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Adjustment through the Crisis: The case of Latvia

Lunchtalk, 9 December 2012

On the 9th of December, Bruegel hosted a lunch time talk on Latvia's recovery from the crisis. The event was chaired by Zsolt Darvas, research fellow at Bruegel, and featured the presentations of Sanita Bajare, Latvian Finance Ministry' State Secretary, Karlis Bauze, EFC member and Head of Monetary Policy Department at the bank of Latvia, David Moore, Resident Representative of the IMF in Latvia, Gabriele Giudice, Head of Unit at DG Ecfin and EU Mission Chief for the Balance of Payment assistance to Latvia. John Fitzgerald, professor at the Economic and Social Research Institute in Ireland, discussed the presentations.

Following the burst of the credit and housing bubble and the sudden nationalisation of the largest domestically-owned bank, the Latvian authorities requested support from the EU and the IMF at the end of 2008. The programme, which started three years ago, is nearing its completion (the IMF Stand By Arrangement ends on the 22nd of December and the EU Balance of Payment assistance on 20th January 2012). During the programme, Latvia experienced important changes. Competitiveness improved, economic growth resumed and fiscal targets were met. However, unemployment problems and banking risks remain.

After a brief introduction by Mr. Darvas, Ms. Bajare started the discussion by raising awareness of the fact that the recent crisis is not the only one to have had a significant impact on the Latvian economy. The country was plagued by negative economic episodes in the 1990s as well, in particular, after the collapse of the Soviet rule.

Budget consolidation from the current financial crisis has been rather successful, Ms. Bajare argued, as she highlighted that austerity measures worth €3.3 billion (17.5% of GDP) had been implemented. Fiscal targets have also been closely followed. She then went on to identify three pillars for the IMF-EC programme in Latvia, namely economic growth, improving the social sector and increasing the efficiency of public administration.

In terms of growth, the implementation of EU structural funds has accelerated and the efficiency of public services improved. In the social sector guarantees for disadvantaged individuals, especially those on minimum income benefits increased, medical compensation went up and social safety nets were strengthened. In order to increase the efficiency of public administration, layoffs took place in the public sector and remuneration decreased by 35 per cent. E-governance became more broadly available in an attempt to reduce costs.

Ms. Bajare then added that a devaluation was neither necessary nor inevitable in Latvia. The country currently has a fixed exchange rate with the euro. She concluded by drawing several lessons from Latvia's experience. Early fiscal adjustment is preferable, she argued, cutting spending is also better than raising taxes. Furthermore, an unstable coalition government is not necessarily an obstacle for crisis resolution. In terms of prospects for the future, several key priorities are clear: sustainable economic development, strong budget implementation, prudent planning for the future and a stronger supervision of the financial sector. At the same time, one needs to bear in mind the challenges brought about by inflation and unemployment.

Karlis Bauze continued the round of presentations, remarking that the Bruegel talk on Latvia was timely, both because of the upcoming completion date of the program and because of the EU summit taking place in Brussels, where leaders can learn from Latvia's experiences.

Mr. Bauze identified some of the main pillars of the developments in Latvia, highlighting how unsustainable growth and external imbalances made the call for help from the IMF and the EC inevitable. When the program was adopted, the latter was based on three guiding principles: a fixed exchange rate, fiscal austerity and structural reforms.

Mr. Bauze then went on to comment on some of the recent developments in Latvia's economy. He illustrated that the third quarter GDP estimates reveal growth of 6.6 percent. Also, the share of Latvian exports has been increasing, particularly in relation to its usual trading partners, such as Finland, Poland and Russia. Export growth has remained substantial, even after the adjustment. The latest export growth rate was estimated at 16 percent.

During the boom, high salaries accumulated. Real wages were increasing, but productivity was not able to catch up. The gap between real wages and manufacturing productivity has however closed, Mr. Bauze argued, and has actually reversed recently. Real effective exchange rate estimates also paint a positive picture for the competitiveness of the Latvian economy. The REER based on ULC in manufacturing decreased by 25% between Q3 2008 and Q1 2010.

Speaking from the perspective of the IMF, David Moore took the floor. He started by listing the initial goals of the programme in Latvia: countering balance of payments strains, stabilizing the financial sector and securing fiscal adjustment. It was agreed at the time that the peg to the euro would be kept and perhaps that at the end of the program Latvia may meet the criteria to qualify for euro adoption.

Macroeconomic developments however led to several changes in the initial expectations. While in 2008, a 5 percent downturn was forecast for 2009, the actual real GDP contraction was 18 percent. This led to a reappraisal of the initial programme targets, which turned out to be a difficult balancing act, Mr. Moore argued. Taking the right fiscal position consistent with keeping the peg required sharp tightening. Determining the correct approach and the appropriate amount of adjustment was a challenging task.

At the same time, Latvia went through a period of deflation that corrected partially the competitiveness problem. This was visible primarily in public sector wages and in consumer prices, once one disregards the indirect tax increases made as part of the adjustment. Even after the end of the programme, the IMF still has a role to play in Latvia. Post-programme monitoring will follow. This will be joined by advice as in all countries, and technical assistance if requested.

Speaking from the perspective of the European Commission, Gabriele Giudice highlighted the importance of structural reforms to accompany fiscal consolidation and financial stabilisation. He stressed that even though the programme implementation has been largely successful, one ought not forget how challenging the build-up to this success actually was. The crisis exposed fundamental problems in Latvia and structural reforms were essential to strengthen the labour market, the business environment, education, skills and innovation, public administration and the public sector. EU structural funds were put to use in all of these fields.

The labour market required major adjustment given the inevitable shift towards more productive sectors, with a central focus directed towards keeping the labour force active, even if this meant putting up temporarily with low paid jobs. In terms of the business environment, fighting the grey economy and illicit trade were key

on the agenda, as were the improvement of public procurement and the attraction of foreign investment. A main target of the reforms in the skills and education realm was the accumulation of human and knowledge capital, with the aim of benefitting long-term growth.

In the public administration sector, the number of schools and hospitals was reduced, as were the number of teachers per student. The latter was also done in an attempt to bring these numbers in line with EU standards. A unified public sector wage was further established in January 2010.

Attempting to draw lessons from Latvia's progress, Mr. Giudice argued that facts, perceptions and confidence can often change very quickly and that policymakers need to be aware of that when devising the working scenario. Furthermore, one should remember that a pre-condition for delivering a successful adjustment is the presence of a national commitment. He concluded by arguing that things are not over yet, and that in a way, Latvia by graduating from the EU/IMF programme is similar to a student who just completed his undergraduate education. Time and effort still need to be invested before a master's degree is obtained, which in the case of Latvia would be the adoption of the euro.

Commenting on the presentation of the panellists, John Fitzgerald, shifted attention to the balance of payments measure in Latvia's economy. He argued that the latter is the best indicator of impending crisis and went on to compare the Irish experience to the Latvian one. He suggested that the size of the fiscal adjustment was identical in the two countries (namely 17.5 percent of GDP). The main difference lay in the fact that Latvia carried out the adjustment much quicker than Ireland.

Mr Fitzgerald argued that Latvia experienced the largest balance of payment adjustment in the EU. This adjustment came mainly from the bursting of the investment bubble. Its incidence has been primarily on the construction sector and on the unemployed.

He then went on to remark on the fact that Latvians are on average better educated than individuals in other EU countries. Many of the people who are unemployed at the moment have at least a high school degree and it should therefore not be particularly difficult for them go back to the labour market, Mr. Fitzgerald argued.

The presentations were followed by a general discussion.

Zsolt Darvas returned to an earlier point made on the topic of devaluation. He argued that all presentations convincingly illustrated that after the decision has been made to keep the exchange rate peg, the adjustment was a heroic and successful effort. However, the presentations have not proven that keeping the exchange rate peg was indeed preferable to devaluation. Furthermore, the presentations did not emphasize the enormous social costs of the adjustment: the huge employment fall and rise in poverty. The experiences of other countries that devalued, such as Iceland, where both gross and net foreign liabilities were much higher than in Latvia, yet employment hardly fell, put this issue to a new light.

Mr. Moore noted that the assessment of options for the exchange rate had taken into account that the balance-sheet effect of devaluation would have been very high in Latvia.

Mr. Bauze went on to defend his view that devaluation was not necessary. He thus argued that domestic debt is denominated in euros and that therefore devaluation would have an impact on the latter as well. He went on to stress the fact that Latvia is a small open economy. Devaluation, he argued, would lead to an increase in

imports through higher prices, not just in export gains, so the overall effect is not as clear cut as one may think. Finally, devaluation would have also had spill over effects on other countries, he concluded.

Mr. Giudice concurred: not only it was doubtful that exports would have risen, given the collapse of trade and the global recession at the beginning of 2009, but also "devaluation just postpones solving structural issues", he argued. These problems should be dealt with structural reforms, which require time and a managed approach without shortcuts.

On the topic of emigration, Mr. Bauze argued that during the economic adjustment period number of people who left the country is similar to that of the boom years.

Addressing further remarks from the audience, Mr Giudice argued that many commentators look at Latvia and stress the significant decline in GDP it experienced compared with the peak in GDP in 2007. That peak however was unsustainable, Mr Giudice argued, as it reflected a massive overheating of the economy. He therefore invited to compare the situation with the pre-boom period, e.g. the years 2004-2006, and this showed that – in spite of the strong correction since 2008 - the country is still better off and overall experienced a cumulated GDP growth higher than most other EU countries. Finally, he highlighted that since the fiscal consolidation effectively started in mid-2009, growth has actually been positive and increasingly dynamic, reflecting the positive impact of strong policies on confidence.