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# The Baltic Tiger

## The Political Economy of Estonia's Transition from Plan to Market

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# 1. Introduction

Economic transformation is a common theme in world history and countries all over the globe have experienced periods of radical changes of its economic structure and economic policies. Many of these transformations have also been shared by a large group of countries, and an even larger group of people, that *prima facie* are very different from each other. Neglecting many pivotal transformations in the long view of economic history, it seems that the last 25 years have witnessed such a period of rapid changes in economic policies in many if not most parts of the world – and the most essential ingredient of this transformation has largely been the principal and effective revival of capitalism and the market economy.

After the oil crises of the 1970s, OECD countries moved away from the *dirigiste dogma* that had guided economic policies since at least the end of the Second World War. The immediate responses to the crises of the 1970s were often illiberal and rested more often than not on a panoply of interventions. Capital and current account regulations that hampered international exchange formed, in most cases, part of Western crisis policy. But as these measures failed to address the core problems, or rather entrenched them, and as other fundamental economic problems surfaced, several countries headed for a reform agenda based on deregulations, privatisations, tax reforms, macroeconomic stabilisation and cross-border liberalisations.<sup>1</sup> Admittedly, one can challenge the notion that these reforms, in scope and significance, were sufficiently comprehensive in all countries, but it is overall obvious that this general trend of liberalisations in Western countries left a significant imprint on policy from the early-to-mid 1980s onwards.

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<sup>1</sup> Henderson (2001) offers a discerning analysis of the revival of liberal economic policies in the post-1970 period.

At roughly the same time, in the aftermath of the debt crisis, a period of comprehensive economic reforms started in many but far from all developing countries. Some countries pursued liberal economic reforms unilaterally, most notably China with the first step of reforms taken in 1978, while others were pushed by multilateral institutions such as the World Bank and the International Monetary Fund, the Bretton Woods twins who then had started to frame its developing-country operations in a context of structural adjustments and conditionality. Reforms in the latter group of countries have been patchy and uneven, many of them were also repealed at later stages of the reform cycle, and overall it is difficult to find evidence suggesting donor-led reforms have been successful.<sup>2</sup> Studies rather show that few developing countries really undertook comprehensive liberal economic reforms as part of a donor programme.

But the unilateral reforms have proved not only to be persistent, and in most cases self-sustaining, but have also had considerable effect on economic growth and development in general. China continues to be the star pupil of market-based economic reforms, but countries such as Chile and India have also taken economic reforms seriously, in some respects even more serious than China. In the Asia-Pacific region several other examples of reviving economic liberalism in the 1980s and early 1990s can be found. Australia, New Zealand and many countries in Southeast Asia decidedly followed the unilateral route and achieved root-and-branch reforms of internal as well as external economic policy.

The task here is neither to provide an analysis of all the reform examples mentioned above, nor to inspire a flavoured discussion of the political-economy nature of economic reforms, but to give a backdrop to the main reform event in the 1990s (or to give it the proper proportion:

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<sup>2</sup> The effects of liberal reforms pushed by aid agencies or international institutions is discussed in Easterly (2002), Erixon (2005), Erixon & Sally (2006), and Killick (2002).

the major world event since the end of the Second World War): the fall of the Berlin Wall and the struggle of former communist countries in Central and Eastern Europe to move away from the command economy and to establish constitutional democracy and a market economy.

It is difficult to exaggerate the depth and scope of the transformation these countries have experienced in the last 15 years. Countries that in one way or the other belonged to the Soviet system experienced full root-and-branch socialism. The planned economy affected every part of the society and no sector was left untouched by the structure of economic socialism – the *modus operandi* of the command economy. Indeed, the whole society changed considerably under communist rule and people was mentally and culturally captured by distorted beliefs and attitudes about the nature of societies and principles of civilisation.

As many other totalitarian ideologies, communism sought to change societies by changing people.<sup>3</sup> Communism, to paraphrase Spinoza, refused to see people as they are but only as they ought to be. Therefore, twentieth century communism was effectively a giant leap backwards in history to pre-enlightenment beliefs and models of society.

In theory communism was supposed to deliver heavenly kingdoms by dissolving the narrow interests and prejudices of man, but in practice nothing of that kind occurred. Societies founded on a naïve and false idea about the nature of mankind has in most cases degenerated into totalitarianism, and communist regimes in the twentieth century bear witness of how such notions deprave the political, economic, cultural and societal fibres of a country.

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<sup>3</sup> The new man was popularly called *homo sovieticus*.

How can such societies, deeply tainted by communism and the command economy, be reformed? Can they be reformed? Apparently they can. The early 1990s was awashed with dark forecasts about the reform spirit and reform feasibility in the Central and Eastern European countries. But these forecasts essentially got it wrong.

The former communist countries in Europe are today very different from what they were in the early 1990s at the time of independence. In some of the countries, in particular the Eurasian countries or the Commonwealth Independent States (CIS), little happened for a long while and some of them are still, in one way or the other, governed by totalitarian and deeply corrupted regimes. The absolutist tyranny may be over, but many feel they are rather living in a tyranny with elections rather than in a democracy or even a proto-democracy. A few countries in that region have performed better and taken incremental steps to open up their societies to the outside world, particularly in the economy. Indeed, economically some of the CIS have grown significantly in the new millennium; partly due to rising oil and commodity prices, partly due to economic reforms.<sup>4</sup> But none of them have undertaken the thorough economic and political reforms that have characterised the former communist countries in Central and Eastern Europe.

Estonia is arguably one of the most interesting countries among the group of Central and East European countries (CEEC). It is a small-to-tiny country in the Baltic region, located just below the Gulf of Finland, and the number of citizens is not more than 1,5 million. But together with Poland it was the country that undertook the most radical market-economy reforms in the early 1990s and that has grown fastest of the former communist countries in

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<sup>4</sup> Åslund & Jenish (2006) show that Eurasian countries have had significantly higher growth than Central European countries since 2000. Falcetti, Lysenko and Sanfey (2005) discuss the nature of growth in transition countries that have not undertaken reforms.

Europe. Therefore it has by some been called a ‘Baltic Tiger’. It’s almost complete free trade policy in the early 1990s has also rendered Estonia the epithet of ‘Europe’s Hong Kong’.

The Estonia reform period is of interest for a number of reasons.

First of all it offers a good example of an age-old wisdom: liberal economic reforms provide the incentives and stimulus needed to experience sustainable economic growth. A number of factors can retard economic growth – policy, geography, cultural patterns – but countries that reform its basic institutions and pursue liberal economic policies will soon also experience growth and economic development. To this date, every country that has pursued such economic policies in a comprehensive and sustainable form has also increased welfare.

Liberal economic reforms are no panaceas, but in a typical developing country adversely affected by excessive regulation and an inferior institutional climate, they arguably are a precondition to growth generally.

Secondly, Estonia undertook a comprehensive reform package in a fairly short period of time. Some call this package, pejoratively, ‘shock therapy’, and largely suggest the reforms were based on fast-and-furious ‘neoliberalism’. Another way of describing the Estonian reforms is that this small country essentially followed a classical-liberal policy that besides a few other examples, notably Hong Kong and Singapore, we have not witnessed since the ‘Victorian social contract’ of nineteenth century Britain.<sup>5</sup> All the other reform examples mentioned above falls short in comparison to the programme of liberalisation in Estonia between 1991 and 2000. Estonia is thus a rare example of classical liberalism in practice.

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<sup>5</sup> Feldmann and Sally (2001).

Thirdly, Estonia differs from most other countries that belonged to the Soviet sphere. As the other Baltic countries, Estonia was part of the Soviet Union and was thus more integrated in the Soviet command economy than many other countries in the COMECON (or CMEA<sup>6</sup>) area. As a consequence, Estonia was much more affected by the economic crisis in Soviet in the late 1980s and early 1990s. Effectively, Estonia's reform package, its reorientation to the West, had to be more extensive than other countries reform efforts.<sup>7</sup>

Fourthly, Estonia pursued trade-policy reforms that led to an almost complete free-trade policy from the early 1990s to 2000 when trade policy started to change as part of Estonia's accession to the European Union. Besides Hong Kong and a few small island tax heavens, no country has moved as thick and fast as Estonia in current and capital account liberalisation. The effect of this policy is of great relevance to models of trade policy in other countries – developing as well as developed countries.

Fifthly, the political economy of Estonia's reforms conveys essential information to reform efforts in other parts of the world.

This chapter intends to analyse the Estonian miracle – its journey from the Soviet Union to the European Union – in more detail. In particular we shall study the major reforms that

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<sup>6</sup> Council for Mutual Economic Assistance.

<sup>7</sup> In various transitions report from the European Bank for Reconstruction and Development (EBRD) – see for example EBRD (1995) – countries reform efforts are ranked by different standards and some reports from the 1990s generally showed the Czech Republic, Poland and the Slovak Republic to be ahead of Estonia in terms of structural reforms. Today Estonia is on par or above these countries, and the explanation to Estonia's lag in the 1990s is generally that it started from a much worse position than Poland and that the reforms in Poland, the Czech Republic, and Slovakia started earlier than in Estonia. Of interest too: Estonia has a significantly higher ranking in policy indexes such as the Economic Freedom of the World – Gwartney and Lawson (2005) – and the Wall Street Journal/Heritage Foundation Index of Economic Freedom – Miles, O'Grady, and Holmes (2006). In the former index, Estonia is ranked as the number 9 in the world (with a score of 7,8) and the Czech Republic is on the 44<sup>th</sup> place (with a score of 6,8). Åslund (2002), chapter 4 and 5, discusses the liberal policy reforms and how they can be measured.



turned this command economy upside down by radical liberalisation and thus prepared the ground for rapid economic growth.

The paper is structured as follows. In the next chapter we will discuss the economic fundamentals and the political economy of Estonia before independence and how key economic indicators changed, rapidly and drastically, after the real reform programme started. In chapter three we turn to the major reforms that radically changed economic policy and boosted economic growth. These reforms were the introduction of the currency board arrangement, unilateral trade liberalisation a la Hong Kong, and the programme for privatisations and new enterprises.

In the last chapter the Estonian development from plan to market will be summed up and compared to the development in Latvia in Lithuania.

## **2. From Soviet Union to the European Union**

### 2.1. The Sovietisation of the Estonian economy

It has often been said about Central and East European countries that their transition from communism to liberal democracy has been extra difficult because none of these countries actually had any experience of liberalism or democracy before the rise of the Soviet Union. This is not entirely correct, but it nonetheless touches upon a central nerve in transition politics: In countries that have lost track of their historical roots because of internal revolutions or external annexations, where can one find the core cultural foundation upon which these societies can build a new political and economic order?

If this concern is warranted, and if it was at the time when the Soviet Union evaporated, the difficulties surely must have been more strenuous in the Baltic countries than in any other country in the Soviet sphere.

Estonia was not only largely devoid of a democratic and liberal past to build upon; it had little experiences at all of being an independent country. It became an independent country after the First World War and the fall of Tsarist Russia, was annexed again by the Soviet Union in 1940, and was part of Soviet (except for the period of German rule during the Second World War 1941-44) until independence in August 1991. Thus, Estonia was faced with concerns that were not present in several other countries in the Soviet sphere. Where does one start such a process of root-and-branch nation building? Many Estonians actually knew where to find historical inspiration to modern life and policy in the new Estonia. But it was in a past, several centuries ago.

The Baltic region had been part of the Hanseatic League and had developed extensive networks of trade with the outside world. This league, in place from the later middle ages to the early modern period, was a trade monopoly of sorts, but its main effect was an unprecedented regional economic integration. Trade increased considerably. Tallinn was during the period of the Hanseatic League a major trading city in the Baltic Sea area, surpassing Stockholm and other major regional hubs, and was in many other ways too the urban centre of the region.

In Estonian folklore this was the high point of the country's history before independence. It is a time of rapid expansion and of growing prosperity. What today are Germany, Finland and Sweden were the major trading partners, a pattern essentially echoed in Estonia's external trade today<sup>8</sup>, and these commercial ties formed larger networks that nourished despite Soviet rule.<sup>9</sup>

But in plain economic terms, the 50 years as part of the Soviet Union led to a complete socialisation of the Estonian economy and an almost complete reorientation of Estonian trade. Trade with the Hansa countries deteriorated and Estonia became subject to the internal trade structure of the Soviet Union and, in 1949, the Council of Mutual Economic Assistance (CMEA).

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<sup>8</sup> Bank of Estonia (2006).

<sup>9</sup> In particular via a vibrant Estonian expatriate community that grew very strong in the Soviet years. Many Estonians left their country before and during the Second World War, and a large share ended up in Sweden. Germany, the United States, Canada, and United Kingdom were also destinations for many Estonian emigrants. Despite the many efforts from Moscow to cut off the connections between Estonia and the Estonian expatriate community, foreign Estonians kept and developed their ties with their home country and was in many ways part and parcel of the different 'resistance movements' that was formed. Laar (2002), Küng (2004) and Fredén (2004) give many examples of these efforts.

The Sovietisation of the Estonian economy had started already a few months before the official annexation in 1940. In the summer of 1940, a new programme for nationalisation of commerce and industry was decided by the Estonian State Council. It was essentially industry and banks that were the subjects of nationalisation. All firms with more than 20 staff and all mechanical industries employing more than ten workers were expropriated by the government. Within a fairly short period of time almost 90 percent of the industry and transport sectors were properties of the government.

Later the same year, other efforts were made to nationalise trade and housing (large apartment buildings). Furthermore, the Estonian kroon was replaced by the rouble and, as a consequence, the Bank of Estonia, the central bank, was closed. The latter reform was not merely a technical issue; not only about switching currency and instituting a new monetary regime. As with many other reforms initiated by Soviet the aim was to increase Moscow's control over the newly acquired territory. It was essentially a reform purported to confiscate the savings of Estonians (all savings above 1000 roubles were directly confiscated) and thereby eroding the capital base of Estonian resistance.<sup>10</sup>

The only economically viable form of property to keep was land. But as a small pocket of individual property in a larger policy of collective ownership, it was not to stay for long. A few years later Moscow sought to take control of all land and farms too.

The programme for nationalisation of land had started, incrementally, in the 1940s but was not pursued at full speed until 1945.<sup>11</sup> German rule interrupted the nationalisation programme.

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<sup>10</sup> Kahk and Tarvel (1997)..

<sup>11</sup> Estonia also pursued a large land reform in the interwar period (1919-1926); a reform essentially based on expropriation of the large farm estates owned by the Baltic-German nobility and other key owners of land, the church for example. In a later stage this reform had effect on the Soviet-led collectivisation; the interwar land

As in other parts of Soviet, the core idea of the land reform was collectivisation. In hindsight one can say that the timing of farm collectivisation was slightly fortunate for Estonia. The dreadful experiences from Russian collectivisation in the 1920s had led to a more 'liberal' attitude to private ownership of farms. To avoid widespread starvation and a mass revolt against the central government in Moscow, parts of Soviet were entitled to experiment with other forms of ownership. After Stalin's death in 1953, Soviet authorities also granted farms additional freedoms.<sup>12</sup> But only at the margin. Still the basic idea was collectively owned and state-organised farms (sovkhozes), and many of them had to be expropriated by force.

In the first stage, collectivisation was said to be voluntary and non-discriminatory. But that strategy did not yield sufficient result in the eyes of the authorities. Instead they opted for plethora of discriminatory policies, largely via taxes and land restrictions.<sup>13</sup> Taxes on farming was high already in 1945 but was raised sharply on numerous occasions in the following two years to stifle farmers resistance to collectivisation. Between 1946 and 1947, taxes demanded from the larger farms were raised from 40 percent to 75 percent.<sup>14</sup> In the last stage of collectivisation, from May 1947 onwards, it was full expropriation by force. As in Russia, independent farmers in Estonia resisting collectivisation were deported *en masse* to Siberia. According to the Ministry of Interior, 22 346 people had to leave Estonia in these deportations.<sup>15</sup> Following these cruel deportations, the number of collectivised farms rose

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reform had created many family based farms that produced significantly amounts of agricultural produce involved in a modern exchange system (that is, not subsistence farming). The land reform had also been accompanied by property rights reform that despite the expropriation of land rooted the idea property right institutions.

<sup>12</sup> The managerial freedom for collective farms increased and several of them could improve the production by appointing knowledgeable people to the management positions. Machine tractor stations were essentially dissolved and the collective farms could but their own tractors. Confiscatory taxes and means of compensation to farms were also replaced by more 'liberal' policies.

<sup>13</sup> Jørgensen (2006), p. 9.

<sup>14</sup> Kahk and Tarvel (1997), p. 122.

<sup>15</sup> Less people were deported from Estonia than from Latvia and Lithuania. In Latvia 50 000 people, more than 2,5 percent of the population, was deported, and in Lithuania the number of people sent to Siberia was as high as 200-350 000 (10-15 percent of the whole population).

considerably and, not surprisingly, the consequence of collectivisation was a sharp decline in agricultural production.<sup>16</sup>

These reforms effectively drained Estonians from resources and made them impoverished. Intentionally, Soviet made proletarians out of citizens. This was the essence of 'homo sovieticus'. The only factor of production left in the hands of the people was their own labour. Indeed, this must have been a wet dream of a Marxian; the inherent conflict between capital and labour was dissolved, all capitalists expelled, and the workers were finally in possession of their labour. But soon people painfully realised that labour was not worth very much either and Moscow made no attempts to hide it felt the same way about them in possession of this factor.

From the 1950s onwards Soviet pursued an aggressive plan for industrialisation in Estonia. This was part of general trend of fast-and-furious industrialisation in many countries at that time, but Estonia's rapid industrialisation was also part of a general plan in the Soviet Union to have the Baltic countries as its factory floor, as an industrial supplier to the whole union. Moreover, the rapid industrialisation was also part of the Russification plan; by forcing Russians to settle in Estonia and the other Baltic countries, Kremlin would gain further control by changing the demographic structure. In this masterplan for industrialisation, the fate of Estonia was to produce industrial products in certain sectors and deliberately lower production in the services and agricultural sectors.<sup>17</sup> Local services was of course locally produced, but the government tried to make this sector as small as possible – which naturally led to invariable shortages – in order to concentrate on industrial production.

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<sup>16</sup> Kahk and Tarvel (1997), pp. 123, present data on the drop in agricultural production after the farm expropriations.

<sup>17</sup> In the Soviet sphere Estonia was designated to produce fuel (oil-shale mining and processing) and textiles.

Rapid industrialisation also led to economic growth. At times the growth was probably considerable.<sup>18</sup> It must have been due to the aggressive input of new factors of production in the industrial sector; the number of staff in the industrial sector tripled between 1945 and 1950. This was also a time when Western economists and leaders had high beliefs in the Soviet model. It's supposedly high investment rates were widely praised and a general fear in the United States was that Soviet would grow much faster in future and supersede America as the leading growth machine.<sup>19</sup>

This did not happen. Growth in the Soviet Union slowed down considerably, probably as early as in the 1960s and the general problems of its economic model soon became obvious.<sup>20</sup>

Some economists have made heroic attempts to put numbers on Estonia's economic development and compared the development in countries starting at a similar position as Estonia before the Soviet annexation – in particular comparisons with neighbouring Finland.<sup>21</sup> Figure 1 presents an estimate on income development in Estonia and Finland from the 1960 to 1988 and shows the relative decline of Estonian wealth in the Soviet years. The figure should be interpreted cautiously. It is based on nominal income data and the Estonian data has been calculated in Finnish marks (FIM) by using the annualised FIM-rouble exchange rate for estimated years. Thus it does not reflect real incomes taking into account purchasing power comparisons. We now for sure that real income in Finland grew at a significantly slower pace than the nominal income. This probably holds for Estonia as well but it is difficult to tell since we only have consumer-price data from 1989. The rouble was definitely overvalued for the

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<sup>18</sup> The economic data collected during the Soviet years is not reliable why it is impossible to tell the true status of the Soviet economy. There are good estimates from the period immediately before the collapse of the Soviet Union, but these estimates do not go as far back as the 1960s or 1970s.

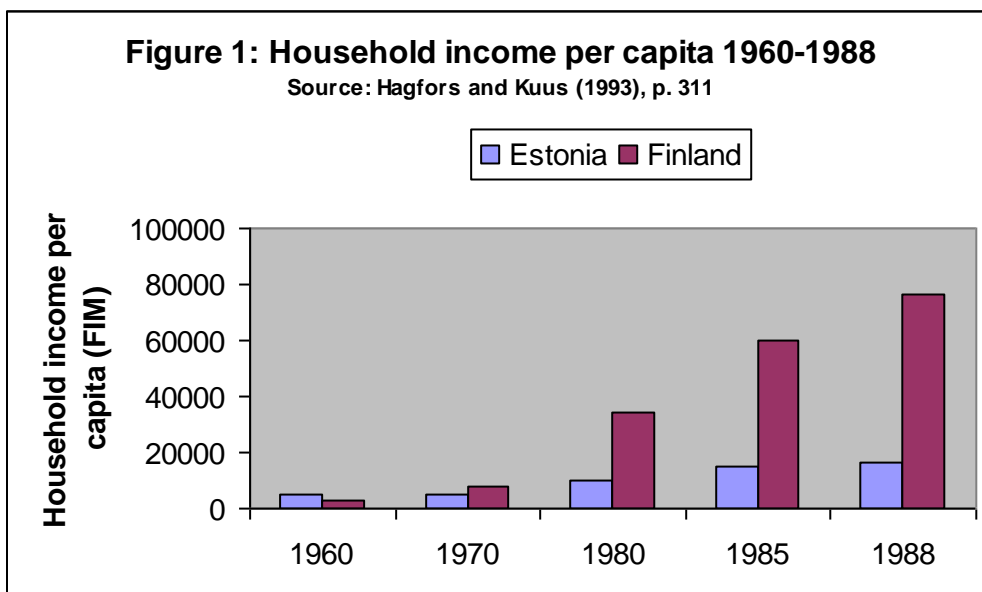
<sup>19</sup> See for example Rostow (1960), ch. 7.

<sup>20</sup> Dellebrant (1991); Kahk and Tarvel (1997).

<sup>21</sup> Kahk (1991); Lugus and Vartia (1993); Hagfors and Kuss (1993); Dellebrant (1991).

whole estimated period, which further undermines the relationship between the exchange rate and purchasing power.<sup>22</sup>

Despite these shortcomings, which alas cannot be corrected due to insufficient data, the figure overall indicates the differences in income development in the two countries over this period. And the differences are considerable. In 1988 the average Finn had 4,6 times higher income than the average Estonian. Estimates for 1938 suggests the difference then was approximately 1,4.



Needless to say, the difference in income development affected the Estonian consumers badly. They had to spend a higher share of their income to get a specific good or service. Studies over wealth in 1988 show that an average Estonian needed to work 547 hours to buy a colour TV while the time needed for the average Finn was merely 92. And to be able to buy a vacuum cleaner in 1988 the Estonian had to work 39 hours and the Finn 28 hours.

<sup>22</sup> There are other problems associated with this comparison too – see Hagfors and Kuus (1993), p. 308-310.



## 2.2 The first reform era

In the middle of the 1980s it had become obvious to even the most doctrinal political leaders in the Soviet Union that the command economy did not produce anything but shortages and poverty. The economies of the West had grown at a significantly faster pace for decades and this fact could not be hidden much longer. Mikhail Gorbachev, the new Soviet President from 1985, decided after a few years in office to embark on a relatively radical reform programme (perestroika) and to open up Soviet to the voices of the people (glasnost) and thus take the first limping steps towards democracy.

This unexpected turn in Soviet policy enabled groups and individuals in Estonia to start exploring new policies to govern their country. Before long the local political leadership decided to use their new freedom and thus took the first step of liberalisation. This became the first phase in Estonia's reform era. Later, in the beginning of the 1990s, radical and far-reaching market-economy reforms would be undertaken, but at this juncture the local leadership in Estonia was considering incremental, small-step the reforms within the boundaries of the new (but limited) independence granted to the Baltic countries.

The government of Indrek Toome started in December 1989 the first phase of reforms by liberalising prices. Until then, almost all prices had been fixed and decided by administrative authorities. As a consequence, shortages were perennial and Estonians, as others in the Soviet Union, had to spend considerable time in getting the goods or services they needed. The transactions costs were extremely high. The fixed-price system distorted supply and demand mechanisms by essentially prohibiting price signals to appear in the official markets. Supply and demand could not match each other as they normally do in free markets. Effectively,

producers in the Soviet economy did not have to listen to the wishes and preferences of consumers and was guided by input factors (resources available) rather than output ambitions. In some parts of Soviet the price system was corrupted to the degree that people made almost all their transactions in the black economy and effectively lived in either a dollar-and-barter economy. Possessing US dollars, or another foreign currency of great recognition, was always an entry ticket to suppliers. If no foreign currency was available, orthodox barter was another way to get the goods or services you needed.

There was a great symbolic value in the price liberalisations of 1989, but in effect they involved only a small part of the economy. Overall this reform pushed the share of goods with fixed prices from 90 to 60 percent of all goods. Furthermore, these liberalisations did not resolve all price regulations and thus did not lead to completely free prices. On the contrary, even after Toome's reform the share of goods operating in a full market-based pricing system remained limited to less than ten percent.

The second step in price liberalisations was taken in the subsequent year. Then a new government had assumed office. In 1990 Estonia had a relatively free election and the leader of the Popular Front, Edgar Savisaar, became the new Prime Minister on a ticket promising radical liberalisations of Estonia. This was still before independence from the Soviet Union and Savisaar, who had made a rapid career in the Estonian bureaucracy, had made his reputation a few years earlier when he and a group of other reform-friendly officials in the Soviet Estonian establishment – including Siim Kallas, who later became governor of the

Estonian central bank, Minister of Finance, and Prime Minister<sup>23</sup> – had proposed far-reaching economic reforms and economic independence from the Soviet Union.<sup>24</sup>

Savisaar, who recently returned to government as a Minister for Economic Affairs after a period as Mayor of Tallinn, was never a principled supporter of the market economy and this reflected on the government assuming office in 1990. Its policy resembled a third way between capitalism and socialism, and it soon run into to problems because of its inability to act rapidly and decisively when faced with signals of a growing economic crisis. However, the government initiated further price liberalisations and after the programme ended only ten percent of the goods had fixed prices.

The Savisaar government also started reforming the fiscal policy in Estonia. Having been fully integrated in the Soviet administrative system, the restoration of fiscal independence had to start with fundamental reforms, such as instituting a new budget process and designing new institutions for monitoring economic policy. These reforms were also associated with the programme of price liberalisation. In this centrally planned system, administrative bodies were responsible for setting prices and generally deciding what should be produced, how and when it should be produced, and to what quantities. All supply-side decisions, and its matching with demand, were matters for bureaucratic bodies.

In the Soviet system of central planning the administrative process was extended to all parts of the union, indeed countries outside the boundaries of Soviet Union were targets of the Moscow bureaucratic machine too, particularly through the Council of Mutual Economic

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<sup>23</sup> Siim Kallas is today a member of the EU Commission.

<sup>24</sup> This proposal was called IME, which is an Estonian acronym for 'self-managed Estonia', or the 'four-man proposal' and it was signed by Edgar Savisaar, Siim Kallas, Tiit Made, and Mikk Titma. See Kallas and Sörg (1994).

Assistance, or COMECON as it was often called in the west. By necessity this model of economic governance implied a transfer of resources via these bodies; the normal function of markets was distorted and in such an environment the producers often needed subsidies from the government to deliver required quantities.

In this respect, the fiscal budget was an underpinning of the centrally planned model; a large part of government expenditures was essentially production subsidies and without them much production would cease. In the late 1980s, from the period when we have fairly reliable data on Estonia's economic performance, price subsidies equalled approximately 50 percent of government expenditures and nearly 15 percent of total GDP in Estonia. A comprehensive package of price liberalisations therefore had to address fiscal aspects as well as the direct regulations of prices. This is also what the newly elected government set itself to achieve and by end 1991 the share of GDP accounted for by production subsidies had decreased considerably to two percent.<sup>25</sup> Thus the programme of price liberalisation was the flagship reform of the Savisaar government.

The final part of this early phase of reform was incremental efforts to stimulate private enterprise. The government started to privatise some companies and this programme of privatisation was pushed through quite rapidly in the late 1990 and early 1991. Not seldom these privatisations were halted by an insufficient structure for property rights and confusion over the legal implications of privatisations. As in several other transition countries, the insufficient preparation for this early phase of privatisations led to asset-stripping.<sup>26</sup> Therefore it took some time before the newly privatised companies could work properly and the process

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<sup>25</sup> World Bank (1993).

<sup>26</sup> The comprehensive privatisation programme started in 1992 after the new privatisation legislation had been drafted. See chapter 3.

of enhancing market efficiency was thus held up.<sup>27</sup> If the new owners had industrial ambitions, they lacked the experience of business and the knowledge of how to run a company based on responding to signals from consumers rather than following instructions and prescriptive orders from the government. But often they did not have any industrial ambitions at all. Instead they awaited offers from parties that would pay full market prices for the company.

The government also made some efforts to stimulate new enterprises. This was not high up the agenda, but it should have been. Estonia was in desperate need of a growing sector of companies. In 1986 Estonia had no more than 34 private companies. Furthermore, state-owned firms were generally large entities and Estonia lacked a community of SMEs that in normal economies represent a large share of output and employs substantially more people than the big firms. This distorted pattern of company size was bound to cause problems for Estonia since the size and structure of companies did not reflect true market conditions. It was largely a product of the mechanisms of central planning, in particular its preference for extensive organisations guided by input management rather than consumer demand and output.

The reforms were mostly focused on stimulating domestic entrepreneurship. Notwithstanding the importance of these reforms, particularly in later stages of Estonia's comprehensive reform era, this was a *cul de sac*. Despite the enterprise reforms, starting a new business required capital and Estonian's were not, mildly put, abundantly supplied with financial resources. The macroeconomic instability also prevented foreigners from investing in

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<sup>27</sup> World Bank (1993), p. 38.

Estonian business ventures and thus the drive for new businesses mainly resulted in a growing sector of local services and retailers.<sup>28</sup>

### 2.3 Crisis, reform and the return to the market economy

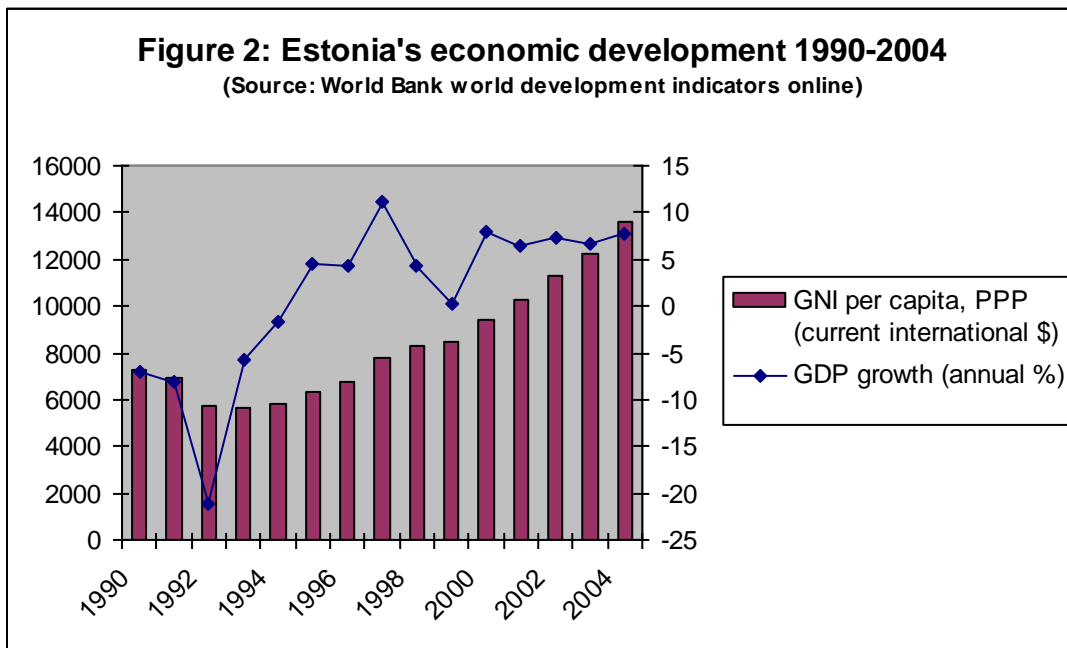
Estonia was badly hit by the severe economic downturn amid and following the breakdown of the Soviet system. The sources of crisis were several and essentially rested on the many inherent flaws of the centrally planned economy. These flaws had been visible for many decades and effectively driven Estonia to a position of perennial economic problems and re-occurring financial difficulties. But the real transition crisis of Estonia did not started before 1991. The first signs of a mounting crisis came with the sharp fall in industrial production between and 1990 and 1991. It was followed by a general decline in all sectors and subsequently a macroeconomic crisis. GDP fell rapidly and the total GDP loss in 1990-1994 was much larger in Estonia than in most other countries in the Soviet sphere.

Figure 2 shows this development graphically. GDP growth deteriorated early in the new decade and continued to be negative for five years. The low point in 1992 was marked by a negative GDP growth of 21,2 percent.<sup>29</sup> As a consequence the general welfare of Estonians fell drastically in these years. In purchasing-power terms, the Gross National Income (GNI) per capita fell from approximately 7500 US dollars in 1990 to less than 6000 US dollars in 1992 to 1994.

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<sup>28</sup> World Bank (1993), p. 38, estimate the number of private firms in Estonia to be 20 000 at the end of 1991. In other words, in a period of five years the number of private firms grew by a factor of nearly 600. Not surprisingly, this estimate has been disputed.

<sup>29</sup> As noted by several studies, official data over output decline probably exaggerate the actual decline as output in the early years of transition is measured at inflated prices. See for example Åslund (2001).



The macroeconomic crisis was not only a product of the sharp fall in output but also a corollary of price liberalisations in the previous years. Liberalising prices in a country suffering from chronic shortages due to distorted signalling functions is bound to lead to a rapid increase in official prices and inflation. Inflation was high already in the late 1980s but rose at increased pace in 1990 and 1991. The annualised inflation in 1991 was just below 40 percent. This was the beginning of Estonia's inflation cycle that subsequently led to a few months of hyperinflation (defined as a rate of inflation above 50 percent a month).<sup>30</sup>

Early in 1992 inflation was pushed up additionally by price liberalisations in Russia. As shown in Figure 3, the annualised inflation peaked at 1076 percent in that year. The immediate effect of Russia's liberalisation was thus disastrous to Estonia. Prices sky-rocketed, particularly energy prices, and this 'systemic shock' led to serious disruptions in trade with Russia. As Estonia was totally dependent on Russia for its trade (almost 90 percent of Estonia's trade was with Soviet) and supply of inputs to production, this led to a rapid

<sup>30</sup> See Figure 8 for monthly data of the inflation rate.

deterioration of its terms of trade, particularly after Russia stop subsidised and rather applied world-market prices for its exports of energy and raw material to Estonia and other Baltic countries.<sup>31</sup> Furthermore, the budget deficit soared as the government needed to increase subsidies to groups badly hit by the high and rising inflation, partly due to price increases on key consumer goods after budget subsidies were removed.

At the beginning of the year, the government budget was set to be balanced but the government soon replaced that ambition with increasingly desperate measures to control the deficit. The general outlook in the winter and spring of 1992 was indeed very gloomy. Political crisis and uncertainties added to the economic difficulties. The Savisaar government resigned amid the crisis and was replaced by a government led by the former Minister of Transport and Communications, Tiit Vähi, a ‘caretaker’ and ‘able technician’ that could lead the government until the new constitution was in place and the first really free election could be held.<sup>32</sup>

But Estonia was not only importing a Russian inflation caused by its price liberalisation; the close ties to Russia provided another knock-on effect on Estonian inflation. In the whole rouble area, which Estonia was still part of, there was a considerable shortage of currency and this shortage had been causing troubles for many years. Essentially, the undersupply of currency provided a profound push effect on inflation. The stock of roubles was fixed, but the high inflation led to a much higher nominal expenditure aggregate, which was not covered with increased money supply.<sup>33</sup> Therefore, the ‘rouble’ effect on inflation enforced an already existing and growing inflation and macro-economic instability.

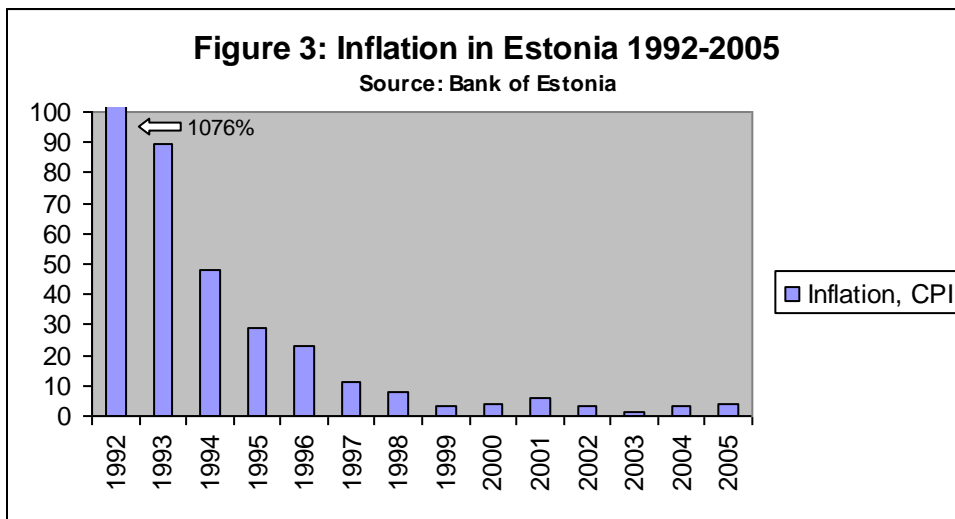
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<sup>31</sup> Knöbl, Sutt and Zavoico (2002), p. 9.

<sup>32</sup> Knöbl, Sutt and Zavoico (2002), p. 8.

<sup>33</sup> Kallas and Sörg (1995).





Estonia managed to handle the crisis in 1992; indeed it was managed surprisingly well. Inflation continued to be high throughout the first five years of the 1990s, but the hyperinflation in early 1992 was mastered already within months. In the rest of the 1990s inflation was under control and from 1997 Estonian inflation was at exemplary low levels. Estonia soon also outperformed other countries in the former Soviet sphere in most macroeconomic indicators. Arguably, the programme for macroeconomic stabilisation operated much more quickly in Estonia and, in contrast to several other countries, it attacked the root causes of instability.

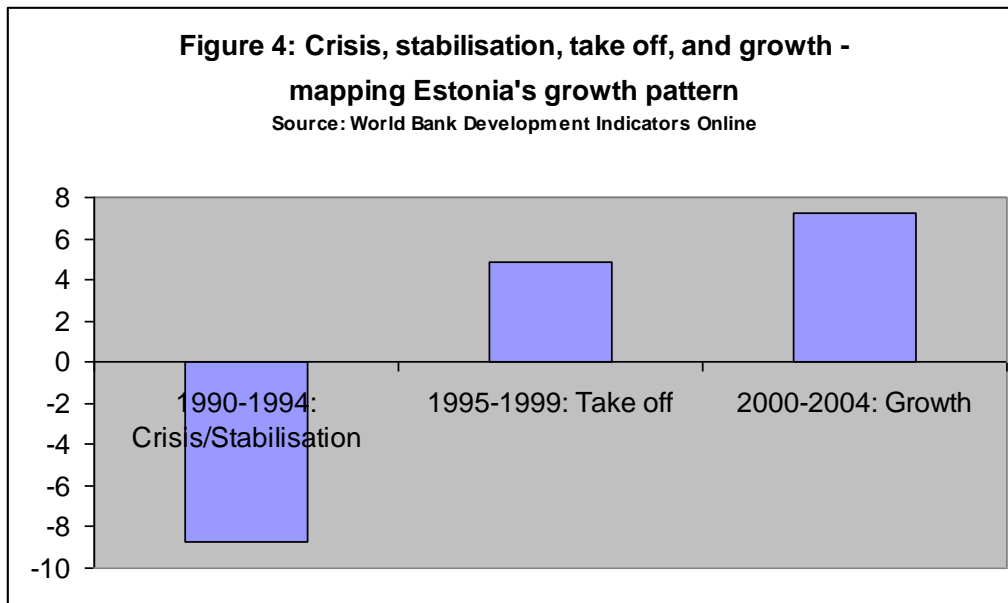
In tandem with this general stabilisation, the economy started to grow again. In 1995 Estonia had the first year of positive GDP growth in nearly a decade. The economy then grew at a nominal rate of 4,5 percent.

As shown in Figure 4, there are three distinct phases in Estonia’s macroeconomic stabilisation and early transition to a market economy – in its first 15 years as an independent country. In the first five years of the 1990s, GDP growth averaged at nearly minus 9 percent. The 21

percent negative growth in 1992 of course pushes the figure downwards, but even if 1992 is withdrawn from the sample the average annual GDP fall is substantial – 5,6 percent.

In the subsequent five years growth picked up considerably at an annual rate of nearly 5 percent. Inflation continued to be high in the first years of this period. In 1995 and 1996 it was well above 20 percent and thus real per capita income (PPP) did not improve much.

The real takeoff in the Estonian economy occurred in the third phase. In the new millennium Estonia has expanded output rapidly, at an annual rate of 7,2 percent. With inflation under control at low levels this translates into a substantial increase in real wealth. Gross national income per capita, corrected for purchasing power (PPP), more than doubled between 1995 and 2004 (see Figure 2) and stood at nearly 14 000 US dollars at the end of that period. That is approximately the same level Greece had in 1995 or Portugal in 1996. These countries were then more than twice as rich as Estonia. A decade later, Portugal's GNI per capita (PPP) is ahead of Estonia's by not more than 25 percent. Admittedly, such comparisons should be interpreted cautiously. Income corrected for purchasing power is often lower in countries receiving a lot of tourists pushing up the price level. In fixed GDP per capita terms, Portugal is still (2004) twice as rich as Estonia, but in 1995 it was thrice as rich.



It is a considerable rate of growth Estonia has experienced in the period after independence, particularly in the last ten years. In comparison to other countries formerly in the Soviet sphere, Estonia also belongs to the top group of countries in terms of wealth increase. In Figure 5 Estonia is compared to ten other countries in Central and Eastern Europe and, as the figure illustrates, Estonia is not the richest countries in this group; Slovenia, the Czech Republic, Hungary and Slovakia are ahead of Estonia. The other Baltic countries, on the other hand, are significantly lagging behind Estonia. The average Estonian has approximately 1000 US dollars more a year in income than the Lithuanian, and nearly 2000 US dollar more than the average Latvian. This might not sound much to an American or European, but for a Lithuanian with an average income of 11-12 000 US dollars a year, it is a considerable difference.

However, this comparison does not give the full picture and cannot, *prima facie*, be interpreted as a ranking of reform success. Exogenous factors (such as initial condition) cloud the comparison. For example: a high ranking for Slovenia and the Czech Republic is not

surprising considering they had a significantly higher wealth at the starting point of this comparison. Similarly, lower wealth in Bulgaria and Romania is expected when their position in 1990 is taken into account.

What is more interesting, from a comparative point of view, is the rate by which the economy grew over this period. Estonia had the second highest growth between 1990 and 2004 in this sample of countries. It was only outperformed by Poland. Estonia grew by 188 percent and Poland by 213 percent. Important to remember in this respect is that Poland started its reform programme earlier than Estonia and that the macroeconomic crisis of Poland preceded Estonia's crisis with nearly two years.<sup>34</sup> This means that the starting point for this comparison (1990) contain a bias in favour of Poland; Estonia's real crisis had not yet started while Poland already had reached its low point in terms of deteriorating GDP, hyperinflation and a general macroeconomic crisis. When economist Jeffrey Sachs in 1991 delivered his famous Lionel Robbins Memorial Lecture on how the 'shock therapy' he had prescribed for Poland started to yield results, Estonia still had three years of negative growth in front of them.<sup>35</sup>

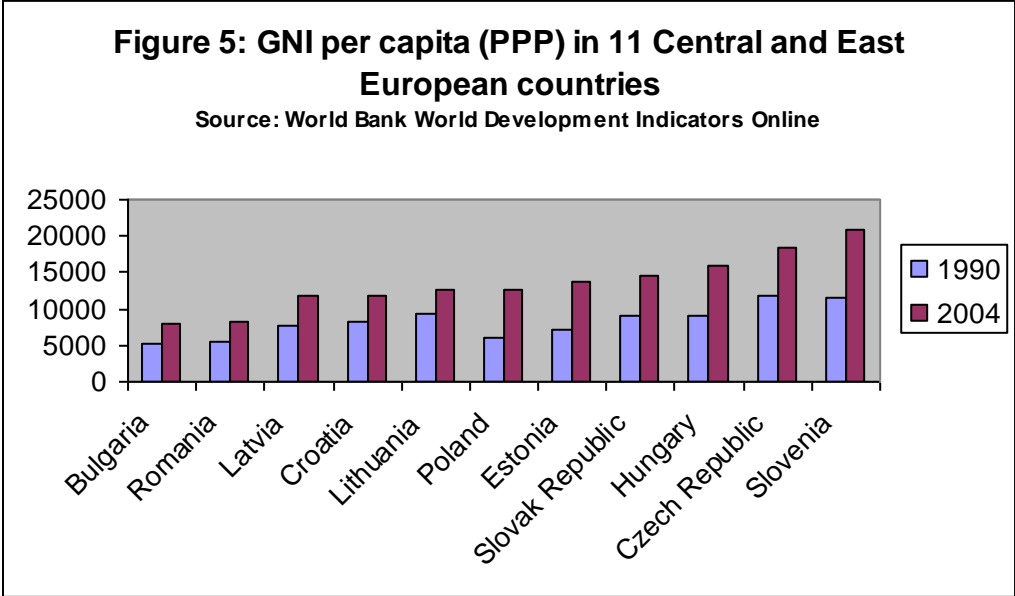
A second note of caution should also be added. The crisis in Estonia and the other Baltic countries was much deeper than in Poland and the other countries in Central and Eastern Europe. Poland had never been as deeply integrated in the Soviet economic system as Estonia and therefore it did not suffer the same blow to the economy when the Soviet economy, and its economic system generally, collapsed. Poland was part of the CMEA and distinctly intertwined with Soviet and other countries in its sphere, but it was independent from Soviet, could to a substantial degree design its own policies, allowed greater flexibility for

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<sup>34</sup> Åslund (2002), p. 161, have compiled the scores in the World Bank/EBRD structural reform index between 1990 and 2000. In 1990 Poland had a score of 0,68 and Estonia of 0,20 (the scale is from 0 to 1), showing differences in starting position as well as level of reforms in the beginning of the decade.

<sup>35</sup> Sachs (1993).

experimenting with market-conducive orders, and had a substantially higher trade with the west than Soviet and its annexed areas.

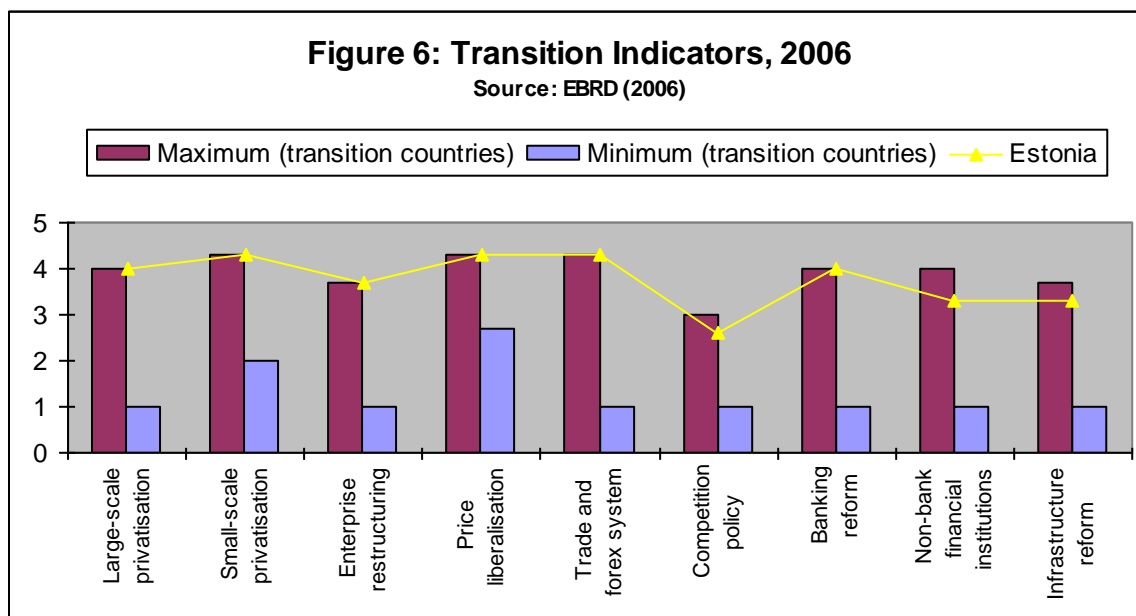


Beside Poland and Estonia, in this sample Hungary and Slovenia have experienced higher-than-average growth in per capita income (average is 165 percent). What is interesting with this group of countries (Poland, Estonia, Hungary and Slovenia)<sup>36</sup> is that they are also well ahead of other countries in policy indexes, the World Bank/EBRD structural reform index in particular. In other words, they have reformed themselves faster and deeper than other post-communist countries. It is not a group of countries sharing the history of ‘shock therapy’, but all of them reformed themselves at earlier stages in the transition period than other countries formerly in the Soviet sphere.<sup>37</sup>

Estonia also continues to perform well in policy comparisons. As shown in Figure 6, Estonia is in the top position in six of nine categories in the EBRD index over transition, which is the

<sup>36</sup> Slovakia can also be added.  
<sup>37</sup> See Åslund (2002), p. 161.

same result as for Slovakia but better than Poland, and much better than Slovenia. Hungary is in the top position in every indicator.<sup>38</sup>



The overall pattern in this index, as well as in many other indexes, is that countries pursuing comprehensive economic reforms also perform well economically. Indeed, countries in the top league of reforms are also the countries that have performed best. Price deregulations, property-rights reforms, privatisations, enterprise reforms, trade liberalisation and macroeconomic stability are the key ingredients for successful transitions.<sup>39</sup>

This was the sort of policy Estonia soon chose to pursue amid the breakdown of the old Soviet order. These policies have also been persistent in Estonia and not been subject to stop-go procedures and endless repeals. There have been sharp domestic disputes over policy, but

<sup>38</sup> See country chapters in EBRD (2006).

<sup>39</sup> For overview studies on the role of liberalisation in boosting growth in post-communist countries, see Berg, Borensztein, Sahay and Zettelmeyer (1999); Havrylyshyn and Wolf (1999); Sachs and Warner (1996); World Bank (1996).

overall the support for the comprehensive reforms has been strong throughout the whole period.

This support has largely continued as Estonia's transition process has matured and later been manifested in other areas, such as tax policies, in particular the lowered flat tax (which will be discussed later in this paper). Since Estonia joined the European Union in 2004 it has been one of the few high-growth countries in the EU and, equally distinguishing, one of few countries that have taken the reform agenda sufficiently serious. Together with the other Baltic countries, Estonia has had the highest real economic growth in the EU-25 area in the new Millennium. Measured in purchasing power terms, Estonia's GDP per capita has grown significantly from being not more than 41 percent of the EU-25 average in 2000 to be 57 percent in 2005.<sup>40</sup> Forecasts from Eurostat, the EU statistics office, hold that in 2007 Estonia's GDP per capita will be 66 percent of the EU-25 average.

In other words, Estonia seems set to follow the economic-growth track. In fact, in the last years growth has peaked at around ten percent, productivity growth has been high, and unemployment has kept falling. But there are flies in the ointment. Some of them are cyclical and regards the sustainability of the current business cycle with its high growth rates. Others are of financial nature and are associated with the high current-account deficit. But there are also concerns of poverty and the extent to which the periods of recovery and take off have sufficiently translated into falling poverty rates.

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<sup>40</sup> Data and estimates from Eurostat was extracted from [http://epp.eurostat.ec.europa.eu/portal/page?\\_pageid=1996,39140985&\\_dad=portal&\\_schema=PORTAL&screen=detailref&language=en&product=STRIND\\_ECOBAC&root=STRIND\\_ECOBAC/ecobac/eb011](http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=STRIND_ECOBAC&root=STRIND_ECOBAC/ecobac/eb011)

Soaring unemployment and rising inflation under the crisis years led to drastic fall in incomes and increasing poverty. Many indicators on development then moved in the wrong direction. Life expectancy fell, and child mortality and the prevalence of poverty-related illnesses increased. The development since has taken the right direction, but Estonia is still facing problems. Unemployment remains rather high. It peaked at 14 percent in 2000 and has come down to roughly eight percent in the last year. But unemployment is a key factor behind why many Estonian's, particularly those living in non-urban areas, live close to, or beneath, the national poverty line. It is difficult to get hold of reliable data on poverty in Estonia – a national poverty line was determined in 1998 – but from the strong growth period in the late 1990s onwards there has been a significant increase in real income generally and, as far as one can tell from data from Estonia's statistical office, the share of the people living in or close to poverty have steadily decline.

Employment has been adversely affected by the comparatively strict labour-market regulations in Estonia. Naturally it is difficult to assess these regulations effect on employment as the difference between formal regulation and effective regulation is not insignificant. But studies suggest Estonia has the strictest employment-protection legislation (EPL) of all EU-10 countries as regards standard employment.<sup>41</sup> In combination with Estonia's high share of employees working at a regular contract, the strict EPL has translated into a rather inflexible labour market where people tend to stay on jobs and being disincentivised to move between employments. According to an estimate for 2001, 75,6 percent of the Estonian labour was working at a regular contract while the average for CEE was 65,8 percent and for EU-15 68,1 percent. Inversely, a smaller share of Estonian's were self-employed than in other EU countries.<sup>42</sup>

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<sup>41</sup> Eamets and Masso (2005).

<sup>42</sup> Eamets and Masso (2005), p. 77.



Estonia has overall also scored low in ratings of labour-market regulations – such as in the Economic Freedom Index.<sup>43</sup> Of particular concern has been the impact of minimum-wage laws. There have recently been improvements, but Estonia is still experiencing some of the adverse effects of a rapidly rising minimum-wage law. These increases had significant negative effects on the employment ratio among the groups affected by the increases. People lost jobs or moved into forms of employment not covered by the minimum-wage law.<sup>44</sup>

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<sup>43</sup> Gwartney and Lawson (2005).

<sup>44</sup> Hinnosaar and Rõõm (2003).

### 3. The great reform era

The *first phase* in Estonia's reform programme started a few years before the collapse of the Soviet Union and Estonia's independence in August 1991. Incremental and small-scale reforms were achieved in a number of fields, as explained in the previous chapter, but these reforms only touched the structural problems and were insufficient in stabilising the macro economy as well as in stimulating long-term economic growth. Indeed, to some of the leading politicians at that time, the main idea was not a rapid transition from plan to market but a slower process to a 'third way' between capitalism and socialism.<sup>45</sup> But they were subsequently replaced by a group of politicians holding radically different views on the substance as well as the pace of the reforms.

In this chapter we shall study in more detail some of the key reforms in Estonia *second phase* of reforms – a phase that can be described as the great reform era of Estonia. In the first section we will discuss the currency board reform in 1992 and macro-economic stabilisation policies. The second section looks at external policies and how Estonian trade policy was liberalised. Lastly, but not leastly, we will discuss the privatisation programme – a much-debated topic all around the former Soviet sphere, and reforms to stimulate enterprise.

#### 3.1 The Estonian currency board

In June, 1992, ten months after full independence in August 1991, Estonia left the rouble zone and established its own currency, the Estonian kroon (EEK). For 52 years Estonia had been part of Soviet's monetary policy and it became the first country that emerged from the Soviet

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<sup>45</sup> Laar (2002), ch. 4.

Union to abandon the rouble. The Bank of Estonia had been closed at the same time as the rouble became the sole legal tender in 1940 and thus the first step in establishing an own currency was to form a central bank.

The new Bank of Estonia was established a few years earlier than the currency reform was undertaken; it was set up in January 1990 and followed the Soviet Law on Economic Independence that was promulgated in 1989 and granted some autonomy to Estonia and the other Baltic states. The new central bank did not have any formal assignments in Soviet monetary policy; the Tallinn subsidiary of the Gosbank, the Soviet state bank, was still responsible for financial intermediaries in that region. But the re-establishment was imperative to the design and the process of the subsequent currency reform; the views that emerged from the new central bank, inhabited by a group of younger market-oriented economists, contrasted sharply with old socialist thinking, and the influential governor of the central bank from September 1991, Siim Kallas, had a significant impact on the substance and sequence of the monetary reform.<sup>46</sup>

A currency reform that distanced Estonia from Russia was instrumental to the whole transition process, for ideological as well as economic reasons. Estonia had suffered and contracted in all possible ways under Soviet rule. Sentiments were distinctly anti-Russian and the vast majority of the population wanted a complete re-orientation of Estonia from the east to the west. A constitutional democracy and a market economy were indeed the popular choice.

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<sup>46</sup> Knöbl, Sutt and Zavoico (2002); Kallas and Sörg (1994).

As the Russian economy contracted, a new orientation of Estonian policies became immediately important. Trade relations with Russia collapsed and the Russian inflation, aggravated by the price liberalisation and the rouble shortages, spilled over to Estonia. An indicator on the need of a new currency policy can be found in Figure 7, showing the market exchange rate of the rouble to the Estonian kroon after the reform in June 1992, and the exchange rate of the rouble against the US dollar over a longer period.

Both indexes illustrate the collapse of the rouble. From January, 1990, to June, 1992, the rouble had depreciated considerable – from 10,27 to 144 rouble per US dollar – but a lot more were to come. Every forecast pointed to an even higher depreciation rate in the near future. The government was in desperate need of money and the Russian central bank kept fuelling money in to the fiscal budget; in the first ten months the Russian central bank lent over 820 billion roubles to the government, of which 94 percent were executed on the demand of the parliament or the government.<sup>47</sup> In June, 1992, at the time of Estonia's currency-board reform, Russian inflation (year over year) was 1300 percent and it had grown to 2600 percent in December that year.<sup>48</sup>

The conversion rate in late June had been 10 roubles per Estonian kroon (see Table 2) and less than a year later the rouble had fallen by more than 600 percent.<sup>49</sup> Had Estonia been part of the rouble zone a year later after the actual currency reform, the economic crisis would have been calamitous. Hyperinflation would have taken a new grip on the country and output would have declined even more than it did. Therefore, another way of interpreting this figure is that Estonia was successful in restoring (or rather instituting) credibility, and ending inflation expectations, by its monetary reform and accompanying stabilisation programme.

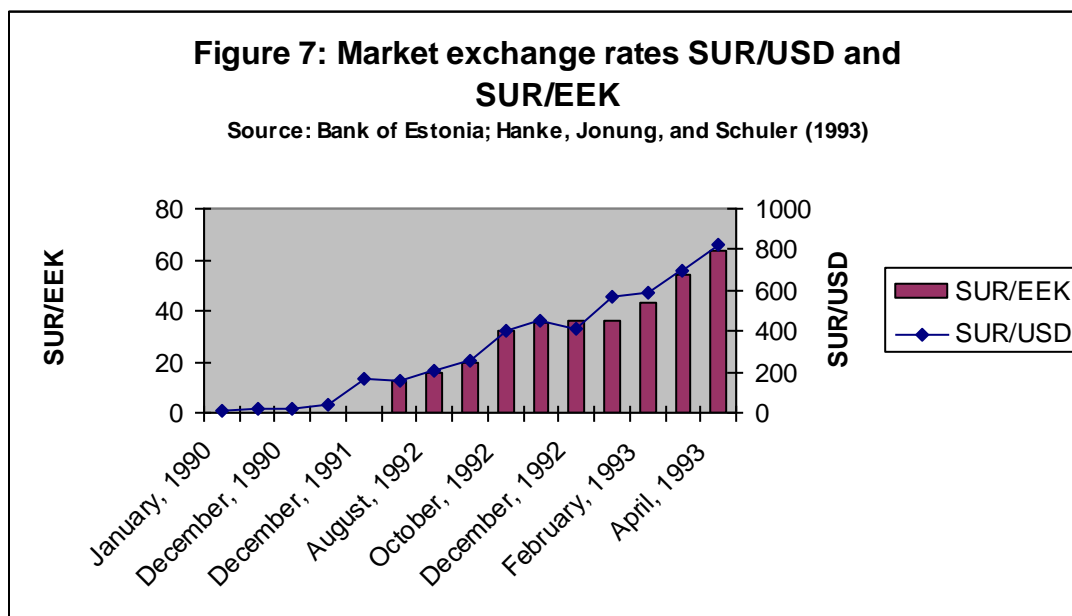
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<sup>47</sup> Hanke, Jonung, and Schuler (1993), p. 47.

<sup>48</sup> Hanke, Jonung, and Schuler (1993), p. 48.

<sup>49</sup> See also Sörg (2004), p. 5.

The kroon helped to stabilise Estonia's economy while the Russian economy continued to fall.



Estonian made a bold choice when it decided to centre its new monetary regime on a currency board or a monetary arrangement in many ways resembling an orthodox currency board.<sup>50</sup> It is common among transition countries or emerging markets to head for a monetary policy based on a pegged exchange rate. But there are several options; fixed peg, horizontal band and crawling band are the typical forms. A currency board essentially means a substantially stricter form of peg leaving very little, if any, discretion to monetary authorities to manage the peg. In its orthodox form, the currency board implies a central bank without any assignment except for issuing notes and coins and holding foreign reserves equalling a chosen indicator of

<sup>50</sup> Currency board *aficionados* would not prefer to call the Estonian monetary system a currency board, but a central bank system mimicking certain features of a currency board, in particular the foreign-reserve backing of issuant currency by 100 percent or more (see Hanke, Jonung, and Schuler (1993); Sachs and Lipton (1992)). In other respects, the Estonian monetary system deviates from the orthodox currency board; it is a pegged and not a fixed monetary regime and it provides for the Bank of Estonia to act as a lender of last resort in terms of financial crisis. In this paper, the Estonian is called a currency board or a currency-board arrangement (CBA). *Aficionados* are correct in their analysis, but it is arguably the case that most features in the Estonian monetary system are in tune with an orthodox CBA.

money supply. The central difference between the Estonian currency-board arrangement and a traditional form of peg is thus the discretion for monetary or political authorities to adjust the peg – the exchange rate to which the local currency is pegged to another currency or a basket of currencies. This is important for a country that strives to end inflation expectations and restore (or build) credibility for its monetary policy. In a traditional peg there is much greater room for adjustments and thus also for diluting the strictness of the monetary order.

**Table 1: A typical currency board versus a typical central bank**

<u>Typical currency board</u>	<u>Typical central bank</u>
Usually supply notes and coins only	Supplies notes, coins and deposits
Fixed exchange rate with reserve currency	Pegged or floating exchange rate
Foreign reserves of 100 percent	Variable foreign reserves
Full convertibility	Limited convertibility
Rule-bound monetary policy	Discretionary monetary policy
Not a lender of last resort	Lender of last resort
Does not regulate commercial banks	Often regulates commercial banks
Transparent	Opaque
Protected from political pressure	Politicised
High credibility	Low credibility
Earns seigniorage only from interest	Earns seigniorage from interest and inflation
Cannot create inflation	Can create inflation
Cannot finance spending by domestic government	Can finance spending by domestic government
Requires no 'preconditions' for monetary	Requires 'preconditions' for monetary

reform

reform

Rapid monetary reform

Slow monetary reform

Small staff

Large staff

*Note:* The characteristics listed are those of a typical currency board or central bank, especially one in a developing country, not those of a theoretically ideal or exceptionally good currency board or central bank.

*Source:* Hanke, Jonung, and Schuler (1993), p. 6

In a currency board arrangement (CBA), as can be seen in Table 1, the peg is fixed and supported by foreign reserves. Extending the circulation of notes and coins must thus be accompanied by an increase of foreign reserves, normally the reserve currency that is the anchor of the domestic currency. All other activities usually performed by a central bank are in a CBA left to the market. In other words it is a very transparent and market-conducive monetary order.

As a consequence, the balance sheet of a central bank that performs as an orthodox CBA should not, ideally, contain more than data on foreign reserves and liabilities in the form of money supply and deposits of commercial banks. Admittedly, many currency boards, present as well as historical, are not designed in this orthodox form and largely extend some discretion to monetary authorities; credit monitoring and 'lender of last resort' arrangements for securing financial stability are common forms of interventions.

The key feature of a currency board is that it has a foreign-reserve backing of 100 percent or more of the monetary base. In normal speak that means all currency in circulation is backed by a foreign reserve held by the currency-board authority. Following this, a central bank do not have an active role at all in determining the monetary base – and thus cannot create inflation at its own discretion. If the monetary base should expand, so must also the foreign reserves. In this respect, money supply is endogenous, created by market activities of economic actors.<sup>51</sup>

This constraint on monetary authorities, indeed on fiscal authorities too, can be accused of inducing problems of inflexibility in economic policy. That is of course true and one of the chief motives for instituting a currency board, but it is essentially not as inflexible as many of its critics argue. In fact, since the monetary regime is based on foreign reserves it is also elastic to changes in demand. Primarily this flexibility operates through changes in the current-account balance (a current-account surplus increases money supply). But that is not the only channel of flexibility in a currency-board arrangement. Endogenous money supply largely implies that commercial banks operate as automatic stabilisers. Excess liquidity is sterilised by commercial banks acquiring additional foreign assets and, if the demand for money is different, they sell foreign assets for domestic assets. Put differently, money supply can increase despite *status quo* in the current-account balance.

## **Table 2: The logistics of Estonia's currency reform**

Date:	The Estonian kroon became the legal tender at 4:00 a.m. on June 20, 1992. Individuals could convert
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<sup>51</sup> Sepp and Randveer (2002).



roubles into kroon at special cash exchange offices at the official conversion rate during the period June 20-22, 1992, during the hours 9 a.m.-10 p.m.

Official conversion rate:

10 roubles = 1 Estonian kroon

Conversion of cash roubles

All resident individuals (including children) and non-residents with resident permits could convert rouble notes equivalent to a maximum of roubles 1 500 at specific bureaus based on place of residence (which was equivalent to about US\$ 13 at the prevailing exchange rate). Cash exceeding roubles 1 500 could be exchanged at the (punitive) exchange rate of 50 roubles = 1 Estonian kroon. Enterprises had until June 20, 1992, to deposit cash roubles into their bank accounts which were then converted as noted below.

Conversion of account roubles at commercial banks

All rouble current accounts, time deposits, and savings accounts were re-denominated into Estonian kroon at the official conversion rate. However, balances in savings accounts in excess of roubles 50 000 deposited since May 1, 1992, and transactions from other rouble states in excess of rouble 1 million and made after May 1, 1992, were blocked until their origin was verified and a decision was made on a case-by-case basis. Commercial banks were closed during the period June 20-25,

1992, to allow for the re-denomination of rouble accounts. The Bank of Estonia guaranteed access to cash by commercial banks up to the amount of their correspondent accounts with itself.

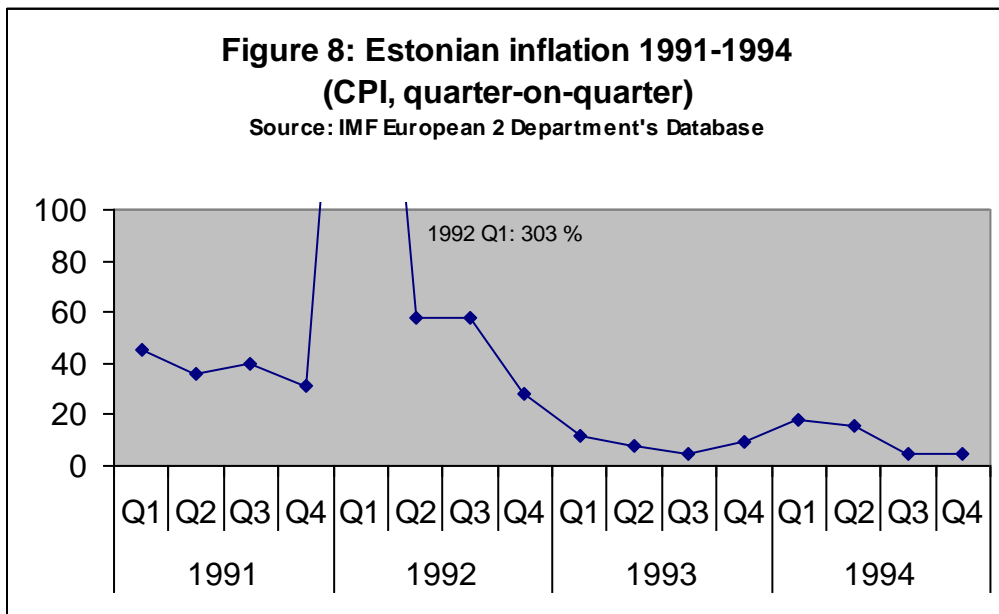
Total cash roubles collected: Roubles 2,3 billion (or about 3 percent of GDP).

*Source:* Knöbl, Sutt and Zavoico (2002).

### **3.1.1 Macroeconomic stability**

Estonia opted for a currency-board arrangement for several reasons. We shall here discuss three of the chief reasons: ending inflation expectations (macroeconomic stability), the political economy of a currency board *vis-à-vis* other monetary regimes, and FDI attractiveness.

Estonia needed a new monetary regime to cut off the air supply to inflation pressures and generally build confidence for the economy – in other words: terminating inflation expectations. This was the chief reason behind the currency reform and why it needed to be achieved urgently. Inflation had peaked in the first quarter of 1992 (see Figure 8). Early that year there were good reasons to believe that inflation would decline from this quarterly rate of 300 percent, mainly because the January peak reflected the Russian price-liberalisation shock, but still the inflation prognoses suggested inflation in the second and third quarter to be in the band of 50-100 percent.



The key element in circumventing the inflation pressures was to abandon the rouble zone. Naturally, other measures needed to be taken too, but unless Estonia could stop importing inflation from Russia and establish a monetary policy in tune with Estonian fundamentals and conditions, every effort to stabilise the economy by other means would fall short.

This does not explain why Estonia established a currency-board arrangement. There were other options. Latvia, for example, did not follow the example of Estonia and established in July, 1992, a new floating regime that in 1994 was pegged to the Special Drawing Right (SDR), the currency unit of the International Monetary Fund. Lithuania left the rouble zone a bit later than the other two Baltic countries and started the new regime with a flexible exchange rate policy. A few years later Lithuania also pegged its currency (to the US dollar). In terms of abating inflation, all three countries were successful and had it under control within a few years. In both Latvia and Lithuania, the pegging of their currencies did leave substantial imprints on stabilising inflation.

Thus, overview studies of monetary policy in transition countries finds pegged regimes to be more efficient in stabilising inflation than flexible regimes. A study by economists at the IMF also find evidence for pegged regimes generally being better at controlling inflation than policies built on floating exchange rates.<sup>52</sup> In their sample of countries, the average inflation was 8 percent in pegged exchange-rate regimes and 16 percent for floating exchange rate regimes. Later research also finds support for CBAs having a relatively slower growth in the velocity of money and thus a slower growth of inflation than an orthodox pegged regime.<sup>53</sup> Such studies should arguably be treated cautiously as there are different forms of pegged systems that operates in different ways and also leads to different results, but arguably the strict form of peg embodied in a currency board is very effective to end inflation expectations, if it is properly designed.

Yet price stability is not the only indicator of the success, or failure, of a monetary regime. Other ambitions matter too and many economists generally side with regimes allowing greater flexibility. In principle, a floating exchange rate regime is what the International Monetary Fund advises although it supports other regimes.<sup>54</sup> This is part of the never-ending story of, or the conflict between, the Scylla of discipline and the Charybdis of flexibility.

Ideally, a monetary regime would discipline monetary and fiscal authorities while it simultaneously allowed for flexibility in matching supply and demand. Pegged regimes can have, and often do have, some adverse effects on economic growth. Some analysts also claims that the exact specifics of monetary regimes does not matter much for stabilisation; monetary

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<sup>52</sup> Ghosh, Gulde, Ostry and Wolf (1996).

<sup>53</sup> Ghosh, Gulde and Wolf (1998).

<sup>54</sup> Lavigne (1999), p. 143. The IMF also supported the Estonian currency board and gave technical assistance to Estonian authorities when it was constructed as well as financial support to the stabilisations programme accompanying the currency board.

discipline and a general stabilisation programme attacking factors of instability are what matters.<sup>55</sup>

General programmes of stabilisation are naturally of great importance, but one should not neglect the design of monetary policy when reviewing the overall efficiency of transition policies. Money matters and it affect economic performance in many ways. The key concern is to end inflation expectations and to restore (or build) confidence – generally to get actors to behave differently and assess the future in ways other than they are used to. At a time of general chaos many circumstances speak for adopting a nominal anchor to hinge the process upon. In particular when politicians and authorities have no real experiences of managing a market-based order. This was the situation in Estonia and the overall reason for why a floating regime was viewed to be less effective in restoring confidence.

It is difficult to tell what tipped the balance in favour of a currency board in Estonia or where it got the inspiration to head for such a monetary solution. Obviously, the recent history of a currency board in Argentina mattered.<sup>56</sup> In the winter and spring of 1992, the new monetary regime in Argentina, only one year old, was seen, quite rightly, as a success in restoring stability. It is also true that Estonia probably would not have opted for a CBA if not Siim Kallas had been the overall master for managing the process to a new monetary order. In addition, some economists exercised a significant influence on Estonian authorities and on Siim Kallas, in particular Jeffrey Sachs, and his former student Ardo Hansson, who was advising Estonia on transitions policies.

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<sup>55</sup> Budina and van Wijnbergen (1997).

<sup>56</sup> The same reason for not calling the Estonian monetary regime a currency board applies equally to Argentina. Furthermore, Estonia has since 1992 acted as a currency board, except for bailing out a bank, while Argentina and its central bank deviated considerably from the behaviour of a typical currency board.

But a comprehensive proposal for a currency board arrangement in Estonia came firstly from economists Steven Hanke, Lars Jonung and Kurt Schuler who early in 1992 published their book *Monetary Reform for a Free Estonia*, which was subsequently translated into Estonian.<sup>57</sup> This book mattered a lot and since Lars Jonung was the chief economic advisor to the Swedish Prime Minister at the time, Carl Bildt, who was very much involved in the Estonian policy process, the currency board idea also had some ‘official’ support.<sup>58</sup>

When Kallas assumed the position of Governor of the Bank of Estonia in September 1991 he was already focused on a currency reform. Such a reform had been part of the IEM proposal four years earlier, but this proposal did not suggest an exact design of Estonia’s new monetary order. Nor did Kallas have a clear idea of the particulars of a currency reform when he took office. He had been fascinated by the gold-standard period in Estonia 1927-1933 and toyed with the idea of a gold-based exchange-rate system for Estonia, but this idea was never materialised into thorough studies of its feasibility, practicality and effect on the Estonian economy.

In the last months of 1991, discussions became more intense and it was decided by the Bank of Estonia and the Monetary Reform Committee (MRC) that Estonia should move directly to an independent currency and not, as had been suggested, start with a transition phase of vouchers or parallel currencies before full reform took effect. In the first quarter of 1992, as inflation skyrocketed and output plummeted, the reform discussion intensified and the search for a new monetary arrangement became more or less desperate. The situation was acute; indeed, the government of the City of Tartu actually established an own currency to mitigate

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<sup>57</sup> Hanke, Jonung and Schuler (1992).

<sup>58</sup> This proposal differs in some respects from the actual currency board instituted by Estonia. Hanke, Jonung and Schuler (1992) proposed a fixed CBA with the Swedish currency as the nominal anchor. Ideally, they believed the German mark to be better as an anchor, but they believed the reserve had to given to Estonia by Sweden.

the effects of rouble shortages, but this move was naturally suppressed by the Bank of Estonia.

This was the climate to which Jeffrey Sachs arrived when he visited Tallinn in the spring of 1992 to meet with Governor Kallas and government officials. Sachs had earlier not endorsed a currency board solution for Estonia; one of his first ideas was that Estonia should stay in the rouble-based order. But when in Tallinn, Sachs suggested to Kallas that Estonia should introduce a currency board and he outlined the details of the proposal in a memorandum.

In order to build confidence in Estonia's new currency policy, Sachs went as far as suggesting a currency-board arrangement based on full coverage of the entire stock of broad money.<sup>59</sup>

Sachs had positive experiences from Poland's new monetary regime from January 1990 when it pegged the zloty to the US dollar as part of the general 'big-bang' programme.<sup>60</sup> In the first month of the new decade, Poland experienced hyperinflation (77,3 percent in January) and in the last five months of 1989 the average monthly inflation had been nearly 34 percent.<sup>61</sup>

Stabilisation came soon after the new programme had set in. In February inflation dropped to 15,8 percent and in the subsequent months that year inflation was single digit.

This was the backdrop to Sachs proposal and Governor Kallas took an immediate liking of the idea of a currency board; in some respects it resembled the gold-standard regime, particularly its political-economy effects (disciplining policy by constraining discretion), that Kallas viewed benignly and had considered briefly as an option for monetary policy in an independent Estonia. Soon thereafter it was decided that Estonia should establish a currency

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<sup>59</sup> Broad money is a wide measure on money supply that not only contains currency in circulation (M1) but also savings and small time deposits, overnight repos, and non-institutional money market account (M2).

<sup>60</sup> Poland floated the zloty in October 1991 but then the economy had stabilised and inflation was low.

<sup>61</sup> Sachs (1993), p. 72.

board. At that time the IMF, which was involved in the discussions, particularly due to negotiations over Estonia's entry to the IMF and a subsequent stand-by agreement, was moving in the direction of supporting a currency board.<sup>62</sup>

The currency board legislation was drafted in May and in June the new monetary regime was introduced (see table 1 for specifics of the introduction). The technical aspects were important and Estonia faced some tough decisions.

*First*, what should be the anchor that the Estonian kroon is pegged to?

*Second*, at what exchange rate should the kroon be pegged?

*Third*, what should the currency board cover?

*Fourth*, where could Estonia find capital and currency for the reserve?

*Fifth*, should the Bank of Estonia be assigned to carry out any other mission than issuance of currency and holding foreign reserves?

The Bank of Estonia and the MRC moved swiftly in May and decided to have the Deutsche mark as the anchor currency. Several reasons were behind the preference for the mark. The German Bundesbank had a long reputation of price stability and its credibility thus could spill over to Estonia. In the forthcoming years, foreign trade with Europe was assumed to grow rapidly why a European currency would be beneficial. The idea of a future membership in the

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<sup>62</sup> The International Monetary Fund had originally favoured a traditional central bank model for Estonia. See Lainela and Sutela (1994), p. 36. Knöbl, Sutt, and Zavoico (2002) also discuss the relations between Estonia and the IMF.



European Union also favoured a European currency. Pegging the kroon to the European Currency Unit (ECU) was discussed but considered to be negative for transparency;<sup>63</sup> Estonia needed a monetary regime that people would have confidence in after the period of a dwindling rouble, and an anchor currency with tangible notes and coins was in that respect important.

When the currency board was introduced, the pegged rate between the kroon and the mark was eight to one (8:1).<sup>64</sup> Eight Estonian kroons would get one mark.<sup>65</sup> This was a deliberately low ratio and it followed the currency reforms in other countries such as Poland in 1990 and (as it then was called) Czechoslovakia in 1991. As CMEA had collapsed and Russia was on the brink of substantial contraction, trade with other European countries needed to increase and devaluation would stimulate export. In hindsight, this deliberate undervaluation may have been ill-judged. It affected stabilisation and slowed down the initial decline in inflation. It could be argued that the era of double-digit inflation was prolonged by this undervaluation and its effect on wage and price increases.

Indeed, in a fixed regime there is no other way an appreciation can occur than through higher inflation. There were also reasons for expecting an appreciation. In transitions from a centrally-planned economy to a market economy there will be substantial differences in productivity growth between sectors. The differences between traded and non-traded goods often lead (if the transition is successful) to an appreciation of the real exchange rate as the traded sectors becomes more efficient than sectors still operating in a closed economy or lagging behind in terms of integration in the world economy.

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<sup>63</sup> Ross and Lättemäe (2004), p. 147.

<sup>64</sup> The Estonian currency board is not fixed but a pegged system. The Bank of Estonia cannot change the exchange rate but the Estonian parliament can. Sachs and Lipton (1992); Hanke, Jonung, and Schuler (1993).

<sup>65</sup> In 1999, when Germany joined the EMU and introduced the euro, the Estonian kroon was re-pegged to the euro.

This so-called Balassa-Samuelson effect also occurred in Estonia.<sup>66</sup> The real effective exchange rate appreciated considerably in 1992. It depreciated in the first two quarters of 1993 but subsequently appreciated again in the last quarter of 1993 and in all quarters of 1994. Another way of describing the different development in the traded and non-trade sectors can be found in Table 3.

Inflation in the sheltered sector slows down considerably after the peak in 1992, but not as fast as inflation in the open sector. Furthermore, inflation continues to be substantially higher in the sheltered sector. There is also a clear difference between the development of producer prices and export prices, suggesting that the export prices reflects a better performing sector than the producer price index taking all production into account.

**Table 3: Inflation in open sector and sheltered sector 1992-1995**

	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
Inflation (CPI)	1076,5	89,8	47,7	29,0
Open sector	991,6	84,9	33,9	17,5
Sheltered sector	1702,7	149,3	89,2	52,1
Producer price index*	...	...	32,8	21,8
Export price	...	...	22,2	17,2

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<sup>66</sup> This effect is named after economists Bela Balassa and Paul Samuelson.

index\*

\* December-on-December

*Source:* Sörg (2004), p. 3; International Monetary Fund (1999), p. 99

Estonia neglected one aspect of Jeffrey Sachs's proposal for a currency board: instead of a wide measure for foreign-reserves coverage (broad money), Estonia determined not to include liabilities of commercial banks in its foreign-reserves coverage, which narrowed the extent of foreign exchange needed to be held by the Bank of Estonia.

This was for two reasons. First, if liabilities of commercial banks would have been included, this would have constrained the operation of banks considerably. Secondly, Estonia did not have much foreign currency to use when building up the foreign currency reserve.<sup>67</sup> Therefore the currency board had to be launched without full reserve backing; approximately 90 percent of the liabilities of Bank of Estonia were backed in the first month of the new monetary arrangement. But within a few months the reserve ratio became positive.<sup>68</sup>

The sustainability of the Estonian currency-board reform – Estonia will in the forthcoming years probably enter the European Monetary Union and adopt the Euro as its currency – is definitely due to its impact on stabilisation. It was the centre of gravity in the post-independence macroeconomic crisis and it managed to not only stay alive but, more importantly, cushion the effects of the Estonia economy of the Russian and Asian crisis that

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<sup>67</sup> The reserve was built up by government-owned forest, gold held by the Bank of Estonia before 1940 when the Soviet Union annexed Estonia, and foreign notes that Estonians exchanged for kroon's. Not all gold had been restituted at the time when the currency-board arrangement was launched, but in July additional reserves arrived from Sweden and the Bank of International Settlements.

<sup>68</sup> Knöbl, Sutt and Zavoico (2002), p. 11, show the reserve development immediately after the reform.

hit emerging markets severely. Estonia was affected too; output and foreign inflow of capital fell, the fiscal deficit soared, interest rates increased and a bank went bankrupt. Still, the currency board restrained policy and facilitated the flexibility needed in money supply at the time. One central policy consequence of these crises was an enforced belief in the currency board.<sup>69</sup>

### **3.1.2 The political economy of Estonia's currency board**

The Estonian currency board essentially implied, figuratively, putting a straight-jacket on fiscal and monetary authorities. In a currency board, base money can only be created by increasing the stock of foreign currency and thus it was not possible for the Bank of Estonia to finance government deficits or to support business by monetary manipulations. In other words, the discretionary power of monetary authorities had been strictly limited in this arrangement.

This was not an unintended consequence or a side-effect, foreseeable or not, of Estonia's currency board; it was arguably one of the chief reasons for why Estonian established a currency board rather than just pegging the new currency in a traditional monetary order based on the central bank as the navigator and regulator of the macro economy. Admittedly, the peg implies possibilities for alterations of the exchange rate, but in contrast to a normal central-bank peg, Estonia had a strong foreign reserve.

It is not difficult to understand the rationale behind limiting discretionary powers. In the years before the currency board was introduced, the Estonian economy was contracting and sober

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<sup>69</sup> Sepp and Randveer (2002), pp. 21, discuss the effects on Estonia from the emerging market crises in the 1990s, particularly the Russian and Asian crises.

observers did not believe in radically better conditions in the years to come. There had to be a complete restoration of the economy. Central planning had to be eradicated and replaced by a market economy. Prices had to be liberalised. Production had to be adjusted to market conditions. Privatisation of many state-owned firms was badly needed. The financial sector stood in front of a radical transformation which would probably result in bankruptcies. Economic policy in general had to be rebuilt.

Furthermore, there were many political uncertainties at the time. The Savisaar government had resigned early in 1992 and been replaced by the Vähi government. They did not differ much; Vähi had been a Minister also in the preceding government. More importantly, the Vähi government was only a temporary solution till the first genuinely free election would be held later in 1992. It was difficult to tell what the result of the election would be and if a new government would have the capacity to deliver reforms and even to gear up the reform pace considerably after years of slowly moving policy changes. Uncertainties such as this pointed to a monetary order that provided strict conditions for monetary as well as fiscal policies. Indeed, in order to gain confidence from citizens as well as the outside world, Estonia had to hedge reform efforts as much as possible from wishes, demands, prejudices or pressures of the interventionist ilk.

There was another uncertainty that suggested a regime easy to manage: the accumulated stock of central-bank knowledge in Estonia was limited. Simply put, there were not many Estonian experts on central banking around. Furthermore, the apparatus for collecting data on the economy was not prepared for delivering the sort of detailed information an orthodox central bank need to operate sufficiently well. These insufficiencies enforced the view that Estonia did not have in place the preconditions for running an advanced central bank.

As every historian of monetary policy knows it is always tempting for political bodies to use this policy for various objectives. Many of the people involved in the discussion over currency reform also nurtured suspicions that discretion would undermine stabilisation. These suspicions were enforced in the months preceding the currency reform.

A sizeable division between the government and the Bank of Estonia over central-bank operations occurred in May 1992 as the former favoured interventionist policies aimed at accommodating fiscal deficits. Moreover, the government proposed, as late as a month before the currency board reform, that it preferred the new currency to circulate immediately and in parallel to the rouble before the real reform was achieved. The hidden meaning of this proposal was deficit-financing as the *ex ante* value of the kroon would be significantly higher than its *ex post* value after the full reform. Essentially the government wanted the Bank of Estonia to finance its deficits and provide credit to businesses that had or soon would run into financial difficulties.<sup>70</sup> Governor Kallas and the Bank of Estonia opposed this proposal and it was also turned down in the MRC. But Vähi continued to fight for his proposal and took it to parliament, which also rejected it.

This reflected an overall difference in economic and ideological outlook. The Bank of Estonia was headed by one of the leading proponents of market-economy reforms, Siim Kallas, and had for some time only hired staff that basically shared that view.<sup>71</sup> The government, on the other hand, harboured Ministers as well as officials taking a more traditional socialist outlook on Estonia's future. Tiit Vähi and several others in the government were reformists, but they

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<sup>70</sup> Laar (2002), p. 120.

<sup>71</sup> Knöbl, Sutt and Zavoico (1994), p. 5.

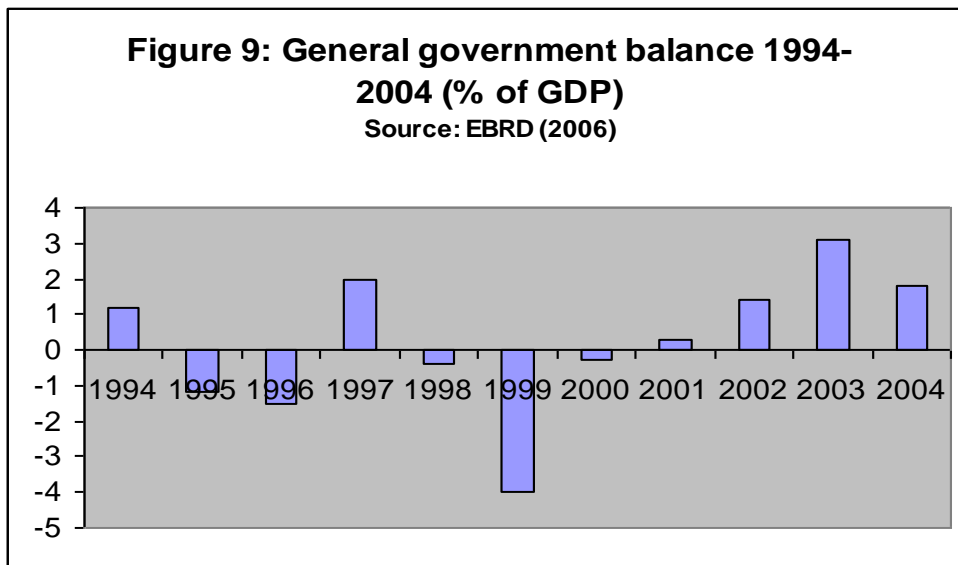
had several doubts about the extent of the reforms and largely favoured an idea of a third way between capitalism and socialism.<sup>72</sup>

Doubts over the use of discretionary power suggested to many involved in the discussion at the time that a currency reform needed to tie Estonia's politicians to a strict reform policy. In other words, the alluring voices of the Sirens would be too tempting to neglect. As political concerns would mount as banks would run into trouble, and possibly also after the election, it became even more important to constrain discretionary bodies.

The link between monetary order and fiscal policy was always present in the reform discussions. The fiscal deficit soared in the winter and spring of 1992. Most observers believed the deficit would continue to be high, perhaps even rising, unless Estonia would undertake a comprehensive stabilisation programme centred upon a new monetary regime. An objective of the currency reform was therefore to limit the possibility for government to finance deficits. Admittedly, a government can lend money on the private market if there are people believing in its creditability, but the key aspect of the reform was to disintegrate fiscal deficits and central-bank credit.

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<sup>72</sup> Kallas and Sörg (1995); Laar (2002).



This constraint on deficit financing has had a significant effect on Estonia's public finances. It has not eradicated budget deficits, which would not be beneficial let alone possible, but the currency board has clearly led to an overall control of the fiscal budget. As shown in Figure 9, fiscal deficits have been small, except in 1999 around the time of the Russian financial crisis that led to a recession and falling tax revenues in Estonia (and several other countries). In several years the government has also run a surplus enabling the government to repay debts.

Estonia is unique among transition countries to have had such control over public finances. And Estonia continues to excel in this field. Of the eight countries formerly in the Soviet sphere joining the European Union in 2004, Estonia was the only country having a budget surplus that year. Four countries did not pass the Maastricht criteria of a budget deficit less than three percent of the GDP. Looking back the last twelve years, in nine of these years Estonia has had the best fiscal record.

This can also be seen in comparisons over government debt. Total public debt in 2004 equalled only four percent of GDP (see Table 3). This can be compared to the other Baltic



countries having a public debt on 15 and 23,3 percent of the GDP. And the Baltic countries have performed well in view of public debt in other Central and East European Countries. In 2004, Hungary would not have passed the Maastricht limit on public debt (which is also true for some countries already in the European Monetary Union). Poland and Slovakia have public debts well above 40 percent of GDP and the average for EU-8, the eight countries formerly in the Soviet sphere joining the EU in May 2004, is 31,1 percent.

The state of the public finance in Estonia is the best among all transition countries. Indeed, it is best in whole Europe.

**Table 3: Fiscal deficits, public debt, inflation and interest rates in EU-8 (2004)**

	<u>Fiscal deficit*</u>	<u>Public debt*</u>	<u>Inflation (%)</u>	<u>Interest rate (%)</u>
<b>EU-8 Countries</b>	-2,8	31,1	4,3	5,4
Czech Republic	-3,5	24,1	2,8	4,8
Estonia	1,7	4,9	3,0	4,4
Hungary	-5,4	60,8	6,8	8,2
Latvia	-1,1	15,0	6,2	4,9
Lithuania	-2,2	23,3	1,2	4,5
Poland	-6,5	49,5	3,5	6,9
Slovak Republic	-3,3	43,6	7,5	5,0
Slovenia	-1,9	27,8	3,6	4,7

\* In percent of GDP

*Source:* IMF (2005)

Except for a strict policy for fiscal deficits, Estonia has established a Stabilisation Reserve Fund where part of the savings from budget surpluses and revenues from privatisation have been placed.<sup>73</sup> This fund was established in 1997 and invests its capital abroad. This is rather exceptional. Other countries that have started funds like these have usually been countries such as Norway, Botswana and Kuwait that have vast current-account surpluses due to their vast resources of commodities and need to sterilise its excess surpluses in ways not lowering their competitiveness. Hong Kong, Singapore, Chile and New Zealand have also established such funds and with Estonia they share the policy of profound unilateral internal, external and monetary liberalisation.

The Estonian Stabilisation Reserve Fund was established for four reasons. First of all, with its experience of a severe macroeconomic crisis Estonia wanted to establish institutions that can help cushion macroeconomic crisis without jeopardising fiscal and monetary conservatism. Secondly, Estonia needed to reform its pensions system and build reserves that cannot be appropriated by politicians for spending on other means. Thirdly, at the time of reform Estonia had a period of rapid credit growth and needed to cool liquidity; this was achieved by transferring public savings abroad. Fourthly, the large revenues from privatisation needed to be sterilised without expanding liquidity.

### **3.1.3 Attracting foreign direct investments**

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<sup>73</sup> International Monetary Fund (1999), pp. 37.

The third and last major reason behind Estonia's move to a currency board was its simplicity, transparency and thereby its attractiveness to foreign investors considering investments in Estonia. As have been discussed earlier, Estonia needed to reorient itself from the east to the west amid the contraction of Russia's economy and the collapse of the CMEA. Trade and investment flows declined considerably in the prevailing chaos at the time. Furthermore, the lack of domestic capital and knowledge increased the demand for foreign direct investments (FDI) in Estonia.

The currency board had several characteristics of relevance to a new outward-looking FDI regime in Estonia. First of all, the currency board rests on full convertibility between currencies and cannot really function under conditions of limitations to convertibility. That is in opposition to the whole idea with a currency board; furthermore, it is overall pointless to restrict convertibility if the central bank is bounded by law to cover all domestic currency in circulation by reserves in another currency that operates under full convertibility.

Full convertibility can be achieved under other monetary orders too, and indeed was so in all European transition countries regardless their choice of monetary regime.<sup>74</sup> Yet a currency board is to be favoured from this point of view; the currency board limits discretionary power to partly repeal convertibility if such a move would be preferred by political or monetary authorities.

Secondly, and following from the first proposition, the limitation of discretionary power implies less possibilities to manipulate exchange rates and engage in business concerns via

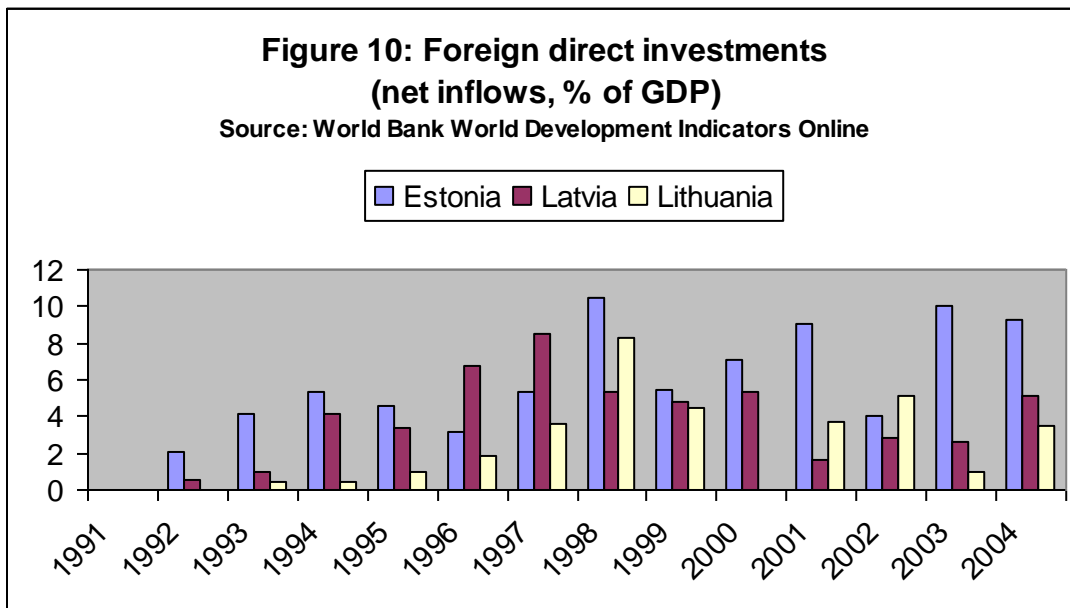
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<sup>74</sup> Several CIS countries continued to limit convertibility after independence.

central-bank intermediaries. This was a central concern in the early 1990s. If Estonia was to attract foreign investors, it needed to institute a monetary order that investors could have confidence in. Of particular importance was price and exchange rate stability, lowering the need for investors to hedge investments for adverse changes in the exchange-rate.

Thirdly, the currency board essentially is a signal of outward orientation and is in most cases accompanied by current-account liberalisation and substantial, if not full, capital-account liberalisation. Indeed, an open trading order is of necessity to the currency board since money supply hinges upon changes in external balances. In this respect, external liberalisation is a locus of changes in domestic monetary demand.

Estonia did not fully liberalise capital-account transactions immediately, but did so soon after the currency board reform. The result has, undisputedly, been beneficial to Estonia. It has attracted vast amount of foreign direct investments and has one of the largest stock of FDI per capita in comparison with other transition countries. As shown in Figure 10, net foreign direct investments have been positive every year since the monetary reform and have averaged at six percent of the gross domestic product a year. Between 1994 and 2004 the average was nearly 8,5 percent of GDP.



In the first years of the 1990s, foreign direct investments were largely constituted by foreign investors buying privatised companies. Many feared this would be a temporary peak subsequently followed by low or even negative net foreign direct investments, but the rapid restoration of the Estonian economy and its high growth has provided good reasons to invest in the country. In fact, the FDI inflows geared up after the privatisation programme. And the inflow growth is basically constituted by direct investments. These have grown rapidly in the last five years while portfolio has declined considerably. The most recent figures for Estonia's international investment position showed the direct investments were five times the size of portfolio investments.

The FDI inflows have originated from several countries, but a major part has come from Sweden, Finland and the United Kingdom. The United States and Germany have also been large investors in Estonia. One of the key sectors for foreign investors have been the banking and financial sector, which are now almost totally owned by foreigners and have facilitated one of the most competitive financial markets in Europe. The banking sector is also very

strong – by far the strongest in transition countries – and the estimated systemic financial risk due to the banking sector is very low.<sup>75</sup> However, the high current-account deficit is seen by some observers as a source of systemic risk.

Figure 10 also illustrates the sizeable difference between Estonia and the other two Baltic countries in attracting foreign direct investments. Except for three years (1996, 1997 and 2002) Estonia has had higher inflows of FDI and it has distanced the other two countries by far. Therefore, the Estonian FDI stock, the accumulated foreign direct investments, is considerably higher in Estonia than in Latvia and Lithuania. Measured as share of GDP, the Estonian inward FDI stock at the end of 2005 was 85 percent while it was around 30 percent in Latvia and Lithuania.<sup>76</sup>

### 3.2 Open for business – Estonian trade policy

Estonian trade collapsed amid the fall of the Soviet Union. As part of Soviet, Estonia had been subject of the union-wide central planning that dictated what should be produced in various parts of the country. The centralised price system had effectively led to zero responsiveness to changes in the real economy – in supply and demand. Market-based trade flows were not part of this regime and thus it is impossible to understand trade in the Soviet sphere with the normal tool-box of international economics.

Trade with the outside world had been small. Estonia's export to countries outside the Soviet Union represented only 2-3 percent of the gross domestic product before the reforms started.

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<sup>75</sup> European Bank of Reconstruction and Development (2006), p. 45.

<sup>76</sup> The data on inward FDI stock was retrieved on May 19, 2006, from the UNCTAD FDI database ([http://www.unctad.org/sections/dite\\_dir/docs/wir2005\\_instock\\_gdp\\_en.xls](http://www.unctad.org/sections/dite_dir/docs/wir2005_instock_gdp_en.xls)).

The vast part of that export, approximately two-thirds, went to other countries in the Council of Mutual Economic Assistance (CMEA).<sup>77</sup> For the Soviet Union as a whole, trade outside the CMEA stood for less than one fourth of total trade.

For a small country like Estonia, trade is imperative for economic growth. Therefore no one doubted in the early 1990s that Estonia needed to employ a new trade-policy regime that reoriented its trade from the Soviet sphere to the western countries, in particular to Europe and the regional neighbours Finland, Germany and Sweden. Yet, the restoration of Estonia's trade policy in the early 1990s is still highly surprising in a comparative context. Few countries ever have liberalised trade to the extent Estonia did in 1992. It adopted a Hong Kong model of almost zero tariffs and this reform was achieved by unilateral means and not as part of a regional trade agreement or in accession to the World Trade Organisation (WTO) and the European Union. In fact, when these trade policy tracks materialised in the later part of the 1990s, Estonia had to re-regulate its trade policy.

In this chapter we shall study Estonia's trade policy after independence. In the first parts we will focus on Estonian trade policy pre and post 1992, and then we will briefly see what policy changes Estonia undertook en route to membership in the WTO and the European Union.

### **3.2.1 From Soviet to Hong Kong**

Foreign trade in the Soviet sphere was generally monitored and regulated by the CMEA (or, as it was known in the west, COMECON). It was founded in 1949 by the Soviet Union,

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<sup>77</sup> Feldmann and Sally (2001), p. 6.

Bulgaria, Czechoslovakia, Hungary, Poland and Romania. In later decades, countries from other parts of the world closely associated with Soviet or the Soviet ideology joined. Cuba, for example, became member in the early 1970s and Vietnam in the later part of the same decade. Mozambique actually tried to join but its application was rejected.<sup>78</sup>

To some extent, the idea with CMEA was to use differences in factor endowments and, at a later stage, the comparative cost advantages among this group of countries. Thus it was supposed to operate as a common market. The common market of the East was also a popular phrase employed by observers in the west to describe regional economic integration in Eastern Europe. But CMEA never became a common market for these countries; indeed it never functioned as a market at all. Countries in the COMECON rather behaved as autarkies – or functional autarkies, to use the phrase coined by Franklyn Holzman.<sup>79</sup>

As every other economic activity in the Soviet sphere, trade was subject of central planning and was not constituted by voluntary agreements by individuals responding rationally to changes in relative prices. Trade was nothing but a function of the input oriented structure of a socialist economy. In such an economy production is generally denoted by the material balance (see Table 4); what resources that are available to production. In this respect, socialist economies were essentially supply-side oriented; demand and consumption was seldom given any significance in the planning procedure, they were just functions of inputs and available resources.

As a consequence, trade was not driven by the mercantilist wish to boost exports but rather the need to import input factors not domestically available. In other words, import had a

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<sup>78</sup> Lavigne (1999), p. 72.

<sup>79</sup> Holzman (1974).



higher priority than export. Export was just a necessary effort to finance import. It is a bit surprising but this particular feature of Soviet-style trade bears close resemblance to the classical-liberal notion of trade in which import is generally seen as more important than export. The anti-mercantilism views of Adam Smith and David Hume thus became embodied in Soviet-style planning for foreign trade!<sup>80</sup> And in contrast to the development model of export-orientation applied in later decades by fast-growing countries, particularly in Asia and Southeast Asia, there was talk of an import-oriented growth model in the Soviet sphere.

**Table 4: Typical material balance**

<u>Resources</u>		<u>Uses</u>	
Domestic production	10 000	Inputs used for production	5 000
Imports	500	Investments	2 500
		Consumption	1 500
		Exports	1 500
<b>Total</b>	<b>10 500</b>	<b>Total</b>	<b>10 500</b>

Trade and international economic relations became part of the administrative process of determining production. This required a specific organisation and the task of administrating trade was assigned to so-called Foreign Trade Organisations (FTOs). They were essentially state monopolies (indeed behaved as such), were under the auspices of a Ministry, normally a Ministry for Foreign Trade, and were organised along the lines of product categories. As these FTOs also organised imports from other countries, they also become monopsonies at the same time as they were monopolies.

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<sup>80</sup> Needless to say, this is nothing but a coincidence; centrally-planned trade is by nature in direct opposition to market-based trade.

A Foreign Trade Organisation performed as the link between a domestic producer and a foreign supplier or buyer. Overall they had all the contacts with the foreign exporter or importer, which caused a lot of trouble since the producer and the buyer could not have contact with each other to discuss and determine specific details of the exchange. Not seldom, the problems took comical proportions. For example, Soviet exported snow ploughs to Guinea because no one had told the producers of locomotives in Soviet that Guinea did not need to have snow-ploughs on their locomotives.<sup>81</sup> There were numerous problems in getting trains to run on time in Guinea, but snow was not one of them.

The Foreign Trade Organisations were also responsible for solving problems such as non-existing currency convertibility and thus how to determine the relation between currencies and domestic prices. This was not a minor problem. In Soviet and the other communist countries, money was effectively not functioning as a medium of exchange. Consumers had, officially, money in form of cash and bank savings. Producers, on the other hand, usually only had money in scriptural form and could use cash only to pay for wages. Such a system is not easily integrated in trade with a foreign country where the value of production must be determined in terms of another country's currency. Two elementary features of a normal economy are missing and must be corrected. First, there must be a domestic price determined for the specific good. Second, this price must be transformed into a foreign currency, which implies setting a market based exchange rate. In many cases these problems were unresolved and the FTOs rather preferred to deal in barter instead of exchange.

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<sup>81</sup> Lavigne (1988), p. 102.

In the CMEA, however, there were some established routines and procedures for intra-trade that made life a bit easier for FTOs and importers/exporters in the other country. Intra-CMEA terms of trade were, quite surprisingly, based on world market prices.<sup>82</sup> To be more specific, intra-CMEA prices were based upon world market prices in the last five years. Indeed, they were also fixed for the next five years. The latter part was changed in the mid-1970s after the first oil shock; from then on it was the price in the previous five years that determined current price and it was not longer fixed for the next years.

This Soviet-based regime for economic integration also had routines for convertibility. CMEA established a currency unit called ‘transferable rouble’ that acted as a unit of account. In reality, though, no money transfers were made between countries. Trade was registered by the International Bank for Economic Cooperation (IBEC), a CMEA body, but in lieu of a traditional current account view on trade, CMEA was rather based on a capital account view which treated trade in terms of assets and liabilities. This institutional setting for trade enforced the inherent bias of import over exports in central planning. Accordingly, a trade surplus led to a positive balance in the IBEC account, but a creditor country (a surplus country) could not get anything out of this credit. Of course, future imports were balanced against this asset, but the net trade balance never materialised in actual payments taking place. Debtor countries were not obliged to pay for their deficits.

Put differently, *bilateral* balances did not matter. The central concern was the overall balance; at the end of the day, aggregate exports and imports within the boundaries of CMEA had to match each other. Thus, the IBEC just performed as a registrar of trade and could not facilitate money transfers between a creditor and a debtor. Not surprisingly, the incentive to

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<sup>82</sup> Lavigne (1999), p. 75.

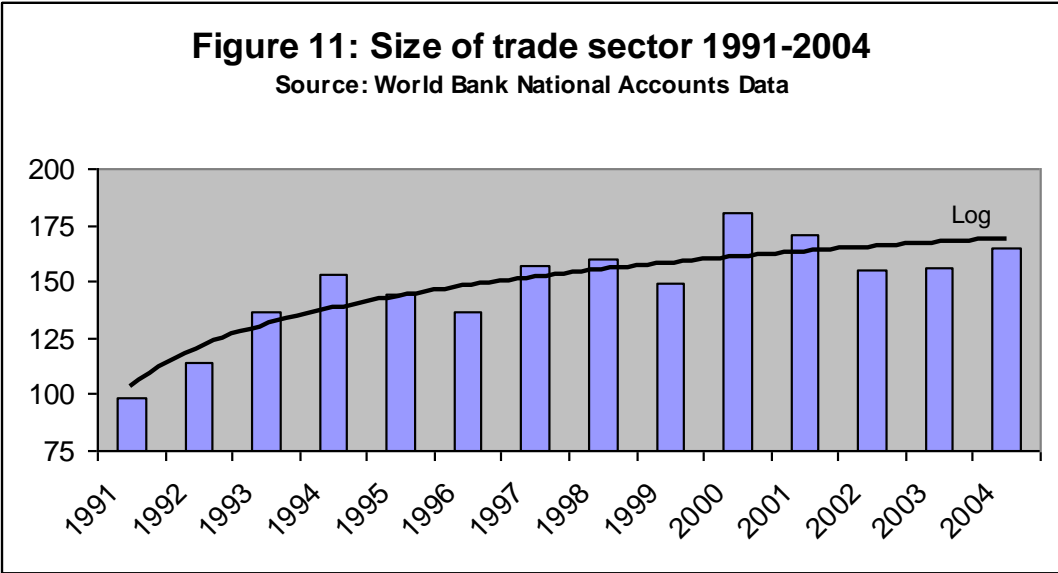
engage in trade, not particularly obvious to begin with, was not improved as the exchange system distorted a country's ability to engage in export activities. In the middle of the 1980s some reforms of this system were undertaken, but they did not fundamentally alter the structure and organisation of trade. Not even marginally. Thus, the root problems continued to live and breath and the stumbling model for intra-CMEA trade lingered on.

This was also the trade-policy setting that Estonia inherited when it first was granted some economic autonomy and, at a later stage, full independence from Russia and the Soviet command economy. Before Estonia could embark on a new policy for external liberalisation, there had to be complete restoration of the domestic system for prices, production and exchange. But as soon as internal prices had been liberalised, and a reliable monetary order was in place, Estonia completely changed external and current-account policies. The major step was to unilaterally lower tariffs to indistinguishable levels.

Estonia's liberal trade has provided a tremendous boost to Estonian trade. Trade has expanded thick and fast. As shown in Figure 11, the Estonian trade sector (import plus export as a share of GDP) grew at an extremely rapid pace in 1992-1994. From 1991 to 1994, the trade sector expanded by 55 percentage units or by 56 percent. Part of the explanation to this world-record pace of trade-sector growth is rapidly falling output; the trade sector grew because production generally was falling. Foreign trade in the first years was to a large extent driven by imports of key commodities that Estonians had lacked in the Soviet era of shortages. In 1995 and 1996, trade sector growth slowed down and fell as the economy had been stabilised and domestic output had started to grow again. Since then the trade sector has grown but the annual variability has been significant. Another particular feature of Estonian trade is the current account deficit (see Table 5). Estonia has had a negative current account balance since

the early 1990s. In recent years the deficit has expanded rapidly and peaked in 2004 at twelve percent of the GDP. The average deficit in the last ten years has been around 8-9 percent of the GDP.<sup>83</sup>

As a trading nation, Estonia can still not be compared to Hong Kong or Singapore; Hong Kong's trade sector is today around 300 percent of its gross domestic product and Hong Kong has been a centre for trade in many decades. Estonia has roughly the same size of trade sector as Hong Kong had in the early 1970s. But there are still a great potential for a rapidly increasing trade sector in Estonia; as Hong Kong, Estonia is strategically located close to a populous country and can facilitate trade to and from that region. However, there are also factors pointing in the other direction; Estonia is today bounded by EU trade policy and do generally not run such a liberal domestic policy as Hong Kong did and to a great extent still does.



<sup>83</sup> Capital and financial accounts have been positive and, in most years, higher than the current account deficit. Thus, the overall balance has been positive.

Table 5 lists Estonia's main trading partners in 2005. Compared to the situation before Estonian independence, very much is different. Then trade outside the Soviet sphere – the COMECON area – represented approximately one fourth of total trade. Today the main trading partners are to be found in the EU-15 area and the CIS represents only a paltry part of Estonian trade. In particular, trade is concentrated to countries around the Baltic Sea and this pattern largely resembles Estonia's trade pattern in the days of the Hanseatic League. Literally, Estonia has accomplished to restore the order before the rise of the Soviet Union and even before the decline and fall of Tsarist Russia.

Thus, Finland is the key trading partner, in exports as well as imports, followed by Sweden, Latvia, Russia, and Germany as the major destination countries of Estonian export. The same countries are essentially also the main import countries for Estonia.

Another significant trend is that Estonian trade is increasingly being diversified in terms of geography. In particular, the share of trade with Finland and Sweden has declined considerably over the last years while other countries, not least China and other Asian countries, have increased their share of Estonian trade. In 1999, before the trade reforms, Finland stood for more than 30 percent of Estonia's export and roughly 29 percent of its import. In 2005 the equivalent figures were approximately 27 percent (export) and 20 percent (import). Export to Finland grew between 2004 and 2005, but the long-term trend still is a diversified trade portfolio with less reliance on neighbouring Finland and Sweden.

**Table 5: Main trading partners 2005**

	<u>Exports*</u>		<u>Imports*</u>
<b>EU-25</b>	77,8	<b>EU-25</b>	76,0
Finland	26,6	Finland	19,8
Sweden	13,1	Germany	13,8
Latvia	8,8	Sweden	8,8
Germany	6,2	Lithuania	6,0
Lithuania	4,7	Latvia	4,7
<b>CIS</b>	8,6	<b>CIS</b>	11,7
Russia	6,5	Russia	9,2
Ukraine	1,4	Belarus	1,3
Kazakhstan	0,3	Ukraine	0,9
<b>Other</b>	13,6	<b>Other</b>	12,3
USA	3,1	China	2,1
Norway	2,9	Japan	2,0
Gibraltar	1,5	Hong Kong	1,9
<b>Total (EEK m)</b>	97,311,4	<b>Total (EEK m)</b>	128,112,8

\* Share of total

Source: Bank of Estonia (2006).

### **3.2.2 Liberalise, then negotiate!**

Estonia started to liberalise trade as part of the programme for price liberalisations generally. Internal liberalisations and external liberalisations had to go hand in hand and they mutually enforced the impact of each individual reform. But the former was a precondition to the latter; before external liberalisation could be achieved Estonia had to leave the old system of determining production, prices and exchange. Thus, the first wave of trade liberalisations was largely constituted by gradual domestic reforms of the planned economy; monopolies were abolished, including foreign trade monopolies (FTOs), and prices were successively determined by market actors and not by administrative bodies. The second step was taken in 1991 and 1992 when most measures of border protection were removed. Import quotas and licenses were abolished on most products and within a few years they did not exist at all.<sup>84</sup>

This process of trade liberalisation did essentially not involve tariff reforms. The reason is that tariffs were never part of the centrally planned economy. Trade regulation was rather embodied by quantitative restrictions, such as quotas, and regulatory barriers, such as state trading monopolies. As a trade-policy instrument, tariffs were never in demand. The input or material-balance outlook on trade held that trade (import) only occurred when there was a specific demand from an administrative body. In some instances the Soviet Union had elaborated with taxing exports to countries outside the CMEA, but these efforts failed to achieve the objective of increased revenues.

More surprisingly, Estonia never established a system of tariffs to replace its earlier restrictions on trade. This had been common in the transition countries liberalising trade

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<sup>84</sup> Feldmann and Sally (2001), p. 9.



before Estonia and it is overall the standard operating procedure in developing or emerging countries moving in the direction of external liberalisation. Estonia largely rejected tariffication as a method of liberalising trade and rather relied on the Hong Kong model of completely free trade. It is difficult to exaggerate the uniqueness of such a bold liberalisation. It implies that domestic producers will have to meet foreign competition upfront and thus adjust to new conditions without any border protection. Arguably, this radical move explains why Estonia managed to restructure its economy at a relatively fast pace; enterprises not competitive on the world market could not continue and the belated transformation in the other Baltic countries never had a counterpart in Estonia.<sup>85</sup> Estonian production was confronted with market reality instantaneously.

This root-and-branch external liberalisation involved a few small pockets of trade protection. Tariffs were introduced on a small selection of products (they were repealed in 1997), but in the greater scheme of liberalisation these tariffs (e.g. on tobacco, alcohol and fuels) were marginal and did not blemish Estonia's free-trade credentials.<sup>86</sup> As shown in Table 6, the average weighted tariff rate in 1993 was 1,4 percent and in 1997, after repealing the tariffs, Estonia was down to a tariff level of zero percent. Upon accession to the World Trade Organisation in 1999, there were no tariffs left to liberalise. Rather, as discussed later, the regulatory structure of the WTO rather led to an upward pressure on tariffs.

Latvia pursued a relatively aggressive policy of trade liberalisation too and had in 1994 an average weighted tariff rate of 3,4 percent.<sup>87</sup> Most other transition countries had substantially

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<sup>85</sup> World Bank (1996), p. 32.

<sup>86</sup> Important to the discussion of trade protection in the early 1990s is the de facto depreciation when Estonia introduced the kroon and the new monetary order in June 1992. This mitigated the Balassa-Samuelsion appreciation of the real exchange rate and, arguably, led to an increased *net protection* (measure as the change in the domestic price of importables relative to non-trade goods).

<sup>87</sup> Feldmann (2000) stresses other trade-policy differences between Estonia and Latvia.

higher tariff rates and never embarked on such a bold liberalisation programme as Estonia did. Not even the other ‘shock-therapy’ countries, notably Poland and the Czech Republic, came close to Estonia in terms of free trade.

**Table 6: Average weighted tariff rates in selected transition countries**

	<u>1993</u>	<u>1999</u>
Estonia	1,4 %	0 %
Latvia	3,4 % (1994)	5,3 %
Croatia	10 %	...
Czech Republic	5,7 %	6,8 %
Poland	11 % (industry); 18 % (agriculture)	11,6 %
Romania	11,7 %	23,8 %
Russia	14 % (1994) (also other means of protection)	...
Slovakia	5,7 %	12 %

*Source:* Feldmann (2000), p. 12; Feldmann and Sally (2001), p. 9

The former Estonian Prime Minister, Mart Laar, has once described Estonia’s trade policy as ‘liberalise then negotiate; but don’t negotiate and then liberalise’.<sup>88</sup> This is an illustrative description of Estonia’s liberalisation – based, in the first instance, on unilateral liberalisations and then on ensuing bilateral, regional and multilateral trade policy tracks (see next section).

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<sup>88</sup> Feldmann and Sally (2001), p. 14.

But it is distinctly uncommon as a procedure for trade liberalisation and it can even be said to be against the grain of ‘modern’ trade policy – indeed, against the political economy of trade policy in its entire form. Following the mercantilist and reciprocal order for postwar trade policy and international economic integration, the proposition should rather be read the other way around: first negotiate, then liberalise. This proposition does not (necessarily) rest on hidden or creeping mercantilism among trade policy observers; it is rather a function of the many strongholds of protectionism in countries that have blocked the way to unilateral free trade, the first choice for most economists. Therefore, the political-economy analysis of trade liberalisation suggests multilateral negotiations as a method of dismantling domestic opposition to liberalisation; concerted efforts enable political leaders to use international agreements as domestic reform levers and to put protectionist interests against free trade interests.

Estonia is an anomaly in this view of trade liberalisation. Estonia moved swiftly to almost completely free trade and then enforced this policy till the EU accession. How did this happen and what factors explain Estonia’s bold move to the Hong Kong model of trade? Six factors were crucial to the taken reform route and below they are outlined (not in order of importance).

First, many key political leaders in Estonia believed in the idea of free trade and basically shared the ‘bottom-up’ view on external liberalisation; home-grown trade liberalisations, instrumentalised in unilateral action (‘just do it!’), are superior to international negotiations leading to top-down implementation of trade reforms. Showing the importance of ideas, this

was arguably imperative to radical liberalisation. Without the strong beliefs held by central leaders, Estonia would never have opted for unilateral free trade.<sup>89</sup>

Naturally, there were divisions among politicians and key officials along the lines of the conflict over pace and substance of the currency reform; a group of young politicians and officials pushed for radical liberalisation while a group of older people in the former Estonia Soviet establishment favoured a less comprehensive reform programme in a larger idea of ‘third-way’ policies. But all were convinced of the need to reorient Estonia’s trade pattern and that a requirement for such a development was a very liberal trade policy.

Secondly, trade liberalisation was part of a greater reform programme and was seen as instrumental to achieve other objectives. Current-account liberalisation was instrumental to the targeted economy and society-wide changes. In the spirit of Ludwig Erhard’s reforms in Germany after the Second World War, trade liberalisation was tied together with internal liberalisations and institutional reforms.<sup>90</sup> These individual efforts, it was argued, would stand or fall together. The proposition of ‘liberalise, then negotiate’ would help to deliver the ‘big-bang’ reforms that, in a later stage, could be locked-in by international agreements.

Thirdly, establishing a new regime of trade protection was seen as impractical and difficult to manage in a country with little experience of trade policy and market economy in general. In countries with weak or fragile states, interventionist policies can easily be kidnapped by various interest groups that hinder later reform efforts or even push the policy to increased

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<sup>89</sup> Strong ideological belief in free trade, *nota bene*, does however not necessarily lead to unilateral free trade. Other countries, such as the Czech Republic, had very principled classical liberals governing transitions policy but did not opt for unilateral free trade.

<sup>90</sup> Laar (2002), ch. 9.

interventionism. The arguments for simplicity and transparency that were earlier discussed in view of the monetary reform, could equally be applied to trade policy.<sup>91</sup>

Fourth, the circumstances, or the surrounding milieu, favoured radical reforms. It is often tempting to explain radical liberalisations by the presence of an economic crisis, and in some cases such an explanation does yield relevant analyses. However, such models, when they are warranted, often lead to oversimplifications and misunderstandings about the true nature of reforms. Arguably, exogenous factors, such as a severe economic crisis, are part of the ‘Estonian puzzle’, but primarily in the sense that crisis mentality interplayed with other factors.<sup>92</sup> In this great reform era of Estonia, the economic crisis facilitated momentum for sweeping reforms, also in the realm of trade policy.

In addition, Soviet trade policy, the institutional order inherited by Estonia, was in one respect beneficial to radical trade liberalisation. As discussed earlier, pre-reform trade policy did not rest on tariffs and as a consequence the government revenue from tariffs (or other means of trade protection) had been marginal. Soviet trade policy was never viewed in a fiscal policy context. Therefore, Estonia did not inherit a revenue structure largely based on taxes on trade, which is often the situation in developing or emerging markets. If this would have been the situation, radical trade liberalisation would presumably have been much more difficult to achieve and would essentially have hinged upon the government’s ability to alter the tax structure as to tax other bases than trade. The discussion over a possible conversion of quantitative restrictions into tariffs was thus not clouded by fiscal policy-concerns. Trade-policy alternatives could rather be judged on their effects on economic fundamentals.

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<sup>91</sup> Laar (2002), p. 238.

<sup>92</sup> Purju (2000); Feldmann (2000); Feldmann and Sally (2001); Laar (2002). The term ‘Estonian puzzle’ is borrowed from Feldmann (2000).

Fifth, important and influential interest groups had been neutralised by other reforms, e.g. privatisations, and was, effectively, prohibited to leave a clear imprint on policy, or did not push for protection despite this was clearly in their interest. The crisis atmosphere and other liberalisations helped to devalue the resistance by protectionist interests.

Sixth, the civil service, in particular the Ministry of Foreign Affairs, pushed for trade liberalisation and supported liberalising efforts in the parliament. As the new Foreign Minister in 1991, Lennart Meri, later the President of Estonia, had recruited a new breed of civil servants that took a liberal view on Estonia's external economic policy. Some of them were assigned to lead the new External Economic Policy Department that was responsible for preparing trade-policy reforms. This department also became the centre of reform. Its staff drafted the legislation and coordinated the work by government. With the support of the government, the Ministry of Foreign Affairs could steer the machinery towards radical liberalisation and effectively block the civil service route to reform resistance.<sup>93</sup> The Ministry of Foreign Affairs had a crucial role in sustaining the unilateral reforms at a later stage when the opposition against external liberalism had become vociferous and gained more influence.

In summary these six factors points to the importance of ideas, interests and institutions. The pro-market ideas of key Estonian politicians at that time – ideas shaped by their acquaintance with liberal theorists and practitioners such as Friedrich Hayek, Milton Friedman and Ludwig Erhard – helped to push the ideological and mental boundaries of reforms. Powerful interest groups had been devaluated or were left outside the inner reform circles. The institutional milieu empowered young and dynamic Estonians in the Ministry of Foreign Affairs to take the lead in shaping the new post-independent trade policy.

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<sup>93</sup> Feldmann and Sally (2001), p. 15. As noted by Feldmann and Sally (2001) many countries that have embarked on radical trade liberalisation has had an institutional trade-policy order with the Ministry of Foreign Affairs at the centre.

To these set of political-economy factors one could also add individuals; policy is always shaped by individuals and radical transformation requires leaders with great courage and determination. In addition, exogenous factors, such as the initial condition of deteriorating output and a macroeconomic crisis, provided a window of opportunity for this thick-and-fast liberalisation.

### **3.2.3 Multitrack trade policy**

After the initial and unilateral reforms, Estonia entered discussions on bilateral and regional free trade agreements (FTAs). According to the principle of 'liberalise, then negotiate', trade agreements with other countries was the corollary of liberalisation. This second phase in Estonia's trade policy post independence started in April 1994 when the Baltic free trade agreement came into force. Initially portrayed as a common market for the Baltic countries, this FTA fell short on its ambitions. Export and import duties were eliminated, but many products were exempted from this overall policy of zero tariffs.<sup>94</sup> Most agricultural products were not covered; Latvia and Lithuania also exempted some industrial products that continued to be subject of an export levy. Furthermore, Estonia ensured its possibility to have an export quota on oil shale and other mining raw materials. In 1996, the Baltic countries took an additional step towards a common market and signed an agricultural FTA that also liberalised trade in agricultural produce. Further steps were taken later in the 1990s when countries agreed to open up the labour market for labour migration.

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<sup>94</sup> Sumilo (2006), p. 6.

As shown in Table 7, Estonia entered many free trade agreements from the mid-1990s onwards. FTAs were signed with the EFTA countries (Finland, Norway, Sweden and Switzerland), Ukraine, the Czech Republic, Slovakia, Slovenia, Turkey, Poland and Hungary. Many other agreements concerning external liberalisation also came into force; in the late 1990s Estonia had signed bilateral investment treaties with 25 countries.<sup>95</sup> Around the same time, 73 percent of Estonia’s trade was under the auspices of preferential trade agreement.<sup>96</sup>

**Table 7: From unilateral liberalisation to multilateral regulations:  
sequencing Estonia’s trade policy**

<b>Phase I:</b> unilateral trade liberalisation	1990	Price and internal liberalisations
	1991-1992	Unilateral external liberalisation; abolishing quantitative restrictions and licenses
	1993	Abolishing almost all remaining tariffs
<b>Phase II:</b> Bilateral and regional trade liberalisation	1994	Baltic free trade agreement comes into force; free trade agreement with the European Community
	1995	Free trade agreement with EFTA and Ukraine; Association agreement with the EU (application for EU membership)
	1996	Free trade agreements with the Czech Republic, Slovakia and Slovenia

<sup>95</sup> Feldmann and Sally (2001), p. 18.

<sup>96</sup> Feldmann and Sally (2001), p. 18.



	1997	Free trade agreement with Turkey; Baltic agricultural free trade agreement
	1998	Free trade agreements with Poland and Hungary
<b>Phase III:</b> Regional and multilateral trade regulation	1999	Member of the World Trade Organisation; new law on introducing custom tariffs
	2000	Custom tariffs on agriculture against third countries
	2002-2004	EU accession following the EU Copenhagen Summit; introduction of 10 000 plus tariff lines

*Source:* Feldmann and Sally (2001); Purju (2000); Sumilo (2006)

There were two key reasons to this new trade-policy focus; Estonia wanted better access to foreign markets for its export and needed agreements to lock in its achieved liberalisations. The second reason rested on the assumption that opposition to Estonia's free-trade policies would soon emerge as interest groups would gain more influence. Such opposition also developed, particularly in the agricultural sector, and it spilled over to the government and the parliament. In 1997, for example, there was a serious proposal in the parliament to introduce agricultural tariffs against the European Union and this proposal was not far from getting the required support. Notwithstanding the risk of creeping protectionism, the overall opinion among political parties was strongly in favour of the free-trade regime.

Free trade agreements with individual countries are not the optimal lock-in device. Securing trade liberalisations from protectionist efforts requires more substantial agreements with

heavyweight countries, preferably in a way that would lead to serious repercussions if they were violated. For Estonia this was to some extent achieved by its Association Agreement with the European Union and its membership in the World Trade Organisation from 1999. But only to some extent; the WTO agreement did not bind tariffs to its applied level (zero) and the EU accession essentially implied imposing several thousand new tariff lines. These agreements tied Estonia to a relatively ambitious level of liberalisation that could not be repealed without great difficulty, effectively by leaving the European Union, but they also ended the very successful era of free trade à la Hong Kong. Estonia moved from unilateral to reciprocal; from free trade to enlightened mercantilism; from Adam Smith, David Hume and Friedrich Hayek to John Maynard Keynes and Jean Monnet.

In this third phase of Estonia's trade policy, the centre of gravity was its accession to the European Union – the graduation of Estonia as a Western and modern country, politically far away from its recent past as a small part of the Soviet Union. This, of course, had been the chief aim of Estonia's foreign policy since independence. Belonging to the community of European countries, and distancing itself from Russia, had been a forceful sentiment underpinning many of the reforms achieved since independence.

The EU accession negotiations became a clash between different views on external liberalism. Mart Laar, the then Prime Minister of Estonia, once recalled the negotiations with the EU over the free trade agreement in 1994 had to start at a basic level: Estonia had to convince EU negotiators that it was actually possible for the economy to live and breathe without tariffs.<sup>97</sup>

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<sup>97</sup> Laar (2002), p. 237.

Harmonisation with EC rules seemed easy at the beginning of the accession but soon faced obstacles. The bureaucratic machinery required to run an EU-style trade policy – the internal as well as the external trade policy – had to be built, from its core foundation to every single manifestation of the internal market. Preferential agreements with third country had to be renounced. Farmers would once again be integrated in a union-wide support system for agricultural production – the Common Agricultural Policy (CAP). All of these obstacles were surmounted and Estonia was the star pupil of the 2004 enlargement of the European Union.

The negotiations over Estonia's membership in the World Trade Organisation also run into difficulties. Estonia had applied for membership already in 1995, after the end of the Uruguay Round of trade liberalisations, but it took four years before it could become a full member.<sup>98</sup> Of course, there was not four year of negotiations, but not far from it. Despite Estonia's recent record of an unprecedented trade liberalisation negotiations stumbled and moved slowly forward. Or, perhaps more accurate, negotiations dragged *because of* Estonia's unprecedented programme of trade liberalisation; the WTO had not before negotiated with a country applying considerably lower tariffs, and lower protection overall, than the developed countries in the WTO. The issue of tariff binding therefore presented a problem to the negotiations, even more so as Estonia wanted to bind their tariffs at EU levels rather than its own applied level (zero). This run against the GATT and the WTO tradition of binding tariffs below pre-accession levels, but a compromise was finally reached. Thus, in November 1999 Estonia could join the WTO as its 135<sup>th</sup> member – and it joined this organisation with the formal status as a developed country.<sup>99</sup>

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<sup>98</sup> Estonia had observer status in the GATT from 1992.

<sup>99</sup> A developing-country status had enabled Estonia to get Special and Differential Treatment.

These regional and multilateral trade policy tracks have been politically important to Estonia. It is debatable if they also have been economically beneficial.<sup>100</sup> The economic upside is clearly its secured access to a large market on the basis of free trade. The downside, on the other hand, is the re-regulation of trade and external economic policy. This can also spill over to other policy areas as economic actors grow accustomed to the higher border protection. Indeed, it can also lead to an empowering of protectionist interests. It still remains to be seen if the EU membership has altered the political sentiment of Estonia. Admittedly, it can also be difficult to distinguish the effects of EU membership from other factors shaping policy and mentality – such as Estonia now is an affluent society and increasingly acquires the habits, prejudices and inclinations of a welfare society.

### 3.3 Enterprise reforms

Estonia's production was completely socialised in the early part of the Soviet years. In 1986 there existed 34 private companies and they were generally of insignificant size. All major decisions concerning production were, *de jure* or *de facto*, taken by administrative bodies and the production was normally carried out by state-owned monopolies. Not surprisingly, they were extremely inefficient producers, could in many cases not cover production costs by sales, and became in practice subsidiaries of the fiscal budget – in constant need of bailouts.

In the decade preceding the reform era, output was plummeting. The organisation of production had therefore to be radically altered in the early transition years. There had to be a comprehensive transformation leading to a greater presence of private firms and normal western capitalism. One could debate the speed and the extent of this transformation, and such

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<sup>100</sup> This tallies with the general analysis by Patrick Messerlin (2002) on the debatable benefits to Central and East European Countries from a closer trading relation (on preferential terms) with the European Union.

debates were abound in Estonia and several other transition countries at that time, but very few doubted such reforms were badly needed.

Until the privatisation programmes took off in the transition countries, other countries had of course privatised state-owned enterprises. In the era of reviving economic liberalism, from the 1980s onwards, government-run entities in most OECD countries had been subjects of privatisation. But these privatisations were never of the same scale and scope as in the former communist bloc. According to an assessment, 6 800 medium-size and large state-owned enterprises were privatised in the 1980s – before the great reform era in Central and Eastern Europe started. In 1994, after only five years of privatisation, transition countries had privatised 30 740 large state-owned companies. Between 1990 and 1998, close to 60 000 companies in transition countries changed hand.<sup>101</sup> In addition, hundreds of thousands small companies went private.

In this chapter we shall study how Estonia's share of these privatisations was achieved and what efforts that have been undertaken to stimulate new enterprises.

### **3.3.1 Privatisations**

The transition programme of privatisations has been the most debated feature of all transition policies. Many observers have offered their views and most, if not all, problems in the tough years in the early 1990s have been blamed on the privatisations. There are good reasons to have a critical outlook on these privatisations, some parts of the privatisation programmes

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<sup>101</sup> Nellis (1998), p. 13-14.

were ill-judged, but largely they achieved their targeted aim and have provided for rapid economic growth.

Many critics also neglect the initial conditions of the privatisation programmes. Output was rapidly falling and the organisation of production was the chief reason to this crisis and many other problems. ‘Corporate governance’ was also deteriorating. In 1987, Soviet passed a Law on State Enterprise making incumbent managers quasi-owners of these enterprises since they could not be sacked when companies not any longer were direct entities of the state.<sup>102</sup> This had boosted corruption and embezzlement. Regardless the content and design of these programmes, privatisation had to be achieved thick-and-fast as the socialist production system was collapsing.

Estonia started to privatise companies early in the transition period. In the first reform era, till the middle of 1992, seven large state-owned enterprises were privatised. Considering the number of such enterprises in Estonia at the time of independence – 450 – this was a slow pace.<sup>103</sup> These privatisations were later described as ‘trial privatisations’, but that is not an entirely justified portrait. True, the Savisaar government wanted to pursue privatisations cautiously, but these first privatisations were spontaneous rather than comprehensively planned, and they were generally not surrounded by a coherent idea of what to achieve with them. In addition, Estonia had not yet a sufficient institutional setting (property rights, commercial law, bankruptcy laws, a s f) for private companies; nor did it have sufficiently liberalised markets. The real privatisation programme started in the autumn of 1992 after a new law on privatisation had come into force and after some capitalist institutions had seen daylight.

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<sup>102</sup> Åslund (2002), p. 256.

<sup>103</sup> International Monetary Fund (1999), p. 9.

Fortunately, since Estonia's transition period started later than others in Central Europe, it could learn from their privatisation programmes. Comprehensive privatisations had been pursued in primarily the Czech Republic (or Czechoslovakia, as it was then called) and the former East Germany. The Polish programme for privatisation had also started before Estonia's, but Polish efforts had been clouded by many enterprises being withheld from mass privatisation. The Czech Republic and East Germany was the two major reform examples and they also offered two very different models of privatisation to draw experience from.

The Czech programme was essentially based on voucher privatisation. This model, originating from Milton Friedman, had a close friend in Václav Klaus, the then Minister of Finance in Czechoslovakia. Voucher privatisation rested on two fundamental propositions; first, if property could not be restituted, handed back to its original owners or legal inheritors – which was very difficult in the industrial sector – privatisation should distribute resources evenly to the people, and, secondly, by granting every citizen a stake in privatisation they would become owners and quasi-capitalists embracing, ideally, the new post-communist order. Many people would of course sell their vouchers and reject the proposition to be a shareholder, but then they would get money in return and thus benefit from the voucher reform.

East Germany followed another path. The so-called *Treuhand* approach to privatisation, named after East Germany's privatisation agency Treuhandanstalt, rested on direct sales and investment tenders. Most of the enterprises in East Germany, nearly 90 percent, were transferred to the Treuhand agency that, in turn, was assigned to prepare these companies for privatisation. That was not easily done and involved substantial reconstruction of some

companies to make them sellable. Companies would then be sold to the bidder who would not only run the company best but also provide for inward investments and transfer of know how from abroad.

Both models had downsides. Voucher privatisation in the Czech Republic, indeed in other countries too, was patchy, seemed impractical, and did not take into account the need for a solid ownership structure post reform that could help companies to, in the first instance, survive and, later, to be competitive in an internationally competitive environment.

Companies with a solid corporate governance structure, in particular a core owner taking the overall responsibility, had generally better life expectancies than voucher-owned companies.

The Treuhand model, on the other hand, suffered from two overall problems. First, it was an expensive model that not many countries could afford to copy. Treuhand has been labelled the ‘world’s most generous corporate welfare agent’<sup>104</sup> and this statement is probably true; the net cost of the East German privatisation in 1990-94 has been estimated to nearly 200 billion US dollars.<sup>105</sup> It worked in East Germany because of all subsidies they received from West Germany. Financial support of that extent could other countries not get.<sup>106</sup> Second, the Treuhand approach to privatisation rested on the assumption that time was not a constraint; reconstructing enterprises and finding the right buyer was a venture that could take years. In an atmosphere of deteriorating output and a collapsing structure of production, speed was in many countries an essential item of the privatisations.

In addition to these two problems, Václav Klaus and other liberal-minded politicians in Czechoslovakia observed a key weakness in the Treuhand approach; politicians and civil

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<sup>104</sup> Åslund (2002), p. 271.

<sup>105</sup> Lavigne (1999), p. 164.

<sup>106</sup> World Bank (1996), p. 54.



servants was not equipped with the right talent or knowledge to reconstruct companies and prepare them for a life in a world of competition. Indeed, industrial policy was against the whole idea with privatisation. The task of politicians was rather to set the rules of the market and ensure there was good market-based competition. Determining the corporate structure should entirely be left to market actors and market forces.

East Germany only used the Treuhand approach, but the Czech Republic did effectively rely on other methods than voucher privatisations. As in most other transition countries, there was a mix of privatisation methods. The Czech Republic combined voucher privatisation with direct sales to outsiders. Russia, who also favoured the voucher system, mimicked that combination. However, Russia’s voucher privatisation was not as evenly distributed as the Czech voucher reform and involved a substantial pocket of management buyouts. Furthermore, there was a lot of room for insider manoeuvring that opened the privatisation process for corruption as the insiders could buy companies at prices far below their market value. No other transition country has a clear record of corruption as regards the privatisation programme, but in the Central and East European countries corruption did not take such grotesque proportions as in Russia.

**Table 8: Methods of privatisation of medium-sized and large enterprises in eight selected transition countries**

Sale to	Voucher	Voucher	Management-	Other
outside	privatisation	privatisation	employee	
owners	(equal	(significant	buyouts	
	access)	concessions		

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to insiders)

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Estonia	Primary	...	...	Secondary	...
Latvia	Secondary	Primary	...	...	...
Lithuania	...	Primary	...	Secondary	...
Hungary	Primary	...	...	...	Secondary
Poland	Tertiary	Secondary	...	Primary	...
Russia	Secondary	...	Primary	Tertiary	...
Czech Republic	Secondary	Primary	...	...	...
Slovakia	...	Secondary	...	Primary	...

*Source:* European Bank for Reconstruction and Development (1997), p. 90.

Table 8 illustrates the combination of methods applied in a selected group of transition countries. The differences reflect diverging opinions and conditions for privatisation – to some extent also objectives of privatisation. Most countries gave highest priority to facilitating the best possible conditions for corporate survival, but some also viewed privatisation through the prism of fiscal policy. In particular Hungary that initially sold state-owned enterprises to the highest bidder despite fears about the sustainability of these bids.

Two additional methods of privatisation, not really tested when Estonia embarked on the privatisation programme, should be added – buyouts and restitution. In many countries the privatisation programme enabled local management and employees to buy the companies they

worked for – not to ‘insider’ prices but to prices reflecting their market value. This was the main method applied in Poland and Slovakia, and it was, *prima facie*, beneficial for a number of reasons. Privatisation could be achieved fast and it was mostly supported by the insiders, which was not the situation in many other countries. Moreover, companies would be led by people who knew about the production and, not seldom, also could easily identify the sources of inefficiencies and thus how companies could enhance productivity. On these grounds, buyout privatisation was favoured by several economists, notably Jeffrey Sachs, involved in transition policy.<sup>107</sup>

This was a sanguine view of the state of the companies; often, local management and staff hindered needed post-privatisation reconstruction rather than supported it. What is more, an oft-occurring problem associated with this model was a bias in favour of distributing ownership to the local management only. This was what happened in Russia and many of the Eurasian countries emerging from the break up of Soviet Union, particularly countries that started privatisation programmes at a late stage in the transition period (Ukraine and Moldova, for example). In contrast to Poland, buyouts were generally offered exclusively to the management and they could earn enormous amounts of money just by not embezzling their companies in the way they did before privatisation. However, in countries that undertook a comprehensive plan for management and employee buyouts, corruption and embezzlement never became as widespread as in the former Soviet Union.

Restitution was not easy to apply as a method for privatisation of industrial enterprises. But it worked for privatisation of land and housing, in particular in countries where agricultural land never had been formally socialised, such as Czechoslovakia. Naturally, there were many

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<sup>107</sup> Lipton and Sachs (1990).

practical obstacles. It required a system of courts to review the merits of claims and judge between rival claimants. These were not minor issues; rather they are the reason for the very long period of privatisation of land and housing in countries that applied restitution.

Estonia is a case in point. Land and housing that had been expropriated before 1940 were subjects of restitution. By early 1993 more than 200 000 restitution claims had been filed and it took a very long time to process all these claims.<sup>108</sup> Years after the privatisation programme had ended, there were still a considerable number of claims that had not been reviewed and as a consequence the transfer of government land and housing moved very slowly. At the time of the millennium, not more than 40 percent of all land was owned by the private sector. The share of arable land owned by private farmers was even less. To no ones surprise, this has affected the productivity of the agricultural sector negatively and partly explains the rapidly declining role of agricultural production in Estonia post independence.

Presumably, the new government assuming office in the autumn of 1992 would not have objected vehemently to restitution as a method for the whole privatisation programme if it had been feasible. Mart Laar, the new Prime Minister, was an ardent believer in restitution – for its moral as well as economic rational.<sup>109</sup> But Laar and his cabinet colleagues acknowledged it was not possible and instead opted for a combination of direct sales and buyouts. In addition, the Estonian government introduced a voucher system along the lines of the Czech example, but it was considerably smaller than in the Czech Republic and cannot be viewed as the principal method used for privatising companies.

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<sup>108</sup> International Monetary Fund (1999), p. 10.

<sup>109</sup> Laar (2002), p. 262-65.

In fact, it is more correct to say that Estonia mimicked the East German Treuhand approach, primarily in the privatisation of large enterprises.<sup>110</sup> There was, however, one significant difference between the Treuhand approach and Estonia's hunt for a core owner: Estonia never tried to reconstruct companies before privatisation. For one, Estonia could not afford it.<sup>111</sup>

The Estonian Privatisation Office (later renamed the Estonian Privatisation Agency), established in late 1992, was assigned the task of finding a core owner for the companies to be privatised. Luckily, already at the creation of this new agency, reformers put a lot of effort in recruiting a staff whose general outlook reflected the purpose of this agency. Thus, reform-friendly and market-oriented people were hired to pursue the actual privatisations. The agency also employed a group of consultants with experience from mass privatisations in East Germany.<sup>112</sup> But it avoided signing up long-term consultants that would have an interest in prolonging the privatisation process.

Finding such potential owners was in most cases accomplished by international tenders. In contrast to many other transition countries applying the direct-sales method, Estonia persistently used international tenders. The reason was simple; Estonia was drained on capital and the number of people with experience of owning or running a large enterprise in a competitive, market-based environment, did not exceed the number of fingers on a normal person's hand. Therefore, an outward-looking privatisation strategy was essential to the future success of Estonian business. Furthermore, the tender process was transparent and hindered corruption.

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<sup>110</sup> Nellis (1996); Åslund (2002), p. 272.

<sup>111</sup> Some large state-owned enterprises were slightly restructured before they were privatised. With support of the European Bank for Reconstruction and Development about 20 companies was 'cleaned up' before privatisation. These companies particularly needed assistance to become financially transparent.

<sup>112</sup> Gillies, Leimann and Peterson (2002), p. 179.

The first international tender was undertaken already in December, 1992. 38 large enterprises were subsequently privatised as a result of that first tender. In May 1993, the second international tender for 52 large enterprises was announced, followed by another 40 in the autumn that year. In this way the privatisation process continued and it geared up come 1994. In the middle of 1996, 430 large enterprises had been privatised.<sup>113</sup> Effectively, what remained to be privatised, beside land and housing, were public utility companies and some state-owned enterprises in the infrastructural sector.

The typical privatisation of a large enterprise followed the Treuhand model; a core investor prepared to become a majority-owner, or a joint venture representing the same share of the ownership, was identified by tenders and after subsequent negotiations the company was privatised. But it also followed the Czech voucher system; the minority holding of companies was offered to people in exchange for their vouchers. In total, the government issued ‘national-capital’ vouchers of eight billion kroons and ‘compensation’ vouchers of 2,5 billion kroons.<sup>114</sup> Estonians could use these voucher for buying shares in privatised companies or investment funds, the house they lived in, bonds in the compensation fund, or simply selling them to a bidder.

From November, 1995, vouchers could also be used as instalment payments for privatised companies.<sup>115</sup> This was of some importance to people buying smaller companies. Small and medium-sized companies were not privatised by international tenders. This would have been too complicated. Instead they were typically privatised in a domestic auction procedure or sold to the local management and staff.

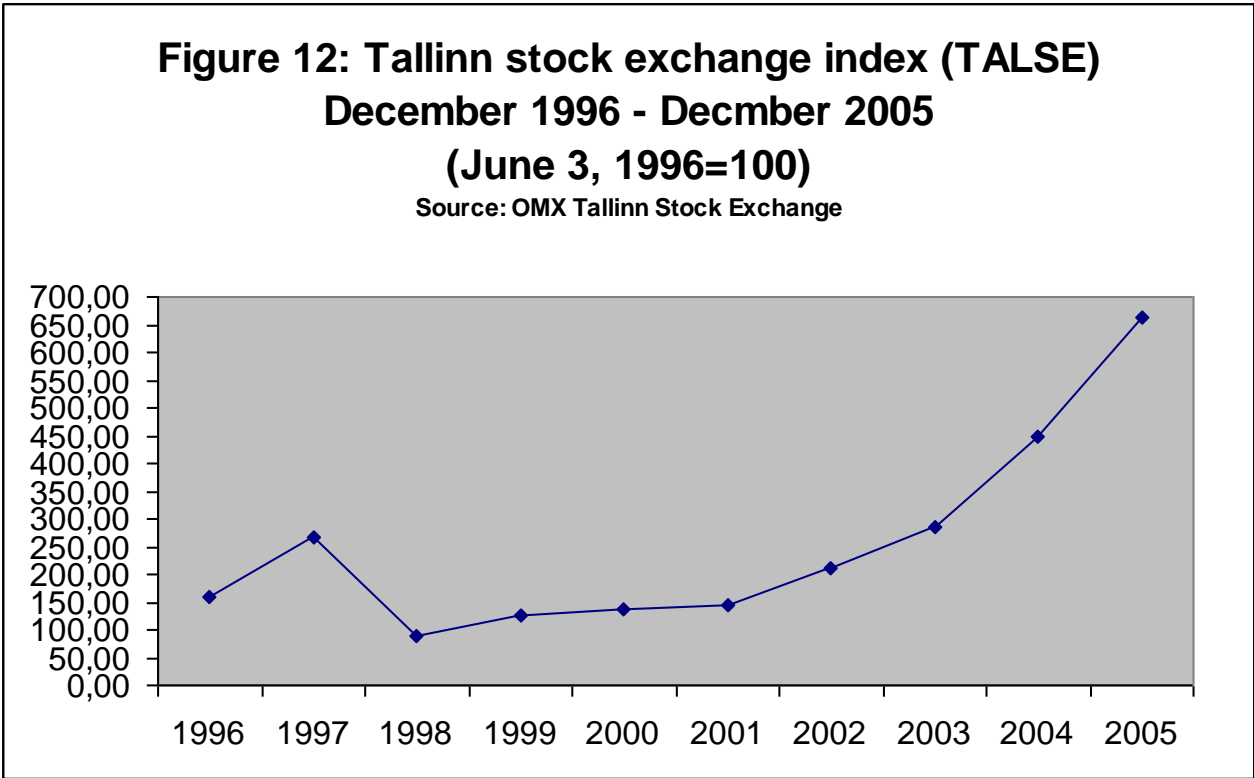
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<sup>113</sup> International Monetary Fund (1999), p. 10.

<sup>114</sup> Nellis (1996), p. 3.

<sup>115</sup> There was, however, a limit stating that only 50 percent of the instalment payment could come from vouchers.

Important to the whole privatisation programme was the presence of an official market for secondary trade in shares. The initial privatisations, regardless their design, would undoubtedly lead to some inefficiencies as owners were in many cases inexperienced capitalists and they took charge over companies that could be difficult to change since old habits die hard. Furthermore, there was a great need for general corporate and market reconstructions which would affect corporate ownership and governance. Secondary markets for trade in shares and ownership was thus important to the sustainability of businesses and to the privatisation process at large. To some extent, the Estonian voucher scheme enabled people to deal in secondary markets, but more important was to establish a stock exchange.



Estonia was one of the first transition countries that started a secondary market for securities. Similarly, it was in Estonia and a few other countries (Hungary, Poland and Russia) that the

stock market really took off already during the period of rapid privatisation. The Tallinn Stock Exchange was born in mid-1996 and primarily constituted by securities of banks and financial firms.<sup>116</sup> Trading volumes were initially small and the securities markets were generally volatile as stabilisation had not yet been completed. The Tallinn Stock Exchange index (TALSE) dropped in the first months but recovered at the end of the year and continued to grow until the Russian financial crisis in 1998. Since then, as can be seen in Figure 12, there has been a rapid growth, particularly from late 2003. When 2005 came to end, the TALSE stood at 664. From the low point in October, 1998, to year-end 2005, TALSE had grown with more than 700 percent.

**Table 9: Revenues from privatisation**

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>
	(in million kroons)					
Total	549	2 030	1 555	704	1 712	326
Revenue	353	1 329	937	474	1 295	318
Obliga- tions assu- med by buyers	196	700	618	230	416	8
	(in percent of GDP)					

<sup>116</sup> The securities listed on the stock exchange were Estonian Savings Bank share, Hansapank share, Compensation Fund bond I-VI, Sampo Bank share, SEB Eesti Ühispank share, and Tallinn Bank share.



Total	2,5	6,8	3,8	1,3	2,7	0,4
Revenue	1,6	4,5	2,3	0,9	2,0	0,4
Obliga- tions assu- med by buyers	0,9	2,4	1,5	0,4	0,6	...

*Source:* International Monetary Fund (1999), p. 11.

The Estonian programme for privatisation was highly controversial and much debated; some even assert, for good reasons, that the method of privatisation applied explains the fall of the Mart Laar government in 1994.<sup>117</sup> Nonetheless it has overall been seen as successful programme leading to competitive enterprises, foreign direct investments and significant revenues to citizens. As seen in Table 9, the privatisation programme peaked in 1994 and provided from than 2 billion kroons in net revenues, despite revenue concerns were not high-up the privatisation agenda.

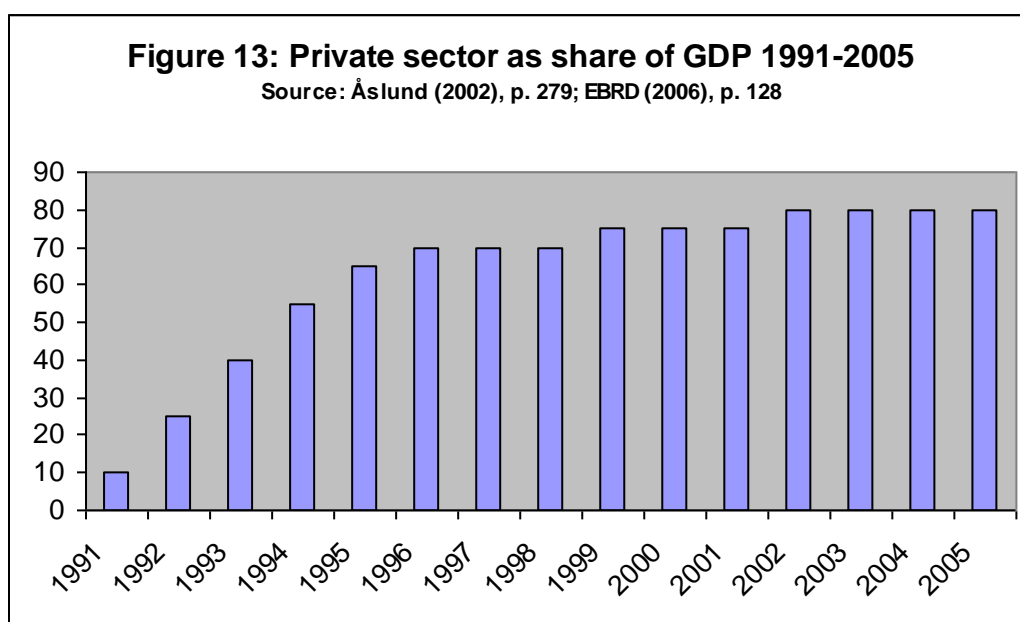
Furthermore, the privatisation process was transparent and the government made many efforts to increase transparency and reduce the possibilities of corruption as the programme geared-up in speed. There have been allegations of corruption and insider dealing, but not at all to the extent in most other transition countries. Arguably, methods of privatisation that involve little room for administrative discretion were much less blemished by corruption practices. Tenders and the IPO<sup>118</sup> style approach to privatisation used in Estonia, provided a better governance of the privatisation process.

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<sup>117</sup> Åslund, Boone and Johnson (1996).

<sup>118</sup> IPO is an acronym for Initial Public Offering.

The privatisation programme also led to a rapidly expanding private sector. In 1991, before the real privatisation programme started, the private sector represented less than 10 percent of the total gross domestic product. The private sector mostly represented low-scale production such as handicrafts. Five years later, the private sector share stood at 70 percent and has since then been growing to approximately 80 percent today (see Figure 13). Or to dress this development in other figures: in October, 1991, Estonia had approximately 10 000 small and 500 large enterprises; by the end of 1997 there were more than 61 000 private enterprises.<sup>119</sup> By all standards, this is a tremendous development and Estonia has today a significantly higher private sector share than the other Baltic countries and most other transition countries. The Czech Republic, Hungary and Slovakia had in 2005 an equal size of their private sectors; no transition country has a private sector share of GDP exceeding that of Estonia.<sup>120</sup> Indeed, many developed countries in the OECD sphere have a smaller private sector than Estonia today.



<sup>119</sup> Gillies, Leimann and Peterson (2002), p. 180.

<sup>120</sup> See country chapters in European Bank for Reconstruction and Development (2006).

It is not an accident that Estonia, the Czech Republic, Hungary and Slovakia have the highest private-sector share. In fact, these countries are those we would expect to be in the top considering the privatisations they achieved and the other structural reforms they pursued. Differently put, a high private sector share is closely associated with extent and speed of reforms generally.<sup>121</sup> Furthermore, privatisation – and a high private sector share of GDP – is closely associated with other indicators on development, such as democracy, civil liberties and corruption. Countries that undertook fast privatisation managed to destroy old nomenclatures and their grip on the society. On the other hand, countries that tried to privatise later had considerable problems. Old communist establishments had then regained the control over the economy and the new breed of politicians had been integrated in the system of state-run production. This happened in Latvia, to some extent also in Lithuania, and it prolonged the period of privatisation and made the process more problematic.

Thus, the overall political-economy lesson is that simplicity, transparency, and speed were instrumental to successful reforms. This tally with the lesson learnt in earlier chapters: limited administrative discretion and an institutional order promoting reform were preconditions to radical internal and external liberalisation.

### **3.3.2 New enterprises**

Privatisation was only one part of the collected efforts to increase the role of the private sector in output. Promoting new enterprises by other means was the other part and it proved to be very important to Estonian business and the Estonian economy. Already in 1995, as shown in

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<sup>121</sup> Åslund (2002), p. 296-297.

Table 10, new start-ups (or De Novo companies) represented approximately 50 percent of GDP. In several other transition countries new companies gained similar standing at the same pace. For the transition region as a whole, new companies stood for about one-third of total GDP in the mid-1990s.<sup>122</sup>

There are three explanations to the rapid growth of new companies. First, after independence, and with the liberalisations, the underground economy became legal and was from then registered on the books. Second, due to strong bankruptcy laws that soon were enacted in Estonia, many state-owned companies went bankrupt and thus opened markets for new businesses.<sup>123</sup> Third, the privatised enterprises were burdened by old habits and were slow in adapting to new market standards. Companies were often occupied by defensive reconstructions – sacking staff or selling physical capital – and had little time or resources to launch new offensive strategies to stay in business or increase their market share. New companies could start afresh and focus on the opportunities provided by internal and external liberalisation.

In addition, Estonia's perverted company structure from the Soviet days – many large enterprises but few small ones (in relation to population) – was difficult to integrate in the new market-based order. New and smaller companies were much better at responding to consumer demand and market signals generally. A rapid growth of small businesses was therefore to be expected during the early transition.

### **Table 10: De Novo share of GDP in selected transition countries 1995**

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<sup>122</sup> Johnson, Kaufmann and Shleifer (1997), p. 192.

<sup>123</sup> The Bankruptcy Law was adopted in June, 1992.

	<u>De Novo share (% of GDP)</u>
Poland	50
Czech Republic	30
Slovakia	25
Hungary	45
Estonia	50
Latvia	50
Lithuania	40
Russia	20

*Source:* Havrylyshyn and McGettigan (1999), p. 9.

Various Estonian governments also tried to stimulate new businesses by other means. Largely they did so without a patchy and complicated structure of subsidies and tax exemptions. Enterprise policies rather rested on general liberalisations and instituting a tax system that promoted savings, investments and labour. Again, simplicity was a guiding principle. Estonia was the first country in Europe to introduce a flat-tax system.

After the first tax reform in 1991, Estonia had several taxes on income and corporate profits. The personal income tax was progressive and the top marginal tax rate was 33 percent. Similarly, there were three different tax rates on corporate profits depending on its size. In 1994, the Laar government reformed the system and introduced a 26 percent flat tax rate that applied equally to personal income and corporate profits.<sup>124</sup> This was the flagship tax reform

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<sup>124</sup> Stepanyan (2003), Appendix I, offers an overview of Estonian tax reforms.

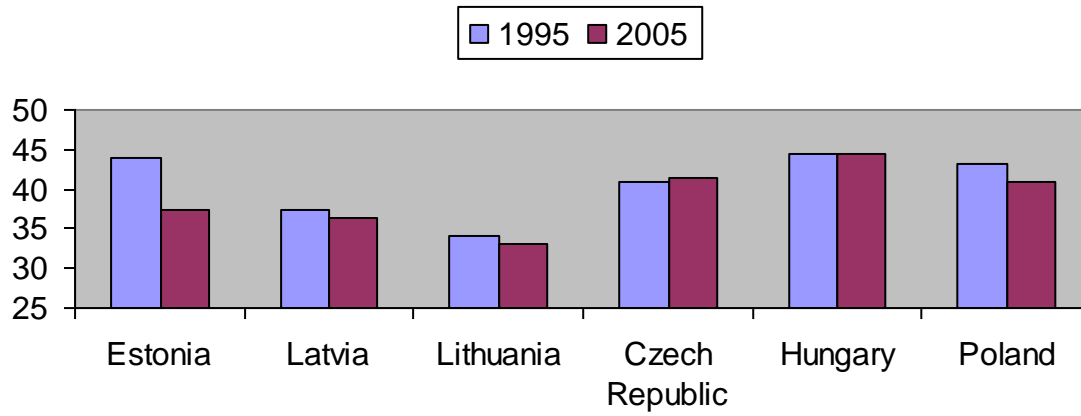
in Estonia's history post independence. It simplified the tax code and made it proportional; no progressive taxes existed after this flat tax reform. The VAT code was a bit different; the number of exemptions were reduced, but it still contained exemptions and was not applied across the board. Therefore it is not entirely correct to speak of an Estonian flat-tax system.

In the new Millennium two additional tax reforms have been achieved. In 2000, Estonia established the principle of only taxing profits that is taken out of companies. In other words, reinvested earnings are not any longer taxed. This has provided a considerable push on investment. The second reform was to lower the flat tax rate to 24 percent.

Declining tax rates and the growing economy have led to a decreasing tax burden. As shown in Figure 12, the general government revenue in Estonia has declined considerably – from 44 percent of GDP in 1995 to 37,5 percent in 2005. Estonia still has a higher tax burden than the other Baltic countries but it is declining rapidly and is forecasted to be below 35 percent of GDP within a couple of years. The declining tax burden is mainly a consequence of rapid economic growth, creating more revenues, and primarily not a function of cuts in government spending.

**Figure 14: Total general government revenue in selected transition countries 1995 and 2005 (% of GDP)**

Source: Eurostat



## 4. Concluding remarks

Estonia has transformed itself enormously since the collapse of the Soviet Union and independence in 1991. It is a completely different country today; central planning, Moscow rule and Soviet oppression are not any longer the core foundations. Free market economy, constitutional democracy and civil liberties have triumphed and again brought civilisation and modern institutions to Estonia. This transition from communism was achieved in an almost miraculously short period of time. Small-scale reforms started in the late 1980s, but the great reform era was between 1992 and 1995. It was then the new Estonia really was born.

Liberalising reforms were pushed on all fronts. Prices and markets were liberalised. A new monetary order, centred upon a currency board arrangement, was established. External liberalisation on an unprecedented scale made Estonia the Hong Kong of Europe. Thick-and-fast privatisations ended the 50 year long era of socialised production. A growth-promoting flat tax reform was achieved. Equally or more important, Estonia established a constitutional democracy and held its first genuinely free elections as an independent country in the autumn of 1992.

All these reforms were associated with a great deal of pain. Old habits and practices washed away and people had to adapt to a new society. The reforms also demanded much from the political elite and the civil service. Many of the reformers were young – some key officials had not yet turned 30; Mart Laar was only 32 when he assumed office as Prime Minister – and had little, if any, experience of policy or politics. But they shared an ideological belief, founded on theory as well as pragmatism, and did not hesitate to act on the basis of this belief.



Technocratic insights were not unimportant, but ideological instincts were the overriding force behind the radical liberalisations.

This, arguably, is the first conclusion to be drawn from this study of the great Estonian reform era; radical reforms were not functions of academic studies or theoretical reflection; more than anything they were acts of faith. Thus, Estonian liberalisation is a great modern example of the power of ideas.

Many other factors must be considered, and many circumstances must be taken into account, to fully understand how the Estonian reform era came about. To start with the latter, the severe economic crisis provided a *milieu* conducive to radical reforms. Before the real reforms were undertaken, small and incremental reforms had been tried, but they did not improve conditions much; nor did these reforms prepare Estonia for the coming economic chaos. Comprehensive reforms, many came to believe, were needed to achieve a fundamental transformation of the economy which could end what seemed to be a very long period of contraction, inflation, unemployment and falling wealth. Exogenous shocks, like the economic crisis Estonia found itself in amid the break-up of Soviet, does necessarily not improve conditions for radical liberalisation, but in Estonia several factors interplayed to make the economic crisis a vector for liberal reforms.

Another 'exogenous' factor explaining the radical reforms, and indeed a very important one, was the deeply held animosity towards Soviet and Russia. Estonians wanted to distance themselves, as soon as possible, from the Soviet past and the long historical influence of Russia. Few efforts could symbolise this animosity and mark this distance as radical

liberalisation. Liberal reforms therefore became bodies of the long-harboured sentiments against Moscow.

To turn to endogenous factors, four additional explanations to the Estonian puzzle are important. First, reform-minded people were in charge of key departments and ministries. They employed new staff sharing their outlook on policy and they played tremendously important roles in the drama of bureaucratic infighting in the reform years. By taking the lead in conducting studies, drafting legislation, and supervising reform policy, these civil servants could circumvent the normal civil service conservatism and block efforts by bureaucrats to delay, undermine or repeal radical reforms.

Second, simplicity and transparency were guiding principles of the reforms and they prevented patchy and complicated policy arrangements to be established. To echo Ronald Reagan, policy should be ‘simple but not simplistic’; policy that rests on a few principles easy to understand effectively makes life harder for those opposing reform. Few monetary regimes are as simple as a currency-board arrangement; it is based on a mechanical rule rather than discretionary power. Completely free trade with zero tariffs keeps the door closed for backdoor protectionism and various arrangements that essentially are nothing but regulations on trade. Had Estonia established a traditional, reciprocal and regulation-friendly trade policy, it would subsequently have been much more difficult to reject the many calls for trade protection.

Also, simplicity and transparency does not require many civil servants, but a complicated regulatory order does. And the greater the number of civil servants, the harder it is to pursue

liberal policies. A relatively small bureaucratic machinery, as was the case in Estonia, is beneficial to reforms.

Third, time was part of the essence. One general lesson from all transition countries is that reforms should be undertaken at a rapid pace. The longer politicians wait to act, the more resistance they will face. Transition countries postponing reforms got stuck in the old order, in suboptimal societal equilibriums, and have paid a lot for these delays, economically as well as politically. In some versions, 'shock therapy' is a pejorative label meaning a headless pace of reforms. To some extent it is true; the ideas and prognoses of some economists at that time were naïve. But it was undoubtedly better to pursue reforms in early stages and rapidly than to wait or move forward incrementally. Countries that had the fastest reform pace are also the countries that have had the best development in the post-crisis period. Estonia is a case in point.

Lastly, radical economic reforms were combined with political and constitutional reforms that effectively enforced the power of the reformers vis-à-vis the less reform-friendly people in the former Soviet-Estonia establishment. Although the actual reforms were designed by a small group of young people, the overall transition from east to west was supported by a vast majority of the people. Many of the economic reformers were also the political reformers. Mart Laar symbolised that combination more than anyone else. Seen by many outside Estonia at that time as a ruthless economic reformer, he was also a great champion of democracy and civil liberties. As an historian intellectually rooted in Estonian culture as much as in the ideas of the Enlightenment, he gave economic reforms a non-economic context and framed them as part of a grander story for Estonia. Thus, a political narrative comprising democratic and constitutional reforms were key to the success of the economic reforms.

All these factors help to understand Estonia's great reform era. What is more, they also explain why Estonia, in substance as well as form, pushed liberalisation more persistently than the other two Baltic countries. Latvia and Lithuania also undertook comprehensive reforms and have developed positively in the last years. But reforms have been patchy and uneven, often marred by a stop-go policy environment, and not as society wide as reforms in Estonia. Nor have Latvian and Lithuanian reforms yielded as positive results as in Estonia.

This cannot be explained by the severity of the economic crisis; Latvia and Lithuania was as badly hit as Estonia. The explanations are rather of the endogenous stripes. Institutionally a lot differed. The Russian establishment was not pushed out as fast in Latvia and Lithuania as it was in Estonia; civil service remained in the hands of the old establishment and few reformers gained influence. Furthermore, many of the post-crisis politicians did not have the ideological instinct as politicians in Estonia. There are political as well as historical reasons to all these factors, but the core of the matter is that Latvia and Lithuania did not have the same vegetation for reforms as Estonia.

Table 11 illustrates many of the differences between the Baltic countries. These differences are sometimes subtle and do not suggest radically different reform programmes. But even small differences lead to large discrepancies in end-result. Annual average GDP growth has not been substantially higher in Estonia than in Latvia and Lithuania, but over the years the faster growth pace has lead to considerable difference in wealth. GNI per capita (PPP) are more than 1 800 US dollar bigger in Estonia than in Latvia. Real GDP estimated at the pre-crisis level suggest even larger differences in welfare.

An area where Estonia really distinguishes itself is integration in the world economy.

Obviously, Estonia's programme for full external liberalisation has borne fruit. Estonia's trade sector is very much larger than Latvia's and Lithuania's. Measured in cumulative foreign direct investments, Estonia is far ahead the other two Baltic countries. Furthermore, policy indicators confirm that Estonia's reforms were considerably broader and deeper than reforms in Latvia and Lithuania.

This boils down to a simple observation mentioned above and confirmed many times in history: countries that embark on a programme of comprehensive liberal reforms, pursue them rigorously and nourish them constantly, soon find themselves in a position of growth and development.

**Table 11: A comparison of Baltic reforms and performance**

	<u>Estonia</u>	<u>Latvia</u>	<u>Lithuania</u>
<u>Economic indicators</u>			
GNI per capita (PPP) 2004	13 631	11 816	12 693
Average annual growth in GDP post crisis (1995-2005, in %)	6,2	5,8	5,5
Estimated level of real GDP in 2004 (1989=100)	112	90	89
Private sector share 2005 (% of GDP)	80	70	75

Unemployment	9,7	8,5	11,4
(% of labour force)			
Trade sector	163	95	123
(% of GDP)*			
FDI stock 2004	85,1	32,9	28,8
(% of GDP)			

#### Policy indicators

Change 1991-1995 in World	0,45	0,38	0,39
Bank/EBRD structural indicators			
Economic freedom 2005	7,8 (9)	6,8 (44)	6,8 (44)
(ranking)			
EBRD index of enterprise reform 2005	3,7	3,0	3,0

#### Corruption Indicators 2005

(2002)\*\*

Bribe tax	0,29 (0,34)	0,71 (0,93)	0,87 (0,74)
Kickback tax	0,46 (1,01)	1,69 (1,32)	1,98 (1,03)
Frequency of bribery	6,47 (12,14)	7,49 (17,90)	24,08 (20,62)

\* annual average 1998-2002

\*\* *Bribe tax* refers to typical unofficial payments/gifts to public officials as a percentage of annual sales. *Kickback tax* refers to the percentage of contract value that is typically paid in additional or unofficial payments/gifts to secure government contracts. *Frequency of bribery* is the percentage of respondents in BEEPS surveys that who agreed to have to pay some irregular payments/gifts for activities related to customs, taxes, licenses, regulations or services frequently, usually or always.

*Source:* World Bank World Development Indicators Online; Gwartney and Lawson (2005); Åslund (2002); European Bank for Reconstruction and Development (2006); UNCTAD FDI Database;

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