II.3. Latvia: maintaining sustainable growth after the boom-bust years [44]

Latvia had been keen to join the euro area at the earliest opportunity, with entry in January 2008 the clear target. As the economy overheated, however, significant macro-economic imbalances accumulated which deferred these plans. Between 2005 and 2007, unsustainable GDP growth went hand in hand with a mounting current account deficit and a housing market spiralling out of control. When credit flows then abruptly reversed, the country's GDP contracted dramatically. Latvia was placed in the EU/IMF-led financial assistance programme and was forced to carry out ambitious fiscal consolidation and structural reforms. Reallocating resources to the tradable sector was the first important step on the road to an export-driven recovery. Under the burden of deleveraging and consolidation, the revival of domestic demand was slow at first. From 2011, however, supported by favourable labour market developments, growth in demand has accelerated. Latvia has reclaimed its position as the fastest-growing EU economy, however, the current level of growth is lower than the unstainable rates recorded in the boom years, and it is now seen as sustainable. Thanks to this balanced growth, Latvia has not been subject to the MIP since its launch in 2012. Despite the financial assistance-supported measures to preserve equity, the social burden of economic adjustment, as evidenced by poverty, social exclusion and emigration rates, has been high, but measures are being taken by the authorities to counter these effects. Continued commitment to prudent fiscal policies will be critical for the country's economic future. The use of macro-prudential tools to reduce the risks posed by large non-resident financial flows, and the implementation of ambitious structural reforms will also play an important role.

Introduction

To welcome Latvia's recent adoption of the euro, this section reviews the country's recent boom-bust experience and discusses the challenges ahead.

Five years ago, it would have been difficult to imagine that Latvia would be able to fulfil the conditions for adopting the euro and enter the euro area in January 2014. After EU accession in May 2004, significant macro-economic imbalances had started to accumulate on the back of an overheating economy, and by autumn 2008 the country was on the brink of bankruptcy. A painful and seemingly impossible economic adjustment, to be achieved by means of internal devaluation, lay ahead. This would require unprecedented fiscal consolidation, huge redundancies and difficult structural reforms, threatening political and social stability. Yet, despite pronounced scepticism from the outset and particularly at the height of the crisis in mid-2009, the economy has moved back to growth. The measures implemented took some time to take effect, with the economy continuing to decline at first before picking up, as seen in the 'V'-shaped recovery, but a protracted recession was avoided. Latvia's GDP growth has exceeded expectations, reaching levels of 5.4 % in 2011, 5.2 % in 2012 and around 4 % in 2013. The two factors that were critical to the country's economic recovery were a return to international competitiveness and the rapid correction of external imbalances. The budget deficit decreased significantly and is expected to reach a balanced position in the near future. The level of government debt is projected to stay around 40-42 % of GDP in 2013-2014 and to decline to 33 % of GDP in 2015 as the repayments to the EU take effect and sizable cash buffers will be reduced. The financial assistance programme was successfully completed in January 2012. Financial support had not been necessary since October 2010, however, and the government had re-entered international bond markets in June 2011, well ahead of schedule. [45] As of 2013, GDP per capita in constant prices has returned to the level reached at its peak in 2007. Due to the decline in the population, however, the absolute value of GDP in constant prices was still about 9 % below 2007 levels, with current projections suggesting that a full recovery to the pre-crisis peak will be achieved in 2015.

Overheating, imbalances and a big bust

Latvia joined the EU in seemingly good macroeconomic health and, having pegged its currency to the Special Drawing Right (SDR) in

(44) Section prepared by Gatis Eglitis and Christian Weise.

(45) Occasional Paper 120 issued by the European Commission, Directorate-General for Economic and Financial Affairs: *EU Balance of Payments assistance for Latvia: foundations of success*: https://ec.europa.eu/economy_finance/publications/occasional_paper2012/op120_en.htm.

1994 and then to the euro in 2005, was keen to join the euro area in January 2008. Upon entering the Exchange Rate Mechanism II (ERM II) on 2 May 2005, the authorities unilaterally committed to maintaining a smaller fluctuation margin of ±1 % around the central rate – seen as a sign of the country's determination to join the euro area. The Latvian economy was the fastest growing in the EU between 2000 and 2007, and between 2005 and 2007 real GDP growth reached a yearly average of over 10 %. Following accession to the EU in 2004, Latvia, along with other EU countries, witnessed a rapid credit expansion. Loans to residents grew at an average annual rate of close to 50 % between 2004 and 2008, a reflection of the excess liquidity at that time and of the resulting hot money inflows into central and eastern European economies, which were rapidly converging with their western European counterparts. Foreign investment exploded, driven by commercial banks' mispricing of risk and over-optimistic expectations of convergence. A number of privatisation deals and, most importantly, a burgeoning real-estate market characterised by soaring prices also served to attract foreign investors. The tradable sector was meanwhile largely neglected. By way of illustration, foreign direct investment (FDI) reached relatively high levels of 8.4 % and 8.1 % of GDP in 2006 and 2007 respectively, but most of this was directed towards the real-estate market, while the proportion of total FDI relating to manufacturing was only 12 % in 2013. Significant imbalances were accumulating, as indicated by a current account deficit that reached around 22 % of GDP in 2006 and 2007 and by labour market tightening. Nominal wages doubled between 2004 and 2007, increasing much faster than productivity and thus damaging international competitiveness.

By early 2008, more cautious bank lending had caused economic growth to slow significantly. By autumn of the same year, this slowdown had developed into a strong contraction, reflecting the wider global economic situation. The global economy fell into recession, commodity prices reached record highs, and the general risk aversion seen in global markets following the collapse of Lehman Brothers cut off Latvia's access to financial markets. The second largest domestic bank, Parex, had to be rescued. Latvia ultimately experienced the most severe GDP contraction of all EU countries, at close to 18 % in 2009. The government deficit threatened to spiral out of control. Having been at 0.3 % of GDP in 2007 and 4.2 % in 2008, in spring 2009 it was projected to reach levels well above 15 % of GDP by the end of year in the absence of a significant consolidation package.

Faced with an economic crisis of this order, Latvia agreed a medium-term financial assistance programme, the balance of payments programme (BoP), with the EU and the IMF in December 2008. [46] The aim of this was to preserve the existing exchange-rate arrangement. The assistance offered to Latvia was made subject to a number of policy conditions relating to fiscal consolidation, financial sector stabilisation and the introduction of a wide range of structural reforms, including a significant acceleration in the absorption of EU structural funds. The Latvian government also undertook to strengthen the social safety net so as to protect the most vulnerable from the effects of the crisis.

Brave measures in difficult times

Given that the exchange rate was at that time pegged to the euro, some economists suggested devaluation as the only way out of the crisis. The national authorities and international partners did not see that as a viable option, however, because its effectiveness would have been severely limited by the degree to which imports were used in the manufacture of exports and the high proportion of foreign liabilities. Furthermore, it would have brought with it the risk of mass bankruptcy and a partial collapse of the domestic banking system at a time when the judicial system was clearly not capable of coping with such a fall-out. In addition, devaluation would have provided no incentive to solve Latvia's structural problems, including weak fiscal governance, the unsustainability of pension expenditure, loss-making state-owned banks, a lack of competitiveness and weak institutions.

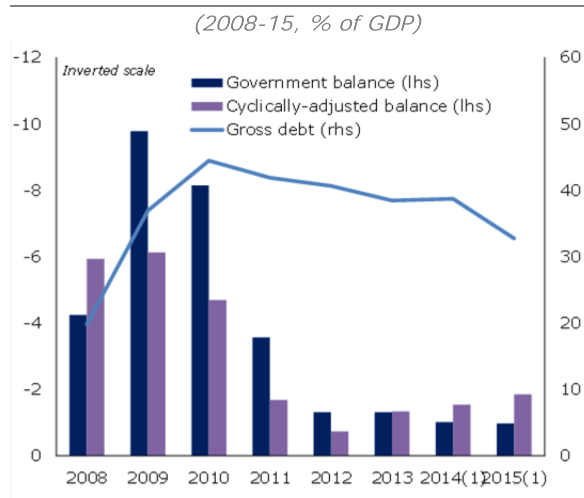
Between 2009 and 2011, the Latvian government carried out an ambitious programme of fiscal adjustment designed to correct the previously loose fiscal policy, the weaknesses of which had been hidden by the country's strong economic growth. This difficult adjustment restored Latvia's public finances to better health and established a

[46] Funds available from EU countries, IMF, World Bank, EBRD and Norway amounted to € 7.5 billion, of which Latvia used € 4.5 billion (60%), with € 2.9 billion lent by the European Commission, on behalf of the EU. The first tranche of EUR 1 billion (1/3 of the total) was repaid by Latvia on 25 March 2014.

framework which would be sustainable in the long term. The nominal balance improved, with the deficit being cut from 9.8 % of GDP in 2009 to 1.3 % of GDP in 2012 and 2013 (see graph II.3.1). The structural deficit also fell from its peak of 5.5 % of GDP in 2008 to around 0.25 % of GDP in 2012 and 2013, beating Latvia's medium-term objective of -0.5 % of GDP as set in the convergence programmes.

Latvia's fiscal consolidation measures were undoubtedly bold, with fiscal savings equivalent to around 17 % of GDP implemented within three years. The measures were frontloaded, and half of these savings were implemented in the first year alone. The measures were on the whole expenditure-oriented, with over half of the savings coming from cuts to health, education and public administration budgets. The most notable measure relating to revenue was an increase in VAT from 18 % to 22 %. The consolidation strategy was eventually successful in containing the adverse effects of the budget deficit on the economy. In fact, it even appears to have triggered 'non-Keynesian' effects on demand, by restoring confidence and stimulating demand and investment at the point when it was most needed. [47]

Graph II.3.1: **Latvia's government budget balance and debt**



Source: DG ECFIN, Commission's spring 2013 forecast.

The fiscal framework was also strengthened significantly by the law on fiscal discipline coming into force in March 2013 and the creation of a fiscal council in January 2014. The signing of the Treaty on Stability, Coordination and Governance in the EMU [48] in March 2012 provided further EU-level support for the national fiscal framework.

An additional factor that was critical to the success of the consolidation strategy, but is often overlooked, was the availability of significant EU funds (particularly from around 2009 onwards), which acted as a much-needed demand trigger in sectors affected by the decline in economic activity. Between 2007 and 2013, Latvia benefited from the third highest allocation of EU funds, after Hungary and Lithuania, receiving a yearly average equivalent to around 2.8 % of GDP or 70 % of gross fixed capital formation.[49] As on average every euro of national budget spending was supplemented by five to six euros co-financing from EU funds, national expenditure on items such as road and public building construction, vocational education and training of unemployed, science infrastructure development, and healthcare was often replaced by Structural funds financing, despite being in conflict with the EU funds "additionality principle". Clearly, such large inflows of EU financing also generated substantial tax revenues, in particular VAT, at a time when private consumption was weak.

The Latvian labour market demonstrated a high level of flexibility during the crisis, thanks in part to a decentralised wage-setting system. Significant public-sector wage cuts indirectly supported nominal wage reduction in the private sector in 2009 and 2010, when earnings per employee fell by a total of 19 % over two years. Employment levels fell sharply, especially in the private sector, as jobs were cut in construction and manufacturing. The unemployment rate reached around 20 % in early 2010, but had fallen back to 11.9 % by 2013, due mainly to growth in employment, with the participation rate also increasing significantly over this period. The projection from the Commission's 2014 winter forecast shows wages in 2014-15 growing broadly in line with productivity, although the labour market is tightening and structural problems, in particular regional differences and skill mismatches, could create pressures in the economy.

(47) Ibid, see Chapter 4: Fiscal consolidation in the midst of the crisis.

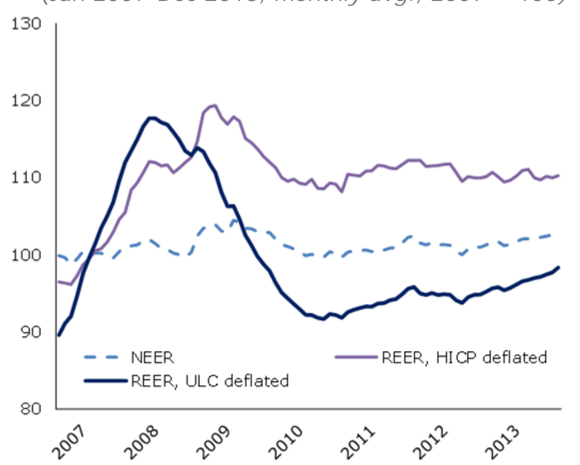
(48) http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf

(49) Source: Directorate-General for Regional Policy, Infoview.

External cost competitiveness has improved noticeably since 2008, with labour costs falling significantly and labour productivity, in particular in the tradable sector, increasing. In 2008, the real effective exchange rate (REER) adjusted for unit labour costs reached a peak of 64 % above the 2000 level, before falling by about 20 % in 2009-10, since when it has remained broadly stable (see graph II.3.2). This level of REER is considered sustainable, as the country has been seen to be steadily gaining market share over recent years (including as measured by exports adjusted for the growth of markets). The percentage of the country's GDP attributable to exports rose to 60 % in 2013, from 43 % in 2007, with some 60 % of exports destined for the EU and 12 % for Russia.

Graph II.3.2: **Effective exchange rates Latvia v. 35 trading partners**

(Jan 2007-Dec 2013, monthly avg., 2007 = 100)



Source: DG ECFIN.

The social burden of economic adjustment has admittedly been high in Latvia, despite the policy measures contained in the Memorandum of Understanding stipulating, inter alia, establishment of a comprehensive social safety net, supporting local governments in providing social assistance, and discounting social payments from overall budget targets. High unemployment has led to a wave of emigration to richer EU countries, which, coupled with Latvia's low fertility and high death rates, has seen the population decrease by 8-10 % since 2008. Net emigration has now fallen substantially, however, since the peak of the crisis years. The rates of poverty and social exclusion in Latvia are among the highest in the EU: families with children, unemployed people, people with disabilities, and people living in rural areas are particularly at risk. The country's spending on social protection and healthcare as a percentage of GDP is among the lowest in the EU. Furthermore, the social protection measures which do exist to reduce poverty tend to be ineffective, highlighting the importance of a robust social safety net. It appears however that, with the improved economic situation and increasing levels of general social awareness, the authorities are finally starting to address the challenges of poverty and social exclusion with greater determination. In recent years, for example, taxation of low-income earners has been cut slightly and child poverty has been reduced thanks to increases in various child-related benefits. Proposals for reforms to social assistance in line with 2013 World Bank's study are being gradually implemented. Better targeted, more effective policies relating to the active labour market, mostly financed by the European Social Fund, are helping unemployed people, in particular the long-term unemployed and young people, to find work or to obtain relevant training.

As part of the BoP programme, and in the context of the assessment of Latvia's readiness to join the euro area, financial supervision has been tightened and EU resources for supervision and monitoring increased, in particular for monitoring the growing non-resident banking sector. Additional liquidity and capital adequacy requirements for non-resident banks were introduced in 2013, regular on- and off-site checks of these banks are being performed, the deposit guarantee fund has been further strengthened, and monitoring has been stepped up in relation to pledged assets and the origin of funds in bank recapitalizations. This strengthened regulatory policy has been introduced partly as a result of lessons learnt, at significant cost, in the past five years, most notably with the Parex and Krajbanka failures.

Latvia has implemented a series of ambitious reforms to the business environment in recent years, with the aim of reducing start-up costs, simplifying procedures for property registration, construction permits and tax collection, and introducing out-of-court settlement of insolvencies. In doing so, Latvia has brought its regulatory framework a significant step closer to what is regarded as best practice. In the World Bank's 2014 *Doing Business* report, Latvia was ranked 25th out of 185 countries, with only four euro-area members faring better.

Conclusion

The origins of Latvia's years of boom and bust can be traced back to the domestic, regional and global circumstances at that time: globally, excess liquidity and hot money flowing into vulnerable countries; regionally, unrealistic expectations of income convergence in central and eastern Europe; and domestically, undue optimism about growth in personal incomes and mispricing of risk by commercial banks, amplified by the behaviour of both policymakers and individuals.

A broad range of country-specific and general economic factors have contributed to the successful economic adjustment seen in Latvia since the height of the crisis. Ambitious, front-loaded and largely expenditure-based fiscal consolidation helped to contain the budget deficit whilst the confidence generated by the introduction of a credible programme itself aided the economic recovery. The flexibility of the labour market meanwhile helped companies to restore competitiveness by means of wage reductions and job cuts. Competitiveness was also improved by steps taken to shift the tax burden from labour to consumption and property. The recovery in Latvia was very much export-driven, with the growth in exports made possible by the openness of the economy and the faster-than-expected economic growth experienced by major trading partners. A number of structural reforms, including bank restructuring and measures improving the use of EU funds, have contributed to the development of a more favourable business environment. A generous allocation from the European structural funds meanwhile helped to boost public investment and supported financing and reforms in many important sectors. Above all, the success of the recovery measures implemented in Latvia proved that, for a tough internal economic adjustment to be effective, there needs to be both a determined political will to carry out unpopular reforms and also a fully-developed, comprehensive social safety net to protect more vulnerable groups in society during difficult times. In addition, Latvia benefited from the fact that those looking for work were able to migrate to other EU countries, which helped to alleviate the social tension created by the effects of the crisis. Some of the lessons above are clearly applicable to other Member States undergoing challenging economic adjustment, while others are more Latvia-specific.

While Latvia's current level of economic growth is regarded as sustainable (50) and the adoption of the euro is recognised as a significant and hard-earned achievement, it is not the end of the road. The current robust economic situation should be used to advance reforms and improve Latvia's long-term growth potential, rather than lead to complacency and relaxation of reform efforts. Sustainable convergence of the economy in the longer term will require, *inter alia*, ongoing commitment to prudent fiscal policies (there are some recent signs of less prudent fiscal decision-making), a continuous use of macro-prudential tools to reduce risks from growing non-resident financial flows, especially in view of recent Ukraine events, and the implementation of reforms in a number of vested-interest-heavy areas. These include higher education and science, state owned enterprise management, electricity and gas market liberalization, and the judiciary, including insolvency framework. But above all, and in order to ensure economic and social sustainability for years to come, high rates of poverty, social exclusion and dismal demographic trends need to be addressed boldly. These and other structural challenges are being addressed by the Commission under the European Semester and the Post Program Surveillance frameworks. Also, Latvia has joined a euro area that is very different from what it was just a few years ago: the euro area economic governance framework has been greatly strengthened, entailing stricter obligations.

(50) The Commission's alert mechanism reports issued under the Macroeconomic Imbalance Procedure have not identified economic imbalances in Latvia requiring further in-depth investigation for possible policy action.
http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf.