completely suppressed in the Baltic states.

29 Quality, for example, can be one of the explicit goals of an enterprise, as in the concept of Total Quality Management. Another example is the permanent improvement of the production process as a goal of every employee, as expressed in the concept of Kaizen.
At the outset of independence, economic reforms already had a substantial history in Estonia, even though the country was in this area far behind the Eastern European economies. As early as 1987 an economic plan, mapping out ways to ensure a substantial amount of economic independence within the Soviet Union, was received with wide support. As more and more younger communist leaders, inspired by the liberalization efforts of the Soviet leader Gorbachev, replaced the old guard of hard-liners and advanced into leading positions, the plan gained momentum, and economists started planning reforms and worked towards their implementation. Even though the rulers in Moscow tried to slow down the process and to water down the reform provisions, price liberalization and a tax reform were carried out and a national central bank, the Bank of Estonia, was constituted in 1989. These changes had to be compatible, at least superficially, with the old Soviet system, and are therefore hardly comparable with the radical reforms that political independence would later allow. However, these early efforts brought together intellectuals, a "semi-clandestine group of scholars", who were economists, businessmen, politicians, and in more than one case all at once. They entered upon discussions of economic theories and became familiar with planning, policy making, and the implementation of reform programs. When the time was ripe for the ultimate step, these new leaders were not only familiar with neoclassic economic theory and the discussion between 'shock therapists' and 'gradualists', they were also very much in favor of the radical solution as the most promising approach to reforms, because they could study the develop-

opments of other countries which had been able to embark on the road to free market economies much earlier.
CHAPTER III
ECONOMIC THEORY AND THE CASE OF ESTONIA

A. The Twin Policy Goal

As a country determined to transform into a market economy linked to the wider
global economy, Estonia faced the twin policy goal of opening the markets to interna-
tional competition and to de-linking from the centralized economy of the former Soviet
Union. It is obvious that many of the new reforms would serve both goals. The prices in
Estonia, for example, were in a way distorted two-fold, first by the membership of the
Soviet Union in the Comecon trading area, where prices were artificially kept below the
world markets, and second by Estonian integration in the Soviet Union itself, where
prices differed from those applied for intra-Comecon trade. While some price reforms
had been introduced in 1989 and 1990, the definite move to world market prices came
with the introduction of the kroon in 1992. By then, it was obvious that this move was
about to have a profound influence on the Estonian economy, unparalleled by the Eastern
European states, where first measures to lift price controls in selected sectors had been
possible much earlier. It was nevertheless a step that needed to be undertaken, and the
government was determined to do it a quickly as possible. Externally, the movement to
world prices would create a terms of trade shock. The recession experienced after Rus-

33 The small domestic market of Estonia makes economic development dependent upon an orientation to-
wards the world markets. See Bradshaw, Hanson and Shaw (1994), p. 171.
sian price increases and cutbacks had been a harbinger of what was about to come. Internally, the new price levels, ideally set at the international market clearing points according to the theory, would result in a change of the importance of economic sectors. Given the role of Estonia as a manufacturer of industrial goods heavily depending on the import of raw materials, it was predictable that the relative share of the national income of the industrial sector would be reduced in favor of the sector of services, and that this adjustment process would be a painful one for the people working in the industrial sector. Nevertheless, it would lay the foundation for the adjustment of the Estonian economy according to its international comparative advantage.

Another step which had already begun when Estonia was still a member of the Soviet Union was the introduction of taxes that were closer to the demands of a market economy. In January 1991, a 18 percent VAT was introduced, followed by a personal income tax, a social security tax, a medical tax, and the replacement of the enterprise turnover tax by a corporate tax. The local governments in the ESSR were provided with their own tax base, an effort intended to further decentralize decision-making and governing. With Estonian independence, the tax base had to be nationalized, which completed the disintegration from the combined budget of the former Soviet Union.\(^{35}\)

The introduction of a new currency is a task that the eastern European nation-states did not have to accomplish in the course of their reforms. To achieve and to maintain currency stability and convertibility, however, were problems that all countries faced. As I have already explained, the establishment of a currency board plays a central role, and

through its implications for the general policy choices of the government, it determines not only the crucial realm of exchange rate management, but it also influences almost all other fields in which reforms were introduced. One of its main impacts on the general reform approach is exerted through the provision to maintain a balanced budget, which was passed into law in 1992. Along with the currency, the banking sector needed to be reorganized along the lines of banking in a market economy as well. The Bank of Estonia had to be transformed into a ‘true’ central bank, which meant that the commercial banking activities it had inherited from the Soviet era had to be transferred to other institutions.

Probably the biggest task was the privatization and restoration of property. Even shock therapists agree that reforms in this area have to be gradual and well-thought processes, and they entail an important regulatory role of the state.36 First, the capital markets would not be able to ‘digest’ the selling of several large state-owned enterprises at once, even in the presence of foreign investors. Second, privatization not only involves strong national sentiments and fierce political debates, it is also obvious that any solution will undoubtedly leave some people dissatisfied and disappointed. In Germany, for example, the restoration of nationalized property to its pre-war owners caused problems that have not been sufficiently solved even until today. Not only were business projects and investments delayed by an endless stream of court decisions on single cases, which in turn slowed down the whole process of economic restructuring, it also caused great discontent among the people, because it pitted east vs. west, when the former owners or their heirs,

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who had fled the GDR decades ago to prosper in the West, showed up at the front doors of eastern families and announced that they are seeking to get their property back.

Internationally, the new policies were geared towards the liberalization of trade. The ESSR had already adopted an independent law on foreign trade in October 1990, and independence finally removed the last Soviet-era restrictions. After independence, the country moved towards the conclusion of free trade agreements and towards exchange rate stability as well as currency convertibility to procure the amount of foreign direct investment needed to modernize the economy.

B. The Return to Europe and its Open Markets

In our present days at the end of the 20th century, international trade is predominantly structured by the neoclassical trade theory paradigm, which posits that free trade allows states to optimize their aggregate economic utility through global welfare maximization. At the end of World War II, the Western powers had institutionalized these ideas of how to organize trade relations between countries in international organizations, which subsequently developed into dominant and influential powers in the realm of international political economy. Most developing countries which had initially pursued policies of economic nationalism, socialism and state intervention in the economy, have changed their direction in the 1970s and 1980s and embrace now neoclassical economic policies. The

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37 The positive correlation between trade liberalization and economic growth has been empirically demonstrated in Sachs and Warner (1995). The authors conclude that “the international opening of the economy is the sine qua non of the overall reform process”, ibid., p. 2.

principle of free trade is installed in the international trade regime, for example, by the GATT articles. Both the theory and the GATT agreement, however, allow for exceptions, that is protectionist measures that enable national policy makers to correct distorted economic sectors under certain circumstances. An economy can therefore be described as open even if it imposes some restrictions on trade and capital flows in and out of the country. Openness is not a definite condition, but rather a scale on which states position themselves through the degree of openness their trade regulations allow. Generally, such trade regulations are “exceptions or temporary departures from policy conclusions that lead logically to the support of free trade”.

The question why Estonia seeks to open its markets is therefore quickly answered - because openness is presently the predominant attribute of the international trade system. This is, of course, not truly satisfactory, because it raises the question why Estonia wanted to link up with the world in the first place, while their economy was clearly not in the shape to do so without suffering immense immediate losses in production and welfare. In the following, I want to present some arguments that go beyond the promise of neoclassic theory, the maximization of economic utility and thus the realization of optimal gains and wealth.

The rise of a desire for economic independence of breakaway states has been generalized by the literature on secessionist movements as one part of the stage of ‘reevaluation’. In the case of Estonia, a relatively developed region had assessed the advantages

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40 See Bookman (1993), p. 37. According to Bookman, this is the first stage, the ‘before of secession’, which is followed by the stages of ‘redefinition’ and ‘reequilibration’, the ‘during and after of secession’.
of breaking out of a larger federation and compared them to the costs involved in this action. Behind this move stood the general feeling that economic relations with the other states in the Union were unfair, namely, that the slow economic reform progress of the Soviet Union was hampering the progress Estonia could make. Similar perceptions can be observed, for example, in the reasons for the secession of Slovenia from Yugoslavia, and they also played a major role in the creation of the northern Italian *Lega Nord*, which wants to split the region from the rest of the nation. The economic reevaluation in Estonia can be based on several developments within the Soviet Union. The obvious failure of command economics triggered a rethinking of the existing policies, first within the framework of communist theories by Gorbachev and his followers, then increasingly outside of it.

The only model available that was able to promise an effective alternative was the neoclassical one, for several reasons. The West was the glamorous role-model of economic success and prosperity, if only because it was the only economic system the communist world could measure its own achievements against. Other models, employed by developing countries in the 1960s, had just proven to be ineffective. Moreover, the success of the new industrializing countries of Asia provided a strong argument for the advocates of liberalism. However, the speed and the efficiency of reforms in the Soviet Union were insufficient for the Estonian people, because the sheer size of this economic giant and the influence that communist hard-liners were still exerting substantially slowed down the process. It became obvious that the potential for reforms in Estonia could not be made use of completely if the country were to stay in the Soviet Union.
Without doubt, the most basic reason for Estonia’s willingness to embark on radical and profound changes stems from its negative experience with fifty years of socialism, an approach which has been profoundly discredited during this time. Academic adherents of economic transformation and the broad masses formed a strong coalition, because they could both perceive the dead end they were heading for, as they judged their situation against the West. In the end, the distaste for anything that even slightly smacked of Soviet rule went so far that even concepts of Baltic economic cooperation and integration, for which the Baltic states would seem to be predestined, were initially, that is in the early 1990s, widely discredited.\(^{41}\)

This economic impulse for a ‘return to Europe’ was supported by the strong feeling that the country is undoubtedly a part of Europe for historical and geographical reasons, something that cannot be said of unambiguously of Russia and most other former Soviet republics.\(^{42}\)

Another reason for Estonia’s turn to the West should be noted, one that goes beyond economic considerations. The fragile status of Estonian sovereignty, inasmuch as its security problems with an unpredictable Russia at its borders are concerned, seems to play an important role. As one Western author reflected the feeling within the country: “Estonia must convince the West that it is worthy of being defended”,\(^{43}\) by demonstrating its ability to introduce, develop and eventually maintain both stable democratic structures and a viable economy. If the country can successfully turn into a dependable and recog-

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\(^{42}\) See ibid., p. 28.

nized member of the world society, it can assure itself that the world will not forget about it and come to its assistance, at least diplomatically, if not through direct military involvement, if its mighty neighbor in the east should want to challenge its independence once again. This understanding is anchored deeply in the way Estonians see their country, and they even derive some sort of a Western obligation from it, when they ascribe a ‘moral dimension’ to the question of their independence and posit it as a test for how sincere the rhetoric of freedom and democracy is, both in Russia and in the West. As one Estonian author puts it rather strongly, “if the West abandons the principle of democracy and relies on some narrow selfish interest only, then they lose their raison d’etre”. How insecure the Estonian people is about the future of their country, which might be, as it has been in the past, completely in the hands of foreign powers, and how deeply they distrust the Russian state, can be read from the following lines, written by Rein Taagepera, the Estonian-American political science professor and candidate for the Estonian presidency in the elections of 1992: “The Baltic states [...] belong to an ambiguous zone: part of the Baltic littoral when ships prevail, but part of Eurasia when horses or tanks prevail. Estonia will last if culture and ships prevail over tanks”. 

If we return to the concept of reevaluation, it cannot have come as a surprise that Estonia’s break with the East came finally to its completion when the collapse of the Soviet empire led to rising pressure on the economic and political situation in Estonia. Economically there were no gains to be realized from staying in a zone of high inflation, a zone where reforms were too slow for the eager Estonians. Politically, the Soviet Union

44 Kanauka (1996).
had lost even the last trace of legitimacy that might have been still present in the minds of some Estonians when its internal political struggle became violent and when its military gave up its allegiance to the incumbent Soviet president and threatened to crush the will of the Baltic people.

C. The Importance of a Stable Currency

1. Money and Inflation

Money has three general functions. It serves as a medium of exchange, it is a store of value, and it is the unit of accounting. The role of money as a medium of exchange is especially important in a market economy, where, in contrary to a centralized economy, goods and services are exchanged on decentralized markets. Compared to the old times of barter trade, money has made this exchange much more efficient. In our times, individuals of a country whose currency is internationally accepted are in a much stronger bargaining position.

Extreme inflation renders a currency useless as a store of value, so people will hoard basically every kind of non-perishable commodity they can get hold of instead, which leads to shortages, and consequently to severe economic dislocations. Black markets spring up where people change their money into foreign currencies. When people are willing to hoard foreign money, they exchange their goods and services for pieces of paper that their issuers print at almost no cost - the inflating country is thus actually subsi-
dizing the hard currency area by providing its seignorage gains. On the level of ‘high fi-
nance’, capital flight, i.e. massive transfer of capital abroad to be invested in foreign cur-
currencies, reduces investment at home and disadvantages the domestic industries in the
long run. An inflating currency is no longer an effective unit of account, because the
structure of prices is distorted. In a market economy, where prices set the incentives for
future economic activity, present market data cannot be correctly evaluated, so planning
and efficient allocation of resources are difficult.

Credibility of a currency is derived from confidence of economic actors, both domes-
tic and international, that a government will be willing and able to keep future inflation
low and exchange rates stable. Credibility influences the function of a currency as a
medium of exchange, because foreign direct investment, which is usually a long-term
commitment, is more likely to flow into a country where the investor can expect that his
investment will not lose its value through high inflation. A credible currency, when ac-
tors have no fear of inflation, can also fulfill its function as a store of value.

Credibility does not come easy for a currency. An expression of intent by the govern-
ment is hardly ever sufficient. Countries like Argentina or Mexico with a long history of
inflation have difficulties convincing the international investors of the trustworthiness of
their latest currency reform, and in more than one occasion their lack of credibility has
helped to bring down reform efforts. Countries like Estonia have no history at all,
which is a very genuine argument - even for the Euro, the future currency of the Euro-

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46 That is, stable within the limits set by its exchange rate regime, which can be fixed, floating within a
certain band, or free floating.
47 See, for example, the evaluation of several Argentine reforms from the late 1980s until today in de la Balze (1995), pp. 70 - 76.
pean Union, critical pundits point out that, after its introduction, it will be prone to instability, because it will have to earn its reputation first, regardless of the history of the single currencies that will be absorbed by it.

In 1992, the government institutions of Estonia, recently reformed, rearranged, cleansed of their communist past and put on a democratic basis, had not yet reached the efficiency of a well-trained bureaucracy. Estonian officials, not only in the banking sector but also in all other fields where economic decisions are made, were not yet experienced enough to be completely trusted to be able to deal with the economic and political turbulence of the transition period. All these factors were strong hints for a rational expectation of inflationary tendencies. The effects of inflationary expectations are exemplified, for example, by domestic wage-setting. Workers base their demands for the next wage increase on what they think their living expenses will have been risen by then. Expectations of future conditions influence today’s price settings, in this case the price of labor. Expectations are expressed in domestic interest rates as well. An investor wants to make sure that his investment will not receive less interest than what his capital loses to inflation. Present interest rates therefore contain expectations of future inflation, and with the rise of interest rates decreases the volume of investments. On the international level, a country with high inflation (or at least low credibility), will only be able to raise money by paying a risk bonus, i.e. interest rates above market level. While controls of prices and foreign exchange by state authorities may be a solution to stabilize a currency, it is only a weak one, since it only represses inflation and does not remove the underlying economic cause. Most of all, it is not really considered to be a viable solution in a market economy,
at least not if done on a wide range and for an extended period of time. While capital controls, that is the restriction of foreign exchange, may help to stabilize a currency because they reduce the outflow of currency reserves, they do, on the other side, undermine the role of the currency as a medium of exchange, because they prolong the single transactions, increase their costs, and therefore eventually reduce their number. Market exchange is then inefficient.

2. The Exchange Rate as a Nominal Anchor

The prices on the world markets are determined by the worldwide supply and demand. A small economy, which holds only an insignificant share of these world markets, is not able to influence these prices. If a small economy like Estonia opens up to free trade, the prices of its tradables, that is its import and export goods and services, will be exogenously determined by the world prices, which are expressed in key currencies such as the US dollar. Domestically determined, on the other hand, are the prices of nontradables, that are the goods and services produced and sold in the domestic market.\(^4^8\) This distinction between prices for traded and nontraded goods is expressed in the real exchange rate.\(^4^9\) Manipulations of the nominal exchange rate therefore have in general little impact on the real exchange rate. Due to the relatively higher dependency of their national

\(^4^8\) Work, for example, is nontradeable in this sense, as are all goods for which input does not have to be imported.

\(^4^9\) The real exchange rate is commonly defined as \(E \cdot P^*(T)/P(N)\), where \(E\) stands for the nominal exchange rate in terms of domestic currency per unit of foreign currency, \(P^*(T)\) is the foreign currency price of traded goods, and \(P(N)\) is the price of nontraded goods. See Hutton (1992), p. 303.
economies on foreign trade, many small open countries find only few of their prices entirely ‘homemade’. For them, the real exchange rate exerts an even greater influence on the domestic economy, which limits the possibilities for beneficial monetary policy. However, the dependence on externally given prices is not necessarily negative as long as the pricing system within the economy is able to translate world prices accurately. If not, that is, if the exchange rate system is not well-focused, the incentives for economic activity will be set incorrectly, and misallocation will distort both the structure of production and of consumption. The right exchange rate is therefore one of the most important aspects of structural improvement especially of transition economies.

Hyper-inflation has an immense effect of distortion. An exchange rate that is fixed to a stable currency area can dampen severe inflation in an open economy, because it links domestic inflation to the inflation rate of the other country - the fixed exchange rate regime serves as an ‘anchor’. It enables the private sector to calculate on the basis of undistorted prices, and, most of all, it allows the government to “put its financial house in order”. It separates the part of the budget deficit that is structural, the part that urgently needs to be reformed, from the part which is caused by inflation. Moreover, it constrains the domestic policy choices of a government, because both monetary and fiscal policy must adjust to the exchange rate policy of maintaining a fixed rate with a foreign currency or a basket. Access to international financial markets is difficult for a country with an underdeveloped financial sector such as Estonia. The government has therefore no

possibility to finance a deficit. The budget must be balanced, especially since other means, such as the imposition of import restraints, are not feasible for an open economy. Committed to a stable exchange rate, the government influences the expectations of private agents. “The exchange rate leads rather than follows other nominal variables, such as domestic price and wage inflation”.

Thus, to ‘import’ the world prices system and some degree of monetary stability, a country has the option to use a fixed exchange rate as a ‘translation device’, whose main advantage lies in its “transparency, its function as a key price that is daily observable, in comparison, for example, to another possible anchor, the quantity of money”. Moreover, it is observed that even pricing agents whose products are not internationally tradable often follow the signals given by the exchange rate. In such a case, the exchange rate anchors even non-tradable goods, which increases its effectiveness. Empirical data supports the theory - in a review of the history of sharp disinflations, it was found that in most cases the exchange rate was used as the nominal anchor.

Once it is decided that a fixed exchange should be implemented to bring inflation down to a level where it does no longer cause serious dislocations of the economy - let alone the political consequences which I have left out here -, the theoretical discussion moves on to evaluate how this fixed exchange rate can be maintained, when “history is full of irrevocable commitments to fixed exchange rates that have broken down”.

56 See Dornbusch and Fischer (1986).
D. Institutions for Currency Stability

1. Central Bank

The central bank of a country is usually the authority which supplies the money for the economy. This central position as the bank of the government accounts for its political power, and its ability to refinance commercial banks by rediscounting commercial bills was the reason why it evolved over time into its present role as the bankers' bank.\(^{58}\) The modern central bank is usually part of a so-called two-tier system, which means that the central bank does not perform functions of a commercial bank. It particularly does not deal with the private sector. The balance sheet of a 'typical' central bank can thus be simplified, so that its liabilities consist of the currency in circulation and the commercial bank reserves, which are funds that commercial banks deposit at the central bank. Its assets are the net foreign currency assets and the central bank credit. These assets of the central bank are called the monetary base. Combined with the credit of the commercial banks, we have the so-called 'broad money' of an economy. This simplification allows us to depict the three ways in which money can be created. The first is the sale of foreign currency to the central bank, for example by exporters. Its net foreign assets increase, as does the amount of currency circulating in the country. The second way is the granting of central bank credit. Since the bank is not conducting commercial business, it is generally only lending to the public sector or, in cases of emergency, to commercial banks. Credits

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\(^{58}\) See Goodhart (1992), p. 322.
to the government are therefore the second way to expand the money supply. The first two cases involve an expansion of the monetary base and are in direct control of the central bank. The third way, the expansion of credits given out by commercial banks, can be influenced by the central bank through a ‘minimum reserve’ provision. Commercial banks are the required to keep a certain amount of their cash reserves with the central bank. The principal function of a commercial bank is that it collects the money of the depositors and lends it out. If a part R of these deposits is required to be kept with the central bank, the maximum bank credit equals the total deposits minus R, and by increasing or decreasing R the central bank can influence the development of the broad money accordingly.

A typical central bank also has functions that go beyond the supply of money for the economy and the control of commercial bank reserves. They are quickly noted here because they will play a role in the following discussion of the monetary system of Estonia. As mentioned earlier, the central bank can serve as the ‘lender of last resort’ by providing short-term credit for banks or public enterprises in distress. While this provision undoubtedly has beneficial effects in the case of a banking crisis, which is almost always followed by a severe disruption of the national economy, it can also serve as a gateway for a politically motivated rescue mission of inefficient banks and state enterprises. Furthermore, a central bank gives economic advise to the government and provides several technical services important for an efficient monetary system, such as a clearing system for checks.
It is obvious, from this brief recapitulation of the interrelationship between the central bank and the money supply of an economy, and ultimately the stability of the currency, that one of the main reasons for inflation is a 'political' one, it occurs when the central bank officials are induced to deviate from a policy of currency stability. In countries with limited access to international capital markets, such as Estonia, the government is unable to finance its deficit by issuing bonds. It is therefore forced to rely on expanding its income from money creation, the so-called inflation tax. Since this income can be used to finance government expenditures, it can be viewed as a tax. As observed in the case of Russia, most of the flexibility in monetary policy that a central bank theoretically has, is subordinated to deficit finance.\(^{59}\) The ideal of an unpolitical central bank, which pursues macroeconomic goals independent from politicians (who are naturally inclined to use it as a means for the goals of their party or their electorate), is unlikely to be obtained immediately in a society in transition from communism to democracy, where old structures of power relations, personal friendship and nepotism may still be in place. A further obstacle is the fact that a central bank with its multiple functions and its important role in the economy, is an institution that requires a large number of personnel, and most of all, personnel with the proper amount of knowledge and experience. It was understood in the discussion of Estonian monetary reform that the country, with its fifty years of socialist banking, will at least for the first years not be able to provide adequate staff to effectively run a central bank.

\(^{59}\) See Hanke, Jonung and Schuler (1993), p. 36.
It should be kept in mind that economic theory itself is divided over the question whether monetary policy is beneficial in the first place. Most countries make use of it, because they regard it as a tool to make minor adjustments within the economy. In this context, the general goal of a government is usually to keep the economy in the balance between the different, and sometimes diametrically opposed economic goals which the pursuit of low inflation, low unemployment, economic growth and a balanced current account at the same time constitute. However, at least three different arguments against discretionary policy can be drawn from different schools of economic thought. Time lags exist between the implementation of a policy and the moment when its effects on the market can be observed, which renders the policy distorting or even counterproductive. Economic actors can anticipate the actions of a central bank and will try to profit from it, which means that most policy changes not only lack the important element of surprise, they also produce counteractions that offset their effects. In a study based on rational expectation models, it is shown that "a regime with discretion has an inherent inflationary bias relative to the equilibrium policy with commitments". An independent central bank can credibly commit itself to monetary stability, a dependent one cannot. A third criticism posits that central banking, similar to central planning in an economy, is harmful because it prevents markets from finding and adjusting to new price equilibria. The basic assumption of this kind of criticism is that planners, regardless of how much academic training and economic experience they might have, cannot have sufficient knowledge

60 For the following, see Hanke, Jonung and Schuler (1993), pp. 38-39.
62 Remember that the ability to credibly commit oneself is the ability to voluntarily limit one's [policy] choices. See Schelling (1963), p. 137-39, see also pp. 160-161.
about the future to be able to choose policies that are actually beneficial. Even if we
moderate this criticism and concede our economic decision makers enough knowledge to
be effective, this argument against monetary policy still holds true for the inexperienced
officials of an Estonian central bank.

A fixed exchange rate is not institutionalized, it is only defended if the central bank is
able to keep the money supply under control. A change of policy, such as the change of
interest rates by the central bank, becomes a political decision the more the bank is influ-
enced by politics. Ultimately an exchange rate might not be defended because political
considerations do not allow for appropriate measures, and the exchange rate collapses
due to decisions that did not originate in the market.\footnote{See Hanke, Jonung and Schuler (1993), p. 26.}

For an exchange rate to be stable, independence of the central bank is only a necessary
condition, not a sufficient one. For persistent, long-term stability a public consensus is
needed that would not allow any government, be it from the left, the center or the right, to
pursue policies that endanger monetary stability. The monetary stability of Germany
might serve as a prominent example. A hyper-inflation and two currency reforms in this
century have created a strong desire for sound money. When politicians or economists in
Germany argue about whether the current policy of the Bundesbank is too strict, and
when they criticize it for subjecting all other policy goals to the goal of keeping the in-
flation at two percent, they may envision an inflation rate of four to five percent as the
maximum that is tolerable. Which is still something many other countries would be de-
lighted of.
2. Currency Board

The advantage of a currency board over a central bank lies in its institutionalized exchange rate defense mechanism, which is almost mechanical. The term ‘currency board’ is nowadays used to describe a certain type of fixed exchange rate system. It was originally the name of the central institution if this system, that is the authority in charge of running the exchange rate mechanism. In the following, I will use the term ‘currency board’ for both the system and the institution.

The currency board issues notes and coins and converts it into a certain foreign currency at any time and up to any amount at a fixed exchange rate. The board does not give out loans, so that 100 per cent of its circulating notes and coins are backed by reserves in the foreign currency. Since one of the main features of the local currency is its unlimited convertibility, it is as sound as the foreign currency. In an ‘orthodox’ currency board, deposits with commercial banks do not have to be backed by reserves, and the board is not obliged to redeem them. As we will see in the next chapter, Estonia is to some extent an exception to this principle.

The issue department has very few tasks. It buys and sells the currency and sorts out old and damaged notes, and it invests the currency reserves in interest-bearing, secure and liquid securities, denominated in the reserve currency. The board cannot employ active monetary policy to influence the economic trend. Attempts to control the interest rates translate sooner or later into changes of the foreign currency reserves. Therefore, the currency board does not allow for such interventions, and as a consequence, interest rates
and the yield curve are market determined. The board cannot serve as ‘lender of last resort’ either, because it cannot provide unlimited cash.

Demand and supply at the exchange market are the only factors that determine the development of the money supply. Basically, the money supply mirrors closely the development of the foreign trade sector. The current account of the balance of payments, that is the balance of imports and exports of goods, services and unilateral payments over a given period of time, determines the growth or decline of the monetary basis on a “one-to-one relationship”. As I have mentioned above, deposits with the commercial banking system are part of the money supply as well, and this fact alters the relationship. When a current account deficit, for example, shortens the monetary base, the commercial banks are forced to reduce their credits. The cash reserves they keep in their vaults and the reserves kept with the currency board can be used as a ‘buffer’ in this situation. Adjustment of the volume of credit would then only be necessary in periods of extreme or persistent contraction. While the dependence of the money supply on external factors is thus limited, it does not eradicate completely the main argument that is made against a currency board. If a country is prone to severe external shocks, that is, if its exports depend on only a few products, then a crash in world prices or a crop failure would largely wipe out the currency reserves of the country, and the following contraction of the money supply would lead to bank crashes, which in turn would intensify the crisis. However, it can be reasonably assumed that any country with an undiversified export structure and little access to international capital markets will find itself in serious economic trouble in such a

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64 See Bennett (1994), p.199.
case, regardless of its type of monetary regime. Moreover, the foreign trade of Estonia is diversified enough that such a scenario is irrelevant.

More important is the development of the broad money, which depends rather on long-term determinants, such as the currency-deposit ratio the public chooses to hold.\textsuperscript{66} Obviously, the higher the percentage of the total circulating currency the public stores in bank accounts, that is, the more the public trusts in the banking sector, the more credit the commercial banks will be able to hand out. Another factor is the willingness of the banks to lend out money instead of building up reserves, that is, to what extent they judge the situation to be stable. The ability of a currency board to supply a sufficient amount of money for the economy is therefore correlated with the existence, or the successful development, of an efficient banking and financing sector.

A long-term factor which influences the monetary base is the autonomous capital inflow, the foreign direct investments, which will depend on how highly the country is rated internationally as an investment opportunity.\textsuperscript{67} The effects that this cash inflow has on an expansion of the monetary base are determined by how much of it is spent to buy foreign consumer goods and will therefore flow out of the country again.

The choice to implement a currency board peg instead of directly using the foreign currency it is pegged to lies not only in the fact that it allows the country to demonstrate its sovereignty by printing its own national heroes and symbols on one of the most heavily used items of everyday life. More importantly, it provides a source of income for the government, because it allows for a special kind of seignorage. The foreign currency the

\textsuperscript{66} See Walters and Hanke (1992), p. 560.
\textsuperscript{67} See the discussion of ‘country risk’ in chapter V.E).
government receives from the public in exchange for interest-free bonds called the local currency, can be invested in interest-bearing bonds on the international capital market. The proceeds of this version of seignorage actually exceed the costs incurred by the currency board. It is estimated that the costs of a currency board are generally at about one percent of its reserves, while it can reasonably be assumed that the interest earned through them on the international capital markets is substantially higher.

The main advantage of a currency board lies definitely in its simplicity. The laws and rules governing it are easily understandable and therefore difficult to manipulate. The currency board provides a much higher transparency than a central bank. This facilitates the monitoring of how its legal provisions are met and policies by the public as well as by international financial analysts and investors and protects it from political pressure. For this reason, the question of the political independence of the central bank is less pre-eminent in a currency board. Since it limits policy choices, it also limits the extent to which the government might be able to influence the actions of the board. While the degree of independence of a central bank can be measured by an examination of its legal framework, for example, by asking who appoints or dismisses the central bank officials, or who has the last word if government and bank have differing opinions, the currency board cannot be forced to work against its own principles, regardless of the degree of formal and material independence bestowed upon its members.

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CHAPTER IV
THE ESTONIAN CURRENCY BOARD

A. The Preliminaries

Along with the general plans for reforms, drafts for a national currency had been in the making for a long time. The banking law adopted in December 1989 instructed the newly created Bank of Estonia (Eesti Pank) to start preparations for a currency reform. It was clearly understood by the political and economic actors that the kroon could only be introduced if the basic regulations for both the institutional and economic framework had been carefully implemented prior to the reform. A profound restructuring of the formerly socialist banking sector was only one of many measures that had to be undertaken first. However, the political and economic collapse of the Soviet Union meant that the need for a sovereign currency became urgent faster than the reforms could show results. The rapidly deteriorating economic conditions pushed the Estonians to introduce the kroon as soon as they were technically able to do so, rather than waiting until all provisions that could ensure stability were in place. A severe recession had been set loose in 1991, after Moscow either cut the supply of raw materials to the Estonian factories or started charging world market prices for them. Estonian production facilities were caught in a trap: they depended on this input but were also not in the financial position to pay world market prices for it. At the same time, Russia was also reducing the supply of ruble notes for the republics of the Union, and later the CIS states. While the ruble zone was heavily
inflating, thus creating more and more demand for bank notes for everyday transactions. Rubles were mostly kept within Russia, and any agreement by the Russian central bank to cut back on the printing of new notes was passed on as supply shortages to the republics. Salaries and pensions remained unpaid, or could only be paid into bank accounts, which left it unavailable for people in a system without checks or credit cards. Whatever progress in economic reforms Estonia had achieved in the previous years was now seriously endangered if membership in the ruble zone continued. Not only did the despised Soviet currency fail to provide the basic functions of money, the combined effects of its hyperinflation and cash shortage blocked most economic activities. It also stalled the reforms—privatization, for example, needs a reliable unit of account to establish the true value of property. Moreover, the monetary chaos seriously endangered what was left of the wealth of the whole nation. The Estonian public was eagerly awaiting the kroon.

The macroeconomic policy premises that had been developed in the preparation for economic restructuring over the last years had now little difficulty to be passed into laws. Since it was widely perceived that currency stability and convertibility would be under heavy inflationary pressure in this country with insufficient experience in monetary policy, institutional guarantees needed to be installed. A law was passed that requires the state budget to be balanced, and as the “key policy decision”, the exchange rate peg was backed by a currency board.

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70 Hansson (1995a), p. 34.
B. The Institutional Set-Up

Estonia adopted a modified currency board system, in which the functions of the board have been incorporated into the Bank of Estonia, which is also responsible for the regulation and supervision of the commercial banks and the management of the payments system. To set the board apart from the central bank functions of the Eesti Pank, it was organizationally separated as the Issue Department, while the other functions are performed by the Banking Department. The Bank of Estonia is subordinate to the parliament, which appoints its president and the chair of the board of directors. The bank is independent, however, from the government. Most importantly, the balance sheet of the Issue Department, which is separated from that of the Banking Department, and therefore the control over the amount of money in circulation, is not under the supervision of government authorities.

The commercial banks are required to hold 10 percent of their deposits as non-interest-bearing minimum reserves with the central bank. This provision is not meant as an instrument of monetary policy, but rather as an arrangement to support the liquidity of the commercial banks. These reserves are held with the Issue Department and have to be backed completely by the foreign currency reserves of the board. This is a deviation from the ‘pure’ currency board, where only the cash in circulation is backed, but it does not change the basic operation principle. It allows the central bank to monitor and regu-

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71 See Buch et al. (1995), p. 77. For the same reason, the minimum reserve for the Estonian Savings Bank, which ‘inherited’ about 60 percent of Estonian private individuals’ savings deposits from Soviet times, was set at 70 percent (partially interest-bearing).
late the Estonian banking sector which was, at that time, in the middle of a profound
transformation.

The banking department holds the excess currency reserves, that is the amount of re-
serves of the central bank that are not needed by the Issue Department to back its bank
notes and bank reserves. In cases of need, the Banking Department can issue loans to
commercial banks as a temporary assistance, and it can even provide loans for the gov-
ernment, as long as they are not used to finance the deficit.\textsuperscript{72} This scope of monetary
policy of the Bank of Estonia, however, has its effective limits by the provision that the
Banking Department has to ‘buy’ the krooni for the loans from the Issue Department,
which means that these loans cannot exceed the bank’s total foreign currency reserves.
One of the consequences of this arrangement is that whatever operations the Banking
Department chooses to undertake to assist the government or the banking sector, it is not
able to undermine the currency backing provisions of the board, because it cannot exceed
the currency reserves available in excess of the requirements of the board.

As mentioned earlier, the introduction of the currency board was accompanied by a
law which requires the government to balance the budget. This is not a prerequisite of a
currency board, but it strengthens the reforms, because it is a further manifestation of the
commitment to monetary austerity. It keeps the government from borrowing from the
commercial banks, which would crowd out borrowing of the private sector, especially in
a country where financial markets were just about to be developed.\textsuperscript{73}

\textsuperscript{72} See Buch (1993), p. 453.
\textsuperscript{73} See Bennett (1994), p. 199.
C. The Currency Reform

On July 20, 1992, Estonia replaced the Russian ruble with its national currency, the kroon. The new currency was pegged to the German deutschmark at a ratio of 8:1, which can only be changed by a law of the parliament.

The kroon became sole legal tender, which effectively barred the ruble from circulation. A conversion rate of 1 kroon for 10 rubles was applied to all prices, wages, enterprise funds, private savings accounts, and private cash up to an amount of 1,500 rubles. Larger cash holdings could only be converted at a 1:50 ratio to avoid the inflow of black market rubles. For the same reason, private accounts of more than 50,000 rubles and business accounts of more than 1 million rubles were converted, at 10:1, only after a close check. Until the conversion deadline on June 30, 32 billion rubles had been exchanged into krooni, 2.3 billions of which were cash. The effects of these very rigid exchange provisions, which left Estonians with about $12 in cash (the equivalent of 1,500 rubles at that time), were alleviated, however, by three facts. First, most rubles had been disposed of through shopping before the reform, or they could be spent after the reform in neighboring countries of the ruble zone. Second, people could try to exchange their rubles for foreign hard currency, which was freely convertible into krooni, and last but not least, most ruble savings had been heavily devaluated by inflation anyway.

74 See Buch (1993), p. 446.
The convertibility of the kroon was guaranteed for transactions concerning the current account at the official exchange rate of the Bank of Estonia. Foreign currencies can also be bought and sold at licensed commercial banks. Since it was feared that massive capital flight could endanger the reform, several exchange regulations were implemented. Export profits had to be exchanged into krooni, and capital transactions were made subject to approval. Private persons were not allowed to open new foreign exchange accounts or to make further deposits on existing ones. It was noted, however, that this regulation was hardly enforced, which implies that volume and number of such transactions were insignificant, so that the officials did not need to act.

The currency reform paved the way for the further success of the kroon, which was supported by several psychological and material factors. National pride of the new currency prevented a run on the central bank’s reserves after the introduction. The excitement about this symbol of national identity and sovereignty provided for wide acceptance. Many stories have been told of Estonians buying new wallets, so that their krooni did not have to be stored in the same pocket where the old scorned rubles had been. The overall quality and appearance of the new money, which was printed in Great Britain, was also very helpful in creating public trust, compared to, for example, the sloppily made and easily counterfeited Lithuanian notes, whose US producer failed to equip them with the proper safeguards. This psychological aspect of money and its influence on

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76 Which has to be set, as mentioned earlier, within the three percent range around the 8:1 ratio.
77 But were generally only registered. See Hansson (1995a), p. 35.
79 For the following, see Shen (1995), pp. 62-64.
how people, who “want to bite into a coin and feel that it is real”,\textsuperscript{82} believe in it, is easily neglected and discarded by economists, most likely because it is not quantifiable, but it is nevertheless important.\textsuperscript{83} The currency reform had also been well devised, with the preparations for it dating back to 1989. Very important for the success of the new money was the fact that the currency could be backed by substantial holdings of gold. Prior to the occupation of Estonia by Soviet troops in 1940, the reserves of the country had been shipped overseas, and had been stored in the vaults of several foreign central banks. Luckily, these countries did not recognize the legality of Soviet rule and did not turn over the gold to the USSR. These reserves were now shipped back to Estonia and provided an initial foreign currency reserve of about 1,500 million EEK 8 (about 120 million USD). Along with the inflow of foreign currency converted by individuals and firms, the reserves very soon surpassed the liabilities of the Issue Department - the note issue and the commercial bank reserve deposits..


Within a few months of the introduction of the kroon, the currencies of its Nordic neighbors Sweden and Finland were caught in a crisis of the EMS. They depreciated significantly against the deutschmark, and as a consequence against the EEK as well. The kroon could rightfully claim to be one of the most stable currencies in Europe.

\textsuperscript{83} To avoid any misunderstandings, I want to make clear that I do not intend to posit that monetary stability can be obtained simply by issuing nicely designed and impressively looking bills.
Admittedly, this was due to the strength of the deutschmark, but it boosted the reputation and the credibility of this new currency, and it brought attention to the positive performance the currency displayed from the very start on. As figure 1 shows, the peg with the deutschmark was kept, and as a consequence the kroon was stable against the dollar as well. The ruble, on the other hand, depreciated from 420 rubles per US dollar at the end of 1992 to 5,200 rubles per dollar in July 1996.

![Exchange Rate EEK / USD and EEK / DEM](image)


Figure 1: Development of the EEK against USD and DEM

In the beginning, the liabilities of the Issue Department were almost equally divided between the notes issue, the Savings Bank deposits and the commercial bank deposits, but in the following, almost all growth in liabilities was due to extended note issue\(^4\) - an

\(^4\) see Bennett (1993), p. 456.
increase of the monetary base. The amount of krooni in circulation rose from 630 mil. on July 16, 1992 to 1,229 mil. on January 1, 1993 and 2,730 mil. on January 1, 1994.\textsuperscript{85}

As mentioned earlier, the decisive factor for the development of the money supply is the development of the net foreign currency reserves of the currency board. In Estonia, they increased quickly - due to the credibility of the board, foreign investments and, especially in the first months, the repatriation of foreign currency accounts, that is, the return of money which had been transferred abroad to save it from the hyper-inflation.

By 1993, half of the total foreign currency reserves of the Bank of Estonia were used to back the notes issue, and one quarter to back the commercial bank reserves (including those of the Savings Bank). The high share of cash, resulting from its growth in late 1992, can be explained by the crisis of the banking sector at that time, which induced people to keep their savings in cash. However, with the growing stability and security of the banks, the currency-deposit ratio turns now in favor of deposits, which generates a growth of the broad money. Also, the more the banking sector is able to stabilize, the more will banks be willing to lend out instead of building up reserves. This trend seems to have begun in 1994, when the share of the currency reserves needed to back commercial bank reserves decreased to 15 percent - a sign that the banking sector was increasingly efficient in safeguarding its liquidity.\textsuperscript{86}

By a comparison of the purchasing power of the domestic currency with foreign currencies, the equilibrium exchange rate can be determined - at least in approximation, and subject to differing opinions among experts. At this rate, both the domestic markets and

\textsuperscript{86} See Buch et al. (1995), p. 78.
the national trade account should be in an equilibrium. A comparison revealed that, at the 8:1 conversion rate of the currency reform, which was practically oriented at the market rate of the time, the kroon was undervalued in real terms. The differing inflation rates in Estonia and Germany set off this undervaluation in the following months. From December 1992 to December 1993 alone, the real exchange rate rose by 20 percent against the deutschmark. While there are discussions about whether overvaluation has already reached a critical level - quite naturally, exporters say yes and importers say no -, one conclusion can be drawn. The 8:1 parity was well chosen, because in the following years until today the exchange rate did not reveal severe underlying disparities. Otherwise it would inevitably have forced a re-evaluation and therefore a change of the exchange rate in the meantime.

The provision that the exchange rate can only be changed by a law in the parliament has received different judgments. While one side points out that the evaluation of the exchange rate is under political pressure in the parliament and that it should be transferred to the ‘unpolitical’ and independent realm of the central bank, others assert that the political costs involved with a change of the law create more security than if the bank could decide about it. It can also be argued that the political process of filing and debating a bill creates more transparency. One should be kept in mind, however, that ultimately it will always be in the hands of the legislative to change the structure of the central bank and abolish the currency board, if a sufficient majority can be found - regard-

87 See Lainela and Sutela (1993), p. 16.
88 See EIU 1/94, p. 17.
89 See Buch (1993), p. 462.
less of where the competence for the exchange rate lies, and regardless of how independent the bank might be.

Shortly after the currency reform, the banking sector found itself in a deep crisis, because the Eesti Pank could no longer serve as a lender of last support. Several banks had to be closed or merged. It is important to point out, though, that it was not the currency board that caused the banking crisis. In contrary, it made it simply obvious that the sector was in need of a fundamental reform, and at the same time it provided the Bank of Estonia with a good argument to pursue tough reform measures.

Full currency convertibility was achieved in March 1994, when the opening of foreign currency accounts was allowed and the last restrictions which had been imposed during the reform fell - the ultimate sign that the introduction of the kroon had been a complete success.
CHAPTER V

REVIEW OF OVERALL ECONOMIC PERFORMANCE, 1992 - 1996

For the following review of the effects of the Estonian Way on the overall economic performance of the Estonian economy in the years after the introduction of the currency board, I have chosen to concentrate on selected data. The GNP is a macroeconomic indicator which I use to evaluate the performance of the Estonian economy as a whole. It serves as an indicator for the success of the combined reform measures. The inflation rate is included because of its strong link with the exchange rate peg and the currency board. The unemployment rate is a good measure of the negative effects of shock therapy, as it is presumably the strongest indicator for potential discontent in the public and the formation of opposition to the reforms. Unlike the GNP and the interest rate, it allows directly to discern some of the groups that are suffering from the transition. The international trade sector is included to assess in how far new trade patterns have developed, which is one of the major goals of the Estonian Way. It shows also the degree of diversification of the Estonian export industry, which is a measure of its proneness to external shocks. Foreign direct investment is important for the future potential for economic development in the country. I have included an assessment of the ‘country risk’ attributed to Estonia. Even though it cannot be considered as ‘hard’ economic data, I see it as a good indicator for how the international financial community judges the country and the progress of its reforms.
A. Gross National Product

As table 2 shows, the GNP had been decreasing sharply in 1991, and this trend continued in 1992 despite the introduction of the kroon in July. This result was predicted, and accepted as part of the costs of transition. It is significant, however, that the steep decline came to a halt in 1993, while the other Baltic countries were still in the middle of a severe recession. In 1995, the negative development was finally over in Estonia, and predictions indicate a moderate growth for the next years. The comparatively early and quick implementation of reforms gave Estonia a headstart over its neighbors - not only did Estonia suffer a smaller decline of GNP, it also achieved a steady reversal of this trend earlier.

Table 2: Development of GNP

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>-11.8</td>
<td>-19.3</td>
<td>-2.1</td>
<td>-2.7%*</td>
<td>+2.9</td>
<td>+3.3</td>
<td>+3.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>-8.3</td>
<td>-33.8</td>
<td>-11.7</td>
<td>+2.0</td>
<td>-1.6</td>
<td>+1.5</td>
<td>+3.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-13.4</td>
<td>-35.0</td>
<td>-16.5</td>
<td>+1.0</td>
<td>+2.7</td>
<td>+1.0</td>
<td>+2.5</td>
</tr>
<tr>
<td>Russia</td>
<td>-5.0</td>
<td>-14.5</td>
<td>-8.7</td>
<td>-12.6</td>
<td>-4.0</td>
<td>-1.0</td>
<td>+3.0</td>
</tr>
</tbody>
</table>


The difficulties researchers have with obtaining reliable statistical data - and the difficulties others have later on with interpreting it - can be illustrated by the dispute over the
Estonian figures for 1994. While the Estonian Statistics Department had always maintained that the economy was still in recession in this year, the Bank of Estonia published positive figures. This cannot only have been due to political affiliation with the government, because the EIU, an independent research institute, followed the view of the central bankers and showed an increase of 4.7 percent up to their 3rd quarter 1996 publication. While the Bank of Estonia has recently revised its predictions for 1996 down to a growth rate of 1 to 2 percent, we can extract one conclusion from all this: there is a positive trend, and its continuation in future remains undisputed by all researchers.

The growth rates of the statistics appear to be rather modest, if not disappointing, especially if compared to the two-digit decline rates in the early 1990s and the widespread enthusiasm and high expectations about the blessings the market economy would bring. Two arguments, however, have to be taken into consideration. First, the GNP figures for the Soviet period were surely ‘inflated’, because they were based on production figures that were distorted upwards by various tricks to show the required fulfillment of quotas. Second, the present data does not show unrecorded and informal activities. Opinions on how much the shadow economy contributes to national economic performance fall in a range between 10 and 40 percent, and the emphasis lies rather at the upper end. This is a further indication that the statistical data can not really be used for more than the confirmation of a generally positive development.

91 See EIU 3/96. Imagine a dispute in one of the advanced economies over whether the GNP has fallen by two percent or actually risen by a hefty four percent!
92 Admittedly, nobody expected Estonia to be the much-quoted ‘blooming landscape’, which German chancellor Helmut Kohl predicted the former GDR to be by the mid-1990s.
93 See EIU 3/96, p. 18.
B. Inflation

As it was planned by the officials and hoped for by the people, the period of hyper-inflation ended with the introduction of the kroon. However, a look at table 3 reveals that the inflation rate still remains unpleasantly high today. Many price adjustments could only be made gradually, and the speed of liberalization varied from sector to sector. While most import and export prices leveled off at world prices rather quickly, many domestic prices, especially those set by the state like public transportation and housing in state-owned apartments, are only increased step by step - whenever the balanced budget provision made it necessary for the government to increase its income or to cut its expenses. The central bank cannot take countermeasures to dampen inflation by managing the interest rates. As mentioned earlier, this monetary instrument has been sacrificed for the currency board. However, it should be noted that the inflation rate is not significantly higher than in other economies in transition. Moreover, the rate is at least stable at this level and it is generally expected that it will decline further to an acceptable level within the next years if the present economic development continues. The battle against inflation remains one of the top priorities of the Estonian government, because the increasing overvaluation of the kroon leads to an increasing trade deficit and therefore to pressure on the currency board and the exchange rate peg. However, it can be assumed that the inflation rate in Estonia will remain higher than in Germany even over the medium term, because the faster growth in productivity in the developing country - unlike Germany,
Estonia starts from a very low level of productivity - leads to rising income and a further rise of the exchange rate.\textsuperscript{94}

Once again, as table 4 shows, Estonia fared comparatively better than its southern neighbors, especially Lithuania, in the early stage of transition in 1992 and 1993, due to its quick currency reform. In the following years, when Latvia and Lithuania followed with their pegs, the consumer prices developed much more equally in all three countries.

Table 3: Consumer Price Inflation in Estonia, Year-on-Year

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>948</td>
<td>35.7</td>
<td>41.6</td>
<td>29</td>
<td>27.2</td>
<td>25</td>
<td>20</td>
<td>17</td>
</tr>
</tbody>
</table>


Table 4: Consumer Price Indices in the Baltic Countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>100</td>
<td>188</td>
<td>229</td>
<td>284</td>
<td>319</td>
<td>360</td>
<td>409</td>
<td>447</td>
</tr>
<tr>
<td>Latvia</td>
<td>100</td>
<td>203</td>
<td>247</td>
<td>284</td>
<td>317</td>
<td>356</td>
<td>389</td>
<td>418</td>
</tr>
<tr>
<td>Lithuania</td>
<td>100</td>
<td>600</td>
<td>820</td>
<td>1000</td>
<td>1200</td>
<td>1370</td>
<td>1610</td>
<td>1750</td>
</tr>
</tbody>
</table>


\textsuperscript{94} See Bennett (1993), p. 469. He also points out that "to the extent that a higher rate of inflation is caused in this way, there is no reason why it should impugn the peg", p. 470.
One remark should be made about the reliability of inflation data. There is unanimity among the research institutes who monitor Estonia about consumer price increases. The price a consumer has to pay for a basket of selected goods and services in year X is compared to the price for the same basket in the previous year. This is relatively easy to do, and so there is much less room for diverging interpretations than for other basic economic figures.

C. Employment

The terms-of-trade shock which followed the separation from the ruble zone and the liberalization of prices led to a hefty 26.6 percent fall of the output of the Estonian industrial sector from 1992 to 1993, mainly in the state-owned businesses. One of the most striking results of the reforms, at least if one follows the official data, is the fact that this rapid decline in production was not accompanied by a corresponding decline in employment. Government statistics indicate that in March 1996 the official unemployment rate was at 2.3 percent, compared to Latvia with 6.9 percent and Lithuania with 8.5 percent. The region with the highest unemployment rate was the town of Narva with 4.2 percent. Yet, in spring 1993, when reliable official statistics had not yet been available, the unemployment rate in Narva was estimated to be around 50 percent. Again, this points out that it is necessary to take a look at how the authorities arrive at this figures before we can use it as a measure for the success of the Estonian Way.

96 See EIU 1/93, p. 15.
The benefits for the unemployed are set below subsistence level, which forces many people to take jobs 'at any price' and keeps the wages low. While this may sound reasonable - at least the people have a job and need not to live on social benefits - the cheap labor also causes overmanning. The process of structural reform is thus only delayed, and the true extent of job reduction that will be necessary for the old industrial enterprises to increase their rentability to Western levels is covered up. Furthermore, relatively high costs are incurred with the dismissing of employees, which leads to many forced vacations that do not show up in the unemployment statistics. A second objection to the official figures is directed at the statistical methods that are used. They do not take part-time working and unpaid leave into account. They count only those who are receiving unemployment benefits, for which there are high standards of eligibility. A further official figure, the 'job seekers' rate, was at 3.8 percent of the working population in October 1995. It counts those who are registered at an unemployment center, and independent researchers estimate that only half of all job seekers actually do so. This is caused by the low unemployment benefits (EEK 180, or one tenth of the monthly minimum wage at the end of 1994), which makes it not worthwhile for people, especially from the countryside, to travel to the registration office twice a month, as required.97 Furthermore, long-term unemployed disappear from the records of the local authorities once their benefits run out and they no longer see a reason to show up. Policies like this are likely to create a major social problem. Because they are not registered, the 'unofficial' unemployed cannot be reached by retraining programs, and within time they are

harder and harder to place, which makes their re-integration into the workforce ultimately impossible.

The data published by non-official researchers on the actual rate of unemployment delivers only a broad range of estimates, which generally converge around a figure of ten times the official rate. Unemployment also varies greatly between regions, "the biggest problem is not the average, but the distribution of unemployment". While job opportunities seem to be readily available in booming Tallinn, the agricultural sector has to deal with a decrease of the level of unemployment by 30 percent in 1993 alone. People return to subsistence farming, the younger leave for the city.

The percentage of the unemployed ethnic Russians is bigger than their share of the whole population. Russians were predominantly employed in the industrial sector, with its large-scale enterprises in northeastern Estonia, because of its large demand for labor. This economic and regional 'bifurcation' - 90 percent of the industrial enterprises were under control of the Soviet Union, due to their importance for military production, while Estonians were only 45 percent of the industrial workforce - renders unemployment a structural problem. The regional and ethnic aspects are inseparable. The Estonian government did not install some sort of an 'Estonians first' policy. While it was correctly predicted at the beginning of the reforms that the "dividing line between short-term winners and losers will run close to the division between the Estonian and non-Estonian

---

98 See, for example, a Norbalt study quoted in EIU 2/96.
102 Minimum language proficiency requirements, as set, for example, for educational jobs, have undoubtedly discriminating effects. They are, however, not primarily geared towards the labor market.
population, this should indeed come true only for the short term. In other words, the ethnic Russians, who have suffered above average from the collapse of the industrial sector, should also be able to profit above average from its recovery.

Unemployment also seems to be hitting women harder than men. Figures given by the Bank of Estonia for the end of 1994 show that 61.6 percent of the recipients of unemployment benefits were female.

D. International Trade

Estonia has successfully changed its import and export structure, turning away from an almost complete dependency on the former Soviet Union to vivid trade with the Western European countries (see tables 5 and 6). The decline of trade with the East was not brought about by nationalistic reasons, the Estonians did not shun these markets. It was simply necessary to find new partners, as the Eastern markets became increasingly unattractive because of the severe recession in these countries and the fact that monetary transactions became difficult once the ruble zone was given up, the currencies were different, and the banks were not yet able to provide efficient transaction services. The turn to the world markets was not easy, because the quality of many Estonian products did not meet Western standards. However, the willingness of Finland to expand its trade, the relative independence of Estonia from energy imports, compared to its Baltic neighbors

103 Hansson (1995a), p. 29
without oil shale mining facilities and, once again, the headstart from the quick introduction of the national currency laid the foundations for the Estonian success.\textsuperscript{105}

Table 5: Estonia: Main Origin of Imports

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>1994</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>in USD mil.</td>
<td>in percent</td>
<td>in USD mil.</td>
</tr>
<tr>
<td>Finland</td>
<td>1,037</td>
<td>33.51 %</td>
<td>495</td>
</tr>
<tr>
<td>Russia</td>
<td>449</td>
<td>14.51 %</td>
<td>279</td>
</tr>
<tr>
<td>Germany</td>
<td>285</td>
<td>9.21 %</td>
<td>165</td>
</tr>
<tr>
<td>Sweden</td>
<td>227</td>
<td>7.33 %</td>
<td>147</td>
</tr>
<tr>
<td>Benelux</td>
<td>155</td>
<td>5.01 %</td>
<td>74</td>
</tr>
<tr>
<td>United States</td>
<td>153</td>
<td>4.94 %</td>
<td>41</td>
</tr>
<tr>
<td>Latvia and Lithuania</td>
<td>101</td>
<td>3.26 %</td>
<td>67</td>
</tr>
<tr>
<td>Others</td>
<td>688</td>
<td>22.23 %</td>
<td>389</td>
</tr>
<tr>
<td>Total</td>
<td>3,095</td>
<td>100.00 %</td>
<td>1,657</td>
</tr>
</tbody>
</table>

Source: IMF Direction of Trade Yearbook 1996; own calculations.

Another incentive for Estonian firms to procure their imports from the West rather than from Russia lies in the divergent development of the real exchange rates. While the kroon appreciated against the deutschmark and dollar (see III.D), it depreciated, in real terms, significantly against the heavily inflating ruble - about 400 percent for the time

from February 1993 to July 1994 alone.\textsuperscript{106} This development may also be one explanation for the relative strength of the exports to Russia at least until 1994.

Table 6: Estonia: Main Direction of Exports

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>320</td>
<td>233</td>
<td>167</td>
<td>16.55%</td>
<td>17.81%</td>
<td>20.75%</td>
</tr>
<tr>
<td>Russia</td>
<td>250</td>
<td>302</td>
<td>182</td>
<td>12.93%</td>
<td>23.09%</td>
<td>22.61%</td>
</tr>
<tr>
<td>Sweden</td>
<td>219</td>
<td>141</td>
<td>76</td>
<td>11.32%</td>
<td>10.78%</td>
<td>9.44%</td>
</tr>
<tr>
<td>Latvia and Lithuania</td>
<td>194</td>
<td>178</td>
<td>99</td>
<td>10.03%</td>
<td>13.62%</td>
<td>12.30%</td>
</tr>
<tr>
<td>Benelux</td>
<td>170</td>
<td>55</td>
<td>38</td>
<td>8.79%</td>
<td>4.20%</td>
<td>4.72%</td>
</tr>
<tr>
<td>Germany</td>
<td>161</td>
<td>89</td>
<td>64</td>
<td>8.32%</td>
<td>6.80%</td>
<td>7.95%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>161</td>
<td>36</td>
<td>11</td>
<td>8.32%</td>
<td>2.76%</td>
<td>1.36%</td>
</tr>
<tr>
<td>United States</td>
<td>63</td>
<td>24</td>
<td>15</td>
<td>3.26%</td>
<td>1.83%</td>
<td>1.86%</td>
</tr>
<tr>
<td>Others</td>
<td>396</td>
<td>250</td>
<td>153</td>
<td>20.45%</td>
<td>19.11%</td>
<td>19.01%</td>
</tr>
<tr>
<td>Total</td>
<td>1,934</td>
<td>1,308</td>
<td>805</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

Source: IMF Direction of Trade Yearbook 1996; own calculations.

The successful restructuring shows the effects of the world market as an orientation mark and motor of the reallocation process. The main challenge for Estonia remains, however, to use the foreign capital for the creation of a solid and reliable basis for the

\textsuperscript{106} See Buch et al. (1995), p. 76. This process started with the currency reform, which separated the Estonian from the Russian inflation rate. However, consistent data is only available from February 1993 on.
export industry, which will keep the trade balance deficit within a manageable range in the long term.\textsuperscript{107} The relatively high degree of industrialization in Estonia has given the country a promising foundation in the form of a diverse sectoral structure of exports, as shown in table 7. Apart from the dwindling chemical industry, which does not seem to have much of a future, industrial firms have managed to secure new business connections.

If both the economic situation in Russia and the political relations between Estonia and its big neighbor return to normal, the harbor of Tallinn, could become of increasing importance. Already one of the best and busiest in the Baltic Sea, has the potential to develop into a major link for the trade between East and West, and with it Estonia could develop into a “veritable Hong Kong of the Baltic”\textsuperscript{108}.

Table 7: Estonia: Principal Exports

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foodstuffs</td>
<td>16.4 %</td>
<td>22.2 %</td>
</tr>
<tr>
<td>Clothing and Footwear</td>
<td>16.3 %</td>
<td>16.4 %</td>
</tr>
<tr>
<td>Timber Products</td>
<td>14.2 %</td>
<td>11.0 %</td>
</tr>
<tr>
<td>Machinery</td>
<td>9.3 %</td>
<td>9.3 %</td>
</tr>
<tr>
<td>Metals</td>
<td>7.2 %</td>
<td>8.0 %</td>
</tr>
</tbody>
</table>

Source: EIU 4/96.

\textsuperscript{107} See Buch et al. (1995), p. 154.
\textsuperscript{108} Economist David Hale, as quoted in “Estonia: Open for Business” (1996).
E. Foreign Direct Investment and Country Risk

Foreign direct investment becomes very important for a small economy undergoing the task of privatizing its large state enterprises, because the amount of capital needed cannot come from Estonians alone. The modernization of production facilities implies that new equipment, technology and know-how need to be transferred into the country, again a task that is accomplished much faster and easier if not done by Estonians alone. Moreover, the trade account deficit the country has developed in the last years implies that a surplus on the capital account is needed to offset it, otherwise the country would constantly lose its currency reserves to a point where the exchange rate peg or the currency board itself are endangered.

International investors are seeking to ensure the growth of company profits. They are permanently looking for new profitable investment opportunities, and once engagements have been made, they are interested in protecting their investment assets. In this context, country risk assessment has developed as an important instrument to support the decision-making of the executive management.109

Country risk assessment encompasses the methods used by banks and firms to evaluate the risks involved with financial engagement in a particular country. It takes into account the political risk, which is "the will to honour one's obligations",110 and assesses aspects such as the extent to which constitutional rights are actually enforced, the degree of social and political stability, the efficiency of the government, corruption, briefly.

political circumstances that could endanger debt payment or the repatriation of direct investments. It takes also into account the economic risk, that is a country’s “ capability to honour obligations and to incur foreign debt”, and comprises next to the ‘traditional’ economic data such as liquidity and debt ratios also an assessment of the quality of a country’s economic policies.

Aspects of both the political and economic risk are evaluated, quantified, measured, weighed, and finally rated, which allows for a general comparative ranking of different countries. The methods used by the different institutions vary immensely, the ratings of the Institutional Investor displayed in table 8, for example, are simply based on a survey of the gradings of 75 to 100 top international bankers.

While the assessments of large firms and financial institutions are mostly used internally, some ratings by professional institutions are widely publicized and have a substantial influence on the decision-making of internationally operating corporations. Since it is an evaluation of the international creditworthiness of a country, it has a strong influence on the flow of capital into a country as well as the risk premium it has to pay for credits in the international financial markets.

According to the evaluations of the international financial community, “Estonia is a star performer that has practically completed its economic reform in terms of privatization and removing the government from day-to-day economic life”. In their eyes, the country seems to have done its homework. Estonia is leading the other former Soviet re-

\[\text{111} \text{ Krayenbuehl (1988), p. 40 (emphasis added).}\]
\[\text{112} \text{ The bankers in turn used the results delivered by the assessment teams of their respective banks.}\]
\[\text{113} \text{ A ‘German banker’ quoted in Shapiro (1996), p. 139.}\]
public in these rankings, including Russia. Its ranking behind the former Warsaw pact states (see table 9) might be attributed to the political risk emanating from a still unpredictable Russia and the comparatively small size of its economy.¹¹⁴

Table 8: The *Institutional Investor*’s Ranking of Selected Eastern European Countries

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Rating</th>
<th>One-year Change vs. March 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>Czech Republic</td>
<td>60.1</td>
<td>+ 4.3</td>
</tr>
<tr>
<td>47</td>
<td>Slovenia</td>
<td>45.9</td>
<td>+ 6.4</td>
</tr>
<tr>
<td>50</td>
<td>Hungary</td>
<td>43.6</td>
<td>- 2.8</td>
</tr>
<tr>
<td>53</td>
<td>Poland</td>
<td>40.2</td>
<td>+ 4.5</td>
</tr>
<tr>
<td>57</td>
<td>Slovakia</td>
<td>38.6</td>
<td>+ 4.5</td>
</tr>
<tr>
<td>76</td>
<td>Estonia</td>
<td>28.9</td>
<td>+ 3.5</td>
</tr>
<tr>
<td>86</td>
<td>Latvia</td>
<td>24.7</td>
<td>+ 2.1</td>
</tr>
<tr>
<td>89</td>
<td>Lithuania</td>
<td>23.8</td>
<td>+ 2.1</td>
</tr>
<tr>
<td>99</td>
<td>Russia</td>
<td>19.9</td>
<td>+ 0.4</td>
</tr>
</tbody>
</table>


¹¹⁴ Desinvestment in times of crisis may be more difficult in small countries than in large ones. This assumption, which cannot be explained with the rational models of international trade, is the reason why small countries, regardless whether they are developed like Denmark or emerging like Thailand, usually carry a so-called ‘exit risk’ independent from the condition of their economy or their public finances. See Martin and Schumann (1996), p. 104.
Foreign companies first started to enter Estonia under the Joint Venture Act of 1987, which had been a part of the Gorbachev reform efforts. However, the Soviet system only allowed for limited flexibility, and as a consequence the main wave of registrations of foreign companies did not come before independence paved the way for substantial reforms. The number of foreign companies in Estonia rose from about 400 in January 1991 to about 3,800 in January 1993, with the biggest increase in the months after the currency reform. A second registration boom the last months of 1993, which let the total number rise to 6,316 by January 1994, can be attributed to the fact that several tax advantages were canceled on January 1, 1994, but it also demonstrates that the positive development of business in the Estonian market met foreign expectations.

Table 9: Euromoney's Rating of Selected Eastern European Countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>73</td>
<td>49.79</td>
<td>23.35</td>
<td>+ 26.44</td>
</tr>
<tr>
<td>Slovenia</td>
<td>46</td>
<td>66.30</td>
<td>42.19</td>
<td>+ 24.11</td>
</tr>
<tr>
<td>Lithuania</td>
<td>85</td>
<td>45.14</td>
<td>21.36</td>
<td>+ 23.78</td>
</tr>
<tr>
<td>Latvia</td>
<td>89</td>
<td>44.21</td>
<td>21.70</td>
<td>+ 22.51</td>
</tr>
<tr>
<td>Russia</td>
<td>100</td>
<td>40.60</td>
<td>18.13</td>
<td>+ 22.47</td>
</tr>
<tr>
<td>Poland</td>
<td>58</td>
<td>56.53</td>
<td>35.78</td>
<td>+ 20.75</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>36</td>
<td>74.61</td>
<td>54.89</td>
<td>+ 19.72</td>
</tr>
<tr>
<td>Slovakia</td>
<td>48</td>
<td>64.88</td>
<td>45.32</td>
<td>+ 19.56</td>
</tr>
<tr>
<td>Hungary</td>
<td>44</td>
<td>67.65</td>
<td>54.92</td>
<td>+ 12.73</td>
</tr>
</tbody>
</table>

Source: "Japan Holds On..." in Euromoney, March 1993; Piggott in Euromoney, March 1996; own calculations.

115 For the following figures, see Liuhto (1995), p. 509.
116 This might also explain why, as Liuhto reports, between 20 and 30 percent of the joint ventures have not begun operations.
In spring 1996, the cumulative foreign investment summed up to EEK 8.4 billion, which is USD 480 per head.\textsuperscript{118} This is by far the largest in the region, both on a per capita basis and as a share of the GNP.\textsuperscript{119} The main investors come from Finland and Sweden, who account for roughly one half of the total investments. The region of Tallinn received the lion's share, mainly because most major Estonian firms operate there, and because the short distances make it possible to cover the whole country from headquarters or warehouses in the capital.\textsuperscript{120}

The investment statistics are distorted, however, because they include an unknown amount of Estonian money which was transferred back into the country through offshore banking centers. By this process, domestic investors can profit from the tax relief for foreign investors and from the lower corporate profit taxes the parent companies pay in these offshore centers.\textsuperscript{121}

The recent development shows that the high levels of investment of the past are unlikely to be maintained in the future, even though the negative direct investment recorded in the second quarter of 1996 should be an exception due to several large-scale investments of Estonian corporations in other countries during this period.\textsuperscript{122} This only emphasizes how important it is for Estonia to come out well in future country risk assessments. International investment banks play an ever-increasing role in placing international capital, and this will still be needed in future, when further enterprises are put up for privatization.

\textsuperscript{118} EIU 4/96, p. 13.
\textsuperscript{119} See Hansson (1995b).
\textsuperscript{120} As, for example, in Russia. See Liuhto (1995), p. 516.
\textsuperscript{121} See Burger and Lenzner (1994), p. 79.
\textsuperscript{122} See Carroll (1996a).
CHAPTER VI
PROSPECTS FOR THE FORMATION OF ANTI-REFORM COALITIONS

A. The Unknown Variable: The Shadow Economy

The shadow economy encompasses every kind of economic activity which is not registered and is therefore not included in the national income account. Such activity does not necessarily have to be illegal profit making. The most common form is individual self-sufficiency and is practiced by pretty much every individual around the world to some extent. Spanning over a wide range, from do-it-yourself or neighborly help to subsistence farming and a whole barter economy, such activities generate positive economic effects but cannot be recorded by the statistics because they do not cause any exchange of money. Illegal, but at least still within the setting of economically positive activity are moonlighting and similar forms of income tax evasion, again nothing uncommon to developed economies as well. For officially unemployed manual workers, for example, the line between ‘neighborly help’ and illicit work is a thin one. Not only illegal, but also disruptive for the development of an economy, are criminal activities such as smuggling and the extortion of protection money.

The informal economy can be seen as a vital part of any developing economy because it is able to generate jobs and to provide income for sectors where the state fails to improve the economic and social conditions. However, it also yields the danger that Mafia-like criminal structures develop. It has indeed been observed that Russian Mafia struc-
tures have expanded into the Baltic region, attracted by its liberal consumer markets with few regulations, its better access to global financial markets, and its shipment facilities and relatively open borders.\textsuperscript{123} Reported as the most flourishing illegal activities in the Baltic region are the smuggling of goods, the smuggling of illegal immigrants from Eastern Europe and Asia into the European Community, the trafficking of drugs, weapons and stolen cars, white slave trade and prostitution, and money laundering.\textsuperscript{124}

Through the proceeds from this activities, the emerging underground networks obtain increasing power and are able to undermine the society and to endanger the stability especially of \textit{laissez-faire} political systems.\textsuperscript{125}

Extensive subsistence farming is restricted to the unemployment-struck rural areas, but even in the cities the smallest garden can be turned into a patch of vegetables, and chickens, rabbits or even pigs can be kept on the balcony. Exchange with friends or relatives from the countryside supplies food cheaper than the local supermarket. Less pleasant for the state is the widespread tax evasion, which seems to have developed into a "national sport" in Estonia.\textsuperscript{126} The many small businesses and the booming tourism industry provide many opportunities for unrecorded work. Cash transactions in private businesses may not be ‘made official’ through an invoice. What this might mean for a small country like Estonia can be guessed by a look at Russia. It is estimated that 90 percent of all private sector transactions go unrecorded there. Only one out of many tricks of larger businesses is to work with double bookkeeping, the unofficial one for the own re-

\textsuperscript{124} see ibid., p. 28-29.
\textsuperscript{125} See Germanangue-Debare (1996).
\textsuperscript{126} Burger and Lenzner (1994), p. 52.
cords and the official one for the tax authority. As a consequence, the economy is doing by far better than indicated, and the standard of living is almost twice as high.\textsuperscript{127}

While people might therefore not suffer as much as economic indicators predict, and while many unemployed and underemployed may in fact be able to eke out a meager living, or may even be able to drive around in the latest Mercedes, it is obvious that such behavior on a large scale will eventually corrupt the whole society, most importantly the bureaucracy. It should be a warning when an OECD study notes that, along with the high inflation, crime and corruption are the “most notable risks associated with investing in Estonia”.\textsuperscript{128} However, the loss in revenues from tax evasion and smuggling might be even of bigger concern to the Estonian government, because the consequences can be felt more directly. Tax revenues are regularly lower than expected and planned. In April 1996, for example, the sales tax was 25.5 percent below target, the alcohol tax 31 percent, the tobacco tax 27 percent, and the estimated loss in fuel taxes was at EK 10 to 15 mil. monthly (USD 825,000 to 1.25 mil.) - the fuel smuggled in from abroad is considered to be about 40 percent of the total market.\textsuperscript{129}

\textbf{B. The Unemployed: A Political Factor?}

The picture of masses of unemployed people in the streets, idle, dissatisfied, maybe hungry, cannot be found in Estonia, even though, as noted above, the estimates talk

\begin{itemize}
\item \textsuperscript{127} See Shama (1996), esp. p. 113.
\item \textsuperscript{128} See Investment Guide for Estonia (1996), p. 15
\item \textsuperscript{129} See Oll (1996).
\end{itemize}
about at least one tenth of the Estonian work force without job. This has not, however, transformed into political pressure ‘from the streets’, for several reasons. First, the shadow economy surely provides a certain income to both officially and unofficially unemployed, be it that they actually do have some sort of a job, be it that they are able to live off their land. Second, they constitute a rather heterogeneous group that cannot be easily forged into a political movement. The economic situation of an unemployed in the rural areas and one in the industrial regions might be the same, but their political demands are less likely to coincide. The situation of one of the harder hit groups in Estonia, the ethnic Russians, will be discussed in the next section. Another group which has been disproportionally affected by unemployment, the women, will now be discussed briefly.

The high share of female unemployment can be attributed to a preference for men in re-employment, which is due to several factors.\textsuperscript{130} First, sociological studies reveal that the traditional classification of employment along sex lines was not completely overcome by state socialism, which means that new gender preferences are likely to appear again if cultural traditions are reinforced by the nationalist tendencies that accompany the independence movements almost everywhere throughout Eastern Europe. The strong value placed on women’s domestic responsibilities accounts for them being perceived as ‘unstable employees’ with the additional burdens of household, children and, increasingly, the elderly parents. Finally, there is an employment argument based on pure economic rationality, which does simply see women not as the cheapest labor available, if their employment brings with it that company kindergartens have to be provided and that

\textsuperscript{130} For the following, see Fong and Paull (1993), p 230.
maturity and child-care leave have to be taken into account. It is also pointed out, however, that the fastest growing sectors of the economy, the services and the light industry, are the ones that have traditionally been dominated by a female workforce, a fact which might give women a good chance to become re-employed if economic growth continues.\(^{131}\)

Politically, this higher unemployment burden did not bring increased political activity with it. To the contrary, all throughout Eastern Europe a “dramatic drop in female representation in the newly democratic formal political structures”\(^{132}\) was observed. This was attributed to the fact that active participation in the arena of formal politics had generally become ‘tainted’ during the era of state socialism, followed by the disillusioning experience that even in a democracy not all groups receive a representation of their interest in accordance with their formal democratic rights. It is thus concluded that women seem not to feel the need to let their legal emancipation follow a political struggle to defend and enforce these rights.\(^{133}\)

C. The 'Foreign' Element: Ethnic Russians

In the course of this paper, I have at several times referred to the large group of ethnic Russians in Estonia. I have pointed out several problems - that they are concentrated in certain regions, that they are especially hard hit by the economic slump, that they found


\(^{133}\) See ibid., p. 58-59.
themselves suddenly as a minority in a foreign country after Estonian independence. It should be expected that this group may constitute the fiercest opposition of Estonian policies. For this reason, I will devote this section to an examination of how the relationship between Estonians and non-Estonians has developed in the last years.

When the Estonian people separated itself from the central authority of the USSR, it also separated itself from the Slavic immigrants that had been placed on its territory during the last decades. In the search of an Estonian national identity, the country adopted a series of laws that sparked worldwide discussion about their exclusiveness. As I have shown above, at the outset of independence more than one third of its population was of different origin than the Estonians. Creating Estonian citizenship based on the reality of the Soviet era, which was, after all, a reality that had been imposed upon the country by force, was rejected, out of the fear that the naturalization of the non-Estonians would endanger the national identity of the country and weaken its inner position. The exclusive citizenship, adopted out of a fear of 'denationalization', is in sharp contrast to the general liberal markets approach of the country.134

Modern Estonia conceives of itself not as a new state, but as the continuation of the pre-war republic. This is why, when the Law on Citizenship was enacted in February 1992, it was based on the law which had been in place in 1938 and had been amended for the last time in 1940. Citizens under this law and their descendants became automatically citizens of the new Estonia, while all immigrants who arrived after 1940 were denied automatic citizenship. The ethnic Russians, as well as the immigrants from other

Soviet republics, can apply for passports in these countries, but few actually did so in the first years. Thus, without any official citizenship, they became in the following caught between a status as a minority, i.e., with full citizenship, and a status as immigrants, that is, with foreign citizenship.

Estonian had been introduced as the official language in 1989, while several years as a transition period were allowed. Naturalization requires the passing of a language proficiency test, which is a barrier for Russians who, even though they might have lived in Estonia for decades, did never really get to learn and speak Estonian, mainly because they live in the regions of the northwest where Russian is the local language. The younger Russians, on the other hand, are much more interested in learning English than Estonian.

Several other laws and regulations were passed after independence, and almost all of them caused heavy protest from the various sides of the political spectrum. For some, they were too rigid, for others they did not go far enough. Next to the language test, a one-year waiting period for naturalization was required, which barred non-Estonians from participation in the 1992 elections and caused a controversial debate about “second class citizenship”. The Law on Local Elections of May 1993 allowed non-Estonians to vote in local elections, but not to run for office, which consequently caused problems for numerous non-Estonian incumbents especially in the regions with a large ethnic Russian population. The most controversial law was passed in June 1993. The Law on Aliens re-

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135 Vladimir Chuikin, Chairman of the Narva City Council: “There was never any reason to learn Estonian...Who ever thought we would be anything but part of the Soviet Union?”, as quoted in United States Congress Commission for Security and Cooperation in Europe (1993), p. 13.

quired that all post-1940 arrivals and their descendants have to formally apply for residence, which caused fear that it could be used as a legal ground for deportations. To avoid a major crisis, the law was revised along recommendations made by the CSCE and the Council of Europe before President Meri, who had vetoed the first draft, finally signed the law.\textsuperscript{137}

The exclusive Estonian policy on naturalization of immigrants based on \textit{jus sanguinis} is by no means different from standard European practice, but it is questionable whether it is the ideal approach for a country with such a large number of immigrants who have obviously settled for good and are unwilling to return to their original or ancestral homes.\textsuperscript{138} The approach of the nationalists, that "a little tension now is worth getting rid of as many Russians as possible",\textsuperscript{139} has so far created more unrest than 'success'. Most of all, the fierce debates about blood and nationhood, about who deserves to be Estonian and who does not, has drawn the attention from the real issue, which is the clarification of the status of persons residing in Estonia who are not eligible for citizenship.\textsuperscript{140}

Russian rhetoric against the Baltic’s naturalization laws continues, the last official statement of "blatant human rights violations in Estonia and Latvia" was made by the Russian UN representative in November 1996,\textsuperscript{141} despite the fact that both international organizations and even the Russians in Estonia themselves are frequently dismissing such accusations.

\textsuperscript{139} Congress Commission (1993), p. 20. 
\textsuperscript{141} See Carrol (1996b), p. 3.
The haggling about the citizenship question conceals the fact that the real concerns of
the ethnic Russians are the economic situation and the possibilities and opportunities for
them to participate in the new economy.\(^{142}\) In June 1994, only 28 percent of the non-
Estonians indicated that they felt that their economic situation had improved, compared
to 61 percent of the Estonians.\(^{143}\) However, while according to a survey conducted in
April 1995 about 30 percent of the Russians in Estonia thought they would be better off
if they were still within the Soviet Union,\(^{144}\) this leaves a two-thirds majority supporting
the country. 87 percent of the Russians said that they have little or no problems with the
locals, and 93 percent wanted to stay.\(^{145}\) It seems obvious that neither the nationalistic
rhetoric nor the economic conditions led to a radicalization. Furthermore, ethnic tensions
are generally perceived to be decreasing, which will give further support to less aggres-
sive parties.\(^{146}\)

More and more, the Russians become politically organized. Three reasons are given
why the Russians failed to become united as one political bloc.\(^{147}\) First, they did not, and
still do not, constitute a homogeneous group with a common sense of purpose. Commu-
nist hard-liners and Russian nationalists met with young entrepreneurs yearning for mar-
ket economy. Second, the Russian immigrants were predominantly technocrats, they
lacked the intellectual leaders who would get the people behind them. Third, the existing
Russian organizations, most prominently the Communist Party which had been left by

\(^{143}\) According to a Saar institute poll, as quoted in Kaplan (1995), p. 258.
\(^{144}\) The New Baltics Barometer II, as quoted in “Them and Us”, p. 74.
\(^{145}\) EIU 3/95, p. 8 (source not cited - presumably the New Baltics Barometer II).
most Estonians, were deeply discredited even among the Russians. In the local elections in October 1993, many of the Russian leaders - most of them with a history of membership in the Communist Party and of open support for the August 1991 coup, were removed from office and replaced by a new generation of more mainstream Russians.\textsuperscript{148} In the elections of 1995, three Russian parties formed a coalition and won six seats, which is well below their potential, considered that about 150,000 naturalized ethnic Russians were allowed to vote.\textsuperscript{149} This seems to be a sign that most Russians do not have political interests which are diametrically opposed to Estonian policies, at least not in economic questions, especially since the Russian parties themselves are far from being truly radical. As the focus of political debate shifts from nationalism to social and economic issues, Estonians and non-Estonians may form coalitions based on similar interest to cause policy changes in their favor.\textsuperscript{150}

It seems to me that ethnic tensions in Estonia are well below a critical level at which they might endanger the society, probably because demagogues cannot effectively turn the Russians into a scapegoat for Estonian problems. The Russian immigrants did not in general behave like oppressors, nor did they occupy all leading positions in the country. The Communists did, and they came out of the Estonian part of the population as well. The ethnic Russians were as much fed up with the old regime as were the Estonians. They both suffered from the economic collapse, and they were both looking forward to the new times. The Estonian government seems to bet on the factor of time, in the hope

\textsuperscript{148} See Pettai (1996), p. 79.
that economic progress will benefit both Estonians and non-Estonians, and that the two
groups might achieve some sort of peaceful cohabitation through this process. In this
case, the Estonian Way of economic reforms would have been successful, because it did
not give rise to severe tensions. In the end, integration should be a matter of self-interest
for Estonia, because an unsettled relationship with its Russians will always be a source
of worries about the behavior of its big neighbor in the East.\textsuperscript{151} This, however, is not a
question of economics.

\textbf{D. The Political Landscape and Election Results}

In the spring of 1992, the political landscape of Estonia was still shaped by the lack of
political parties possessing a clear political program and a certain amount of internal
unanimity. A constitution had not yet been introduced, and the legislature, the Supreme
Council, was a remnant of the old Soviet Union. Its legitimacy had been heavily chal-
lenged over the last years by the Congress of Estonia. The 1990 election had left the
Council dominated by pro-independence forces that had very different ideas for reforms,
particularly on the fiercely debated question of citizenship for non-Estonian residents.
What the factions had in common, though, was that they all shared the desire for a na-
tional currency and a relatively good understanding of the implications of its introduc-
tion. The Estonian government was headed at that time by Prime Minister Savisaar. Al-
though by no means an opponent of reforms, he preferred a more gradual pace and was

\textsuperscript{151} See "Them and Us", p. 75.
always trying to slow down the process. In January 1992, in the political aftermath of a severe energy crisis due to a cutback on Russian supplies, he had to resign from office. While he remained in the political arena, forming a center-left party that would eventually become a voice of the critics of the market reforms, he was discredited to an extent that would make his return to a governing coalition unlikely for the near future. The caretaker government appointed after Savisaar’s resignation could then draw support from a wide political spectrum, from a moderate group of Social Democrats and centrists to rightist-nationalist groups. When the need for currency reform became urgent, the radical reformers and economic experts in this coalition could introduce the currency board without difficulties.

The first fully free election, held in September 1992, about ten weeks after the currency reform, showed that support for radical reforms existed in the public. It laid the ground for a center-right coalition stable enough to continue the reform process. The coalition was led by the Fatherland alliance of several Christian Democratic and Conservative parties, which were focused on rapid and decisive reforms. Partners were the Estonian National Independence Party, hard-liners in the question of the Russian minority, but willing to cooperate with the reformers in economic issues, and the Moderates, a conglomerate of Social Democrats and rural Centrists, which were indeed rather moderate and liberal. The opposition was dominated by the Popular Front, which was the remainder of the broad movement of the days of the struggle for independence, and by Secure Home, party of the old nomenklatura and other people interested in slowing reforms

152 See chapter IV, A.
down. Significant was the collapse of the reform-communist Left Alternative, which failed to receive the five percent of the nationwide vote required to make it into the parliament. It was also observed that the electorate was divided between the urbanites, who largely supported the reform coalition, and the rural areas, where personalities prevailed, which accounted for the large vote for the former chairman of Soviet Estonia’s Supreme Council, Arnold Rüütel, who was almost elected president of the new republic.\textsuperscript{154}

In the following years, the parties underwent several transformations, and individuals would change their affiliations, so that in October 1994 the government fell when Fatherland split up into three parties. The caretaker government relied mainly on incumbent ministers, which indicates that the political support had not diminished. The March 1995 elections shifted power towards the center, to a coalition of the KMÜ, which is in itself “an uneasy coalition of protectionist farm interests and market-oriented former Soviet managers“,\textsuperscript{155} and the Center Party. The main opposition comes from the right, from the Reform Party and Fatherland, which are ideologically close but failed to join to form a strong pro-reform movement. However, neither one of the major parties is strongly opposed to reforms - it is significant that a viable movement left of the social democratic Moderates did not emerge.

The Reform Party replaced the centrists in the government coalition after Center Party leader Savisaar was involved in a political scandal in spring 1996. In the latest development, the KMÜ broke with the Reform Party again and is looking to form a minority

\textsuperscript{153} For an overview of all Estonian parties in the first post-independence parliament, among them a group of comedians running as the Monarchists, see Fitzmaurice (1993), esp. p. 172.

\textsuperscript{154} See Kionka (1992), p. 10.

government, either on its own or together with the Development Party, a breakaway from the Centrists. The little influence this ‘coalition jostling’ has on the overall economic policy can be illustrated by the comment of an opposition politician on the plans of the new government to raise the pensions as a concession to the new prospective coalition partners: “The Prime Minister could have sent the pension increase wish directly to Santa Claus”. The results of the municipal elections in October 1996, which showed an even distribution of votes over the biggest election unions and thus no bigger change, the announcement of the new government that they “will continue pursuing the same domestic, economic and foreign policies as before“, and the comment that the “general policy is the same”, because the “groups are all quite similar“, show that the overall consensus on reforms is still stable.

E. Saving the Sayers: The Banking Reform

In the last paragraph of this chapter, I would like to give an example for the care the Estonian government takes with its reforms, as an example that, even though shock therapy is the guiding model of economic change, the government does not confuse it with an unrestricted rush to the promises - and deceits - of liberal markets.

After the currency reform had limited the ability of commercial banks to refinance themselves through the Eesti Pank, it soon became clear that many of the banks would

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158 Tartu University political science professor Rein Toomla, as quoted in Sharp (1996).
not survive. It is indicated, in a close examination of the bank’s business practices prior to the crash, that the commercial banks may have misjudged the willingness of the central bank to back its directives with sanctions, especially since this had hardly been done before.159 When the Eesti Pank refused to bail out the banks in distress, an action which would undoubtedly have caused the early demise of the exchange rate peg and the currency board, the banks became illiquid, and in the following banking crisis in fall and winter 1992, the central bank closed one of the banks and merged two others, while depositors and owners were not or only partially compensated. In the following, eight further banks lost their license, and ten others were merged. The demands for minimum capital requirements and liquidity were raised and are planned to be adapted to EU norms by the year 2000.160 As a consequence, liquidity and solvency of the banking sector improved steadily, and the efficiency of the payment system was raised as well. The rigid approach has brought the country two years ahead of its Baltic neighbors in banking reforms, and the bad debt ratio of Estonian banks is nowadays with 4.7 percent the lowest throughout post-communist Europe.161

It should be remembered, when discussing the effects of the banking reform on private individuals, that most of their savings were held with the Savings Bank, which did not get into trouble during this crisis. Thus, even though banks were closed and investors lost money, the general public remained relatively unaffected. The savers were spared. The increased efficiency of the payment system and the more solid and reliable ground

160 See ibid., p. 145.
on which the banks stood that survived the crisis, benefited both the general public and the ‘risk-takers’, which incurred losses, but were at the same time rewarded with the prospect for better chances on financial gains in the future.

It can be observed that the shock therapy measures employed in Estonia were not accompanied by a hasty implementation of all the instruments of the Western liberal financial services sectors, and this caution paid off. It was not until May 1996 that the Tallinn stock exchange was set up, after an adequate infrastructure and regulatory environment had been established, and yet it developed quickly into the biggest stock exchange of the Baltic states.\textsuperscript{162} Even though private investors play only a minor role on this new market, it emphasizes that the Estonians are able to reform their economy quickly, but not blindly, and that potential ‘victims of the new times’ are taken care of wherever the reform plan allows for it.

\textsuperscript{162} See Kaminski (1996).
At the time Estonia gained independence, when the country could set out to reform its political and economic structure unrestricted by objections from a central government in Moscow, other former centrally planned economies had already begun the transformation process. Observing their neighbors' experiences with reforms, the Estonian government was convinced that changes had to be quick and definite, that any 'third way' would not only be unlikely to result in a favorable economic development, but lead directly to further impoverishment. Independence and the economic collapse of the ruble zone caused a period of "extraordinary policies" in which the level of acceptability of radical reforms in the electorate was high, and in which oppositional forces had not yet been formed. This was an opportunity to introduce the radical and painful reforms that were considered to be necessary, and these reforms were indeed backed by the support of a people who was willing to endure economic hardship in the hope of being rewarded as their country would become a worthy member of the democratic world and its liberal markets.

The examples of several developing and post-communist countries demonstrate that macroeconomic stabilization generally requires quick reforms, because inflationary ex-


\[^{164}\] This much-quoted term goes back to Leszek Balcerowicz, former deputy prime minister of Poland. See Balcerowicz (1994). He is one of the most prominent academics in the field of transformation policy questions and a strong supporter of the shock therapy approach. See also Balcerowicz (1995).
pectations are hardly ever successfully broken by gradual attempts. Even though the present inflation rate in Estonia might be very high by Western standards, there is no doubt that the introduction of the kroon and its institutional backing by the currency board brought a reliable and fully functional currency to the country. In the field of monetary stability, the currency board approach clearly worked the way it was hoped for.

Along with all other reform measures, which I have noted, but not discussed to the same extent as I discussed the currency board, the Estonian Way led to the largely positive picture I have described above in chapter V. Debates about the accuracy of the data notwithstanding, the economy is growing, after the years of stagnation at the end of the communist era. The quick implementation of the foundations of the liberal market system, such as a reformed court system, a civil code and a trade code, led to a flourishing private sector, which produces more than 60 percent of the GDP today. This is one of the reasons why “any return to the communist system is now out of the question”.

This is not only political rhetoric. Extremist political parties from both the right and the left have slipped into insignificance in the last elections. A substantial part of the people may agree with the statement “I am worse off today than under the old regime“ in public opinion surveys, but this may not be equaled with refusal of democracy or remorse about the decision to leave the Soviet Union itself. Moreover, research indicates that democratic commitment is dependent on the process of democratic reform rather than on the eco-

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167 The statement “Let’s put up the wall again“, for example, can be frequently heard in both parts of the reunified Germany. However, such a statement is easily made if one can be sure that it will not come true!
Dissatisfaction with democracy is therefore rather created by the politicians and their behavior and less by a failure of their economic policies. It is unfortunate, in this context, that Estonian politicians have not always displayed a picture of integrity and altruism in the last years. Many cases of nepotism have been observed, and many times individuals failed to meet the demands of a position in the government. However, none of these events have transformed into a level of dissatisfaction with the political system that would exceed the level of dissatisfaction that can be observed in Western democracies.

I have shown that economic development has produced negative effects. This has been expected, and even though the most optimistic pictures drawn at the outset of the reforms have since been revised, none of the negative developments is dramatically outside of the scope within which the Estonian government should be able to deal with it successfully. This is probably the reason why these problems have not created a 'revolutionary potential' so far. The shadow economy not only draws a veil over the true economic performance of the Estonian national economy, it is also likely to 'mollify' the economic distress of individuals to some extent, despite the fact that it also brought increased criminal activity with it. There is no doubt that some groups have been hard hit. Unemployment is high among the ethnic Russians, but as I have shown, the Estonian government is not further aggravating that situation by deliberately discriminating against them. The situation of the Russians surely is not an ideal one, and it will certainly cause further discussion in future, but most Russians know that their economic situation is unlikely to im-

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prove if they return to Russia, as the almost insignificantly low rate of ‘emigrating’ Russians shows. As the country changes from state socialism to free markets, so changes the role of the woman in it, and it might, at least in some aspects, not be a change to the better. The agrarian sector is struggling, but structural adjustment here needs time, and its political representatives are constantly lobbying for the import taxes that are not allowed under an agreement with the IMF until July 1997.¹⁶⁹ Pensions are low, and employment opportunities for elderly people are scarce, but the situation is still better than in the neighbor countries, and the Estonians might well be aware of it. Moreover, pension increases are more likely if the government politics turn out to be successful than if they fail, so pensioners may be interested in policy changes in their favor, but not to an extent that they would prefer a radical reversion.

Much like the Russians, the unemployed are not a homogeneous group. Apart from the difference between rural and urban unemployed, there is also a difference between those who try to become self-employed by setting up small businesses and those who try to become re-employed as industrial workers. So the disadvantaged fail to form a strong oppositional movement because unemployment, underemployment and low social benefits are not reason enough to unite the people across social and ethnic borders. The general economic policy, though exposed to a lot of criticism, is not discredited. For those who profited from it, the Estonian Way worked well. For the others, it has not worked poorly enough to forge them into a truly challenging ‘left alternative’, and it is not likely to do so now that the worst seems to be over.

¹⁶⁹ See EIU 1/97, p. 9.
Despite its general commitment to shock therapy, the Estonian government has nevertheless tried to dampen its effects where possible. Not all prices have been liberalized immediately, not all state enterprises have been radically closed just because they were momentarily unproductive after the reforms. As I have shown with the example of the finance sector, deliberation played a role even where reforms were to be quick and radical. This is undoubtedly true for the beginnings of the reforms, and now that, after the 1995 elections, the most eager reformers, the young urban professionals from the Reform Party, are actually in opposition, this is even less unlikely to change.

What is striking is that, even though there still are many remnants from the old regime, the basic economic problems the country has to deal with are not restricted to Estonia and other transition economies who opted for a similar path - the role-models, the Western economies, have to deal with them as well.

First, many of the jobs that have been created in the trade and services sector are at the lower income levels, with the exception of the financial services. This development, which is not unlike that of Western countries such as the US, does not create an adequate revenue base which would allow for an extension of the social services. Second, it seems unlikely that the situation in the job market will improve essentially within the next years. The potential for further economic modernization implies increases in production, but also less demand for labor. Regardless of the official data, the real unemployment rate might level out at the high rates of Western Europe. Third, the process of

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170 In fall 1992, for example, the government waived unpaid taxes owned by a big textile company in Narva, because they did not want to let the situation in this hard-hit (and mainly Russian) region deteriorate further. See Lieven (1993), p. 360.

widening income differentials will continue under the present policies, again not unlike the trend in the major Western countries. While self-sufficiency and illicit work might take the explosiveness out of these developments, at least in the short term, it can surely not be regarded as a solution in the long term.

The social benefits are set at a very low level. This was not only done of necessity, because the balanced budget law does not allow for much leeway, it was also done deliberately to set an incentive for the people to think for themselves and to take matters into their own hands, something they were not used to under the communist regime. A commendable policy, because self-initiative of the individual is one of the cornerstone of the liberal paradigm. It cannot be denied, however, that the economic activity of individuals does not necessarily have to create socially desirable outcomes, especially not if equal opportunities cannot be provided. The impoverishment especially of families with young children, which results, for example, from the lack of tax breaks, is seen at least in the case of neighbor Latvia as one reason for the increase of prostitution and similar activities, or, as the economist calls it, the ‘sexual services market’.172

We should keep in mind, however, that shock therapy and the Estonian Way do by no means demand that the society be subject to aspects of economic efficiency alone. The transformation process leads an economy from central planning and communism to markets and liberalism. It does not say anything about the shape of the market economy after the transformation has been completed. Whether a country opts for a social market economy along the models of Germany and Sweden, or whether it embraces the policies of

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Reagan and Thatcher, is only the ‘fine tuning’ at the end of the road to private ownership, private financial markets and active labor markets.\textsuperscript{173}

The main question for the people of Estonia is therefore whether the shock therapy transition is able to establish institutions which will in the long term ensure that the transformation process will be confined to the boundaries set up by the regulatory policy. The currency board and the peg have been of good service so far. They have not been unchallenged, but they have not been changed either, and the government is determined to keep it at least until the year 2000.\textsuperscript{174} What remains to be done until then, however, might eventually prove to be even more difficult than the quick reforms: the expansion of the social safety net in a financially sustainable way, so that the peg is not endangered. Room for steps in this direction is indeed given. Tax evasion will eventually be reduced, and tax revenues increased, as a more and more efficient bureaucracy develops. Moreover, the tax system itself might allow for a change towards more redistributive effects, for example by a change from the present flat income tax rate to a progressive one. As the industrial economies have shown, economic growth and equity may well be consistent.\textsuperscript{175}

As far as the currency board is concerned, the economic literature, which contains ample discussion about the reasons why a currency board should be introduced, provides no clear statements on when it has fulfilled its purpose. However, the discussion of reasons for its establishment allow me to deduce several conditions that would have to be fulfilled before the Estonian government can decide to drop the currency board. First, the

\textsuperscript{173} See Sachs (1990), p. 21.
\textsuperscript{174} See EIU 3/96, pp. 11-12.
government should have sufficient experience and well-trained staff at its hands to run a central bank effectively. Second, the Estonian economy should have developed up to a point where the severe monetary disturbances that are likely to appear during a transition period are no longer a threat, which means that the country has reached a stage of economic stability in which the government will only have to deal with the ‘usual’ ups and downs of business cycles. Third, the decision to abandon the currency board should be made at a time and in a context in which it is clear to everybody that the government will keep up its commitment to a policy of stability.

With the methods of the personnel management, the Bank of Estonia should be able to assess exactly how good its staff is, and the officials can draw their conclusions accordingly. How far developed the Estonian economy is, on the other hand, appears to be a rather subjective question, open for interpretations by everyone. The biggest problem, however, is posed by the third condition. Whether a government will actually stick to its declared intentions can only be answered ex post. Allowing for a policy change always implies that the policy will indeed be changed sooner or later. What remains important in this context is the will of the public for stability-oriented politics. As long as this will prevails, the government, any government, will try to meet the demand. What becomes ultimately clear is that there is indeed room for dropping or phasing out the board if it is felt that its time has come.

The self-restraint that the Estonian government imposed upon itself by adopting the currency board did successfully propel the country towards market economy and political stability. While experts might debate about the extent of the social costs that were in-
olved with it, we cannot overlook the most unmistakable empirical proof available. Almost every day news can be read about an Eastern Europe filled with examples of countries which try to reform their economies in a different way. In Bulgaria, the people took to the streets in to force the government of ex-Communists to resign over its failure to stop the country’s decline into mass poverty - how much more discredited can a party and its politics possibly get? In Albania, hundreds of thousands of people lost their savings in financial schemes, while there are signs that the government, which must have known, profited from it and did therefore not warn the public - quite a different approach to reforms than the Estonian Way. Belarus can hardly be called a democratic country today, and even its future as an economically and politically independent state is now doubtful. Compared to these sad examples, Estonia indeed deserves to be described as “The Little Country That Could“. \(^{176}\) Whether it will now be able to set off the remaining negative sides of transition - within the set of rules prescribed by the currency board, or without it, but in any case within the scope of monetary stability and free markets -, is not a question of the Estonian Way any longer. Whether the global market economy forces will allow the country to introduce some social reforms without being punished by the international financial community, whether the country, like many others, will continue to lose tax revenues from corporations who operate internationally and can therefore almost at will manage to pay profit taxes where the rates of taxation are the lowest, whether employment can be secured in a world where less and less people are needed to produce more and more, all this is not a question of the approach to these free global

\(^{176}\) *Newsweek* magazine headline as quoted in Laar (1996), p. 97.
markets Estonia has taken. The quick reforms have generally brought the expected results, even if they may have not fulfilled all the promises. The country has arrived in the world of neoclassical economics, and it is doing far better than others who tried ‘third ways’. That even in this world the sun does not always shine - that is a whole different story.
APPENDIX

A SHORT CHRONOLOGY

1721  Treaty of Nystadt. Estonia becomes part of the Russian Empire under Peter the Great

late 18th century  Tsarist Russification policies are met with raising national awareness and activism for independence

1917  Demand of autonomy by the national assembly of Estonia during the Russian Revolution

Feb 24, 1918  Estonian independence declared
German troops occupy the Baltic provinces

Jan - Mar 1919  Estonian forces drive out the Bolsheviks that had followed the Germans

Feb 2, 1920  Tartu Peace Treaty signed. The Soviet Union accepts Estonian independence

1928  Estonia introduces the kroon as its national currency

Aug 23, 1939  Molotov-Ribbentrop pact between Nazi Germany and the Soviet Union assigns Estonia to the Soviet sphere of influence

June 1940  Soviet Union invades Estonia

Aug 6, 1940  Estonia is declared a republic of the USSR

late 1980s  The Gorbachev era of glasnost gives rise to public expression of political protest. Ecological concerns create the first autonomous political action in Soviet Estonia.

August 1989  Moscow accepts the existence of the illegitimate secret protocol of the Molotov-Ribbentrop Pact, a quasi-acceptance of the illegitimacy of Soviet rule over the Baltic States

March 18, 1990  Supreme Council Elections in Estonia lead to a two-third majority for independence
<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>Aug 20, 1990</td>
<td>Supreme Council declares the Soviet annexation to be cancelled and proclaims “de jure” independence</td>
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<td>Aug 19, 1991</td>
<td>In the course of the attempted coup against Gorbachev in Moscow, Soviet troops try to seize public buildings in Riga (Latvia) and march towards Tallinn</td>
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<td>Aug 20, 1991</td>
<td>Estonian Supreme Council declares the restoration of independence</td>
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<td>In the following weeks, Estonia receives international recognition</td>
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<td>Sept 6, 1991</td>
<td>The Soviet State Council recognizes Estonia’s independence</td>
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<td>September 1991</td>
<td>Estonia joins the United Nations</td>
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<td>Dec 31, 1991</td>
<td>The Soviet Union ceases to exist</td>
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<tr>
<td>Feb 26, 1992</td>
<td>Estonian legislative adopts Citizenship Law, which guarantees Estonian citizenship to individuals who were Estonian citizens before June 16, 1940, and their descendants</td>
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<td>June 20, 1992</td>
<td>The Estonian kroon replaces the ruble</td>
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<td>June 28, 1992</td>
<td>The parliamentary constitution is passed in a referendum</td>
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<td>Sept 20, 1992</td>
<td>Parliamentary elections give small majority to a center-right coalition</td>
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<td>May 1993</td>
<td>Estonia admitted to the Council of Europe</td>
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<td>June 21, 1993</td>
<td>Political crisis after the passage of the Law on Aliens. Law amended after presidential veto</td>
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<td>February 1994</td>
<td>Estonia joins the Partnership for Peace program of NATO</td>
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<td>April 1994</td>
<td>The Baltic states sign a free trade agreement</td>
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<tr>
<td>Aug 31, 1994</td>
<td>The last Russian troops pull out of Estonia</td>
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<td>Jan 1, 1995</td>
<td>Free Trade Agreement with the EU in force</td>
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<tr>
<td>March 5, 1995</td>
<td>Second Parliamentary elections shift power toward the center, brings seats for a coalition of ethnic Russian parties and eliminates several nationalist figures</td>
</tr>
</tbody>
</table>
November 1995  

Estonia’s associate membership in the EU ratified by European Parliament
Estonia applies formally for EU membership
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