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EU Balance-of-Payments assistance for Latvia
Foundations of success

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European Commission
Directorate-General for Economic and Financial Affairs
Publications
B-1049 Brussels
Belgium
E-mail: mailto:Ecfin-Info@ec.europa.eu

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Directorate-General for Economic and Financial Affairs

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Introduction

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Latvia was the fastest growing economy in the EU from 2000 to 2007, reaching double digit real GDP growth rates in 2005-2007. International capital inflows, rapid credit growth, and a business-friendly environment resulted in a GDP increase of 34% from 2004 to 2007 and total employment growth of more than 10%. However, the boom was not sustainable and significant imbalances built up during the same period, which were largely neglected by national authorities: on the eve of the crisis in 2007, consumer price inflation had reached double-digits, property prices had increased fourfold in the last few years, and nominal wages had doubled from 2004 to 2007, increasing much more than productivity. Imports grew much faster than exports and resulted in current account deficits above 20% of GDP in 2006 and 2007.

In 2008-09, the economy entered a severe recession, with 18% GDP contraction in 2009 alone, reflecting a combination of a sudden stop of capital inflows, a freeze of liquidity and weak external demand, exacerbated by the loss of competitiveness dating back to the boom years. This was further aggravated by the unfolding global financial crisis and record commodity prices. The general risk aversion in the global markets reached a peak after the collapse of Lehman Brothers, when the Latvian government lost access to financial markets and the second largest bank had to be rescued. These developments inevitably had a significant impact on public finances with the budget deficit widening from 0.3% of GDP in 2007 to 4.2% in 2008; in summer 2009, the budget deficit was projected to go well above 15% of GDP by the end of the year in the absence of a significant consolidation package.

To address the crisis, Latvia reached an agreement with the EU and the IMF on a medium-term financial assistance programme in December 2008. The Balance of Payments (BoP) assistance was provided by the EU for three years starting from 20 January 2009.

Given the exchange rate peg to the euro, many prominent economists and policymakers at the time suggested devaluation as the only way out of the crisis. However, devaluation was not considered a viable solution by the national authorities and international partners for several reasons: first, exports has a high import content; second, due to the high share of euro-denominated liabilities a devaluation would have meant immediate insolvency for many corporates and households; third, several domestic banks may have followed Parex Bank into insolvency; and last, devaluation would have provided no incentive to solve the deep-rooted structural problems Latvia was facing. The only agreeable solution was to unwind the imbalances generated during the boom period by going through a comprehensive adjustment programme, agreed between the national authorities and international lenders, preserving the existing exchange rate arrangements and relying on substantial fiscal consolidation, financial sector stabilisation, a wide range of structural reforms, including a significant acceleration in the absorption of EU structural funds and a strengthening of the social safety net to protect the most vulnerable.

The focus of the 2009-2012 adjustment programme was on fiscal consolidation so as to correct the loosening of fiscal policy during the boom years, which had been concealed by buoyant economic growth. Consolidation was bold, frontloaded and expenditure-oriented: it amounted to roughly 17% of GDP over a few quarters, half of it was implemented already in the first year, with most of it decided within just a few months (June-December 2009), and well over half of it consisted of expenditure cuts, especially in health, education and public administration. The consolidation strategy was also successful in containing the adverse effects on the economy by triggering a positive reaction of the private sector, whose confidence was restored resulting in a recovery of private demand and investment when it was most needed (the so-called non-Keynesian effects). The strategy also involved adjustments on the supply side, as cuts in public wages, supported by massive layoffs of

public employees, spilled over to the private sector. Overall, the consolidation of public finances has favoured a more efficient allocation of resources, making the economy more productive, competitive and sustainable, laying the basis for a robust and balanced recovery.

Despite pronounced scepticism at the outset of the programme and during the lowest point of the crisis in mid-2009, the Latvian economy has been steered back to growth in a V-shaped recovery and a protracted recession has been avoided. The economy started to grow again and to create jobs in 2010-11 at a pace exceeding expectations. The GDP grew by 5.4% in 2011, making Latvia one of the fastest-growing countries in Europe, together with Estonia and Lithuania. The recovery was underpinned by regained international competitiveness and a fast correction of external imbalances. The budget deficit decreased significantly and is expected to reach a balanced position in the near future. Public debt has stabilised at around 45% of GDP, a level well below the initially expected peak (close to 100%), and is expected to decrease rapidly in the future. Balance-of-Payments financing was no longer needed since October 2010 and the government re-entered international bond markets in June 2011, well ahead of schedule. The programme was successfully completed in January 2012. While Latvia can now "stand on its own legs", a number of challenges remain, such as completing fiscal consolidation, reducing the structural unemployment, and dealing with unfavourable demographic trends that threaten potential growth and fiscal sustainability in the long run.

On 1 March 2012, the Directorate General for Economic and Financial Affairs at the European Commission (ECFIN) and the Bank of Latvia organised the seminar "EU balance-of-payments assistance for Latvia: foundations of success" to take stock of the country's experience and draw some key lessons for the future. This occasional paper stems from the academic contributions and political insights presented at the conference. It consists of three parts, preceded by the conference's opening remarks in which the Latvian Prime Minister Valdis Dombrovskis, Central Bank Governor Ilmars Rimševičs, and ECFIN's Director General Marco Buti and Elena Flores, Director responsible for Latvia at the outset of the crisis, set the scene by providing valuable insider information on the political process that brought the programme about and the main difficulties experienced at the time.

The first part of the volume focuses on Latvian competitiveness trends and the accumulation of external and internal imbalances that eventually led to the financial and economic crisis. In the second part, it turns to the economic and social impact of the measures agreed during the programme negotiations. Finally, in the third part, it investigates the political dynamics associated with the bargaining and implementation of the programme.

External financing played a significant role in bolstering Latvian robust growth of the 2000s. Yet, the misallocation of part of the huge inflows of capital into non-tradable overpriced assets harmed the sustainability of growth by making some sectors of the economy less competitive and exposing the country to external shocks. The strong link between economic performance and external financing is shown by Karsten Staehr in Chapter 1. The author studies how external capital inflows and international price competitiveness have affected economic growth in Latvia since the late 1990s. Current account deficits are found to have an immediate and substantial positive impact on economic growth, while higher relative unit labour costs reduce growth after two years. Simulations for Latvia suggest that capital import raised annual growth by 2-3 percentage points in 2004-2005 and by 6-8 percentage points during the peak of the boom in 2006-2007, but reduced growth by 5-9 percentage points during the deep downturn in 2009-2010. The author also finds that changes in competitiveness had minor effects during the later stages of the boom, but shaved 2-3 percentage points of growth in 2009-2010. The severe downturn in Latvia in 2009-2010 was then exacerbated by a combination of a sudden stop of capital inflows and weak competitiveness dating back to the preceding boom. The findings suggest that the performance of the Latvian economy is highly sensitive to changes in capital flows and competitiveness.

The potential trade-off between short-term credit- and FDI-fuelled growth and medium- and long-term sustainability is analysed by Francesco Di Comite, Gabriele Giudice, Radoslav Krastev and Daniel Monteiro in Chapter 2, following a multifaceted disaggregate approach to assess trends in competitiveness. The authors find that, even before the balance of payment crisis erupted, the accumulation of current account deficits led to significant imbalances, notably in the country's net

international investment position. The typical explanation would be that imbalances were driven by a lack of competitiveness due to the excessive increase of unit labour costs during the overheating period, leading to the corresponding policy prescription of cutting wages or devaluate. However, the Latvian case shows that this kind of analysis can be too simple. First, the authors show the need to expand the concept of competitiveness embracing non-labour factors of production in the analysis: capital, profit rates, intermediate consumption (energy unit cost, transport unit cost, etc.). Second, they propose additional indicators of competitiveness which take into account not only labour costs, but also non-price competitiveness and product quality, which may offset increases in labour costs. Third, they identify the role of external financing and household dissaving in pushing up imports. Finally, it is shown how a sector-by-sector analysis is needed to identify with a higher degree of precision the policies to undertake and uncover trends that may be hidden in aggregate statistics. This analysis shows that Latvia's imbalances were mainly demand-driven and only to a lesser extent due to a loss of external competitiveness. Specifically, high consumer demand, driven by capital inflows, low saving rates of households and the wealth effects associated with an asset price boom, was a major cause of imbalances. On the other hand, supply side factors were largely related to the construction sector and other non-tradable parts of the economy.

Further evidence on the strength of Latvian external competitiveness, even during the crisis, is provided by Konstantīns Beņkovskis, who in Chapter 3 proposes a methodology to improve our reading of export price indices by taking into account possible quality improvements, which in the case of Latvia helps explain why export market shares grew as export prices increased. The author starts from the consideration that different competitiveness indicators for Latvia show some discrepancies, suggesting that traditional REER indicators may have some drawbacks that need to be fixed. For example, structural issues such as the export structure of the country or the heterogeneity across sectors are not captured. More specifically, when price competitiveness is studied some measures are adjusted for quality, but important factors are left aside (e.g. taste, or image of brands). The way proposed by the author to take these factors into account is to use the available information on both prices and quantities exported in order to avoid a wrong interpretation of positive developments, such as quality improvements, as a pure loss in competitiveness. This is particularly relevant when real market shares improve while relative export prices increase, as in the Latvian case, where price competitiveness is shown to have worsened only marginally, whereas factors associated with non-price competitiveness improved significantly.

Unfortunately, the dynamism of Latvian external sector did not suffice to shield the country from the combined effect of an international credit freeze due to increased risk aversion and the spectacular domestic burst of the property bubble. The balance-of-payments crisis forced the country into undertaking deep fiscal rebalancing to get back on a sustainable growth path and regain the confidence of international investors. The effects of the reforms and fiscal consolidation measures are studied in the second part of the volume. First, Francesco Di Comite, Gabriele Giudice, Julia Lendvai and Ingrid Toming in Chapter 4 focus on the economic impact of fiscal consolidation on economic growth and try to clarify what was behind the immediate rebound observed in the Latvian economy. Given the rapid moves prevalent in the Latvian experience, the size and composition of the Latvian adjustment programme are assessed on a quarterly basis to provide a more precise idea of its impact and to enable more detailed lessons for the future. The authors find that the consolidation strategy adopted by the government in agreement with international lenders was successful in containing the adverse effects on the economy. In fact, Latvian fiscal consolidation appears to have triggered non-Keynesian effects on demand that offset the drastic fall in external demand in 2009 and the contractionary effects of the budget cuts. The Latvian consolidation strategy relaxed the binding financing constraints suffered by the private sector as a consequence of the high risk premia on government debt and was able to restore confidence and stimulate demand in the short run, while at the same time making the economy more productive and competitive in the longer run.

However timely and boldly addressed, the burst of the property bubble and the ensuing economic crisis entailed dramatic social consequences, which represented a major concern for policymakers and international lenders at a time in which fiscal consolidation was required. This situation pushed the Latvian government to pursue reforms in the provision of social services, as documented by Peter Harrold, Indhira Santos and Emily Sinnot, who in Chapter 5 analyse in depth the social impacts of health, education and social protection reforms from the perspective of efficiency and equity, starting

from the consideration that the main medium- and long-term challenge in Latvia is to adapt to a decreasing and ageing population. In particular, the authors' focus is on the impact of the emergency social safety net measures. Policy proposals are presented to deepen structural reforms and reduce the vulnerability of the poorest segments of the population. Expenditure on health, education and social protection is assessed to see how these sectors adjusted during the economic crisis, both as a result of automatic stabilisers and as a consequence of policy changes, and to study the consequences of these developments. The analysis helps identify which structural reforms in the social sectors are still necessary to ensure future fiscal sustainability and growth.

Some specific issues related to the Latvian programme experience deserving attention are analysed by our contributors in Chapter 6, reflecting on the specificities of the Latvian consolidation experience and the possibility for it to be reproduced in future circumstances and in other contexts.

Specifically, Andris Vilks, the Latvian Minister of Finance, moves from a comprehensive overview of the Latvian experience of internal adjustment to identify the way ahead for Latvia and the euro area. According to the author, the Latvian economy already showed clear signs of overheating in 2005-2006. At that time, various imbalances were building up in the economy, fuelled by easy credit conditions and strong capital inflows. These first symptoms, however, were ignored by the government. The deterioration of the external economic situation led the government to ask for support from international partners (EU and IMF). Despite the strong criticism faced from some international actors, the government decided to go through a programme of internal devaluation, considered the only viable way to address imbalances.

Then, IMF's Mark Griffiths addresses three fundamental topics related to the Latvian crisis: (1) why the Latvian programme worked; (2) what remains to be done for adopting the Euro; (3) what are the lessons of the Latvian programme for Europe. Two main reasons for why the programme worked can be identified, namely strong political ownership of the programme and a fair degree of flexibility. However, flexibility was granted only after observing the serious degree of commitment that the government showed with respect to structural reforms. The author notes that Latvia provides a good example for what other euro countries need to do to adjust and return to financial stability and economic growth. Although some factors were indeed country-specific, some general lessons can be learnt from the Latvian case, notably the importance of strong ownership by the government, honest cooperation among institutional partners, and the capacity to frontload the adjustment.

Karlis Bauze from the Bank of Latvia focuses on recent trends in the labour market in Latvia to identify what factors contributed to the success of the programme. The author describes the main characteristics of the labour market in order to clarify which features can explain recent trends in unemployment. During the crisis, Latvia went through a very necessary and eventually fruitful restructuring process. This process included the reduction of the total number of jobs in the public sector and, therefore, inevitably induced an increase in unemployment in the short term. The economy has managed to reallocate resources from the non-tradable to the tradable sector: in the long run this is likely to have a positive impact on economic growth and the overall resilience of the economy. To conclude, the author goes through some of the lessons arising from the Latvian experience from a central bank perspective. These lessons include: (1) internal adjustment for a small, open economy can be done and works well – it depends on identifying the right policies and using the right tools; (2) some preconditions, in particular the flexibility of the labour market, are very important for the ultimate success of the reforms; (3) the frontloading of the adjustment and of the consolidation process is essential.

Swedbank's Martins Kazaks focuses on the banking sector, highlighting the drivers of the Latvian boom-bust cycle in order to provide relevant policy recommendations. The main roots of the problem are identified at different levels: globally, as a false belief that income convergence in Central and Eastern Europe will be very fast no matter what; domestically, as commercial banks showed undue optimism about customers' income growth and their own ability to assess risk. In addition, the government pursued a pro-cyclical fiscal policy and fiscally favoured property developments. Based on this analysis, the author proposes structural reforms to strengthen the banking sector, foster income, productivity and growth potential. In particular, the financial infrastructure to support sustainable growth, such as a developed stock market, should be improved.

Concluding this chapter, Ettore Dorrucci from the ECB compares Latvia to the other programme countries to understand the extent to which Latvian lessons can be extended to other realities, as the author expresses the concern that probably there is still too much polarisation in the public debate on the issue. On the one hand, the "Krugman view" sees the Latvian experience as very peculiar and impossible to replicate elsewhere; on the other hand, other economists claim that Latvia's experience clearly indicates the way to follow. Using a cross-country perspective, the author concludes that the truth is probably somewhere in between. This can be understood looking at the evolution of some economic indicators. Both groups, in drawing their conclusions, highlight some specific points and neglect others. Hence, the likelihood of the success of a programme of internal devaluation eventually depends on both the country's initial conditions and the use of the correct policy tools. In addition, it is noted that, looking ahead, the core challenge for Latvia will be to lock in the competitiveness that has been achieved, improving non-price competitiveness and the business environment. He concludes that despite the undeniable progress that Latvia achieved in the last few years, there is still room for improvement as also indicated by the fact that Latvia exhibits the largest dispersion of ranks in different competitiveness indicators.

The internal and external political dynamics of the programme are at the centre of the analysis of the last part of the volume. In Chapter 7, Marion Salines and Kristaps Bērziņš turn their attention to the internal political dynamics in Latvia and try to explain the Latvian "possible trinity": achieving consolidation, structural reforms and re-election at the same time. A political economy approach is used to understand how harsh austerity measures and unpopular structural reforms could be associated with electoral victory in Latvia in 2010. The aim is to identify those factors that allowed the Latvian Prime Minister to carry out an ambitious internal devaluation strategy without encountering large-scale social resistance and eventually to win the subsequent elections, thereby differentiating between country-specific and incumbent-specific factors. It is found that the country context only partly explains the Latvian experience. Of decisive importance for the public acceptance of reforms were also the design of the anti-crisis policy and the strategy of political communication, a dimension that is often ignored in other crisis-management contexts.

In the last chapter, Samuel Dahan studies the external political dynamics involved in the negotiation process, which in the case of Latvia was characterised by a considerable complexity, given the high number of players sitting at the negotiation table and their wide heterogeneity. To enhance our understanding of the EU/IMF financial assistance programme, the author presents an analytical approach to the negotiation process. In particular, the focus is on what ultimately shapes strategies and outcomes in financial assistance negotiations, keeping in mind that behavioural options vary along a spectrum between two polar ideal types: competitive versus cooperative strategies. This analysis yields important lessons that can be used in other negotiation processes, the most important being that flexibility on both sides and effective communication are necessary to find a mutually advantageous agreement. In particular, persuasion should be used rather than coercion in order to avoid unnecessary tensions and a deadlock in the negotiations.

Finally, Matthias Mors concludes this volume with an overview of the Latvian programme experience by drawing some key lessons for the future. The occasional attention lately received by Latvia from international observers often does not acknowledge the impressive challenges that Latvia overcame to rebalance its economy and set it back on a sustainable path. This volume aims to fill this gap by providing a fair account of the magnitude of the problems and the boldness of the solutions, possibly providing valuable guidance for future action in difficult times.

Opening remarks

Elena Flores

Let me welcome you to this important event, jointly organised by DG ECFIN and the Bank of Latvia. It is a great pleasure to see all of you around the table. You showed interest in discussing the Latvian experience and I am sure that we will all have lots of things to contribute and lots of things to learn from this discussion.

I think that the timing of this event could hardly be better. The three-year Latvian programme has just been concluded on 20 January: this is the first successful finalisation of a Balance-of-Payment financial assistance programme. Considering that at the moment there is a number of other countries under financial assistance by the EU, we can certainly draw lessons from the Latvian experience that will be very relevant for the current policies in other countries. I am sure that today's presentations and interventions will allow you to capture the extraordinary scope of the adjustment that has been achieved by the Latvian authorities and the Latvian people during the last three years.

As the lessons of the adjustment will be discussed extensively during the seminar, here I do not want to go too much into details. However, let me reflect briefly upon some of the crucial aspects that we had to face on the very first days and weeks of this financial assistance programme, back to late-2008 and early-2009. Obviously many of the decisive players of that time are now here around this table.

As some of you may know, the request for financial assistance to the EU from Latvia came on 10 November 2008; immediately afterwards Latvia also addressed a similar request to the IMF. On 13 November, discussions at technical level were held with the Latvian authorities here in Brussels and since then a very active working context started to take place. After consultations with Member States, very rapidly, by 22 November, the EU agreed to open negotiations with Latvia - as in the case of Hungary some months before - and to provide financial assistance in coordination with the IMF.

However, before presenting the programme for approval to the Council, we were faced with three immediate challenges that we had to address. The first issue was related to the financing needs for Latvia. In fact, we immediately realised that they would be significant (maybe not in terms of total amounts, but still very significant in relation to the size of the country). Initial estimates were predicting a financing gap of around EUR 8 billion – to give an order of magnitude something like 35% of Latvian GDP. At the same time we knew that the Latvian quota in the IMF was only around EUR 150 million: that meant that the IMF's contribution could have been expected to reach at most around ten times the quota (at the end it was twelve times). That also meant that the EU had to agree to cover the largest part of the total package (around 40%). In addition, it was necessary to be sure that we could count on bilateral contributions, in particular from the Nordic countries which had a significant role in the stability in the Baltic region. Hence, before going ahead and presenting a proposal, we had to be sure that these relevant amounts could be put on the table and that all the players involved were ready to take responsibilities into the agreed package. Discussions were not always easy, as some parties doubted the credibility and the commitment of the Latvian authorities to undertake the significant financial, fiscal and structural adjustment required by the programme. Indeed, while some factors were probably beyond the control of the authorities, it was also known that in the years before the crisis Latvia had clearly misbehaved on various policies. Still at that point in time it was not guaranteed that lessons had been learnt and credibility was there.

The second challenge was to persuade everybody involved in the programme – in the Member States, within the Commission, etc. – that such an adjustment was possible without a devaluation of the currency. As you may remember, at that time, devaluation was in fact depicted by many economists as the only way out. We knew that the adjustment would be huge and difficult; the Latvian authorities also knew this - and we discussed this issue with them extensively. But we also realised that this was the "least bad" option. In fact, it was the only way to maintain regional economic and financial stability and - given already extensive use of the Euro - to avoid the major adverse balance sheet impact of devaluation within Latvia.

The third element, on which I will not spend too much time, was to get ourselves organised. For the Commission in fact it was a new type of challenge, a new experience, and we had also to learn how to work together in full partnership with the IMF. These three fundamental issues had to be made extremely clear before proceeding with the programme.

Lastly, if I compare the Latvian case to other programmes that we started during 2008-2009 (i.e. Hungary and Romania) - since I was involved also in those - we had the initial impression that the Hungarian and Romanian programmes were relatively easier to frame than the Latvian one. The Latvian situation was really more complex: it was a combination of fiscal, financial, monetary and structural challenges, while the situation of Hungary, for instance, was clearly linked to high public debt eventually related to bad fiscal policies. However, with hindsight, we see that the Hungarian and Romanian programmes have encountered difficulties to deliver, now and then, while the Latvian programme appears like a true achievement. This is linked partly to the consistency in the policy approach in Latvia, contrary to changes in the policy approach in the different governments of these other countries. That is an important element to keep in mind.

The seminar today aims at assessing the foundations of this success, to discuss how imbalances were created in a time of apparent economic stability and growth, how the crisis hit Latvia and how national efforts and international assistance worked together to lift Latvia back on a path of, hopefully, sustainable growth. We would like to identify and learn from an economic, a political economy and an institutional point of view what made this programme and these policies work.

At the same time we think it is very important to avoid the pitfalls of excessive celebrations. We think it is absolutely essential to look at the challenges which Latvia still faces (and Latvia obviously is not alone in facing these challenges today).

We have today the privilege of having with us very distinguished speakers, who played a key role in drawing the country out of a very uncomfortable and difficult situation. I am sure we are all eager to hear their views on the recent history of Latvia and its prospects.

Thank you.

Marco Buti

It is a privilege to be here. I believe this is an excellent opportunity to exchange views on the Latvian experience. As I was telling the Prime Minister just before coming here, we desperately need some good stories and not only the difficult ones that are dominating the news these days. I believe that the spill-overs of Latvia's experience are well beyond the size of the country.

Let me first bring you the wishes of Vice-President Rehn who unfortunately cannot be here today. You know that at present we have some countries that are in a worse position than Latvia and in this very moment some crucial discussions on this are on-going before today's European Council.

I think we were bold and also the Central Bank of Latvia was pretty bold in dubbing this seminar "Foundations of Success". As a matter of fact this may be seen as quite optimistic and ambitious - if not premature - but I think that the title is indeed justified. What I would like to do in my initial comments is not so much dwelling on Latvia's experience per se – there will be many presentations in the course of the day and you will be able to go into details on that – but in my speech I would like to draw the conclusions from the point of view of other programmes; what we can learn from Latvia and how I see the role of the Commission in this.

As Elena Flores clearly explained, setting up the Balance-of-Payments assistance programme required a lot of effort. The financing needs were large, especially compared to the size of the country. Ultimately, of the EUR 7.5 billion which we managed to put together, Latvia only used EUR 4.5 billion, that is 60% of the total envelope. Not only absorption was less than we expected, but also no disbursement was required since October 2010. On the contrary, Latvia returned to the financial markets very successfully in June 2011 and, again, in February 2012. The regained trust and confidence of the financial markets, which was also in a sense rubber-stamped by the rating agencies (and in this respect it should be highlighted that Latvia is the only country, during this period, that has been upgraded and whose outlook has become positive) did not come on its own; it was the result of hard work - clearly first and foremost in Latvia, but also in Brussels and Washington - to devise, shape and ensure the implementation of a very ambitious programme and its numerous measures. Even more importantly, the success of the programme was clearly the result of the ability of the Latvian people to adapt quickly to the challenges of the crisis and their willingness to undertake a major and difficult adjustment.

The Latvian experience shows, and this is an important lesson also for other countries, that commitment, decisive action and strong ownership of the programme by national authorities are crucial ingredients of a successful adjustment: credible and consistent policies and ambitious reforms are necessary ingredients to deal with the serious imbalances and vulnerabilities that a country faces in the midst of a crisis. Such policies can be understood by the population - if they are well explained - and can eventually reward a government that has the courage to deal with these challenges. Valdis Dombrovskis, the Prime Minister of Latvia, is the prime example to show that if one is able to implement the programme and the adjustments successfully, if one does so with determination and also manages to explain it well, then one can definitely defy the so called Juncker Curse (i.e. the popular saying by which: "we all know what we have to do, but then we don't know how to be re-elected afterwards"). Obviously policies can be understood by the population. This requires, as I indicated, careful communication and a lot of pedagogy. The Latvian example is something encouraging also from a political viewpoint: if governments are willing to take action with determination, being re-elected is indeed possible.

The Latvian experience also proves that much of the analysis surrounding the debate on economic adjustment during a crisis can be partial and short-sighted, and that policy conclusions built on these may eventually turn out to be misleading. As Elena indicated many called for a devaluation of the currency or massive wage cuts as the only way to address the loss of competitiveness of the Latvian economy. But the problems of Latvia did not stem only from burgeoning wage costs at the peak of the crisis. In fact, this was rather a symptom of exuberant demand, imports fuelled by easy financing, an asset bubble, a drain of labour supply into the construction sector and imprudent budgetary policies.

Rebalancing the economy required an articulated mix of fiscal, structural and productivity adjustments, which needed time and could not be delivered through shortcuts. We believed that, rather than letting the peg go, credible policies, a frontloaded and steady fiscal adjustment based on economic and budgetary reforms would lead to a return of confidence, stabilisation of consumption, a pick-up of investment, lower interest rates and a fast return to growth. In this respect it has to be acknowledged that, when we decided to support the authorities in keeping the monetary arrangements of Latvia, we were thinking not only of Latvia itself, but also of the broader picture of the region and its very large neighbours. In fact, risks of contagion were considered very important: we thought that foregoing the peg was an important risk for the whole region. Thus, also geopolitical considerations were at the basis of our choices; the choice we made had a Latvian-specific economic justification, but was also set within this broader picture.

The crucial aspect of this programme was the sizeable fiscal consolidation which was necessary to close the gap left by the temporary revenues generated by the boom and the new permanent outlays which were decided at the time. Identifying the fiscal adjustment was not easy, but I think the strong emphasis that the Commission placed on the need to strongly frontload the consolidation, as well as to support it as far as possible with a permanent restructuring of the budget and not across-the-board cuts, has been one key component of the final outcome. It has to be said that the discussion with Latvian authorities was not always easy. We had at a certain point to insist that the composition of the adjustment should not be done in a way which could undermine the social fabric of the country. Unlike in other countries, where we have to insist on having an adjustment which is essentially expenditure-based, in the case of Latvia we took the view that, whilst cuts in expenditure were absolutely essential, reforms on the revenue-side were also important in order to guarantee the social balance and social acceptability of the programme. The Commission also gave strong prominence to structural reforms, which are now paying off. We could build on the preparatory work made by the Latvian authorities with the World Bank and the IMF in several fields. We also focused on fighting the grey economy, on upgrading skills and improving the business environment.

I have already mentioned this aspect several times: communication and the management of expectations have been crucial. It was essential to establish a common understanding of the situation by the national government, the stakeholders and the general public to persuade them to address the situation and eventually create support for some key measures which were indispensable for the success of the programme. It was a recurrent necessity, for us, to explain what had to be achieved, why and by which means and how the programme could help the country to overcome the crisis. Here is a lesson for other countries, i.e. to shift the attention from the pure austerity to the foundations for growth coming through if the programme is implemented successfully. We are struggling with this issue also in other countries where the perception is indeed that it is all on the adjustment-side austerity, painful hardship and there seems to be no chance to see the light at the end of the tunnel. I think this pedagogical element in explanation was an important component of the programme.

Let me now offer a few comments on the experience of the Commission in his context. Let me pay tribute also to Gabriele Giudice and the Latvian team in ECFIN for having worked in a relentless way and with such dedication – dedication that has been acknowledged by the Latvian authorities, but also, within the Commission, by the President and by the Commissioner. For the Commission it was a huge challenge. This was one of the first programmes, the second after Hungary, and we had to shift essentially from a Committee-based surveillance to a hands-on mission-based surveillance, which for us was absolutely unprecedented, as we were not used to this type of work. We had to build our own operational and institutional capacity with little experience on how a real, on-the-ground surveillance and conditionality is to be implemented. We learnt a lot from the IMF in the first place and I believe that the cooperation with the IMF was extremely useful. One of the points we also discussed with the IMF, as I referred before, is the one on the monetary and exchange regime. I think there was a strong cooperation with other institutions as well – the World Bank, the EBRD, and the Nordic countries. I remember particularly well the experience and the surveillance we had during the Swedish presidency; basically at each ECOFIN we had a side-meeting with the Swedish Minister of Finance Anders Borg and the Swedish authorities to put pressure to convince the Latvian authorities to carry on with the implementation of the programme. As I said, I believe that strong pressure from regional partners was important.

The conditionality of the programme affected many areas, beyond the responsibility of DG ECFIN. The Directorate Generals for Competition, Employment or Regional Policies, Internal Market, Transport, Energy and others were very much involved in the programme and therefore we had an important role of coordination. I think there was an important role of the Commission also as a trusted and impartial player promoting the European interest; this became visible, in particular, in the summer of 2009 when the Commission clearly expressed the many reasons from a European perspective which justified the need to support Latvia with further liquidity injections, once the consolidation effort had finally picked-up. All in all, providing cash, expertise, advice, sometimes strong arguments to focus energies and minds, proved crucial for the implementation and the success of the programme. Definitely we have learnt a lot from this experience and we hope we can be successful in exploiting what we learnt here to help other countries.

To conclude, let me come back to the title of the seminar. Can we claim really that the programme has been a success? The answer is YES. Can we claim that continuous success is now guaranteed? The answer is NOT NECESSARILY. We need to continue to address the many challenges we still have in front of us to make sure that Latvia develops into a strong and just economy with the necessary decisive policy-making processes to address the emergence of new imbalances. To do so we need to continue to build on this early success; success cannot be taken for granted: complacency is not the name of the game today. However, certainly, this is a very good start.

Thank you.

Valdis Dombrovskis

In my intervention I will go through Latvia's programme from the point of view of the Latvian government. I will try to highlight what were the key issues we were dealing with and what are the key outcomes.

Looking at Latvia's effort to overcome the crisis, it can be said that government action was based on three main pillars: it was an issue of fiscal consolidation; it was an issue of economic stimulus which we had to face with the means we had; it was also an issue of social safety network, to deal with the social consequences of the crisis.

As regards fiscal consolidation - and Marco Buti has already outlined the most basic and fundamental elements – the overall size of adjustment was some 17% of GDP, which is huge by any scale. Roughly one third of this consolidation came from the revenue side, namely tax increases, while two thirds came from the expenditure side. On the revenue side, most of the emphasis was on increasing taxes on consumption and property, but unfortunately also some other taxes were affected, like social security contributions, given the problems which we had in our social budget and also following some Constitutional Court decisions. On the expenditure side, as a saying goes, "reforms start when the money ends". This is exactly what happened in the case of Latvia. Money ended, so reforms started. Luckily, in quite a few areas we had well-prepared reform proposals - like in education or in health care - which were prepared, were documented, but then just put on a shelf and forgotten because they were not very popular; without some additional impetus, governments were just not willing to make those reforms. During the crisis, we had to implement those reforms on an accelerated pace and this is what we did; as a matter of fact, we also had to implement quite a few other reforms. There were various successful examples, for instance our reform of the defence command structure (basically moving from six different commands to one, which is now seen as a good example in NATO and actually used as an example on how to effectively restructure commands structures in NATO countries). We also made many across-the-board cuts, the most notable being wage reduction. Average wage in the public sector was reduced by some 25%; the average size of a Ministry was reduced by one third; the number of agencies has been cut by half. As you can imagine 17% of GDP fiscal adjustment is very serious, so we had to take very massive and serious adjustment measures in pretty much every field. It is easy to understand that all these fiscal adjustments also acted as a huge fiscal anti-stimulus and it must be noted that at that time still it was more fashionable to talk about fiscal stimulus to address the crisis (the IMF itself was writing working papers on fiscal policy during the crisis describing how to properly do fiscal stimulus).

In the case of Latvia it must be admitted that, of course, raising taxes and cutting expenditures during a recession does not act as a fiscal stimulus. However, what we could do to stimulate the economy was to use EU funds and this is exactly what we did: we accelerated to the maximum possible extent the absorption of the EU funds available to us, we re-allocated them to deal with the social consequences of the crisis, to support entrepreneurship and the industrial production. Those programmes were successful and acted as some kind of economic stimulus during the recession and during the fiscal adjustment. It was also quite important to deal with liquidity constraints which our businesses were facing therefore we introduced the export credit guarantee system as of June 2009. We were also working quite seriously to reduce red tape in many different fields. All in all, we tried to combine economic stimulus with the necessary fiscal adjustment.

The third element of our programme, as I mentioned before, was the social safety network we set to deal with the social consequences of the crisis. This was done mainly in cooperation with the World Bank and it proved to be very successful during the crisis. It involved many measures including a prolongation of payment of unemployed benefits, an increase of guaranteed minimum income benefit (which is a benefit you receive when your unemployment benefit expires), an improvement of accessibility of healthcare and medicines for poor people, help to local governments affected by school reforms to provide pupils' transportation and so on. Probably the most important measure we implemented was a very large temporary-works programme: by now more than 100,000 people have gone through this programme. I think that this programme was effective in two different ways. First, it really helped to soften the social consequences of the crisis and, second, it also served as a signal

that, while doing all those cuts and tax raises and adjustments, we still do take care of those which are worst affected. All those three elements combined – fiscal adjustment, economic stimulus and social safety network – I believe were the three key pillars in overcoming the financial and economic crisis.

Another element which was very important, and here maybe we were luckier than other countries currently facing problems, is that we had a broad degree of understanding in the society and with our social partners that we needed to go through this programme, that we had to do this kind of adjustment to overcome the crisis and that the right way to do so was to work together. We set a reform management group with employers' confederation, trade unions, chamber of commerce, local governments' union and we were deciding together which measures were to be taken. This is not to say that trade unions or employers' organisations were not criticising us, but at least they were partly involved and partly on board with this programme. I think that this aspect was quite important and it also helped to prevent the kind of social unrest we have seen in other countries.

After the conclusion of the programme, if you look at the macroeconomic data, they are quite convincing. This year budget deficit is planned below 2.5% of GDP. We stick with the intention to meet the Maastricht criteria this year to be able to join the Eurozone as of 1 January 2014. Economic growth last year was 5.5%, this year it is forecasted at 2.5% (our initial forecast was 4%, but then, given problems in the EU economy and the Eurozone crisis we had to revise the forecast downwards). Industrial production growth was also quite considerable. We had some 10% industrial production growth in 2010 and in 2011; we also had some 30% export growth in both of these years. Eventually, also registered unemployment went down to 11.5% and we expect further reduction this year. Not only we have overcome the financial crisis and reduced the budget deficit, but we are also back to economic growth. Even more important, the structure of the economy now is definitely more sustainable, with much more emphasis on industrial production and exports.

Talking about key lessons of this programme, I think that in the case of Latvia we had both components to have a successful programme. First of all we had certainly a sizable firewall (as it's now being called): EUR 7.5 billion was certainly a huge amount of money for Latvia. It convinced markets that there was enough money in the programme to deal with the crisis and it helped the markets to calm down. At the end of the day we did not need all these EUR 7.5 billion, but we used only EUR 4.5 billion. The second aspect is that we decided to frontload the fiscal adjustment. This aspect was also mentioned by Marco Buti: we did the bulk of the fiscal adjustment already in 2009. This helped to restore confidence in the financial markets and return to economic growth. Certainly we see that financial stability is a precondition for economic growth, because without financial stability it is impossible to finance public finances, capital starts fleeing the country, banks do not lend to businesses and citizens pushing down the economy deeper into recession. We can also draw some comparisons with some other programme countries which are trying to delay the adjustment: we actually see that delaying the adjustment is not helping: it is prolonging the recession and just making issues worse. Of course we had very difficult discussions with both the European Commission and the IMF on the size of the adjustment, but I think that at the end of the day this lesson is really quite clear: the frontloading of adjustment indeed helped to return to economic growth.

There was also a huge debate on whether to devaluate lats or not. I'll leave most of this debate to the Governor, but it was quite clear from the start that for a country as small and as open as Latvia, we would not gain much from devaluation, simply because any competitiveness gain would have been eaten away by inflation really quickly. It did make sense to move right away to the structural adjustment and do real reforms instead of just trying to devaluate the lats and then discover, one year or two later, that we need to devaluate again.

On the international economic debate, in 2008, Paul Krugman famously stated that Latvia is a new Argentina and that all ideas of fiscal adjustment and internal devaluation are doomed to fail. In 2012 the same Paul Krugman, talking on the very same topic, with the very same attitude, said that financial consolidation is not working and no country managed to return to the confidence of financial markets … except Latvia. There are indeed some reasons for this. Somehow he did not know those reasons in 2008, but luckily he noticed them in 2012.

To conclude, I believe that now we have a very good basis for future growth. What we need to do now is to concentrate on how to ensure stable economic growth, how to avoid another bubble, how to create jobs and growth - which is now one of the priorities in the agenda in Latvia. I also think that it is a very good coincidence that we are having this seminar just a day before signing the EU25 fiscal compact, which I think is demonstrating that fiscal discipline matters. It matters in the whole EU, in the Eurozone, in the EU25. I hope that this will also send a positive signal about the determination of the Eurozone to overcome its economic and debt crisis and it will help to avoid similar crises in the future. We are very much willing to join fiscal compact, because we have learnt in a hard way what consequences you have if you try to live beyond your means.

Thank you very much.

Ilmārs Rimšēvičs

It is really my pleasure to be here. First of all, I would like to thank the European Commission for this opportunity to advertise Latvia's success. I share Marco Buti's thoughts that maybe the title of the conference is optimistic, maybe it is a little bit premature, but nevertheless I think that today, when Latvia has finally completed its programme - and it is already spring 2012 - it is a very good time to look back at how the whole thing happened. Of course, nothing is better than if somebody else appreciates your success. Therefore it is really a pleasure to hear from Marco Buti himself that YES, the Latvian programme was a success; and this is not something we are only inventing ourselves.

I will not go through much of the history, but I think that, to understand Latvia's context and where its success lies, one should definitely learn how we got into trouble and how we got absolutely uncompetitive. During three years wages doubled; Latvia was living beyond its means and we were thinking that this was a never ending story that was going to continue forever. I think that there will be a lot of research around this area in the academia in the next several years: on how a country, having a current account deficit of more than 20%, could still be alive and not devaluing. I also think that one should not neglect that we had been borrowing at a pace probably not seen anywhere else before; in some years lending exceeded 100% growth annually.

2008 was indeed a very difficult time. After the Lehman crisis and after the difficulties of one of the commercial banks of Latvia, the crisis was really looming over Latvia. At that time interesting discussions and debates started. In our case in particular, the core of the discussion centred on whether it was possible for our country to go ahead with just consolidation or, as it was done by the IMF in many other cases before, the best medicine was just to devalue. I think we had a lot of interesting discussions whether this is the right way of going forward and I think that somehow we felt there is a support in Washington and in Brussels that Latvia will be given the chance to do it itself. And I think it is important also this morning to hear from Marco Buti that, yes, there was a wider context, a wider discussion with the European partners. Maybe it was also due to the consequences of what might happen to Latvia and of possibly huge spill-over effects, but we were given the chance because we ourselves, at that time, absolutely knew that there was not any other option. There was only one option: Latvia had to unwind all the imbalances, all the instabilities which had been created during the boom years. There were absolutely no benefits, not a single one, which would speak for devaluation. All the positive effects of devaluation associated with increasing exports, if any, would be wiped out - as the Prime Minister just mentioned - in a couple of months and there would be a new wave of inflation around the corner.

Indeed at that time there were many vocal voices telling "Yes, Latvia is Argentina 2". We will never know exactly what were the discussions held in Washington. Without a doubt there were many sceptical people, but I would like to thank the colleagues who have been in the team working with Latvia for their courage, for their trust in Latvia in those lengthy late-in-the-night discussions - when it was already around twelve o'clock in Latvia and maybe five or four o'clock in Washington. We were given the chance to go ahead and to do what was necessary. Indeed it was very important for us. If somebody said that we would be "Argentina 2", it gave us the necessary strength and courage to tell: "NO, we are going to be Latvia 1".

Another aspect important to be mentioned when we speak about Latvia's success centres on the remark: "yes, you did it, but it is not doable for anybody else". Paul Krugman said something along these lines: "something we don't really understand, something mysterious has happened there, but let's come back to Greece, this is not attributable or usable anywhere else". I would strongly DISAGREE with those statements. I definitely think that there has been some time lost and you cannot simply replicate this programme, especially if you do not start from scratch but after you are already four or five years in a different story. As a matter of fact, I think that a key feature of Latvia's programme is that there was a huge frontloading of consolidation in the first two years. What we observed during these two years is that once the programme was in full swing, then speed was everything. It was very crucial to give the chance to the public – what the Prime Minister was referring to – to see that the programme is working and there is potential for growth.

What this crisis, this programme and this consolidation exercise clearly showed is that "less is more". This is something very difficult to grasp, after we have all been learning in school economic textbooks that during a crisis you have to stimulate, put more money into the economy just as everybody is swimming in liquidity (or, as we sometimes say "throw the money out of the helicopter"). However, by bringing the finances in order and cleaning expenditures - returning to a level of expenditures which is sustainable in the long run - we started to see growth in the second half of the 2010. And I think this was very crucial. Looking at the macroeconomic figures you can see that three countries - three Baltic states - with fixed exchange rates (Estonia is not anymore, but still was until 2010), were producing the highest level of growth.

I think it is very important, when you look at the Latvian programme, that you clearly distinguish four elements. This is the core reason why Latvia and the other Baltic states managed to carry out successfully this programme, whereas it seems so difficult for others. One is frontloading of the consolidation exercise: because, if you know that you will have to do it sooner or later frontloading is exactly the key. Number two is not to create the image that somebody is imposing this on you. This programme was not really imposed on Latvia: it was absolutely owned by the Latvian government and all the measures and all the consolidation were done by the Latvian parliament and government. Third, there was outside trust that the country could do this on its own, and the commitment was clearly there. Fourth and last, but not least, an important element is also solidarity across the board on all levels of the society. This was the only way out and there was no way that Latvia or any other country could do something else.

I believe that some time has been lost in some other countries and it is more and more difficult, but if in the future there will be similar situations, then Latvia's experience will be very valuable. In Latvia, we tried to coin phrases like "less is more" or "expansionary consolidation". We also knew from the very beginning that, once we started this programme, Latvia will write a new chapter in macroeconomic books. Yes, there is no reason for a very huge optimism, but there is at least some cautious optimism. In any case the story would not be complete if Latvia were not fulfilling all the Maastricht criteria. Therefore, as it was written in the programme – in all the memorandums on which the whole exercise was based – that the Euro introduction is the exit strategy. I think that the book on Latvia and financial crises resolution will only be completed when we join the EMU. Hence I believe that this is a very crucial time. Latvia has really gone through very difficult and challenging times. Now the Latvian authorities and the government should continue to work together to strengthen the success which has been achieved during the last several years. I think it would be very sad if we lost what we have achieved so far. Therefore I would like to wish everybody here today very interesting discussions and I hope that people will be able to answer all the difficult and tough questions, because this situation and this experience –we have lived in Latvia – needs more analysis. I wish you a very good work and, once again, thanks to everybody who helped to organise this conference today.

Thank you.

Part I – Macroeconomic Imbalances and external competitiveness

Chapter 1 – External capital flows, international price competitiveness and short-term economic growth in Latvia

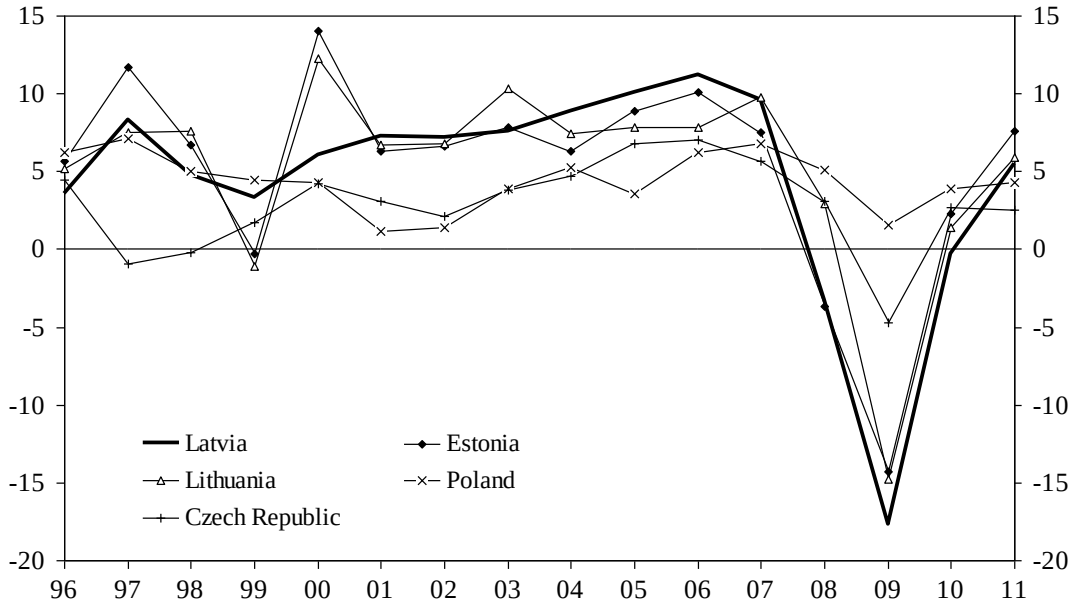
Karsten Staehr [1]

I. Introduction

Latvia is one of the 10 countries from Central and Eastern Europe (CEE) which joined the European Union in 2004 or 2007. The country regained independence in 1991 and experienced a very deep recession during the first part of the 1990s. Positive growth rates returned from the mid-1990s when the transitional recession had run its course. Economic growth was held back in 1998-1999 following the Russian financial crisis, but the most dramatic event was the economic downturn in 2008-2010 following the global financial crisis. Latvia experienced an output drop of 17.7% in 2008 and positive full-year growth only returned in 2011.

Figure 1.1 shows the GDP growth rates for Latvia, Estonia, Lithuania, Poland and the Czech Republic for the period 1996-2011 (where the 2011 observation is a forecast of the European Commission). Three observations are in place. First, the average or trend growth rate has been high in Latvia. This is, however, a feature of most CEE countries, arguably connected with the catch-up process of these countries. Second, the GDP movements are rather similar across the three Baltic countries but are much more volatile than in Poland and the Czech Republic. Third, the Latvian economy experienced a pro-longed boom from the Russian crisis and until 2007. Remarkably the growth rate increased in every single year during this period.

Figure 1.1: Annual GDP growth in Latvia and four other CEE countries, percentage



Source: Eurostat

[1] Martins Bitans, Juan Carlos Cuestas, Francesco Di Comite and Radoslav Krastev provided useful comments to a previous version of the paper, but do not carry any responsibility for the final product. The views expressed are those of the author and not necessarily those of the institutions to which he is affiliated.

The long period of increasing growth rates during the boom period was accompanied by the build-up of macroeconomic imbalances. The inflation rate increased markedly and reached double digit levels in 2007 in spite of the Latvian lats being linked to first the SDR and later the euro. The high inflation levels in combination with the fixed exchange rate led to deteriorating international price competitiveness. Meanwhile, capital inflows grew throughout the boom period, especially after Latvia joined the European Union in 2004. The current account balance, a conventional measure of capital flows, exhibited deficits above 10% of GDP for each year during the period 2004-2008.[2] The crisis in 2008-2010 was characterised by a very substantial reversion of external capital flows, a sudden stop (Calvo, 1998). A current account deficit of 22% of GDP in 2007 was turned into a surplus of almost 9% of GDP in 2009. A range of other macroeconomic indicators show similar dramatic developments.

The pronounced pattern of short-term economic growth in Latvia and the highly volatile macroeconomic environment have affected the livelihood of Latvians in dramatic ways. Rapidly increasing incomes and lower unemployment during the boom was replaced by falling incomes, higher unemployment and increasing poverty. It is nonetheless certainly safe to argue that the underlying causes for the pronounced pattern of GDP growth have not been fully identified.[3]

The objective of this chapter is to ascertain the importance of two of the arguably most important factors driving short-term changes in economic growth in Latvia, viz. changes in external capital flows and changes in international competitiveness. The aim of the analysis is to provide quantitative information on the importance of two factors. For this purpose, the analysis is structured in two parts. The first part comprises panel data estimations in which the growth rate of the 10 EU members from Central and Eastern Europe is explained by measures of external capital flows and changes in international competitiveness in additional to various control variables. The second part uses the slope estimates from the panel data estimations to compute the contributions of, respectively, external capital flows and changes in international competitiveness to economic growth in Latvia since the late 1990s.

The two factors, external capital flows and international competitiveness, have been chosen because a substantial academic literature has focused on these measures and their impact on economic growth in the short term (see the review in Section II). The two factors may be proxied by variables that can be kept under surveillance and possibly affected through policy measures. The factors have also been singled out by the European Union as important gauges of economic performance. In the spring of 2011, the EU countries agreed to the Euro Plus Pact, which posits new policy commitments and an adjacent monitoring regime. EU countries must inter alia target unit labour costs to ensure that they are internationally competitive and also avoid the build-up of financial imbalances (European Council, 2011).[4] Another piece of EU regulation, agreed in 2011, is the Excessive Imbalance Procedure (European Commission, 2012b). The Procedure comprises a scoreboard of different indicators of macroeconomic imbalances, which is monitored by the European Commission. A main indicator of macroeconomic imbalances in this framework is the current account balance.

Evidently the literature dealing with the growth performance of Latvia and other CEE countries is plentiful; space constraints imply that only a few studies can be discussed. The economic survey in OECD (2000) discussed impediments to economic growth in the Baltic States and stressed the importance of financial sector development. ECFIN (2010) provides a broad discussion of economic challenges in the Baltic States. Chapter 2 considers the accumulation of financial imbalances in the run-up to the global financial crisis and Chapter 3 provides a discussion of financial sector developments. Chapter 5 discusses the growth performance and the future prospects in the light of developments of international competitiveness, but there is little emphasis on financial flows in this

[2] The current account balance and the capital and financial account (including changes in international reserves) always sum to zero. This implies that, for instance, a current account deficit must be financed by a surplus on the capital and financial account (including changes in international reserves).

[3] This point was also explicated in the Call for Papers for the European Commission Latvia Country Seminar, ECFIN/G/2011/020.

[4] Competitiveness was also at the centre of the EU's Lisbon Strategy from 2000, according to which the European Union should strive to become "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth…" (European Council, 2000).

context. Purfield and Rosenberg (2010) consider the three Baltic States and chronicle the developments during the boom in 2004-2007, the subsequent crisis and the adjustment process that followed the crisis. Developments in financial markets and international competitiveness are the two main factors discussed, but the effects on economic growth are not quantified.

Hansen and Kvedaras (2004) examine economic growth in the Baltic States and estimate growth rates consistent with different rates of capital inflow. For the period before EU entry, they find that whereas growth in Estonia and Lithuania might have been restrained by the availability of external capital inflows, this is not the case for Latvia. Bajo-Rubioa and Diaz-Roldanb (2009) undertake a similar exercise on a larger set of CEE countries and find that until 2007, Latvia, among other countries, attained growth rates substantially in excess of levels consistent with a sustainable path of the current account balance. Shelburne (2009) also stresses the large current account deficits in the CEE countries prior to the global financial crisis and argues out that the eventual assessment of the growth model in CEE depends on their ability to finance their often substantial current account deficits.

This chapter contributes to the literature in three ways. First, it discusses different factors of importance for short-term economic growth with particular emphasis on the short-term effects of external capital flows. Second, it estimates short-term growth regressions for the CEE countries in which capital flows and competitiveness are the main explanatory variables. This quantification is novel in the context of CEE countries and enhances the policy relevance of the chapter.[5] Finally, the chapter discusses the Latvian economic development based on simulations seeking to uncover the contribution of capital flows and competitiveness. A better understanding of the causes is important for identifying the vulnerabilities of the Latvian economy and possibly also for forecasts of future growth.

The rest of the chapter is organised as follows: Section II provides a conceptual framework for explaining short-term economic growth in emerging economies. Section III presents the data and shows graphs to guide the empirical analysis. Section IV comprises the baseline panel data estimations along with a number of alternative specifications. Section V computes the contributions of capital flows and competitiveness to economic growth in Latvia. Finally, Section VI summarises the chapter and draws some policy conclusions.

II. Factors driving short-term economic growth

Economic growth has the potential to transform livelihoods and societies over time. Long-term trends in economic growth are typically measured as averages across over long time intervals (5 or 10 years or longer) so that the long-term growth data are not unduly affected by short-term fluctuations. Empirical research generally finds evidence of beta convergence, i.e. long-term growth is, ceteris paribus, faster in countries with low initial income than in countries with high initial income. Factors such as investment levels, education attainment and openness are other factors that most empirical studies find to have a positive effect on economic growth (Barro and Sala-i-Martin, 1995). The multitude of factors of potential importance for long-term economic growth, multicollinearity between the factors, and the limited number of observation points make it difficult to attain precise and robust results in empirical growth studies (Mankiw, 1995).

The factors seen to affect long-term economic growth are almost exclusively supply factors affecting the productive capacity of an economy. It is outside the scope of this chapter to analyse factors that drive long-term economic growth in the CEE region as the number of countries is small and reliable data are generally only available from the mid-1990s. Instead, the chapter focuses on the factors driving economic growth in the short and medium term. Given this perspective it is reasonable to focus on annual GDP growth.

[5] The use of panel data estimations is necessitated by the low number of observations available for Latvia alone. Robustness analyses suggest that the marginal effects of external capital flows and international competitiveness for Latvia are likely fundamentally different from those estimated for the panel of 10 CEE countries.

Growth performance in the short and medium term is affected by both supply and demand factors. The supply factors are those affecting the production capacity, for instance the capital stock, the labour stock, education levels etc. These factors are likely to change relatively slowly and may therefore be of secondary importance for short-term growth performance. One exception may be sudden shifts in oil prices and other inputs, which make certain production processes uneconomical and, hence, affect the production capacity. Another possible exception may be changes in migration patterns, increasing or reducing the labour force.

In the short term, demand factors are likely to play a dominant role for changes in economic growth and for other business cycle indicators. Demand changes from year to year and leads to changes in GDP growth rate associated with changes in total factor productivity and/or the degree of capacity utilisation. Two factors have received particular attention in European policy-making and policy discussion, viz. international competitiveness and external capital flows. The theory and empirical evidence linking these two factors to short-term economic growth are discussed in turn.

International price competitiveness

There are many different definitions of competitiveness, often distinguished by the way they are measured (Boltho, 1996). In this context competitiveness refers to international price competitiveness, which is a measure of the cost of domestically produced goods relative to the costs of goods produced abroad. The level of competitiveness at a given point in time is dependent on the structure and quality of production. An improvement in international price competitiveness takes place when the relative cost of domestic production declines – given that the production structure and quality remain largely unchanged.

Changes in competitiveness can affect demand and output (Boltho, 1996; Romer, 2011). Improved competitiveness will stimulate demand from foreign markets or from domestic markets competing with import. The demand effect may, however, be subject to a lag due to long-term contracts, contracting in foreign currency, etc. (j-curve effect). The demand stimulus from improved competitiveness will increase production in the short term provided sufficient production capacity is available. Conversely, increased costs and/or lower productivity will lead to deterioration of international price competitiveness, which causes domestic production to lose market share at home and abroad and the end result is lower demand and downward pressure on economic growth.

The longer-term effects of changes in competitiveness shock are likely to hinge on the structural functioning of the economy. An improvement in competitiveness may have longer-term effects on output if additional production capacity is installed in anticipation of the increase in demand. Rodrik (2009) notes that several East Asian countries have successfully implemented development strategies that seek to retain a depreciated real exchange rate over long periods of time in order to stimulate export-driven economic growth.

The conception that international competitiveness effects output growth is alluring, but the operationalisation is not straightforward. First, it is an empirical regularity that the price level of a country measured in a common currency broadly follows the income level of the country. This holds whether consumer prices or the GDP deflator are considered. Moreover, as income increases over time, the price level also increases; a regularity which has been labelled the Dynamic Penn Effect (Ravallion, 2010).[6] This effect has also been found to hold for the 10 EU countries from Central and Eastern Europe (Staehr, 2012). The upshot is that measures of international competitiveness computed as the domestic price level relative to the foreign price level (in common currency) will generally exhibit a positive co-variation with relative income levels. This issue must be addressed in empirical studies in order to avoid biasing the results unduly.

[6] This tendency of income levels and price levels (in a common currency) to move in parallel is sometimes labelled the *Balassa-Samuelson effect*. This is, however, misleading as the Balassa-Samuelson effect is a *theoretical explanation* of an empirical regularity, the Dynamic Penn Effect. The Balassa-Samuelson effect, incidentally, receives very little empirical support in the case of the CEE countries (Egert, 2008).

Many studies have found that international competitiveness is important for growth performance, but studies generally focus on the medium- and long-term effects. Fagerberg (1988) is an early study regressing output growth on changes in unit labour costs and a number of control variables. The sample consists of 15 industrialised countries and the time sample is 1960-1983. The finding is that changes in unit labour costs affect economic growth, although rather modestly. Razin and Collins (1999) use a large sample of developing and high-income countries and find that moderate, but not extreme, real exchange rate undervaluation, is beneficial to economic growth.

Rodrik (2009) constructs a measure of real exchange misalignment as the actual real exchange rate minus the predicted real exchange rate given the income level. This variable is used as an additional explanatory variable in standard growth regressions and it attains a positive coefficient that is statistically and economically significant. The conclusion is that the real exchange rate is of importance for the long-term growth performance of emerging economies.

Krugman (1994) posits that the focus on international competitiveness is a "dangerous obsession" and argues that policymakers should instead focus on the trend productivity development as the production per capita will eventually determine the resources available. Eichengreen (2007a) discusses the use of the real exchange rate as a policy tool to maintain stable growth. He argues that the lack of compelling theories explaining the links between international competitiveness and economic growth is regrettable as it makes it difficult to assess the policy-relevance of the empirical studies finding such a link.

External capital flows

Capital flows take many forms, including foreign direct investment, portfolio investment, loans, etc. The standard neo-classical theory of international capital flows posits that capital flows from countries with a low return to countries with a high return. Capital import allows a country to expand its production capacity and to bring consumption spending forward in anticipation of higher income in the future. The standard one-sector neo-classical model typically posits that capital inflows have a positive supply effect, occurring with a certain lag (Obstfeld and Rogoff, 1996; Prasad et al. 2007).

The direction of capital flows predicted by standard neo-classical theory is often not supported in empirical studies. Lucas (1990) raises the question why capital in many cases flows from low-income countries with a small capital stock to high-income countries with abundant capital. Kaminsky et al. (2005) find that capital inflows are pro-cyclical, which is not immediately consistent with the neo-classical model. Kim (2000) uses VAR models for four middle-income countries and uses structural decomposition analysis to trace the causes of capital flows. The conclusion is in all cases that external factors, such as world interest rates and foreign business cycles, play a dominant role, while domestic factors are rather unimportant. Calvo et al. (1996) provide a broad discussion based on a sample of emerging market economies and reach similar conclusions. The overall conclusion may be that capital flows in practice are difficult to predict and often exhibit pro-cyclicality or result from external factors.

Notwithstanding the long-term effects, capital flows present a number of macroeconomic adjustment issues in the short term, potentially complicating short-term macroeconomic management. The implied macroeconomic adjustment has been the focus of economic analysis in several directions, the transfer problem, the Dutch disease and foreign aid effectiveness (Cardoso and Dornbusch, 1989; Bosworth and Collins, 1999).

The most straightforward link between international capital flows and short-term economic growth is that capital flows may affect demand such as private consumption, investment and government spending (Obstfeld, 1998; Bosworth and Collins, 1999). We consider cases of capital inflow and capital outflow separately. Inflow of capital increases demand. The increase of demand for traded goods can be met externally, but the increase of demand for non-traded goods can only be met by domestic production. If nominal rigidities are present in the short term, the effect is increased non-traded production, while traded production keeps up. The short-term net effect of capital inflow is a

demand-driven boom in the non-tradable sector.[7] Outflow of capital reduces demand. This will lead to a lower demand for tradable and non-tradable products, which will harm production in the non-tradable sector in the presence of sluggish adjustment. Calvo (1998) drew attention to sudden stops, where a period of capital inflow is followed by an abrupt stop of a capital inflow or possibly a reversal leading to an outflow. Emerging-market economies appear to be especially prone to sudden stops, frequently followed by very substantial output losses (Edwards, 2004).

The literature on the balance of payments constraint stemming from the 1970s also stressed the importance of external capital flows for economic growth (Thirlwall, 1979; Thirlwall and Hussain, 1982). The main argument was that net export (export minus import) is closely related to the income level in the short term. If income increases, net export drops, potentially leaving a current account deficit. A current account deficit requires, however, that external financing is available. The implication is that the balance of payments constrained income growth, at least in the short term.[8] This demand-view on the linkage between capital flows and economic growth is also a main component of the Two-Gap Model formulated by Chenery and Strout (1966).

The balance of payments constraint was often circumscribing or even engulfing economic policy in Western European countries in the period until liberalisation of the capital account in the 1970s. Governments were repeatedly forced to implement contractionary policies as current account deficits were difficult to finance and therefore threatened to exhaust foreign currency reserves (Eichengreen, 2007b).

Empirical studies on data from the 1960s and 1970s gave support to the hypothesis that availability of external financing had a substantial impact on economic performance. Thirlwall and Hussain (1982) conclude for instance that: "…it is difficult to believe that the growth process, and constraints on it, can be understood properly in most countries without reference to the balance of payments."

Empirical challenges

The discussion above suggests that it is reasonable to hypothesise that improved price competiveness as well as net capital inflows stimulate economic growth in the short run. This is essentially the model which will be estimated in Section IV. It is also clear that an empirical implementation of this model poses some challenges.

First, measures of competitiveness and capital inflows are likely endogenous with respect to economic growth. Rapid increases in output may lead to inflation and an appreciating real exchange rate with deteriorating price competitiveness as the result. Economic growth may also increase import demand and lead to a deterioration of the current account balance. Second, competitiveness and capital flows might be mutually interdependent (Calvo et al., 1993; Aherne, 2008; Bakardzhieva et al., 2010). Large capital inflows may lead to an appreciation of the real exchange directly through nominal exchange rate appreciation or indirectly through domestic inflation. Deteriorating competitiveness may also lead to external imbalances. It may, up to a point, be possible to address the endogeneity and multicollinearity issues through the choice of appropriate lag structures and/or instrumentation of the explanatory variables.

III. Sample and data

The empirical analysis is carried out on a panel consisting of the 10 countries from Central and Eastern Europe that joined the EU in 2004 or 2007. The data are annual and the sample generally runs from 1996 to 2010, but sometimes forecasts for 2011 are used in descriptive presentations and in simulations. Missing observations for Bulgaria and Romania imply that the sample generally is

[7] In the longer term the increased demand for non-traded goods might be met by transferring resources from the traded sector, which will be facilitated by a real appreciation. The academic debates on the *transfer problem*, the *Dutch disease* and foreign aid effectiveness relate to the size and the consequences of such real appreciation following an inflow of resources.

[8] Other contributions to the literature include *inter alia* McCombie and Thirlwall (1994), McCombie and Thirlwall (1997), McCombie and Roberts (2002), McGregor and Swales (2006) and Moreno-Brid (1998).

unbalanced. All data are downloaded from the web-based database of Eurostat and are current as of 18 April 2012.

The dependent variable is annual percentage output growth, GY. The variable is downloaded from the Eurostat database (classifier: nama_gdp_k). The dataset contains a number of additional variables, of which two are the main explanatory variables, viz. the annual percentage growth in relative unit labour costs, GRULC, and the current account balance as percentage of GDP, CA.

The unit labour cost is used as a proxy for international competitiveness for two reasons. First, the variable is subject of monitoring by the European Commission (as discussed in Section I). Second, the variable is computed as remuneration per time unit divided by production per time unit. The Dynamic Penn effect posits that price and income levels co-vary over time. The division of the remuneration by the production implies that the unit labour cost does not necessarily drift in case of high trend productivity growth.

An index of nominal unit labour cost is downloaded from the Eurostat database (classifier: nama_aux_ulc). For the countries using their own currencies, the index is converted to common European currency units (ECU/EUR) using the annual average exchange rate from the Eurostat database (classifier: ert_bil_eur_a). For the countries participating in the euro area (Estonia, Slovenia, Slovakia), the index is denominated in "euro fixed" units (i.e. the index values prior to the adoption of the euro are converted to EUR/ECU using the irrevocably fixed rate). To ensure comparability across the sample countries, the indices are converted into EUR/EUR terms using the time-varying conversion factors reflecting the exchange rate of the national currency against the EUR/EUR (Eurostat classifier ert_bil_conv_a). The variable GRULC is then calculated as the percentage change in the unit labour cost in the CEE country relative to the unit labour cost in the EA12 euro area. A positive GRULC signifies that the unit labour cost increases faster in the CEE country than in the EA12, and the CEE country is therefore losing competitiveness vis-à-vis the euro area. A negative GRULC indicates improved competitiveness vis-à-vis the euro area.

International capital inflows make resources available for domestic absorption, while outflows remove resources. This makes it logical to use the current account balance as the measure of capital flows in the empirical analysis. The current account balance depicts the difference between production and absorption in a country. In the balance of payment statistics, the current account balance is equal to the sum of the capital account balance, the financial account balance and changes in international reserves.[9] The financial account is of greater importance as it comprises foreign direct investment, portfolio investment and loans and other debt-related transactions. The CEE countries have often had substantial current account deficits financed by a net capital inflow, and this inflow has typically taken the form of a financial account surplus. The current account balance, CA, as a percentage of GDP is taken from the Eurostat database (classifier: bop_q_gdp).

Beyond the dependent variable and the two main explanatory variables, a number of other variables are occasionally used as control variables or instruments. The variable YPPP denotes the purchasing power parity adjusted per capital income as a percentage of the EU15 average. The source is the Eurostat database (classifier: nama_aux_gph). The Latvian GDP per capita adjusted for purchasing power was 28.1% of the EU15 average in 1996, peaked at 50.5% in 2008 and reached 46.8% in 2010. The variable GYEU15 depicts the average rate of economic growth of the EU15. The source is the database of Eurostat (classifier: nama_gdp_k). Finally, the dataset contains a dummy variable, DUM2009, which is equal to one in 2009 and zero otherwise; the variable equals one in the year in which the fallout of the global financial crisis peaked.

IV. Panel data estimations

The panel data analysis is based on annual data for the 10 new EU members from Central and Eastern Europe with data which generally cover the sample period from 1996 to 2010. The aim is to explain

[9] A bit confusingly, the capital account is usually of little importance as it only comprises certain types of foreign aid and transactions related to intangible assets.

the dependent variable, economic growth, using measures of external capital flows and international competitiveness as explanatory variables. Early experimentation made it clear that it is infeasible to reach one superior model encompassing all other specifications. Instead the estimation strategy will entail the estimation of a number of models using different samples, variables, estimation methodology etc., in order to attain a broad picture of the effect of the two dependent variables on short-term economic growth in the CEE countries.

The baseline estimation is a relatively parsimonious specification in which economic growth, GY, is regressed on the change in relative unit labour cost, GRULC, and the current account balance, CA. The estimation includes country fixed effects, which control for country-specific factors that do not vary over time. It follows from the discussion in Section II that it is reasonable to assume that the variable enters with a lag, since it will take time before changes in international competitiveness lead to changes in export and import quantities and, hence, output (j-curve effect). It turned out that the estimation results in all cases were better when the variable GRULC was lagged two years than if it was lagged one year, so GRULC is in all cases entered with a two-year lag.[10] The contemporaneous value of the current account balance should enter in order to capture the short-term demand effect of capital flows.[11] This gives rise to a potential endogeneity problem, an issue which will be addressed at the end of the section.

Table 1.1 shows the first set of results using Fixed Effect OLS estimation (FE-OLS). Columns (1.1) and (1.2) show the results when the change in relative unit labour costs and the current account balance are included separately (along with country fixed effects). Column (1.3) shows the baseline estimation with both explanatory variables and country fixed effects. The estimated slope coefficients have small standard errors, attain the expected sign and are of substantial magnitudes. If the unit labour cost increases one percentage point faster than in the EA12 euro area, economic growth is reduced by 0.16 percentage points after a couple of years. An increase by one percentage point in the contemporaneous current account balance as a share of GDP is associated with a reduction of economic growth of slightly less than 0.5 percentage point. These point estimates are broadly in line with those found in Columns (1.1) and (1.2).

Table 1.1: Estimation of economic growth in the CEE

	(1.1)	(1.2)	(1.3)	(1.4)	(1.5)	(1.6)
GRULC(-2)	-0.168*** (0.047)	..	-0.160*** (0.046)	-0.155*** (0.047)	-0.322*** (0.079)	-0.359*** (0.104)
CA	..	-0.472*** (0.119)	-0.482*** (0.108)	-0.453*** (0.091)	-0.562*** (0.142)	-0.480** (0.147)
Constant	4.561*** (0.452)	1.010 (0.911)	1.670** (0.802)	1.816** (0.651)	2.514 (1.544)	2.494 (1.611)
R^2	0.121	0.270	0.364	0.330	0.530	0.757
Countries	10	10	10	10	3	1
Time	1998-2011	1998-2011	1998-2011	1998-2011	1998-2011	1998-2011
Observations	133	140	133	133	42	14
Method	FE-OLS	FE-OLS	FE-OLS	OLS	FE-OLS	OLS

Notes: Robust standard errors are shown in brackets. Superscripts ***, **, * denote that the coefficient estimate is statistically different from 0 at the 1, 5 and 10% level of significance, respectively

[10] An increase in the relative unit labour cost increases, ceteris paribus, the level of the relative unit labour cost in the following periods. It is therefore not unreasonable that economic growth subsequently reacts to the changed level of international competitiveness. Experiments in which (the logarithm of) the *level* of relative unit labour cost was used as an explanatory variable were unsuccessful. The estimated coefficient of the level was usually statistically insignificant and the sign very sensitive to specification changes.

[11] Table A1 in Appendix A provides estimations of GDP growth in which different lag structures of the two explanatory variables, GRULC and CA, are used. It follows that contemporaneous GRULC has no explanatory power, while the effect GRULC(-1) is negative but estimated imprecisely. The coefficients of the lagged CA are positive and statistically significant. The latter result may suggest that changes in the current account, CA – CA(-1), has explanatory power, an issues which will be pursued below.

The estimated country fixed effects are generally small (with the partial exceptions of Bulgaria and Poland). Column (1.4) shows the results when the baseline model is estimated using OLS without country fixed effects. The estimated slope coefficients remain largely unchanged and the coefficient of determination is only reduced marginally. This suggests that the two explanatory variables explain a very substantial part of the variation in rates of economic growth across the sample countries. Different country performance may to a large extent be explained by different development of competitiveness and capital flows.

The overall results of baseline model (1.3) also apply to samples consisting of subsets of the 10 CEE countries. Column (1.5) shows the results when only the three Baltic countries are included. The slope coefficients retain their statistical significance and actually increase in numerical terms; the coefficient of the two-year lagged growth in relative competitiveness is -0.322 (higher in numerical terms), while the coefficient of the current account balance is -0.562 (essentially unchanged). The upshot is that international price competitiveness matters not only for the whole CEE sample but also, and possibly more, for the Baltic countries. Column (1.6) shows the results, when the reduction of the country numbers is taken to the extreme and the sample includes only Latvia. Surprisingly the results are broadly the same as in model (1.5). The sample in model (1.6) is clearly very small, but the results nevertheless suggest that the drivers of short-term economic growth in Latvia are not fundamentally different from those in the full CEE sample.

Results that in qualitative terms are very similar to those in Table 1.1 can also be attained if the change in the unit labour cost is replaced by the change in the real exchange rate (not shown). This suggests that the specific choice of variable proxying international price competitiveness is of secondary importance.

Table 1.2 shows the results when the time sample is shortened and additional control variables added. Column (2.1) repeats the baseline estimation but shortens the sample to end in 2006 and, thus, excludes the years covering the global financial crisis. The estimated coefficients are substantially smaller in numerical terms, suggesting that the gyrations of the global financial crisis affected the estimated coefficients markedly. This hypothesis is examined further in model (2.2) which uses the full time sample, but includes a dummy variable taking the value one for 2009. The estimated coefficient of the dummy is -10.6, reflecting the severity of the global financial crisis in most of the CEE countries. An arguably better way to account for external economic developments is to include the rate of economic growth in the EU15 as a control variable. The result is shown in Column (2.3). It is noticeable that the estimated coefficient of GYEU15 is more than one; almost all the CEE countries were more severely affected by the global financial crisis than the Western European EU countries. If the coefficient of GYEU15 is restricted to one (not shown), the slope estimates of GRULC(-2) and CA are close to those in Column (2.3).[12]

The conclusion from the sensitivity analyses in Table 1.2 is that the estimated coefficients in the baseline specification in (1.3) may be rather large in numerical terms, in particular the coefficient of the current account balance. Still, when controls for the global financial crisis are included, the coefficients estimates retain their sign, magnitude and statistical significance. It may be argued that the estimates in Columns (1.3) and (2.1) span the likely range of marginal effects, which are reasonable given the available data.

Column (2.4) shows the results when the current account balance is replaced by its change, i.e. CA – CA(-1). The estimated coefficient of the new explanatory variable is -0.794 and it is highly significant. At the outset it might be difficult to discriminate between the baseline estimation in Column (1.3) and the present one. The coefficient of CA – CA(-1) is, however, very sensitive to sample changes and inclusion of additional control variables. It may also lead to unreasonably large contributions from the current account balance during times of large changes in the balance.

Column (2.5) suggests that the lagged growth rate is without explanatory power; there is no persistence left in the rate of GDP growth when changes in the unit labour cost and the current

[12] If the baseline model in Column (1.3) is estimated using time fixed effects in addition to country fixed effects the estimated slope coefficients are very close to those in Columns (2.2) and (2.3).

account balance are taken into account. The lagged income level, YPPP(-1), attains a coefficient estimate that is statistically significant, but its size is unreasonably large (in numerical terms). It is noticeable, however, that the estimated marginal effects remain very similar to those in the model without the lagged income.

Table 1.2: Estimation of economic growth in the CEE, alternative specifications

	(2.1)	(2.2)	(2.3)	(2.4)	(2.5)	(2.6)
GRULC(-2)	-0.096** (0.039)	-0.098*** (0.033)	-0.126*** (0.034)	-0.075** (0.034)	-0.160*** (0.046)	-0.167*** (0.042)
CA	-0.197** (0.094)	-0.304*** (0.054)	-0.296*** (0.061)	..	-0.461*** (0.132)	-0.424** (0.090)
DUM2009	..	-10.598*** (1.442)	..	..	..	..
GYEU15	..	..	1.422*** (0.186)	..	..	..
CA – CA(-1)	..		..	-0.794*** (0.101)	..	..
GY(-1)	..	..	..	..	0.036 (0.089)	..
YPPP(-1)	..	..	..	..	..	-0.238*** (0.060)
Constant	4.419 (0.765)	3.252*** (0.420)	0.313 (0.599)	4.444*** (0.297)	1.646** (0.795)	13.973*** (2.821)
R^2	0.447	0.664	0.661	0.569	0.365	0.474
Countries	10	10	10	10	10	10
Time	1998-2006	1998-2011	1998-2011	1998-2011	1998-2011	1998-2011
Observations	83	123	123	123	123	123
Method	FE-OLS	FE-OLS	FE-OLS	FE-OLS	FE-OLS	FE-OLS

Notes: Robust standard errors are shown in brackets. Superscripts ***, **, * denote that the coefficient estimate is statistically different from 0 at the 1, 5 and 10% level of significance, respectively

The final issue to be addressed is the possibility of reverse causality. Given the two-year lag of GRULC, the main problem relates to the current account balance, CA, which enters the estimations in contemporaneous form. The discussion in Section 2 suggested that whereas the current account balance might affect economic growth, economic growth might also affect the current account balance.[13] The use of instrumental variables may facilitate identification of the effect from the current account balance to economic growth, provided good instruments are available. Two different instrumentation schemes will be applied to judge the sensitivity of the results to different sets of instrumental variables. The results are presented in Table 1.3.

Column (3.1) in Table 1.3 shows the results when baseline model (1.3) is estimated using Two-Stage Least Squares in which the current account balance is instrumented. The additional instruments chosen are the one period lagged purchasing power parity adjusted income level of the country and the contemporaneous, the one period lagged and the two period lagged EU15 growth rate. The choice of instruments are guided by studies showing that both external and internal factors play a role for capital movements to CEE countries and other emerging markets (Lipschitz et al., 2002; Kaminsky et al., 2005; Lane and Milesi-Ferretti, 2007; Jevcak et al., 2010).[14] The estimated coefficient of changes

[13] The direction of causality is not of vital importance for the main finding of this chapter, namely that the availability of external financing has played a major role for economic growth in the CEE countries. Assume for the sake of the argument that the causality goes from economic growth to the current account balance. Rapid economic growth would then lead to current account deficits, but such deficits would need to be financed, i.e. economic growth is subject to a balance of payments constraint (Thirlwall, 1979; Chenery and Srout, 1966).

[14] The results of the first stage estimation of the current account balance were plausible; the coefficient of GRULC(-2) was statistically and economically insignificant, the coefficient of YPPP(-1) was positive and statistically significant, and the coefficients of GY, GY(-1) and GY(-2) were all negative and statistically significant.

in the relative unit labour cost is little changed, but the coefficient of the current account balance has become larger in numerical terms and is relatively large.[15] The exercise nevertheless shows that the negative relationship between the current account balance and economic growth is robust to instrumentation of a potentially endogenous explanatory variable.

Table 1.3: Estimation of economic growth in the CEE, instrumental variable estimation

	(3.1)	(3.2)	(3.3)	(3.4)
GRULC(-2)	-0.156*** (0.044)	-0.094** (0.045)	-0.157*** (0.043)	-0.095** (0.042)
CA	-0.740*** (0.149)	-0.503*** (0.156)	-0.711*** (0.132)	-0.361** (0.161)
Constant	0.116 (1.006)	2.399** (1.083)	0.294 (0.932)	3.333*** (1.153)
R^2	0.294	0.345	0.309	0.417
Countries	10	10	10	10
Time	1998-2011	1998-2006	1998-2011	1998-2006
Observations	133	83	133	83
Method	FE-IV	FE-IV	FE-IV	FE-IV

Notes: Robust standard errors are shown in brackets. Superscripts ***, **, * denote that the coefficient estimate is statistically different from 0 at the 1, 5 and 10% level of significance, respectively

Column (3.2) presents the result when the time sample is shortened and ends in 2006 (cf. model (2.1)). The estimated coefficients retain their signs and approximate size, but they become smaller in numerical terms. The same pattern was seen in the OLS estimations. Columns (3.3) and (3.4) show the results when the EU15 growth rates are replaced as instruments by year dummies for each of the sample years. The new set of instruments leads to results that are very closes to those in Columns (3.1) and (3.2). Other experiments (not shown) have confirmed that the findings using instrumental variable estimation are qualitatively similar to those attained using OLS and they are not very sensitive to the specific choice of instruments.

The econometric analysis in this section can be summarised as follows. Both capital flows and competitiveness have been important for the short-term output performance of the 10 EU countries from Central and Eastern Europe. Changes in competiveness as proxied by unit labour costs appear to affect economic growth with a lag of around two years (see also Appendix A). At times capital inflows have made high rates of economic growth possible; at times capital outflows have constrained growth. Overall the results were very robust in qualitative terms, as changes in the number of countries in the sample, additional control variables and the use of instrumental variables estimation did not change the results in pronounced ways. The main exception is that the size (but not the sign or significance level) of the estimated coefficient of the current account balance seems to vary depending on whether or not the global financial crisis is included in the sample. The state or time dependence of the coefficient of the current account balance is a robust finding across different specifications and is likely to reflect that the global financial crisis amounted to a marked and sudden regime change in which relations between macroeconomic variables are prone to change. The different estimates of the slope estimates constitute a complication in the simulations of the impact of different factors on economic growth in Latvia.

V. Economic growth in Latvia 1996-2011

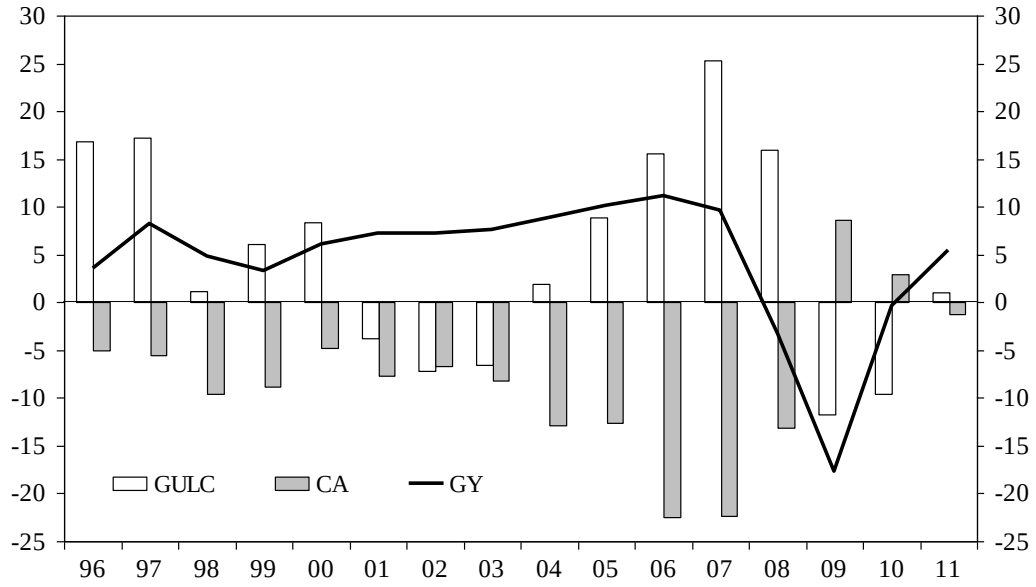
This section seeks to assess the contributions of capital flows and competitiveness to economic growth in Latvia based on the estimation results in Section 4. The methodology is straightforward.

[15] It is somewhat surprising that the instrumentation leads to the increase in the coefficient of the current account balance (in numeral terms). Economic growth might lead to a deterioration of the net trade balance which may be financed through capital inflows. Instrumentation might be expected to remove this effect and, hence, *lower* the estimated coefficient relative to the result of the OLS estimation.

The slope coefficients from the estimations along with measures of "normal levels" of the change in the relative unit labour cost and the current account balance will be used to compute the contribution of the two variables. The results will form the basis for a broad-based discussion of factors driving growth in Latvia and other countries in Central and Eastern Europe.

Figure 1.2 shows economic growth (GY), growth in relative unit labour costs (GRULC) and the current account balance for Latvia (CA). The extent of fluctuations in all three variables is remarkable; the developments of the first two variables will be discussed in some detail.

Figure 1.2: Growth in relative unit labour cost in per cent (GRULC), current account balance in per cent of GDP (CA), economic growth in per cent (GY), Latvia



Source: author's calculations

The unit labour cost relative to the EU12 euro area increased dramatically in the period 1996-1997, which in part reflects catch-up after the transitional recession. The relative unit labour cost fell significantly or remained stable in the period 2001-2004. The Latvian lats was pegged to the SDR from 1994 and until the end of 2004 and the dollar depreciated in the beginning of this period substantially vis-à-vis the euro and, thus, contributed to the development. Another factor was an upshot in unemployment after the Russian financial crisis, which restrained wage demands.

The relative unit labour cost figuratively exploded during the boom period from 2005-2008, the growth peaked in 2007 at more than 25%. The lats was pegged to the euro from the beginning of 2005 so the development cannot be explained by nominal exchange rate movements. The economic boom, easy access to capital after the membership of the EU and some migration pressure were among factors driving up wages and other production costs (Purfield and Rosenberg, 2010). The crisis led to an improvement in competitiveness in 2009 and 2010.

Turning to capital flows, developments are relatively stable until 2004 with the current account deficit fluctuating in the area of 5-8% of GDP. The deficit dropped somewhat in 2000, in part due to capital flight after the Russian financial crisis. The deficit increased markedly in 2004 in connection with Latvia joining the EU and the world experiencing a savings glut in which capital increasing went to new borrowers (Purfield and Rosenberg, 2010). The deficit increased further in 2006-2007 and reached levels above 22% of GDP. The capital flows reserved in the course of 2008 as Latvia experienced a sudden stop after the outbreak of the global financial crisis. The current account exhibited a substantial surplus in 2009, but the surplus was reduced markedly in 2010 and turned into a small deficit in 2011.

The econometric analysis in Section IV showed that both capital flows and competitiveness have played an important role in the short-term output performance of the 10 EU countries from Central and Eastern Europe. Two issues must be addressed when the estimation results can be used for simulations of the contribution of changes in unit labour costs and the current account balance to economic growth in Latvia.

First, the results were robust in qualitative terms, but the quantitative estimates varied somewhat across different specifications, in particular depending on whether or not the global financial crisis was included in the sample. We address this issue by producing two different simulation scenarios based on different values of the marginal effects. Scenario 1 adopts the coefficients of baseline estimation (1.3); the marginal effect of GRULC(-2) is -0.160 and the marginal effect of CA is -0.482. Scenario 2 is based on estimation (2.3) which controls for demand effects from Western Europe; the marginal effect of GRULC(-2) is -0.126 and the marginal effect of CA is -0.296.

Second, in order to compute the contributions of changes in the relative unit labour cost and of the current account balance, it is necessary to establish "normal" levels of the two variables, i.e. levels at which their contributions are zero. The straightforward choice is to choose the average values of the two variables for Latvia. In the estimation sample, the average value of the change in the relative unit labour cost is 6.3% (1996-2009) and the average value of the current account balance is -8.5% of GDP (1998-2011). This parameterisation is labelled (a) and is used in two simulations. The average values are, however, rather extreme and may not reflect "normal" long-term levels from which the actual values deviate. In other simulations, it is therefore assumed that the "normal" change in the relative unit labour cost is 3% and the "normal" value of the current account balance is -4% of GDP.[16] (The assumed "normal" current account deficit is still large in comparison with the experience of Western European countries when they rebuilt their economies after World War II.) This parameterisation is labelled (b).

Figure 1.3a shows the contributions in Scenario 1 with "normal" parameterisation (a), i.e. when the "normal" values are taken to equal the averages for Latvia during the estimation period. The contributions are the results of the deviation of the change in the relative unit labour cost and the current account balance from their assumed "normal" values. In this simulation, the current account balance plays a major role, which is reasonable given the numerically large slope coefficient used in the simulation.

The peak of the boom in 2006-2007 coincided with large contributions from capital inflows, while the recession in 2009-2010 conversely coincided with large contributions from capital outflows. Competitiveness nevertheless played an important role. In 2004-2005, during the early stages of the Latvian boom, improvements in competitiveness helped increase growth and, thus, indirectly contributed to the optimism surrounding the economy after accession to the European Union (Purfield and Rosenberg, 2010). The deterioration of international competitiveness during the boom period subsequently contributed negatively to GDP growth in 2009-2010, likely by a couple of percentage points in 2009.

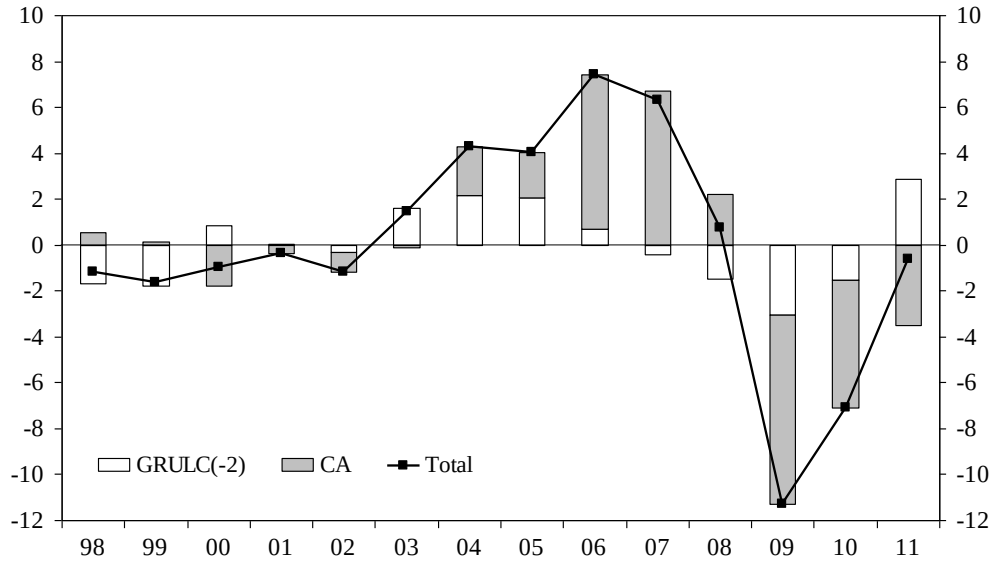
For 2011 the two counter-acting forces were at play. Competitiveness improved markedly during the recession in 2009-2010 and this contributed to higher economic growth (Purfield and Rosenberg, 2010). On the other hand, capital outflow had the opposite effect on economic growth, largely neutralising the effect of the improved competitiveness.

Figure 1.3b presents the contributions when the slope coefficients of Scenario 1 are retained, but the "normal" values of the variables are assumed to be less extreme than their averages in the estimation period. The contribution of capital inflows during the boom is somewhat larger, while their contribution during the recession is correspondingly smaller. The overall picture of the drivers of growth in Latvia during the period 1998-2011 is, however, relatively unchanged.

[16] The Macroeconomic Imbalance Procedure of the EU posits a threshold of the three-year backward moving average of the current account balance of -4% of GDP (European Commission, 2012a).

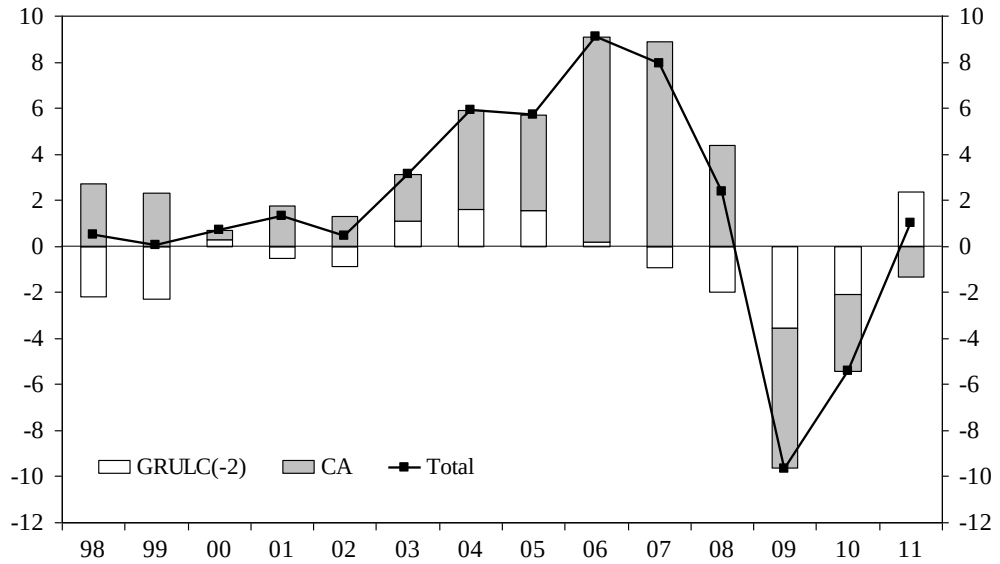
Figures 1.4a and 1.4b show the simulation results according to Scenario 2, where the slope coefficients from model (2.3) are used. Figure 4a uses assumption (a) that the "normal" values of the variables are equal to their means in the estimation sample. The findings from Figures 1.3a and 1.3b are largely retained, but the contributions from the current account balance are now smaller. Still, the extreme capital inflows in 2006-2007 appear to have contributed by around 5 percentage points to economic growth each year. Capital outflows and weakened competitiveness can explain much of the downturn in 2009 and 2010. The counter-acting forces of improved competitiveness and continued capital outflow are apparent for 2011. Finally, Figure 1.4b provides the results when the "normal" values of the focus variables are assumed to be 3% and -4% of GDP, respectively. All main conclusions remain.

Figure 1.3a: Simulation of contributions to economic growth in Latvia, Scenario 1(a)



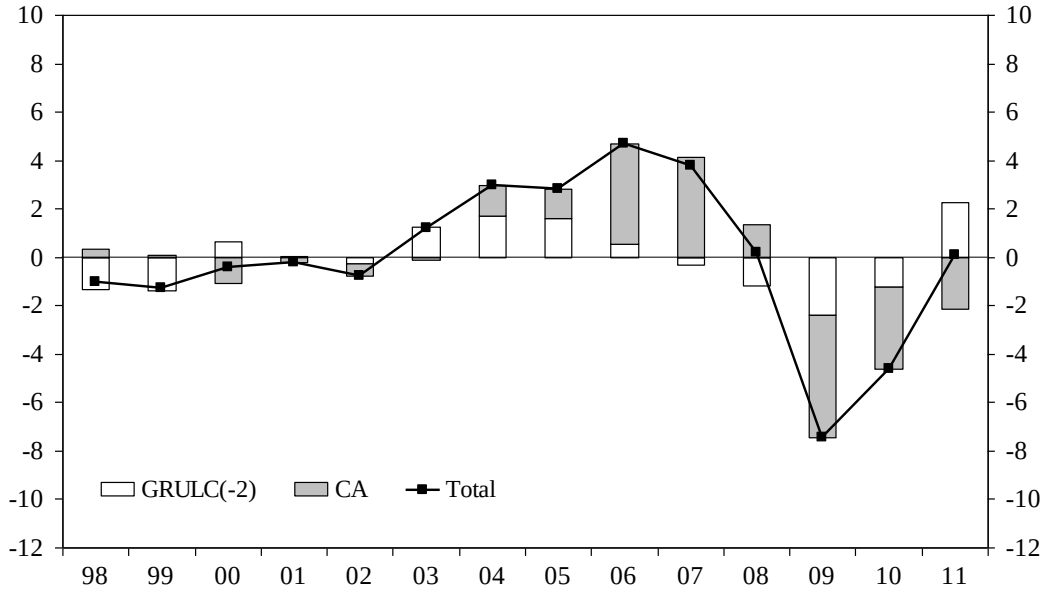
Source: author's calculations. Notes: Simulations based on the following assumptions: Coefficient of GRULC(-2) = -0.160, coefficient of CA = -0.482, "normal" value of GRULC(-2) = 6.3%, "normal" value of CA = -8.5% of GDP

Figure 1.3b: Simulation of contributions to economic growth in Latvia, Scenario 1(b)



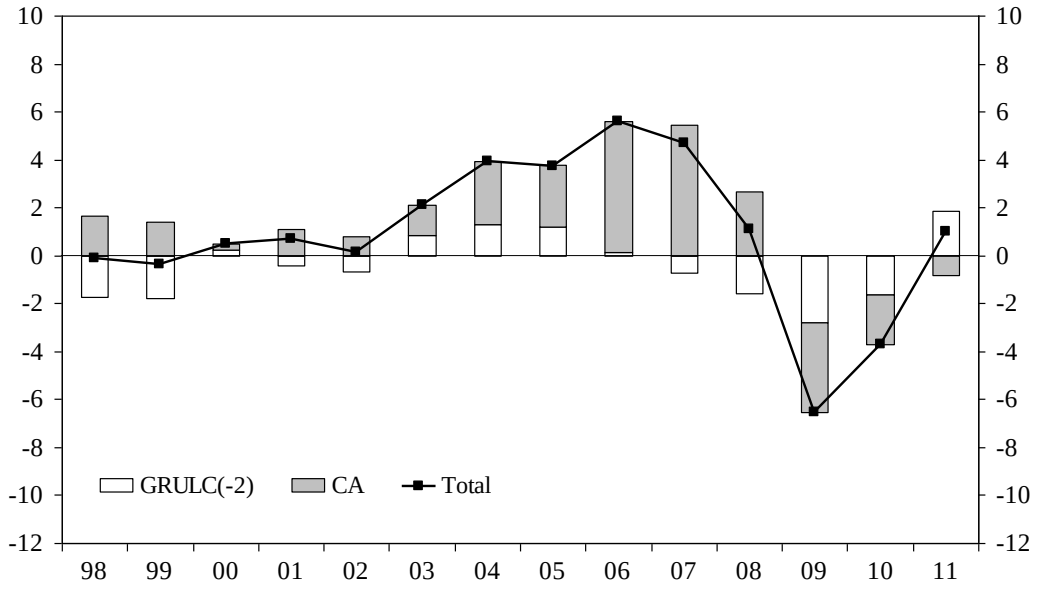
Source: author's calculations. Notes: Simulations based on the following assumptions: Coefficient of GRULC(-2) = -0.160, coefficient of CA = -0.482, "normal" value of GRULC(-2) = 3%, "normal" value of CA = -4% of GDP

Figure 1.4a: Simulation of contributions to economic growth in Latvia, Scenario 2(a)



Source: author's calculations. Notes: Simulations based on the following assumptions: Coefficient of GRULC(-2) = -0.126, coefficient of CA = -0.296, "normal" value of GRULC(-2) = 6.3%, "normal" value of CA = -8.5% of GDP

Figure 1.4b: Simulation of contributions to economic growth in Latvia, Scenario 2(b)



Source: author's calculations. Notes: Simulations based on the following assumptions: Coefficient of GRULC(-2) = -0.126, coefficient of CA = -0.296, "normal" value of GRULC(-2) = 3%, "normal" value of CA = -4% of GDP

The simulation results presented in Figures 1.3-1.4 provide additional insights into the impact of international competitiveness and external capital flows on growth performance in Latvia during the period 1998-2011. In spite of some differences across the simulations, the overall picture is relatively clear. Changes in international competitiveness and capital flows seem to have played rather modest roles until around 2003. In 2004-2005 the Latvian economy was blessed by higher growth stemming from a combination of improved competitiveness and increasing capital inflows. This strong performance set off two years of frenzied capital inflows, which only came to an end with the

outbreak of the global financial crisis. Thus, the relatively "balanced" economic performance in 2004-2005 was replaced by extreme current account deficits and exploding relative unit labour costs in 2006-2007.

The global financial crisis unfolded in the second half of 2008 and massive capital outflow in combination with the hangover from increases in the relative unit labour cost of the previous years were major contributors to the downturn in 2009-2010. Latvia is clearly a paramount example of a country experiencing a sudden stop (Calvo, 1998; Purfield and Rosenberg, 2010). It is also clear that the growth reversion was larger than what can be explained by international capital flows. Weak international competitiveness was one factor which pulled down GDP growth in 2009-2010, but other factors, such as a rapid drop in export demand and financial instability, affected Latvia adversely from the autumn 2008.

The relatively benign growth performance in 2011 appears in part to result from two counter-acting contributions, viz. a positive and substantial contribution the improved competitiveness attained during the crisis and a negative contribution from continued capital outflow. The continued capital outflow was clearly restraining post-crisis recovery in Latvia.

VI. Concluding remarks

This chapter has considered the impact of external capital flows and international price competitiveness on economic growth in Latvia since the end of the 1990s. The analysis was built on (short-term) growth regression on a sample of EU countries from Central and Eastern Europe. The econometric analysis suggested that both capital flows and competitiveness have played important roles in the short-term output performance of the 10 EU countries from Central and Eastern Europe. Changes in relative unit labour costs appear to affect economic growth with a lag of two years and the estimated marginal effect is between -0.2 and -0.1. The current account balance enters contemporaneously and the estimated marginal effect is between -0.5 and -0.2. The results are fairly robust, but the global financial crisis appears to have strengthened the effects of the competitiveness variable and, particularly, the capital flow variable.

The estimated country fixed effects are generally small and the slope estimates change only marginally if they are removed. This suggests that most of the differences in growth performance across the 10 CEE countries during since 1998 may be attributed to differences in competitiveness and capital flows. This may be a reasonable conclusion as the countries entered the 1990s with a rather similar economic structure, undertook transition reforms and subsequently changed their legal and institutional systems to adhere to the *acquis communautaire*.

Another tentative result is that the marginal effects of changes in the relative unit labour cost and the current account balance are higher for the Baltic countries than for the whole sample of 10 CEE countries. This may suggest that the very large fluctuations in output growth in the Baltic countries stem not only from large fluctuations in capital flows and competitiveness, but also a larger sensitivity of economic growth to such changes. The underlying reasons for this finding cannot be ascertained within the present empirical framework, but the small size of the economies might be a contributing factor.

Simulations sought to ascertain the impact of capital flows and changes in competitiveness on economic growth in Latvia. The simulations were based on the coefficients from two different estimations and also assumed different value for the equilibrium or "normal" values of the two variables. The simulations showed that the boom period, which started immediately before Latvia joined the European Union in 2004 and lasted until the after global financial crisis four years later, can be divided into two sub-periods. Improved competitiveness and capital inflows stimulated growth during the first two years of the boom, but extreme capital inflows subsequently became the sole driver. The downturn which started in 2008 as the global financial crisis hit Latvia was in large part driven by a massive capital outflow, but the deterioration in competitiveness during the later stages of the boom also contributed to lower GDP growth in 2009-2010. Improved competitiveness helped increased growth in 2011, but the continued (albeit modest) capital outflow had the opposite effect.

It is noticeable that the current account balance has generally played a larger role in short-term changes in economic growth than changes in competitiveness. This illustrates the vulnerability of the Latvian economy to changes in capital flows. Capital inflows might stimulate growth and raise the growth rate above levels otherwise achievable, but outflows may also have severe contractionary effects. It is unfortunately not possible to provide a precise point estimate of the marginal effect due to uncertainty regarding the model specification. The simulations also reveal, however, that changes in cost competitiveness have the potential to affect short-term growth in Latvia.

The immediate policy implication of the estimations and simulations in this chapter is connected with the great importance of capital flows and competitiveness on economic performance in Latvia. Capital inflows played a major role for the post-accession boom, but also for the succeeding crisis. Changes in international competitiveness have also affected economic growth substantially at different times. In a nutshell these results summarise the challenges of a small open economy in a world economy, which changes rapidly and exhibits phases of euphoria and gloom.

This vulnerability suggests that policymakers should monitor developments on financial markets carefully, in particular the current account balance. It may also be possible to take measures that would help reduce excessive fluctuations in capital flows, in part by measures meant to affect the domestic demand for credit. It may, in a similar vein, be useful to monitor the relative unit labour cost carefully and possibly to take measures in case the variable deviates markedly from its trend path. Such a scheme of more active monitoring and adjustment is at the heart of the Pact for the euro adopted by the EU in 2011 (European Council, 2011).

At a deeper level, this chapter casts some doubt on the standard "neoclassical growth model" adopted by all the CEE countries, at least as part of their preparations of EU membership. The model posits that the liberalisation of financial markets will lead capital to flow to the countries with capital scarcity and therefore high returns to investment. The additional investment financed by capital inflows increases growth rates. The developments until 2007 largely confirmed the model as the CEE region experienced substantial capital inflows (Lipschitz et al., 2002; Lane and Milesi-Ferretti, 2007; Shelburne, 2009). The events during and after the global financial crisis showed, however, that capital flows can be erratic and highly dependent on developments outside the CEE countries. The doubts have two anchor points.

First, empirical research has shown that fast-growing emerging market economies, especially in Asia, often experience a pattern in which the rate of economic growth is positively correlated with the current account balance (Prasad et al., 2007). In this group of countries, current account surpluses are typically associated with high rates of growth. This arguably reflects that the countries pursue an economic model based on export-led growth and the results have generally been encouraging (Rodrik, 2009).

Second, the vulnerabilities of the CEE countries have led scholars and policy-advisors to rethink economic and structural policies for the region (Fabrizio et al., 2009; Atoyan, 2010; Ghosh et al., 2011). The objective is to reduce the vulnerability to external shocks while sustaining high trend growth. Typical policy recommendations include new rounds of deeper and more "qualitative" reforms within education, justice, etc., but there are also calls for measures to reduce the degree of financial integration and increase domestic saving (Fabrizio et al., 2009; Atoyan, 2010).

The main contribution of this chapter was the estimation of simple regressions, which allowed a quantification of the effect of external capital flows and international competitiveness on (short-term) economic growth. The novelty of the exercise and the problems differentiating between different empirical models imply that the quantitative results should be interpreted with some caution.

Further work may provide additional insights. First, it may be useful to include additional control variables in the regressions. One possibility might be the rate of partner growth, i.e. the rate of GDP growth of the trading partners weighted by their share of the trade of the individual CEE country (Blanchard et al., 2010). The addition of more control variables is constrained by the relatively small sample size and the need to avoid over-parameterisation of the estimations. Second, it might be worthwhile using quarterly data in order to gain additional data points. Some preliminary work along

this line has suggested, however, that the additional noise of quarterly data may outweigh the benefits of more degrees of freedom.

Third, it might be useful to distinguish between different types of capital flows, for instance foreign direct investment flows, portfolio flows and flows from loans etc. It may also be useful to consider in detail the allocation of capital flows within the country as, for instance, increased lending to households may affect the economy differently from increased lending to the enterprise sector. Although potentially very important, such decomposition exercises are complex both in conceptual terms and in practical terms. Fourth, simultaneous modelling of economic growth, external capital flows and international competitiveness may provide additional knowledge on the linkages between the three variables. Some preliminary work suggests that the modelling of capital flows, in particular, is a difficult exercise, which may, however, be an additional argument for pursuing this direction of research in future work.

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Appendix A

Table 1.A1. Estimation of economic growth in the CEE, different lag structures of explanatory variables

	(A1.1)	(A1.2)	(A1.3)	(A1.4)	(A1.5)	(A1.6)
GRULC	0.014 (0.022)	..	-0.036 (0.036)	..	..	..
GRULC(-1)	..	-0.098 (0.068)	-0.114** (0.057)	..	..	..
GRULC(-2)	..	..	-0.144*** (0.036)	-0.162** (0.078)	-0.092* (0.052)	-0.070** (0.028)
CA	-0.460*** (0.101)	-0.514*** (0.114)	-0.553*** (0.140)	..	..	-0.806*** (0.102)
CA(-1)	..	..	..	0.064 (0.051)	..	0.525*** (0.102)
CA(-2)	..	..	..	..	0.446*** (0.067)	0.191** (0.075)
Constant	1.227** (0.549)	1.324** (0.614)	1.677** (0.766)	4.938*** (0.287)	7.184*** (0.378)	3.922** (0.321)
R^2	0.275	0.303	0.401	0.124	0.261	0.619
Countries	10	10	10	10	10	10
Time	1998-2011	1998-2011	1998-2011	1998-2011	1998-2011	1998-2011
Observations	153	153	153	153	153	153
Method	FE-OLS	FE-OLS	FE-OLS	FE-OLS	FE-OLS	FE-OLS

Notes: Robust standard errors are shown in brackets. Superscripts ***, **, * denote that the coefficient estimate is statistically different from 0 at the 1, 5 and 10% level of significance, respectively

Chapter 2 – The evolution of the Latvian external sector: imbalances, competitiveness and adjustment

Francesco Di Comite
Gabriele Giudice
Radoslav Krastev
Daniel Monteiro

I. Introduction

Since 1992 Latvia has undergone intense economic restructuring which led in the early 2000s to a period of sustained growth fuelled by capital inflows and a strong domestic demand. At the same time, the country developed unsustainable external and internal imbalances that kept on increasing until 2008 and put government finances under strain, pushing it to ask for assistance when the international financial crisis caused a sudden stop in external financing. The country's external position deteriorated to such extent that its current account deficits reached a staggering 25% of GDP in the quarters preceding the crisis. Similarly startling was the development of internal imbalances, with housing prices doubling in just a couple of years and the emergence of a construction bubble financed by a steep increase in private sector debt, which more than tripled as a percentage of GDP in less than a decade, from 39% in 2000 to more than 130% in 2008.

This chapter focuses on the process leading to the accumulation of internal and external imbalances in order to understand the reasons behind them and the precautionary measures that can be adopted to prevent their reappearance in the future. More precisely, we investigate the sources of these imbalances and seek to determine the relative contributions of the demand and the supply side. Our study shows that most of the problems confronting Latvia arose from excesses on the internal demand side rather than from a loss of international competitiveness or other possible export performance-based explanations. In particular, the availability of cheap credit and extremely optimistic expectations regarding future income appear to have played a leading role in pushing households and enterprises to excessive levels of consumption, indebtedness and risk taking. As for external competitiveness, we show that the country didn't show any particularly worrying trends in terms of export performance in the period considered, as the increases in labour compensation appear to have been offset in the tradable sector by quality upgrading and improvements in product specialisation. However, this is shown to be less the case in the context of the non-tradable sectors, construction in particular, where the virtually unlimited availability of credit resulted in a boom that inflated profits and wages in the sector, causing labour and capital to be reallocated from more competitive sectors towards non-tradable ones and playing a key role in inflating internal demand.

The chapter is organized as follows: first we take a long-term view of the economy and look at the evolution of Latvian net external positions since its independence in 1991; we then analyse the factors that undermined their sustainability by the time the crisis set in, looking at them through the lens of both traditional competitiveness indicators and alternative measures; finally, we focus on the role played by internal demand factors and imports in generating these imbalances.

II. Latvia's external position since independence

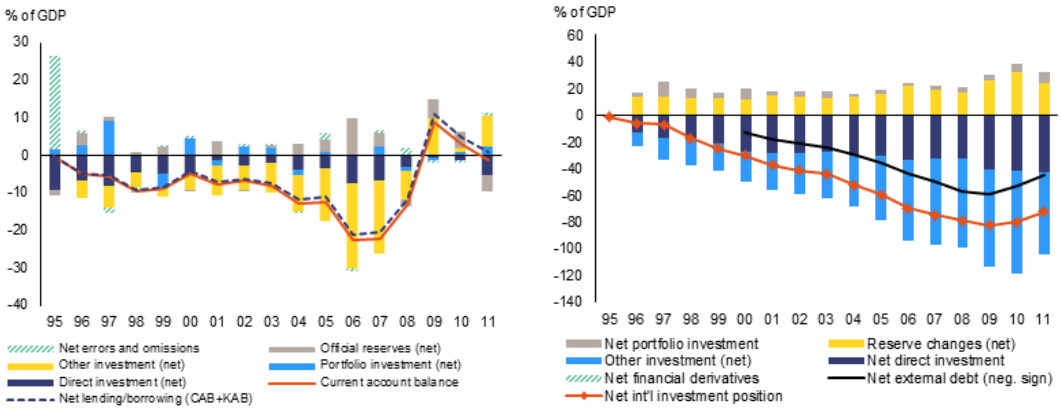
In the early phase of Latvia's independence and transition to a market economy (1992-1994), the country's current account posted surpluses which were mainly due to limited access to external financing and weak purchasing power in the course of a process of price liberalisation and foreign trade reorientation. The current account was broadly balanced in 1995, moving to relatively large deficits afterwards as catching-up dynamics and capital inflows started to gain momentum. In the period of 1996-2000, the current account deficit as a percentage of GDP remained in the single-digit zone and was largely covered by net FDI inflows. However, the deficit widened significantly in 2000-2007 and only a small share of it was financed by net FDI inflows in that period. The current

account (CA) deficit peaked to the extremely high levels of 22.5% and 22.3% of GDP in 2006 and 2007, respectively, showing clear signs of overheating in the economy. The 2008 crisis sharply reversed the CA to a surplus, driven by the collapse of domestic demand as well as large losses in foreign-owned companies that are booked symmetrically as an inflow in the income balance of the CA and an outflow in the FDI balance of the financial account.

II.1. External balance and debt position

Unlike some other countries in Eastern Europe, Latvia did not suffer from a heavy external debt burden in the early phase of its transition to a market economy. The country was even a net creditor in the first years of independence. However, the following period of large CA deficits caused a rapid deterioration in the country's external indebtedness (see Figure 2.1, left pane). The gross external debt increased from 31.6% of GDP in 1995 to 129.2% in 2008. Although the nominal debt value stabilised in 2009-2010, its value as a share of GDP deteriorated further to 165.2% in 2010 as a result of the recession. In net terms, the external debt widened from -3.4% of GDP in 1995 to a peak of 58.7% in 2009, moving downwards to 53.2% in 2010 due to the accumulation of reserves in the government sector and deleveraging in the private sector. The net international investment position of the country thus deteriorated significantly to -81.4% of GDP in 2009 reflecting both private debt and FDI dynamics (see Figure 2.1, right pane).

Figure 2.1: Decomposition of current account balance (left pane) and net international investment position (right pane)



Source: Commission services

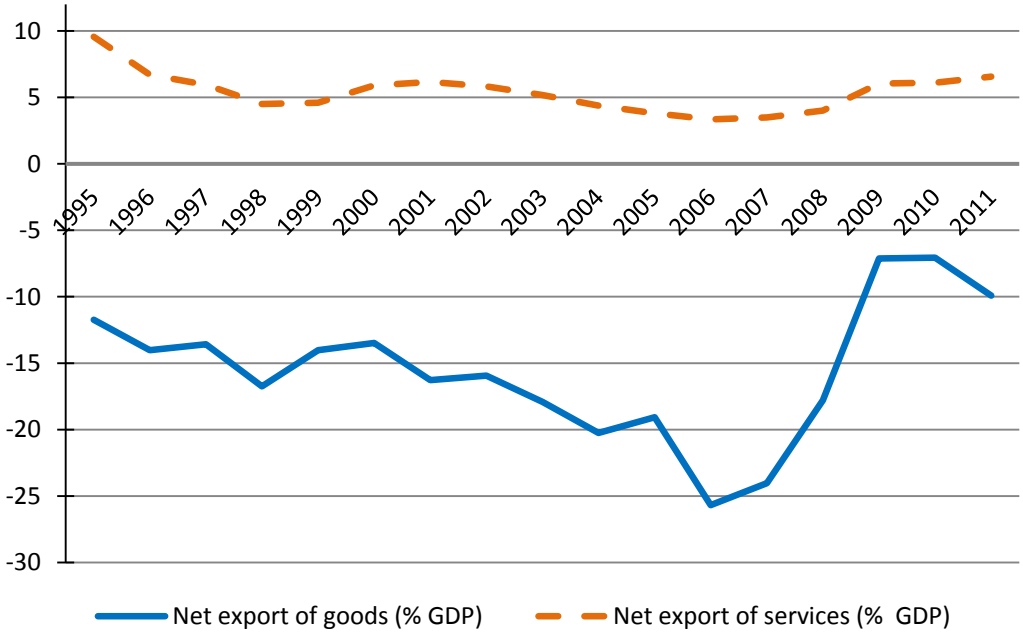
The rising share of foreign ownership has significantly influenced Latvia's external balance. This improved access to external financing and supported the modernisation of the economy. However, the rising share of foreign ownership has also increased the importance of dividend outflows and reinvested earnings in the balance of payments. The impact of reinvested earnings on the CA balance has been substantial in some years even though this item does not correspond to a cash outflow.

II.2. External trade dynamics

The country's export sector has undergone significant structural changes since independence. On the one hand, the geographical dimension of exports moved from the planned markets of the former Soviet Unit to the free market of Western Europe. On the other hand, many industries dependent on cheap energy imports and outdated technologies had little chance to survive the challenges of liberalised energy prices and direct competition from technologically advanced western companies. Not surprisingly, the merchandise trade balance of the country has deteriorated significantly since 1992. However, the services trade balance was always on surplus during the transition to a market economy. Within the economy of the former Soviet Union, Latvia was an important transport corridor and most of its service exports were transportation, mainly sea and railway transport services. In the early period of transition (1992-94), transport businesses generated around 90% of

total service exports and the latter accounted for about 1/3 of the total value of exports of both goods and services. As Latvia progressed towards a market economy, the range of service exports widened substantially, in particular towards tourism and financial intermediation. Transportation remained an important sector with 49% of the total value of service exports in 2010 but well below its levels from the early period of independence (see Figure 2.2).

Figure 2.2: Trade balance of goods and services



Source: Commission services

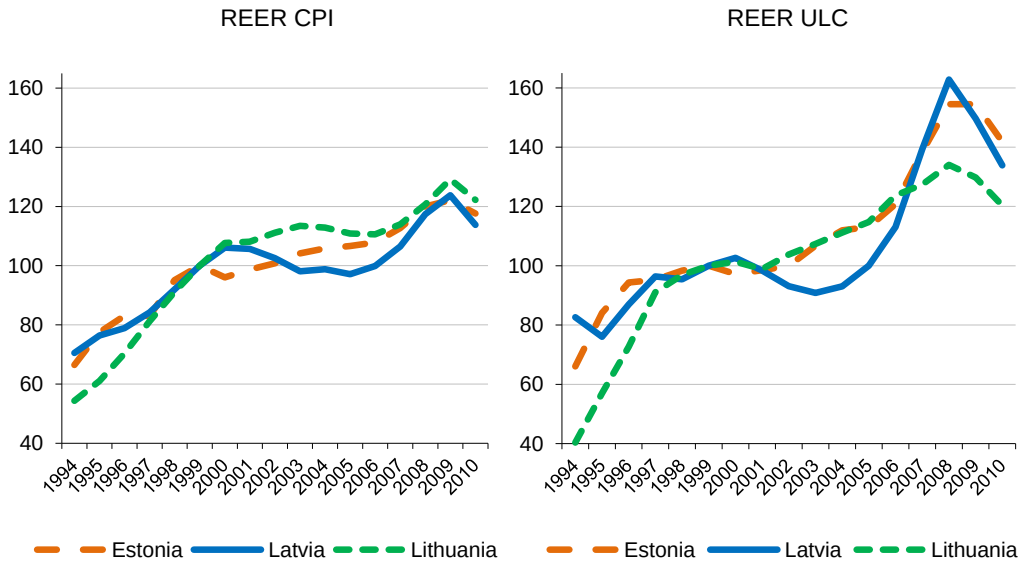
The diverging trends of net exports of goods and services suggests that economy-wide labour cost developments, with the exception of some extreme hikes in 2006-07, cannot be fully blamed for the overall deterioration in the external balance of the country, as the more labour intensive sector of services was consistently in surplus. The structural dynamics in the foreign trade balance from 1992 until the economic crisis of 2008-09 shows that the factors underpinning the deterioration in the country's external position and competitiveness are more complex and are related to a comprehensive range of indicators that capture more than just labour cost and labour productivity.

II.3. The evolution of price and cost competitiveness

The standard approach to analysing external competitiveness through real exchange rates and labour productivity explains only part of the movements in the Latvian external balance. Similarly to the other two Baltic countries, Estonia and Lithuania, the real effective exchange rate in Latvia appreciated significantly in the pre-crisis period of rapid economic growth, as shown in Figure 2.3. In Latvia, and to a lesser extent in Estonia and Lithuania, the appreciation was more pronounced for the rate based on unit labour costs than on CPI, showing that wages rose faster than the cumulative effect of consumer prices and real GDP growth. This divergence was quite significant in the period of overheating between 2005 and the first half of 2008. However, the fluctuations of the real effective exchange rates, based either on consumer prices or unit labour costs, fail to explain the rapid increase in the CA deficit in the period of 2000 until 2005. In that period, the real exchange rate depreciated in consumer price terms and did not change significantly in unit labour cost terms while the CA deficit surged to 12.5% of GDP in 2005 from 4.8% in 2000. Subsequently, when the crisis hit the country in 2008-09, the CA balance moved to a surplus before the spike in the real effective exchange rate and unit labour costs was fully corrected.

The dynamics of the CA balance and standard competitiveness indicators in Latvia show that the assessment of the country's external position need to cover a much broader area of indicators that go beyond the simplified model of relative export prices and labour costs. The remainder of the study seeks to assess the relevance of standard competitiveness indicators and to propose complementary analysis that may provide a better understanding of developments in competitiveness and external imbalances. The Latvian case also emphasizes the need to analyse the demand side of the economy, in particular savings and import demand, as excessive external imbalances can arise even in periods of improving export competitiveness.

Figure 2.3: Evolution of REER CPI (left pane) and REER ULC (right pane) in the Baltics



Source: Commission services. Note: 1999=100

III. Sustainability of the external position and traditional competitiveness measures

The set of traditional indicators on external balance sustainability comprises flow variables derived from the balance of payments as well as stock values of external assets and liabilities that have direct implication on future balance of payments transactions such as dividend, interest and principal payments. As for the flow values, balance of payments indicators are largely focused on the CA balance and its components, including trade in goods and services, income and current transfers. FDI and other financing flows are also analysed within the financial account of the balance of payments. All these indicators provide a fairly good picture of the country's external balance in historical terms but they are not forward looking and may not always signal risks of sudden reversals in the future. As far as the external balance sustainability may be dependent on market sentiment, especially in small open economies, credit default swaps and yields on private and public external debt can be used as indicators with forward implications on the external balance.

The use of stock indicators such as foreign reserves, the net international investment position and gross and net external debt also provide important information on future balance of payments flows. The country's indebtedness at a certain point in time has direct implications on future outflows related to interest payments (part of the CA balance) and principal debt repayments (part of the financial account). In addition to the debt exposure, the net international investment position includes the FDI stock (foreign equity) that is not of a debt nature but has important implications on the future external flows related to dividend payments and reinvestment earnings. Table 2.1 shows that both dividends and reinvested earnings have a significant impact on Latvia's external balance as the share of foreign equity in the country is relatively high.

Table 2.1: Selected external sector indicators (% of GDP)

	1992-95	1996-00	2001-05	2006	2007	2008	2009	2010
CA to GDP	7.0	-6.8	-10.1	-22.6	-22.4	-13.1	8.6	3.0
- o/w net dividends	*0.0*	*-0.2*	*-1.0*	*-1.0*	*-1.7*	*-1.4*	*-2.4*	*-1.7*
- o/w net reinvested earnings	*0.0*	*-0.8*	*-1.3*	*-3.6*	*-2.1*	*0.2*	*8.0*	*1.3*
Net FDI to GDP	4.4	5.7	2.9	7.5	6.8	3.0	0.6	1.5
- o/w reinvested earnings net	*0.0*	*0.8*	*1.3*	*3.6*	*2.1*	*-0.2*	*-8.0*	*-1.3*
Gross external debt (eop)	31.6	61.9	100.0	114.5	128.1	130.0	156.5	165.2
Net external debt (eop)	-3.4	13.1	35.8	44.2	49.7	57.1	58.7	53.2
Net IIP (eop)	-1.7	-30.2	-59.6	-69.9	-74.7	-79.0	-82.7	-81.4

Source: Commission services

Although the analysis of the external balance indicators is often straightforward, there are some important additional aspects that need to be taken into account for Latvia as well as for other small and catching-up economies with a high share of foreign equity.

Firstly, the CA balance is strongly dependant on cyclical effects in the external environment that can be linked to the prices of primary resources, as Latvia is strongly dependant on energy imports, on the prices of commodities with a high weight in the export and import volumes, and on the external demand in major trading partners. Cyclical effects could also affect the CA balance through the income statements of foreign-owned companies, as profits and consequently reinvested earnings usually rise in periods of rapid economic growth which results in a higher accounting outflow in the CA balance and a symmetrically booked inflow in the financial account with an overall neutral effect on the balance of payments. In periods of contraction, losses of foreign-owned entities have a reverse positive impact on the CA and a symmetric negative impact on the financial account. However, reinvested earnings do not originate from actual cross-border transactions and could be often influenced by cyclical effects rather than long-term trends. Therefore, the adjustment of Latvia's CA balance by excluding the impact of reinvested earnings provides additional information on actual cross-border flows and eliminates some cyclical effects. Table 2.1 suggests that such adjustment could significantly change the reading of the CA balance in Latvia, as for example the large surplus in 2009 was largely based on losses in foreign-owned entities that cannot be sustained in the long run.

The second specific aspect of the balance of payments analysis for Latvia is related to the catching-up status of its economy and EU convergence prospects. Investment demand in such economies tends to exceed the rates of domestic savings and the difference is reflected into relatively large CA deficits. However, such deficits are not necessarily a sign of worsening competitiveness and can be sustainable in the long term, particularly if they are financed by non-debt financial flows (FDI), which are directed to export-oriented or import substitution industries. However, FDI flows directed to domestic demand-facing industries are more difficult to interpret as on the one hand they may improve the technological base and the productivity of the economy but on the other hand may also worsen the long-term outlook on the CA through dividend outflows that will not be offset by a positive impact on exports.

III.1. Competitiveness through prices: real effective exchange rates (REER)

Real effective exchange rates provide a measure of price developments in relation to trading partners and therefore have some forward-looking implications on the country's competitiveness. However, it is often difficult to determine the equilibrium REER and consequently moves towards the equilibrium could be mistakenly interpreted as a loss of competitiveness. Moreover, different price indicators used for the calculation of REERs can lead to very different conclusions. Tax impacts on consumer

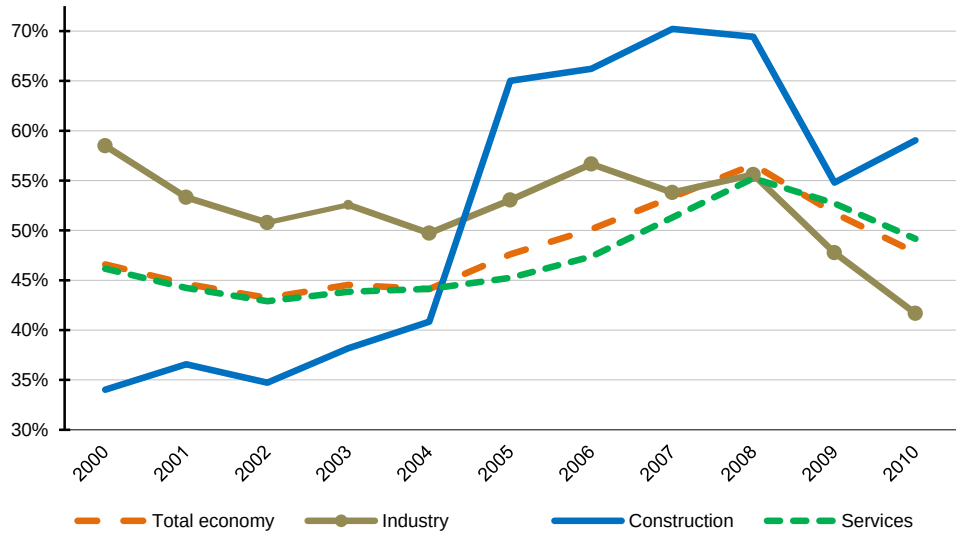
prices can also distort the REER readings as value added taxes or excise duties do not affect export prices and have fully identical effects on imported and domestically produced goods and services. Finally, REERs do not take into account changes in productivity unless they are adjusted for unit labour costs. For catching-up economies, structural changes with shifts to higher value-added or more labour intensive sectors (e.g, services) are more pronounced than in trading partners and REERs will tend to overestimate potential price effects on competitiveness. There is also empirical evidence that fluctuations in the REERs are not always fully correlated with external balance indicators even if the data series are adjusted for time lags. This is also the case for Latvia as can be seen from Figures 2.2 and 2.3, especially in relation to the CPI-based REER.

III.2. Competitiveness through productive efficiency: unit labour costs (ULC)

Changes in ULC relative to major trading partners provide a good overview of competitiveness in terms of labour productivity. It also provides some information on the side of import demand as far as labour income is one of the main determinants of household consumption. However, labour costs are only one factor of production and in some tradable sectors they account for less than 50% of the total production costs. A more comprehensive analysis of competitiveness needs to take into account all input costs as well as profit margins. While non-labour input costs may be difficult to measure, changes in the profit margins could be relatively easy to monitor both on aggregate and at a sector level through the value added approach of calculating GDP.

For catching-up economies, structural changes can have a significant effect on ULC dynamics. The way ULC indices are usually calculated does not include any adjustments for these changes, as aggregate labour costs are simply divided by GDP. In case the economy is shifting towards more labour-intensive sectors such as services, like is often the case in catching-up countries, this approach can show deterioration in the aggregate ULC index even if indices at sector level remain unchanged. In order to account for these composition effects, changes in ULC at an aggregate level can be calculated as a weighted average of the changes in the ULC values for each sector, following the approach of calculating consumer prices or GDP indices. For example, Figure 2.4 plots the evolution of the ratio of labour compensation over gross value added at a sector level and it shows that there can be significant heterogeneity in wage dynamics across sectors. Considering that labour share increased enormously in construction during the boom and went through a strong correction since the bust, a sector approach to ULC assessment would identify the role of the construction sector in driving imbalances, as the negative impact of its growing wage share was reinforced by its increasing contribution to total GDP.

Figure 2.4: Ratio of labour compensation over gross value added at a sector level

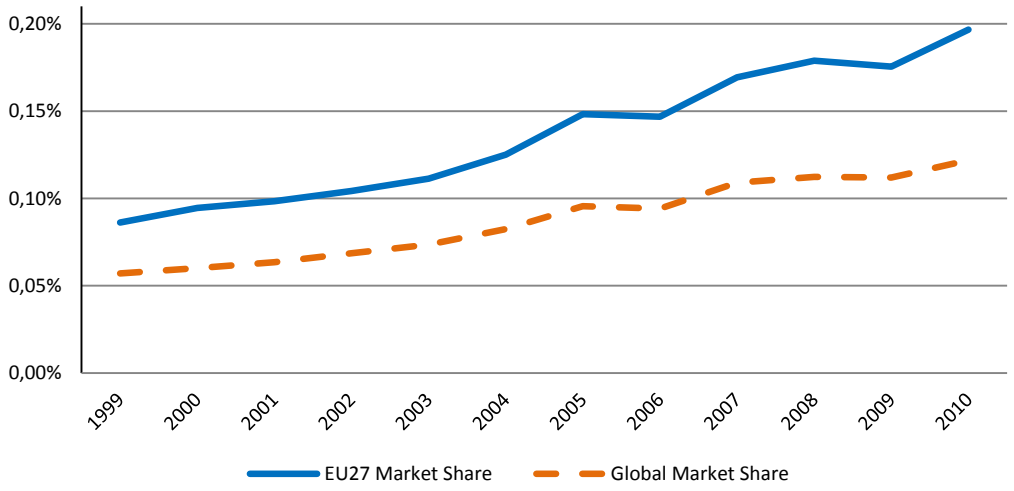


Source: Commission services

III.3. Export performance and capacity to compete abroad

The evolution of the country's export market share in world imports (or the change in the share vis-à-vis major competitors) is a good outcome indicator of export competitiveness. Latvia's share in EU and global imports are plotted in Figure 2.5. Even if it does not capture the dynamics in the external balance, since imports need also to be taken into account to that end, the indicator gives an idea of the capacity of the country's enterprises to compete on international markets. However, this is also a backward looking indicator that does not capture the dynamics in production and other factors, and therefore cannot be entirely relied upon to forecast future movements in the external balance. Nevertheless, the steady improvement in Latvia's export market share, even in periods of deteriorating REER and ULC, suggests that standard competitiveness analysis needs to be expanded to include a broader range of indicators going beyond prices and labour costs, for example by taking into account the fact that higher domestic costs of production may be offset by higher quality and better access to foreign markets. The diverging trends in the current account balance and export market shares also suggest that the vulnerability of the Latvian external position was mostly driven by demand factors, and notably the huge growth of imports, which should be carefully studied in parallel to export competitiveness indicators.

Figure 2.5: Evolution of Latvia's export market shares



Source: Commission services

- **Quality and non-cost competitiveness of exports**

Following the methodology proposed in Di Comite (2012) on the measurement of quality upgrading and non-cost competitiveness at a country-product level, it is possible to go beyond market shares to analyse Latvian firms' capacity to compete abroad. By comparing how Latvian enterprises fare vis-à-vis international competitors in a given market, a fair indicator of competitiveness can be produced, which is not distorted by home market bias or trade barriers (as would be the case if Latvian products were compared with imports in the Latvian market).

Keeping EU27 performance as a benchmark, Latvian trends in physical unit labour costs, quality content of exports and non-cost competitiveness can be inferred from the observation of export prices and wage bills at a sector level.[17] In this way, it is possible to identify to what extent long-term competitiveness issues arose in the tradable sector during the boom years and whether the country is getting back on track after the crisis. There is currently no consensus on the definition of quality and

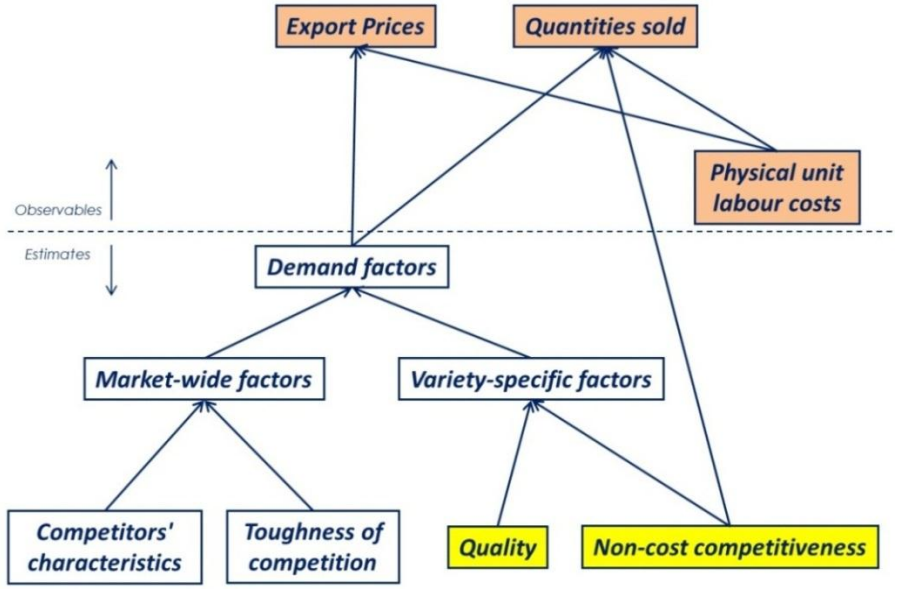
[17] Physical unit labour costs (PULC) are defined as the cost, in euros, of producing a given quantity of the products exported. Quality is the vertical intercept of the inverse demand function, net of competition effects, and is expressed in the same unit as prices: euros per given quantity of the product sold.

non-cost competitiveness, which also implies that instruments to measure them vary substantially. In the next chapter, for example, quality and taste have been measured simultaneously through a methodology based on a nested constant-elasticity-of-substitution utility function, resulting in a parameter called non-price competitiveness which captures the two dimensions simultaneously. In this chapter, instead, results are based on a quadratic utility function which can be used to identify separately two components of demand. One, referred to as quality, captures the capacity of firms to extract higher mark-ups from their products. The other, called non-cost competitiveness, expresses the ability of a firm to sell higher volumes of their products, for a given level of mark-ups. Specifically, the functional form adopted for identification purposes is the following, based on the utility function of a representative consumer *U* in the market *i*, consuming $q_{s,i}$ quantities of a mass of varieties S available in a market i and a numéraire variety q_0, which may be seen as representing the consumption of all the other goods in the economy and just serves as a unit of account for all the other parameters in the model:

$$U_i = \int_{s \in S_i} \alpha_s q_{s,i}\, ds \; - \frac{1}{2} \int_{s \in S_i} \beta_{s,i} q_{s,i}^2\, ds \; - \frac{\gamma_i}{2} \left[\int_{s \in S_i} q_{s,i}\, ds \right]^2 + q_0 \; .$$

The demand shifter $\alpha_s$is a positive and continuous function measuring the quality of a variety *s* (in this case a country-product), defined on the total mass of varieties *S* present in the export market considered *i*. Similarly, the parameter $\beta_{s,i}$ measures the non-cost competitiveness of a variety *s* in the export market *i*, and can be seen as a demand function slope shifter, which in equilibrium affects only quantities sold but not prices of mark-ups. Finally, the market-specific parameter γ_i captures the substitutability between all the pairs of varieties of the same kind of good in a particular market. While the details of the identification strategy and the data requirements are explained in Di Comite (2012), an intuition is provided in Figure 2.6. Price dynamics are interpreted as a function of cost and demand factors: changes in demand are then divided into market-wide effects and variety-specific characteristics; these are finally disaggregated into a quality and a non-cost competitiveness component, the latter being obtained by exploiting information on quantities sold.

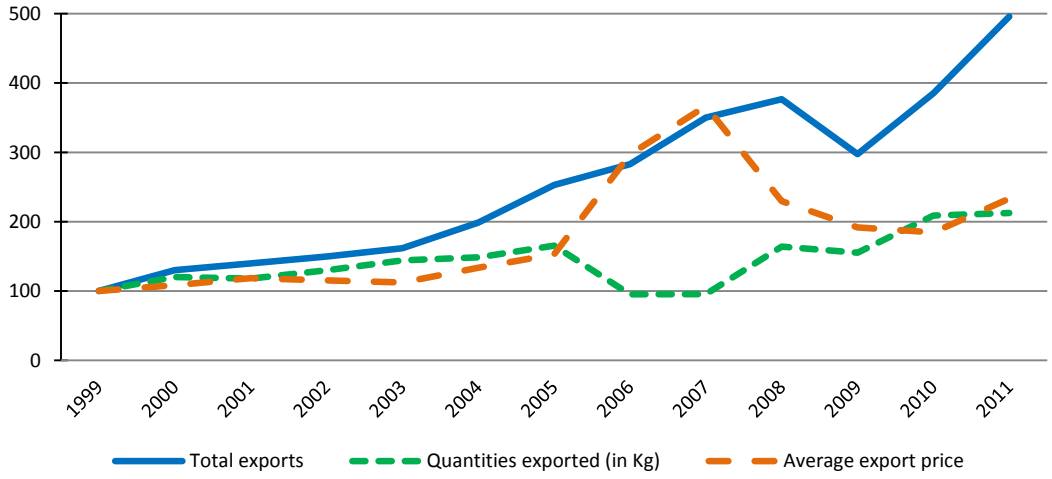
Figure 2.6: Scheme of quality and non-cost competitiveness identification strategy



By focusing on quality and non-cost competitiveness, this methodology can be used to single out trends on the supply-side of the economy, at least as far as tradable products are concerned. In the case of Latvia, we know from the previous analysis that wages increased substantially from 2003 to 2008, but did they actually outpace productivity growth? Combining trade data with information on value added and wage bill at a sector level, it can be seen already in Figure 2.4 that in the export sector this does not appear to be the case, consistently with the wage share dynamics in the industry sector. Turning to Figure 2.7, it is clear that only in 2006 and 2007, the years of overheating, did an

abnormal spike in intra-EU27 export prices result in a drop in quantities exported, with prices quickly falling in the aftermath of the crisis.

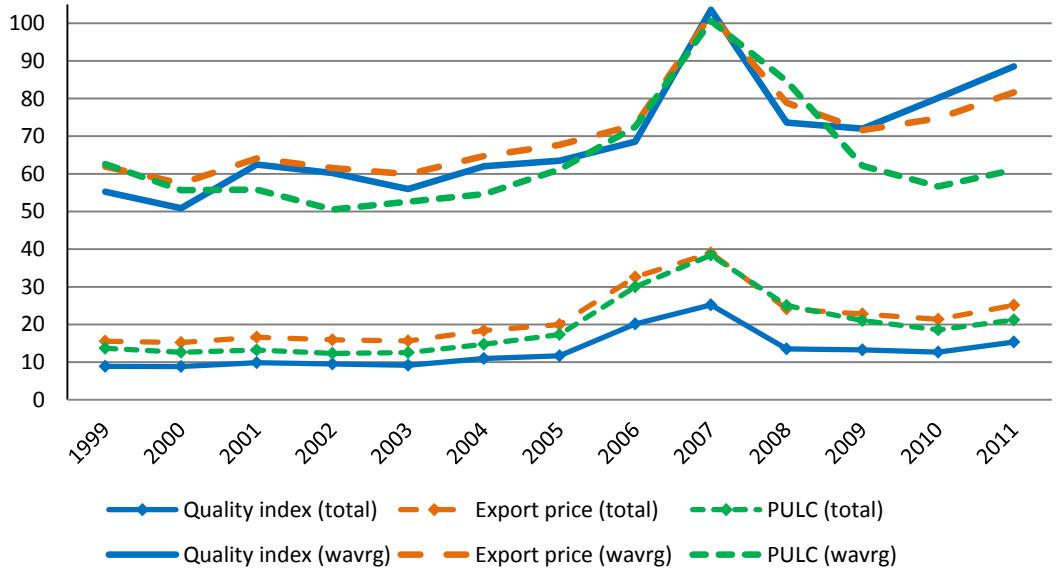
Figure 2.7: Evolution of total value of Latvian exports of goods, decomposed into quantities exported and average export price



Source: Eurostat Comext. Note: 1999=100

This is also what emerges from Figure 2.8, where the above-mentioned methodology is used to measure the relative importance of quality improvements and changes in physical unit labour costs (PULC) in determining Latvian export price dynamics. First, unweighted total Latvian exports (*total*) are considered; then, CN2-product-level parameters are calculated and added up weighting each product by its yearly share of total Latvian exports (*wavrg*). Disaggregating Latvian export price dynamics into a cost and a quality component, normalising them to EU27 levels and focusing on the series that corrects for industrial Latvian specialisation, it can be noticed that quality has improved rather constantly during the decade, whereas in the same period physical unit labour costs of exports did not really increase, with the notable exception of the overheating years 2006 and 2007 and the crisis starting in 2008.

Figure 2.8: Evolution of PULC, quality and export prices of Latvian exports as compared to the EU average

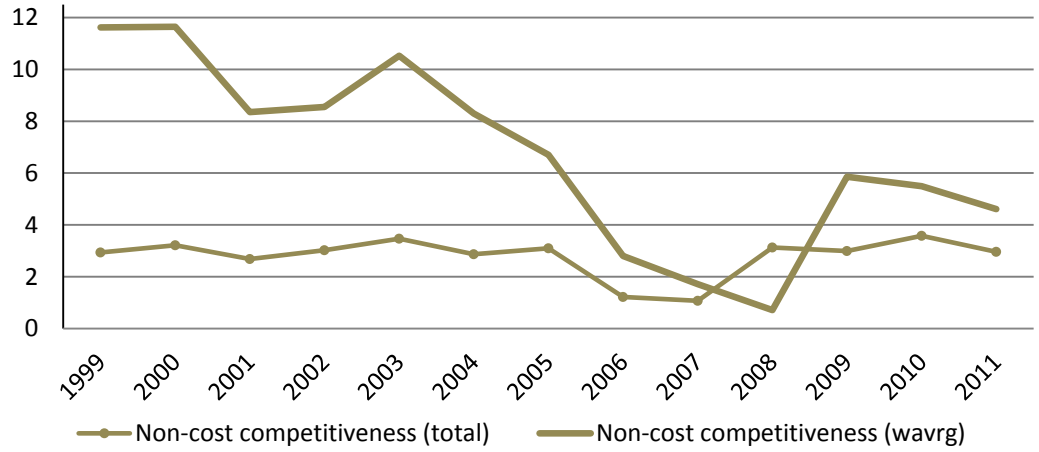


Source: Authors' calculations based on Eurostat Comext data. Note: EU27 average values=100. Results corrected for Latvian product specialisation by measuring each parameter at a product level for Latvia and EU27 and then aggregate them weighting each product by its Latvian export share. Physical unit labour costs (PULC) are defined as the cost, in euros, of producing a given quantity of the products exported. The quality index indicates the intercept of the vertical inverse demand function, also expressed in euros per a given quantity of the product sold

The dynamics observed in Figure 2.8 would be consistent with a process of constant quality upgrading and catching-up with the European Union average which was interrupted only by the crisis. What is most remarkable is that after the crisis hit, Latvian physical unit labour costs of export decreased while at the same time the quality content of its products vis-à-vis EU27 has increased. This suggests that the Latvian industrial sector managed to keep innovating and improving its products in the context of falling or stable physical unit labour costs, resulting in the significant rebound in exports in 2010 and 2011 observed in Figure 2.7. This is a reassuring sign of the renewed capacity of Latvian firms to compete in international markets, which underlines the positive contribution of the export sector to the current account balance of the country.

The dynamics of non-cost competitiveness, shown in Figure 2.9, also deserve to be mentioned, as the gradual decrease of the weighted average series vis-à vis the unweighted total indicator suggest that the most important export products, while experiencing a process of quality upgrading, are also selling less for a given level of markup with respect to EU27. This may be explained by the fact that they are entering new markets or products niches and still have to build up a customer base or a good distribution network. It should be noticed that non-cost competitiveness is measured as the capacity to sell, given a level of mark-up, so it is not its absolute level that matters (as countries may differ in size and number of firms) but its trend over time. Looking at non-cost competitiveness for the unweighted total exports, a drop can be noticed in the years 2006 and 2007, which are the years in which Latvian export prices soared dramatically and quantities dropped substantially (see Figure 2.7), whereas the rest of the EU did not experience any major shocks in those years (to a much lesser extent, a similar drop in quantities was experienced by the rest of the EU in 2008 and 2009, but with no particular effect on prices). Non-cost competitiveness recovered to some extent in 2008. However, the observed reversion in the relative non-cost competitiveness indicator was probably affected by a fall in its denominator, since the non-cost competitiveness of EU27 contracted because of the international financial crisis which unfolded in 2008.

Figure 2.9: Evolution of non-cost competitiveness of Latvian exports as compared to EU27



Source: Authors' calculations based on Eurostat Comext data. Note: EU27 average values=100. Results corrected for Latvian product specialisation by measuring each parameter at a product level for Latvia and EU27 and then aggregating them weighting each product by its Latvian export share

It is worth noting, though, that the aggregate trends shown here may hide substantial heterogeneity across products. Table 2.2 shows that this is actually the case, as it shows linear trends in quality, physical unit labour costs, non-cost competitiveness and export prices for the whole manufacturing sector and for the ten most important Latvian export products. We also report the results for the export-share weighted sum of the manufacturing products to provide a more precise aggregate indicator than the trends in total exports.[18] It can be noted that all the products experienced quality increases vis-à-vis the rest of the European Union which were larger than increases in their physical

[18] Total values shipped and average prices calculated on total exports implicitly amount to weighting each sector according to its physical weight and are thus not the most relevant dimension to analyse aggregate trends.

unit labour costs, which points to an overall positive effect on mark-ups, driven by lower costs of production and a higher willingness to pay for Latvian products. On the other hand, non-cost competitiveness often shows a negative sign, pointing to the fact that all the market share gained by Latvian firms came from the actual quality improvement of their products rather than from a better capacity to sell their products on foreign markets (for a given level of mark-up). This is particularly evident looking at Latvia's most important export product, "Wood and articles of wood", which is indeed experiencing a sharp fall in non-cost competitiveness labour costs but an increase in quality much more pronounced than the increase in physical unit labour costs, resulting overall in an increase in market shares.

Table 2.2: Simple linear trends of Latvian quality, PULC, non-cost competitiveness and export prices vis-à-vis EU27

Product (CN2 Product Category)	***Average share of Latvian exports (1999-2011)***	***Quality trend***	***Physical Unit Labour Cost trend***	***Non-cost competitiveness trend***	***Export price trend***	***Market share trend in the EU***
Wood and articles of wood (44)	26.19%	1.20%	0.39%	-0.51%	0.98%	0.07%
Iron and steel (72)	7.60%	3.32%	1.60%	0.03%	2.57%	0.04%
Machinery and mechanical appliances (84)	5.18%	8.73%	5.02%	0.00%	6.73%	0.01%
Electrical machinery and equipment (85)	4.92%	12.04%	7.17%	-0.02%	9.20%	0.01%
Mineral fuels and oils (27)	4.17%	1.51%	0.71%	0.03%	1.62%	0.01%
Furniture (94)	3.98%	3.35%	1.63%	-0.14%	2.50%	0.00%
Apparel and clothing (62)	3.76%	8.36%	3.74%	-0.05%	5.97%	-0.02%
Vehicles and accessories (87)	3.15%	8.34%	5.48%	0.01%	6.86%	0.01%
Pharmaceutical products (30)	3.09%	4.41%	1.90%	-0.01%	3.40%	0.00%
Articles of iron or steel (73)	2.44%	2.63%	0.63%	0.02%	1.74%	0.02%
Whole manufacturing		0.69%	1.16%	-0.02%	1.09%	0.01%
Export-share weighted sum		3.35%	1.37%	-0.16%	2.39%	0.03%

Source: Authors' calculations based on Eurostat Comext data. Note: Aggregates are shown for the "whole manufacturing" product as measured by Eurostat and for the "export-share weighted sum" as a weighted average of all the manufacturing products, where each product is weighted by Latvian export shares, in values. Physical unit labour costs (PULC) are defined as the cost, in euros, of producing a given quantity of the products exported. The quality index indicates the intercept of the vertical inverse demand function, also expressed in euros per a given quantity of the product sold

Table 2.3 confirms the qualitative results provided in Table 2.2 by running a simple linear trend regression first on all the products, with and without product dummies, and then on the weighted average results for the entire economy. Prices and quality levels are all significantly increasing, as compared to the European Union average, confirming that Latvian export industry has fared extremely well during the last decade and even the overheating and the subsequent crisis do not seem to have caused lasting damages on the export capacity of the country. Physical unit labour costs also show an increase, partly offsetting the gains obtained by quality upgrading, but it is more modest than quality and export price increases and it is not statistically significant along all the specifications. As for non-cost competitiveness, it appears to have worsened only when weighted average results are

considered, but not when all the products are pooled in the regression. This is in line with what has been observed in Figure 2.9 and points in the direction of major economic restructuring within product categories towards more value added varieties, whose full demand potential has possibly not been tapped yet.

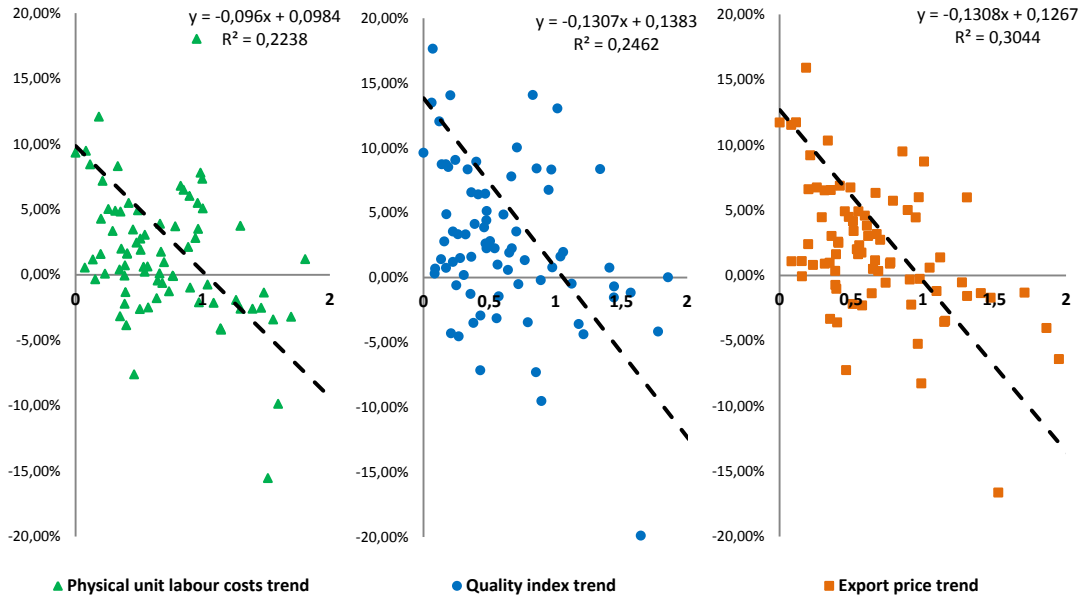
Table 2.3: Linear trends of Latvian quality, PULC, non-cost competitiveness, export prices and market shares. Evolution vis-à-vis EU27, compared product-by-product and on weighted average aggregates

Regression type	*Quality trend*	*Physical Unit Labour Cost trend*	*Non-cost competitiveness trend*	*Export price trend*	*Market share trend in the EU*
Simple time trend	**2.47%** (4.70)	0.61% (1.63)	0.00% (0.19)	**1.63%** (4.16)	**0.01%** (8.54)
Product dummies	**2.26%** (5.87)	**0.56%** (1.98)	0.00% (0.12)	**1.57%** (5.23)	**0.01%** (12.93)
Simple time trend on weighted averages	**2.54%** (86.97)	**0.89%** (13.84)	**-0.71%** (-43.09)	**1.75%** (71.99)	**-0.05%** (-47.97)

Source: Commission services. Note: t-statistics are reported in parentheses. Results in bold are significant at 1% level. The first row represents a regression on a simple linear trend, the second adds product dummies, the third takes the weighted average values for the entire economy, each product being weighted by Latvian export shares

Another way to grasp the high level of heterogeneity across export products is to plot their parameter levels vis-à-vis EU27 in 1999 and their linear trend growth from 1999 to 2011. This is shown in Figure 2.10, where it can be clearly noticed that a rapid process of price and quality convergence to EU levels is taking place, involving especially the products which are furthest from EU27 levels. The steeper slope and higher intercept of the price and quality trend lines as compared to the PULC line also confirms that costs are converging more slowly than quality, which is a good indicator of long-term sustainability of external competitiveness.

Figure 2.10: PULC, quality and price growth and initial levels vis-à-vis EU27



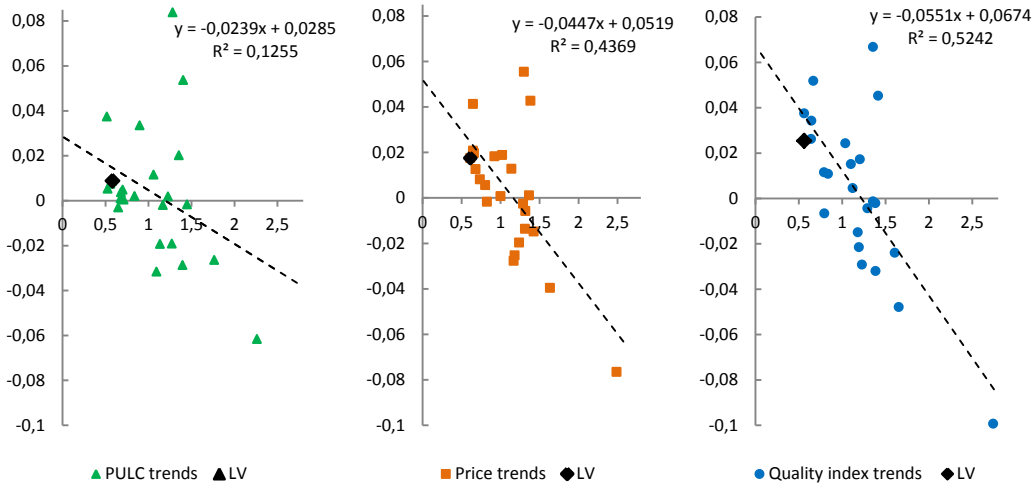
Source: Commission services. Note: On the horizontal axis the levels in 1999 of Latvian physical unit labour costs, quality index and export prices against the European Union (EU27=1) for each product in the sample (97 CN2 product codes). On the vertical axis the product-specific linear trend growth over the period 1999-2011, with a dashed linear trend line

Putting Latvia in a cross-country perspective, in Figure 2.11 shows the initial levels and trends of the EU Member States for weighted average PULCs, export prices and quality indices for the entire economy.[19] For the definition of the trends, the third specification shown in Table 2.3 is used.

[19] The only Member States which have not been included are Cyprus, Malta and Ireland because of the high volatility of their trade series and the presence of many abnormal observations at the product level both across time and across varieties.

Latvia's annual speed of convergence in quality is remarkable, and so is the fact that physical unit labour costs converge more slowly than prices and quality.

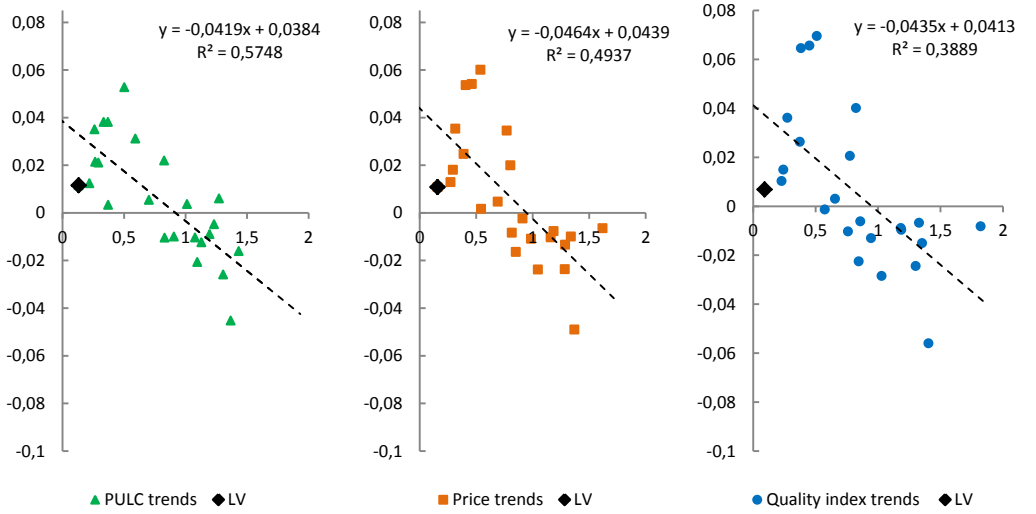
Figure 2.11: Weighted average physical unit labour costs, price and quality growth (vertical axis) and initial levels (horizontal axis) in the EU Member States



Source: Authors' calculations based on Eurostat Comext data. Note: On the horizontal axis are reported the initial weighted average of EU Member States' PULC, price and quality index vis-à-vis the European Union (EU27=1). The average of years 1999, 2000 and 2001 is chosen as initial value. On the vertical axis is displayed the product-specific linear trend growth over the period 1999-2011 of the same indicators. EU15 aggregate results are indicated by a black diamond. The dashed line is a simple linear trend of the results

This looks to be less the case when unweighted total exports are considered, as in Figure 2.12. The export composition effects noticed when describing the indicators are also visible in this case, as the evolutions of PULCs, prices and quality indices are much less differentiated in this case and would wrongly signal a much lower convergence process towards EU27 levels than is actually in place. The comparison between Figure 2.11 and Figure 2.12 again confirms that aggregate indicators can be misleading when substantial heterogeneity is present across individual components.

Figure 2.12: Physical unit labour costs, price and quality growth (vertical axis) and initial levels (horizontal axis) in the EU Member States when total exports are considered



Source: Authors' calculations based on Eurostat Comext data. Note: On the horizontal axis are reported the initial EU Member States' PULC, price and quality index in unweighted total export vis-à-vis the European Union (EU27=1). The average of years 1999, 2000 and 2001 is chosen as initial value. On the vertical axis is displayed the product-specific linear trend growth over the period 1999-2011 of the same indicators. EU15 aggregate results are indicated by a black diamond. The dashed line is a simple linear trend of the results

A key message emerging from the above analysis is that the different products appear to have a certain degree of heterogeneity and are not necessarily affected by the same shocks and dynamics. Notably, while unit labour costs in the non-tradable sector increased substantially in the years leading up to the crisis, the tradable sector, as captured by external trade data, appeared rather sheltered from this trend for most of the decade. This analysis also points to the benefit that the economies could obtain by allowing resources to be reallocated smoothly across products, as the Latvian economy managed to do. However, it should be noted that the export mix of the country is still very much concentrated on a few products, as the six most important export products account for 50% of the total value of exports, which suggests that there is still a lot of space for differentiation and reallocation of resources towards products with higher growth potential. This should be clear by looking at Tables 2.2 and 2.3, showing that the current largest export product, "Wood and articles of wood", underperforms the rest of the economy on almost all the competitiveness dimensions observed.

III.4. Further alternative indicators of competitiveness

As highlighted in the previous section, standard competitiveness indicators based on prices and labour costs may fail to capture the full scope of factors affecting production costs and revenues, which can be affected by changes in quality as well as in product and market structures. For example, in some sectors of the economy, labour costs account for a relatively small share in total production costs and therefore other input costs have to be also taken into account. In particular, Latvia's historical exposure to energy-intensive industries calls for a closer look at energy costs, but also various other costs in the field of transportation, technology, logistics, and others could be brought into consideration subject to data availability. A way to assess the effects of other costs that could offset or add to changes in labour expenses is to look at corporate profit margins. In the case of Latvia, corporate profit rates have remained among the highest in the EU through the whole transition period which is a clear indication that increasing labour costs have been offset by other cost or revenue factors affecting the corporate income statements.

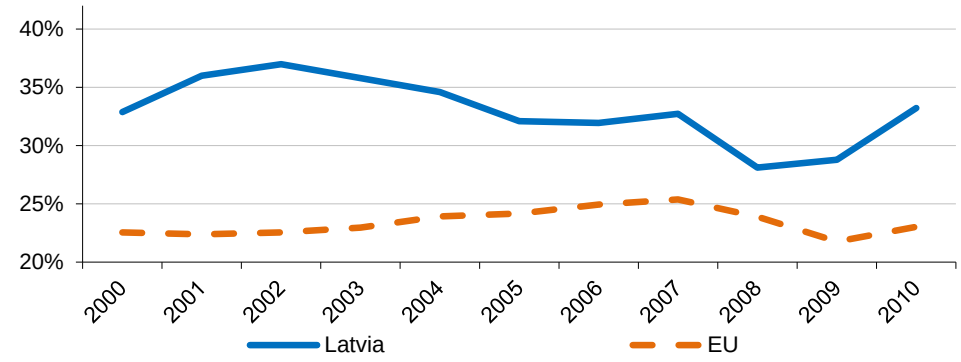
Profit margins

The share of corporate profits in gross value added can be calculated from national accounts statistics both at sector and aggregate levels on the basis of the following identity:

GVA *(Gross Value Added) =* ***P*** *(Profit and other capital remuneration) +* ***K*** *(Capital depreciation) +* ***L*** *(Labour remuneration)*

In addition to production-related costs, the analysis of corporate profitability reflects various competitiveness effects channelled through the revenue side of the income statement, in particular re-positioning of products in different geographical markets, product segmentation, as well as external demand and price effects. Figure 2.13 shows that Latvia's corporate profit rates remained higher than in the rest of the European Union in the period of 2000-10, even during the crisis, providing another argument in favour of the view that the major cause of accumulating external imbalances in the boom years was linked to excess domestic demand and not linked to a loss of competitiveness or difficulties in the industrial sector.

Figure 2.13: Evolution of Latvia's corporate profit rates

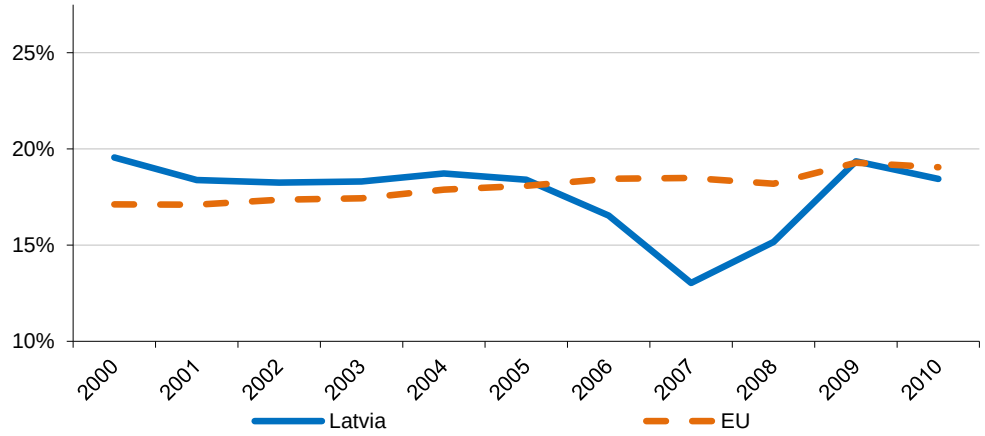


Source: Commission services. Note: Corporate profit rates are calculated as a net-operating-surplus-to-GVA ratio)

- **Capital productivity**

The above identity (GVA = P + K + L) also provides information about changes in capital productivity by monitoring the ratio of capital use to gross value added (K/GVA). A decrease in the ratio means improvement in capital productivity as it shows lower capital costs per unit of value added. The ratio follows the logic of unit labour costs and could be similarly named as unit capital cost. The calculations for Latvia (Figure 2.14) show that unit capital cost has improved (use of capital to GVA has declined) in periods of increased unit labour costs which has to some extent sustained the favourable export position in the corporate sector and explains the large profit margins.

Figure 2.14: Evolution of unit capital costs for Latvian and the EU



Source: Commission services

- **Energy and other input costs**

In the analysis of the gross value added, profits can be seen as a residual value determined by other capital and labour remuneration. However, in the corporate income statements, profit is also determined by a number of other costs that are booked as intermediate consumption in the national accounts and deducted from gross output. Therefore, in order to have a fuller picture of the factors affecting profits, it is also useful to look into output and intermediate consumption. In the case of Latvia, it is worth to focus the analysis on energy costs as a key component of intermediate consumption, as Latvia's energy intensity, calculated as the share of energy intake in GDP, is still among the highest in the EU (80% above the EU average in 2010).

Energy constitutes a pervasive input, being used to a larger or lesser extent in all economic activities. For the Baltic countries and Latvia in particular, energy costs in relation to output are substantial. In replication of the ULC (unit labour cost) approach, it is possible to construct a unit energy cost (UEC) for the assessment of possible gains/losses from energy efficiency and energy prices relative to trading partners. Given the country's high dependence on energy imports, changes in the UEC also have an important impact on the country's foreign trade balance as nearly 50% of the goods' trade deficit is generated by net energy imports (52% in 2010). In a similar vein, it is possible to construct unit transport costs and other unit input costs that affect companies' income statements. From the point of view of the national accounts, all these costs are booked as intermediate consumption and deducted from gross output:

Gross Output – Intermediate Consumption = GVA = P + K + L

This identity of gross valued added suggests that more efficient use of energy, transport or other inputs will result into lower intermediate consumption and higher value added. These gains could be then allocated to profit or labour on the right-hand side of the equation with different implications on ULC. Historical data show a stable ratio of intermediate consumption to output in Latvia which suggests that on aggregated basis, the country's economic agents have not gained or lost efficiency

through changes in the modes of using inputs counted as intermediate consumption. However, there is a strong potential for reducing the share of intermediate consumption to output through energy efficiency, given Latvia's high energy intensity at present, and therefore it is important to monitor both sides of the above equation in future analysis of competitiveness.

IV. Beyond export competitiveness: the role of imports and internal demand

After having seen how the export sector of the economy fared during and before the crisis, in this section we analyse the demand side of the economy.

IV.1. Analysis of the national account identities

The aggregate supply and demand of the economy provides a field where "real-variable" policies may be implemented in order to improve the current account. Starting from a breakdown of output into expenditure components, it can be shown that current account imbalances may be ultimately ascribed to imbalances in the relationship between savings and investments of an economy:

$Y = C + I + G + X - M$

where Y is GDP, C is consumption, I is investment, G is government expenditure, X is exports and M imports.

$Y - T - C = I_P + I_G + G - T + NX$

where T is taxation, I_P and I_G are private and public investment, *and* NX is net exports.

$S_P - I_P = I_G - S_G + NX$

where S_P and S_G are private and public savings.

$NX = (S_P - I_P) + (S_G - I_G)$,

or, if we consider the existence of factor income and transfer payments from abroad and add their net value to both sides of the identity

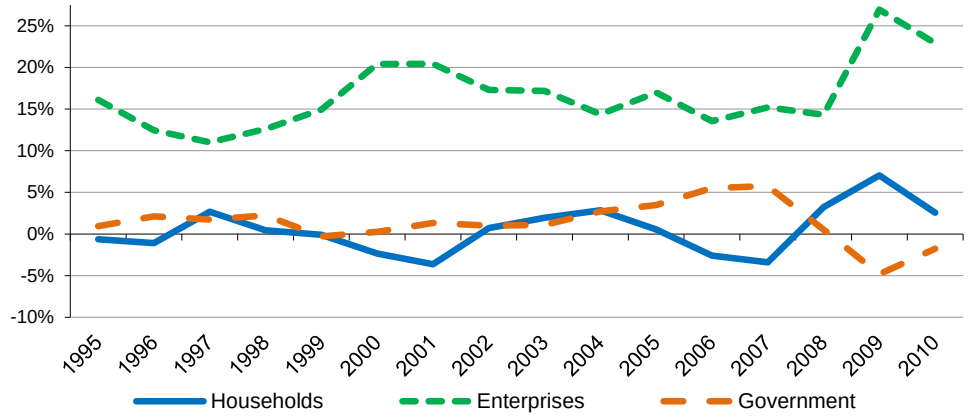
$CA = (S_P - I_P)' + (S_G - I_G)'$,

where the new levels of net savings, $(S - I)'$, should increase with factor income and transfer inflows, and decrease with outflows. Private sector savings and investments $(S_P$ and $I_P)'$ can be further broken down into household and corporate sectors, $(S_{Ph}$,S_{Pc} , I_{Ph} and $I_{Pc})'$:

$CA = (S_{Ph} - I_{Ph})' + (S_{Pc} - I_{Pc})' + (S_G - I_G)$

Therefore, a positive trade balance or current account can only be maintained when the economy as a whole saves more than it invests domestically. The surplus can then be exported, thereby increasing the international investment position of the economy. The evolution of gross saving rates in Latvia is show in Figure 2.15.

Figure 2.15: Evolution of gross saving rates in Latvia (% of GDP)



Source: Eurostat

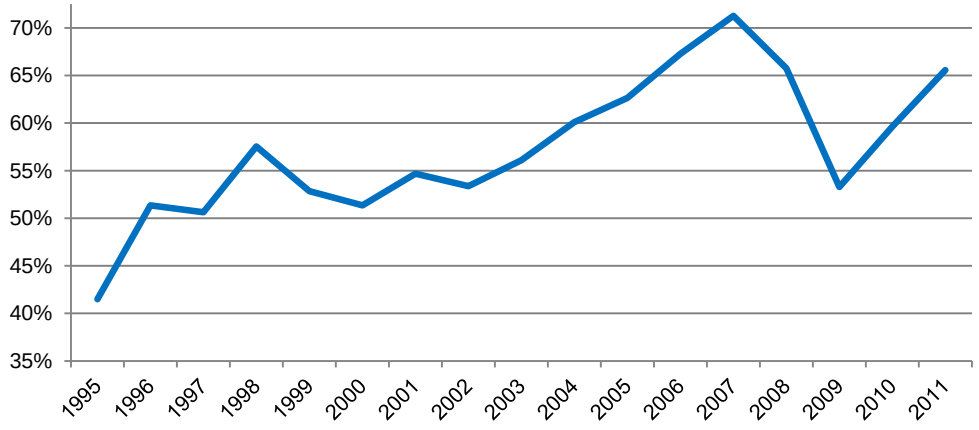
External imbalances beget the question of who is saving and dis-saving in the economy. The role of the different institutional sectors – public, private and, within the latter, households and firms – should then be assessed. In fact, an imbalance may be rather benign when it is the result of a high investment rate of corporations in an economy with many growth opportunities which may then translate, for example, into larger volumes of imports of capital goods. Quite differently, an imbalance that stems from a continuous decrease in the saving rate of households and that translates into high volumes of consumer goods being imported may give rise to worries regarding sustainability. A similar argument carries over to the government sector, where the composition of government expenditure and investment and their repercussion effects on the economy as a whole play a crucial role.

As detailed in the next section, Latvian external imbalances were clearly influenced by import demand. The historical overview of the Latvian economy shows that domestic demand was pushed by two major sources: very high external financial inflows (both through bank lending and FDI) and high consumption propensity in the household sector. In fact, household saving rates in Latvia were very low in the boom years in comparison with the EU average. When the crisis took place in 2008-09, a quick adjustment of household saving rates combined with lower aggregate incomes quickly reversed the current account to a surplus.

IV.1. Excess imports and import content of consumption

Latvian imports increased markedly as a percentage of GDP in the heating-up period, reaching a peak of more than 70% in real terms, as can be seen in Figure 2.16. The speed and magnitude of the observed increase in imports could hardly be matched by a similar increase in exports, the consequence being that Latvian current account balance deteriorated markedly in the run-up to the crisis.

Figure 2.16: Latvian imports-to-GDP ratio, in real terms



Source: Eurostat

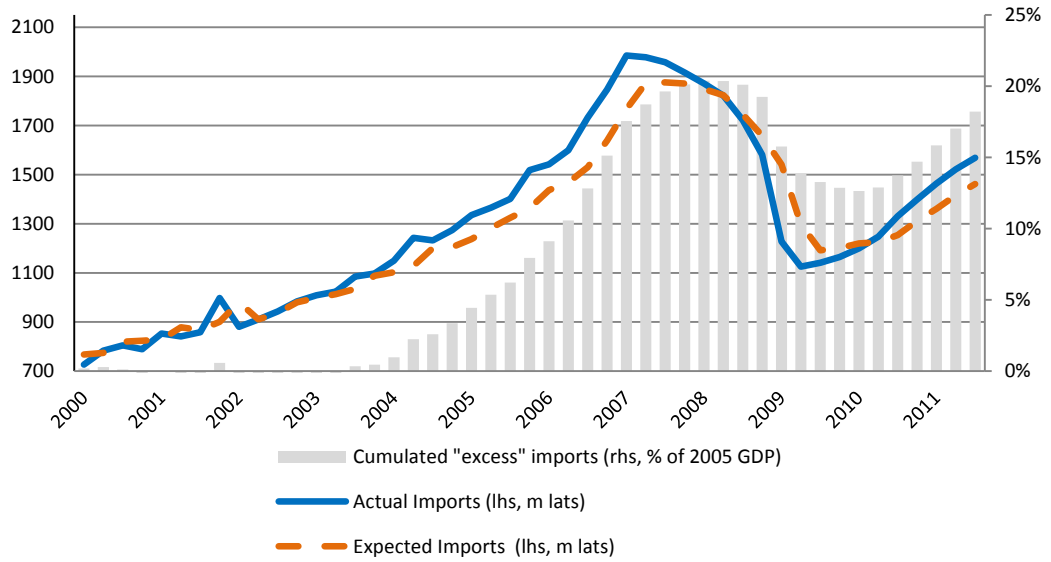
In fact, Latvian import behaviour appears to have undergone an important change during the boom and subsequent adjustment period when compared to historical trends. Figure 2.17 contrasts the expected Latvian import demand, derived from an estimated import demand function for the pre-accession period,[20] with actual import behaviour in recent years.

[20] In line with a general class of parsimonious models used to explain aggregated imports, the following import demand function was estimated on quarterly data from Q1 1995 to Q4 2003, i.e., the pre-accession years:

$$\ln(real\ imports_t) = \beta_1 \ln(real\ GDP_t) + \beta_2 \frac{import\ deflator_t}{GDP\ deflator_t} + \beta_3 \ln(real\ imports_{t-1})$$

The choice of this particular specification was based on a standard battery of statistical criteria and comparisons with alternative specifications. The estimated statistical model passes standard misspecification and serial correlations tests, and all the estimate coefficients have the expected sign and are significant at a 5% level. The regression explains 94% of the variance in real imports.

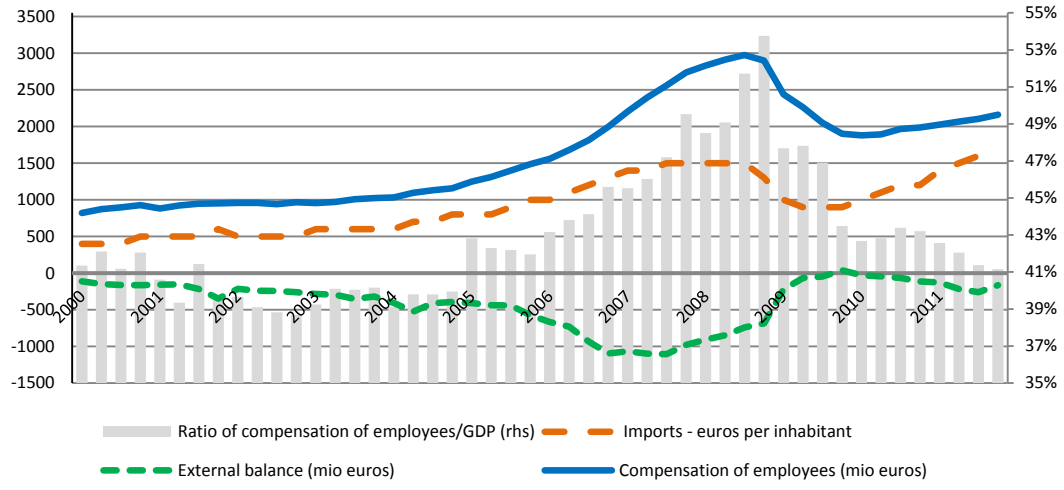
Figure 2.17: Actual vs. expected imports, at constant (2005) prices



Source: Eurostat and author's calculations

A change in import behaviour is noticeable in the wake of EU accession, with actual imports decoupling from expected imports during the 2004-2007 heating up period. In fact, 'excess' imports, defined as the difference between actual and expected imports, cumulated from 2004 through 2007 to reach 20% of 2005 GDP, with a correction period following from 2008 to 2010. While an increase in imports can be partly explained by the opening-up of the economy in the wake of EU-accession, other important factors contributed to a spike in import demand. Among these are very dynamic developments in compensation growth (Figure 2.18), a bout of "EU-phoria" following accession in 2004 which may have masked the important economic challenges still confronting Latvia, unrealistic expectations of high and fast growing future incomes by households and, possibly, a shift in preferences towards foreign, more expensive goods.

Figure 2.18: Compensation growth and external imbalances

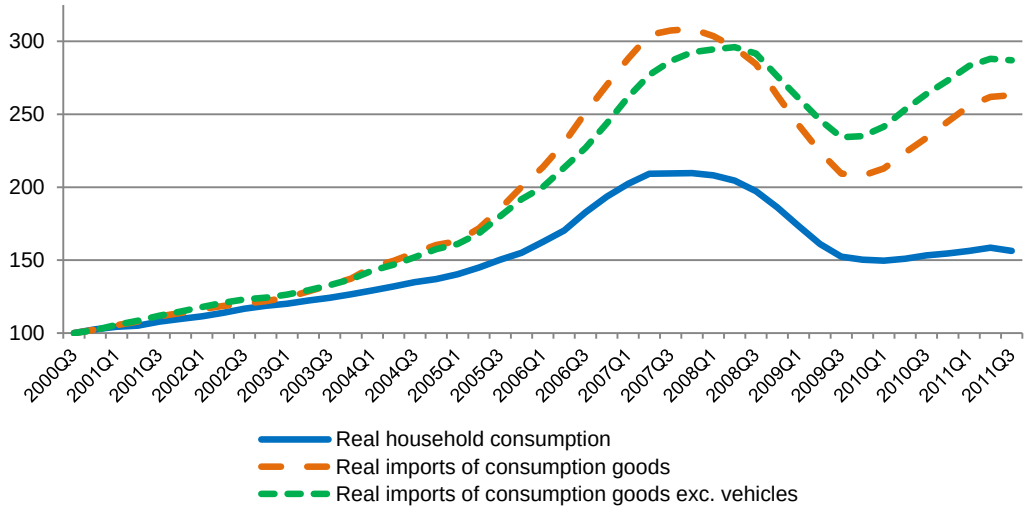


Source: Eurostat

In fact, the import content of consumption appears to have increased significantly in the pre-crisis period. As depicted in Figure 2.19, in the heating-up period from 2004 until the collapse of Lehman brothers in the third quarter of 2008, Latvian imports of consumption goods increased much faster

than household consumption, with the chart data suggesting a 28% increase in the real imported-consumption-to-total-consumption ratio.[21]

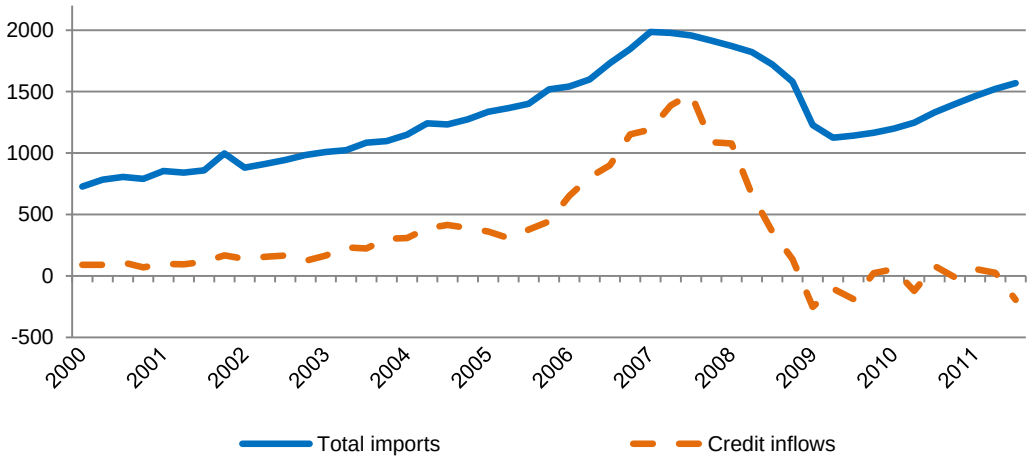
Figure 2.19: Latvian imports of consumption goods and consumption growth



Source: Eurostat

The aforementioned effects were compounded by increased credit flows, namely from abroad, as the private sector leveraged up in a context of favourable credit conditions. Figure 2.20 evidences the important role of credit inflows in financing a buoyant import demand. Credit inflows in the form of bank loans from abroad are seen to have co-moved strongly with soaring imports.[22] In fact, whereas prior to 2004 foreign credit inflows played a minor role, accounting for as little as 10% of total imports, they grew to represent almost two thirds of import values in the 2004-2007 heating up period. When the collapse of the Lehman Brothers investment bank in 2008 brought about a sudden stop in credit inflows, imports collapsed along with GDP. However, whereas credit inflows were brought to a halt, there is a limit to import adjustment in a small and very open economy such as Latvia's, which prompted the country to seek a balance of payments assistance programme from the EU in order to support its international transactions.

Figure 2.20: Credit growth and imports



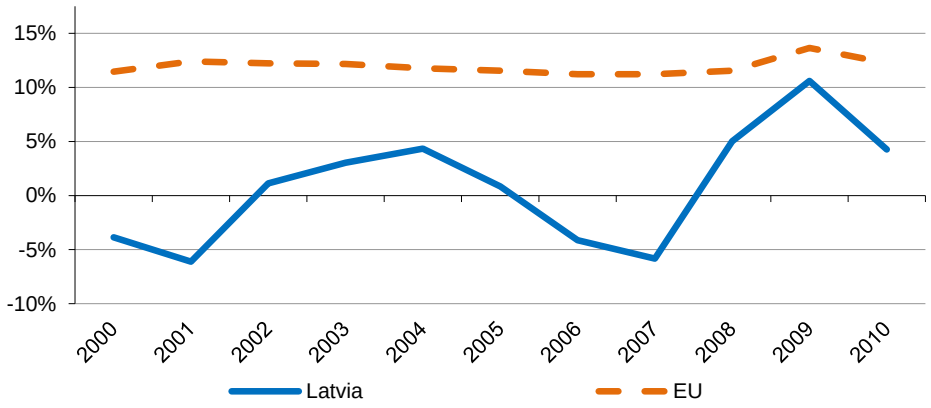
Source: Eurostat, Bank of Latvia

[21] Due to the fact that Latvian input-output tables do not cover this period, more exact figures on the import content of consumption are not available.
[22] Credit inflows are obtained from the financial account's "other investments" category of the balance of payments (4-quarter average).

V. Conclusions

In this chapter it has been argued that rather than a competitiveness problem, the Latvian economy suffered from an excess of demand, fuelled by an extraordinary credit expansion. While controlling import behaviour in an economic union without capital controls and under a currency peg may be difficult, there are nevertheless some policy tools available. For example, indirect taxation may be used to redirect income from consumption towards savings, while property taxation can help curb the expansion of the non-tradable sector and taxation of vehicles (an entirely imported good in Latvia) can help moderate import values. As can be seen from Figure 2.21, this is going to be a challenging task for Latvian authorities, as household savings rates have been historically very low in Latvia (significantly below the EU levels) and declined steeply to negative rates in boom years

Figure 2.21: Household savings, as a percentage of disposable income)



Source: Eurostat, Bank of Latvia

Authorities have basically two major tools for managing demand. One of the tools is related to financial and bank regulations that could increase risk awareness and limit excess credit growth, especially in the area of mortgage lending that was a major source of overheating in Latvia. The second tool for managing household demand is based on taxation and fiscal policies whereby the tax burden can be rebalanced from labour to consumption. This would simultaneously reduce labour costs for businesses and exporters, discourage excess consumption and support higher saving rates. Additionally, property taxation can help curb excessive expansion of the non-tradable construction sector and taxation of vehicles (an entirely imported good in Latvia) can help moderate import values. The rebalancing of the tax burden was effectively done in Latvia through increases in VAT, excise, housing and transport vehicle tax rates during the period of radical fiscal consolidation in 2008-10. However, the potential for further rebalancing is still in place as both excise tax rates and property taxes (for real estate and transport vehicles) are below the EU average.

While a significant part of the change in Latvian import behaviour is bound to be structural and associated with its integration in the single market, the future sustainability of the Latvian external position will depend on the judicious management of its internal demand and on the continued promotion of its external competitiveness, so that, differently from what happened in the 2008-2009 crisis, exports dynamics can accommodate import growth. Under the conditions of fixed exchange rate regimes and demand-driven imbalances, the policy response to offsetting the import demand effects of external financial inflows and encouraging saving propensity in the household sector appear of high importance and with much lower negative effects on growth than the alternative fiscal and budgetary measures.

References

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Chapter 3 – Evaluation of non-price competitiveness of exports from Latvia

Konstantīns Beņkovskis

I. Introduction

Despite the amount of discussion and empirical work on the topic, the concept of competitiveness is still elusive. The definition of competitiveness is so broad that it includes the extremely large set of macro- and microeconomic issues: per capita income levels, performance of institutions, levels of productivity, comparative costs and many others not mentioned here. As a result, the number of ways a researcher can evaluate the competitiveness of a country is vast. This research is narrowing the definition of competitiveness to one given by OECD, "competitiveness is a measure of a country's advantage or disadvantage in selling its products in international markets," and concentrate on the performance of Latvia's exporters.[23]

The motivation for the focusing on export activities is obvious – Latvia is very open and extremely small economy, where exports are the main source of economic growth in the long run. Our research is by no means a unique attempt to discuss the competitiveness of Latvia's exports. However, some of the empirical papers are already outdated and observe years before the accession to the EU (like Dulleck et al., 2005, or Fabrizio et al., 2007), some are relating competitiveness issues mostly with effective exchange rates (like Purfield and Rosenberg, 2010), some are not covering all Latvia's exports (Benkovskis and Wörz, 2012). Therefore, there is a need for updating the assessment of competitiveness as well as broadening the set of available indicators.

Is real effective exchange rate a complete measure of competitiveness? Can we assess non-price competitiveness of Latvia's enterprises? Our chapter tries to address these questions. Although real effective exchange rate is widely used for the analysis of export competitiveness, it is an imperfect tool for many reasons. Perhaps, the limitation of the analysis to price competitiveness is the most important drawback of this type of indicators. Detailed trade data from UN Comtrade allows us not to restrict the analysis to some specific geographical areas or subset of products, while disaggregation gives researchers the possibility to track the performance of separate sectors and to take into account structural differences.

The next section illustrates the data, which is extracted from UN Comtrade. Section III makes use of information on trade volumes and prices, briefly describes the methodology behind the evaluation of price and non-price competitiveness on a highly disaggregated level and presents the empirical results. The last section concludes.

II. Description of the database

For the empirical analysis in this chapter we use trade data from UN Comtrade. The main reason for such choice is its comprehensive country coverage. Although the data in UN Comtrade has a lower level of disaggregation and a longer publication lag comparing with Eurostat Comext, the world-wide coverage of the UN database is a significant advantage. Our view on Latvia's exports will not be complete without partners so important as Russia or Belarus. Moreover, despite the low shares of countries like China, India and Brazil in current Latvia's exports, these markets are huge, dynamically growing, and have significant potential for Latvia's products. Eurostat Comext contains detailed data on Latvia's exports outside the EU, but only UN Comtrade can give information on the product and partner structure of non-EU markets.

[23] For the OECD definition, see http://stats.oecd.org/glossary/detail.asp?ID=399 .

UN Comtrade provides reasonably good disaggregation of export and import flows and we are using the most detailed available – six-digit level of the HS (Harmonised System, 1996), which includes 5132 different products. As mentioned above, this level of disaggregation is lower than in Eurostat (more than 10000 products), but is still reasonably high to calculate unit values.

Even if our final goal is to evaluate competitiveness of Latvia's exports, in most cases this chapter achieve it by using import data of partner countries. The reason for focusing on imports from Latvia rather than on Latvia's exports is driven by the theoretical framework, which focuses on the evaluation of price and non-price competitiveness. The methodology used in section III is based on consumers' utility maximisation. Import data is clearly more preferable in this case, as imports is reported in CIF (cost, insurance, freight) prices and includes transportation costs until importers' border; therefore, import data provides a better comparison of prices from a consumer's point of view. On the other hand, the usage of import data implies some drawbacks. Obviously, the data on imports from Latvia does not fully coincide with Latvia's exports data due to differences in valuation, timing, sources of information and incentives to report. The problem can be more severe for the intra-EU trade, as measurement of trade in goods within the EU relies on the VAT reports. This creates a greater incentive for the reporting of export activities, which are subject to a VAT return.[24] For that reason we are still using Latvia's export data while determining the structure of Latvia's exports for computations of aggregate adjusted relative export price index.

Our import dataset contains annual data on imports of 75 countries at the six-digit HS level between 1999 and 2010.[25] The list of reporters (importers) can be found in Appendix, Table 3.A1. By collecting data on imports of abovementioned 75 countries we a covering more than 96% of World imports in 2010. Several importers (such as the United Arab Emirates, Vietnam, Egypt, and Kazakhstan) were not included in the dataset due to lack of detailed data or missing information for 2010. To avoid calculation burdens we restrict the list of partners (exporters) to 75 countries as well. The list of exporters can also be found in Table 3.A1 (note that the list of exporters is not fully coinciding with the list of importers). These 75 most important exporter countries cover around 93% of World imports in 2010; therefore, our database is a representative reflection of the World trade flows.

We use unit value indices (dollars per kg) as a proxy for import prices and trade volume (in kg) as a proxy for imported quantities. If we are missing data for either values or volumes, or data on volumes is not observed directly but is estimated by statistical authorities, no unit value index can be calculated. Unfortunately, the possibility to estimate unit values is relatively scarce for many reporting countries. Even the US import database – the major World importer – allows one to calculate unit values only for approximately 70% of imports in 2010 (in value terms). Situation is much better for the EU countries, China, Japan, but there are countries (e.g. Canada, Mexico, Australia) where coverage is around 50% or even less. In addition, the coverage is usually worse for the first half of the sample period. This problem makes the analysis of non-price competitiveness more challenging and our results should be treated with a pinch of salt. However, low coverage of available unit values in several countries is rather homogenous across different products and we can argue that this problem should not bias our results significantly. The other adjustment we made to the database is related to structural changes within the categories of goods. Although we use the most detailed classification available, it is still possible that sometimes we are comparing apples and oranges within one particular category. One indication of such problem is the large price level difference within a product code. Consequently, all observations with outlying unit value indices were excluded from the database.[26]

[24] An extreme case of such problem is a VAT missing trader intra-Community fraud, which was not captured in imports data and significantly overstated UK trade balance in 2001-2002, see Ruffles et al. (2003).

[25] For some countries data is not available for several years at beginning or middle of the sample period: imports data for South Africa, Philippines, Oman and Tunisia is not available in 1999, Ukraine and Ethiopia – in 1999-2000, Malaysia, Bahrain and Dominican – in 1999-2001, Pakistan and Bosnia Herzegovina – in 1999-2002, Serbia – in 1999-2004, Sri Lanka – in 2000, Panama – in 2004, Nigeria – in 2004-2005.

[26] An observation is treated as an outlier if the absolute difference between the unit value and the mean unit value of the product category in the particular year exceeds three standard deviations. The exclusion of outliers does not significantly reduce the coverage of the database. In majority of cases only less than 1% of total import value was treated as an outlier.

As for Latvia's export dataset, which is mainly used for the analysis of extensive and intensive margins, it contains annual data on exports to the above-mentioned 75 importer countries (actually 74, excluding Latvia) at the six-digit HS level between 1999 and 2010. In case of exports we are restricting ourselves only to value data, which is enough to calculate market shares and export structure.

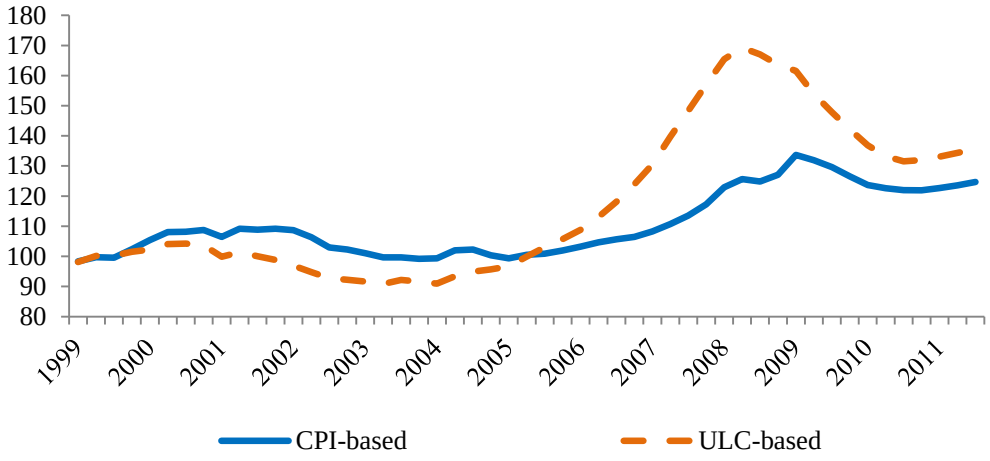
III. Price and non-price competitiveness

III.1. Traditional real effective exchange rate indices

The real effective exchange rate is one of the most widely used tools in the analysis of a country's competitiveness. It proxies relative changes in prices of a country's exports by changes in nominal exchange rates and inflation differentials, which can be captured in various ways leading to different measures of the real exchange rate. The most popular indicator is based on inflation differentials as measured by the Consumer Price Index (CPI) due to data availability and comparability. Other popular definitions of real effective exchange rates are based on the Production Price Index (PPI) or the Unit Labour Costs (ULC). Figure 3.1 reports CPI-based and ULC-based real effective exchange rates for Latvia. Both indicators show similar picture – no big changes in real effective exchange rate before 2005, a sharp increase in relative prices during the boom years of 2006-2008 and regaining of competitiveness after the financial crisis. At the end of the observed period real effective exchange rate is higher by 25-35% comparing to 1999 which might be interpreted as a loss of price competitiveness. Such a simple interpretation of these indices, however, can be quite misleading for various reasons.

Traditional real effective exchange rates have several drawbacks related to approximation of export prices. The CPI-based index is showing the dynamics of relative consumer prices. Domestic and export prices are faced by different demand and supply conditions and can therefore differ greatly. Further, the CPI-based index includes changes in indirect taxes, which do not affect export activities directly. Although the PPI-based index is closer to the production side of the economy, it still includes production for the domestic market (data on export-oriented PPI is usually very scarce). The ULC-based index has a similar drawback; moreover it usually refers to the total economy, including also the services sector. In addition, ULC refers to only a part of production costs and ignores such important factors as profit margins. A solution to these shortcomings is to use a relative export price index – an indicator that is often used in macroeconomic models when explaining the dynamics of real exports. However, an aggregate export deflator still ignores one serious problem – the structure of exports differs across countries. Therefore, the need arises to conduct the analysis on the most disaggregated level to ensure that similar export products are compared for different countries.

Figure 3.1: Real effective exchange rates of Latvia



Source: Eurostat. Notes: 36 trading partners; 1999=100

In addition, real effective exchange rate indices are measuring only price competitiveness, while ignoring non-price factors that affect the performance of exports. One such non-price factor, emphasised by Flam and Helpman (1987), is related to vertical differentiation or quality of exported products. Another non-price factor is change in consumers' tastes, which can be driven by objective as well as by subjective factors like image or branding. Finally, as emphasised in particular in the recent empirical trade literature, consumers gain additional utility from increased product variety through international trade. Therefore, change in the set of rivals can affect the competitiveness of an exporter (higher amount of rivals, exporting the same product to one particular market means increasing variety for consumers). Although several price measures (CPI and PPI) are adjusted for changes in product quality, they do not provide the possibility to incorporate changes in consumer's tastes or product variety.

III.2. Disaggregated approach to measure price and non-price competitiveness

In this section we will apply the disaggregated approach proposed by Benkovskis and Wörz (2012) to measure price and non-price competitiveness of Latvia's exports. This approach is based on the methodology developed by Feenstra (1994) and Broda and Weinstein (2006), while the evaluation of unobserved quality or taste parameter is based on work of Hummels and Klenow (2005). The main idea is that consumers are not focused just on physical quantities, but they also value variety (set of exporters, as we are stick to assumption of Armington, 1969). Moreover, consumers' utility also depends on quality and taste parameter of a product. By solving consumers' maximisation problem it is possible to introduce the above-mentioned non-price factors into the relative export price measure (see Appendix, sections 3.A.1 to 3.A.4 for technical derivations).

According to Benkovskis and Wörz (2012), changes in the relative export price of good g exported to a country i are defined in the following way:

$$RXP_{ig,t} = \prod_{c \in C_{ig}^{-LV}} \left(\frac{p_{igLV,t}}{p_{igc,t}} \frac{p_{igc,t-1}}{p_{igLV,t-1}} \right)^{w_{igc,t}^{-LV}} \left(\frac{\lambda_{ig,t}^{-LV}}{\lambda_{ig,t-1}^{-LV}} \right)^{\frac{1}{1-\sigma_{ig}}} \prod_{c \in C_{ig}^{-LV}} \left(\frac{d_{igLV,t}}{d_{igc,t}} \frac{d_{igc,t-1}}{d_{igLV,t-1}} \right)^{\frac{w_{igc,t}^{-LV}}{1-\sigma_{ig}}} \quad (1)$$

where LV denotes imports from Latvia, $p_{igc,t}$ is the price of good g imported by country i from country c, $d_{igc,t}$ is unobservable quality and taste parameter of a product, C_{ig}^{-LV} is set of countries exporting particular product in both periods (excluding Latvia), $w_{igc,t}^{-LV}$ represents the shares of Latvia's rivals competitors on a particular market, $\lambda_{ig,t}^{-LV}$ shows the share of new/disappearing exporters (excluding Latvia).

The index of adjusted relative export price in (1) can be divided into three parts:

- The first term gives the traditional definition of changes in relative export prices which are driven by changes in relative export unit values weighted by the importance of competitors on a given market (represented by $w_{igc,t}^{-LV}$). An increase in relative export unit values is interpreted as a loss in price competitiveness;

- The second term represents Feenstra's (1994) ratio capturing changes in varieties (i.e. the set of exporters of this product in our case). This term is calculated excluding exports coming from Latvia. It can be interpreted as the effect from a changing set of competitors – more competitors for the same product give higher utility and lower minimum unit costs for consumers while at the same time lowering market power of Latvia's producers. Therefore, more competitors imply a positive contribution to the adjusted relative export price index and are associated with a loss in non-price competitiveness;

- The third term is simply the change in relative quality and taste of exports. If the quality and taste of Latvia's exports is rising faster than that of its rivals, the contribution to the adjusted relative export price index is negative, thus signalling improvements in non-price competitiveness. Although relative quality and taste is unobservable, it is possible to evaluate it using information on relative unit values and real market shares (see Appendix, section 3.A.3).

Finally, we need to design an aggregate relative export price as index in (1) describes relative export prices only for one specific product *g* which is exported to one particular country *i*. The aggregate adjusted relative export price index can be defined as a weighted average of specific market indices, where weights are given by shares of those markets in Latvia's exports.

III.3. Results of disaggregated approach for Latvia's exports

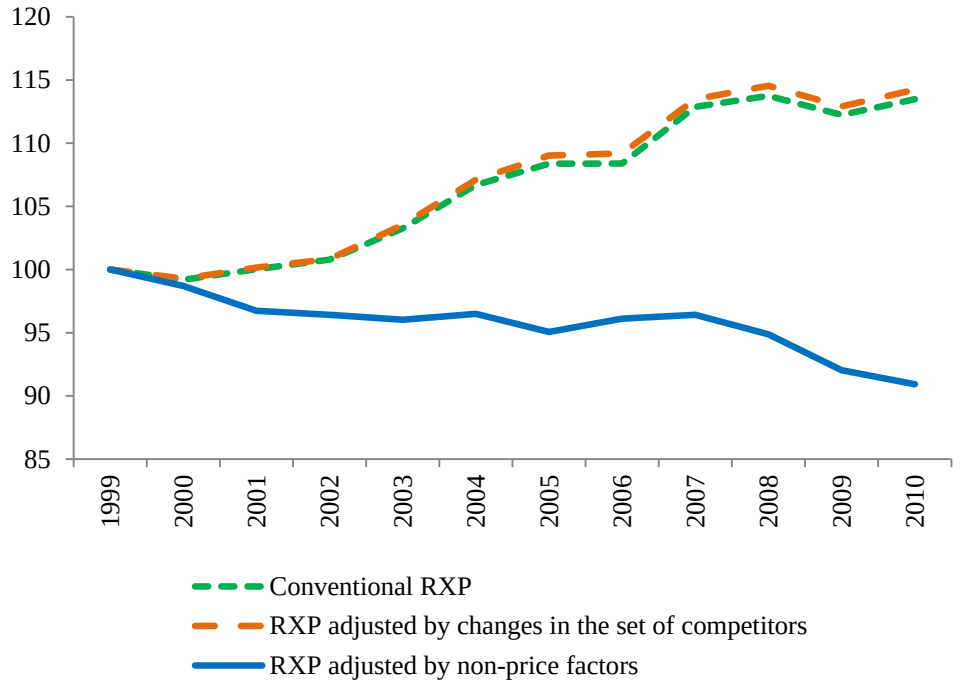
Now we can calculate the relative export price index for Latvia, which will take into account several non-price factors like quality, taste and changes in the set of rivals. This is done using equations (1) and (A9), while unobserved relative quality is evaluated by equation (A10). Figure 3.2 shows three different relative export price indices for every country. The first one is the traditional or conventional relative export price index (RXP) which does not take into account changes in quality and set of rivals and is calculated using the first term in equation (1). This index can serve as a benchmark denoting pure price competitiveness of Latvia's exports. The second index also takes into account changes in the composition of competitors on the market. It is calculated using the first two terms in equation (1). A comparison to the conventional index indicates the contribution of changes in the set of rivals to competitiveness. Finally, the relative export price index adjusted by non-price factors is calculated using all three terms in equation (1). This index includes all non-price competitiveness factors analysed in this chapter. By comparing it with the conventional RXP we can highlight the role of non-price factors in Latvia's export competitiveness.

Before analysing the role of non-price factors for export competitiveness we shall contrast our relative export price index – based on trade data – to the more frequently used real effective exchange rates reported in Figure 3.1. As both real effective exchange rates are mostly describing price competitiveness, we must compare them with the conventional relative export price index. Although all indicators are signalling overall losses in price competitiveness between 1999 and 2010 for Latvia's exporters, the magnitude of losses and dynamics over the years is different.

Both real effective exchange rates calculated from aggregate price indices show more pronounced real appreciation. At the peak they point to ~70% appreciation (ULC-based) and ~35% appreciation (CPI-based) comparing to the level of 1999. Price competitiveness improved significantly during and after the crisis, however, the level of real exchange rate is still significantly higher than in 1999 (by ~35% for ULC-based and ~25% for CPI-based). In contrast, relative export price index calculated from highly disaggregated trade data shows much lower loss in price competitiveness of Latvia's exporters – highest point is observed in 2008 (losses of almost 15% comparing to 1999). Second, there is a difference in time pattern of changes in price competitiveness.

All indices show the weakest point of competitiveness in 2008-2009 (for CPI-based index late peak is due to increase in VAT and excise tax rates in Latvia), although in case of aggregated indices, price competitiveness is rather stable until 2006, while disaggregated index shows a gradual loss in price competitiveness until 2008. These differences could be driven by various reasons including differences between CPI, ULC and export prices (unit values). In contrast to ULC, export prices include profit margins, which declined during the boom years, thus partly compensating the rapid growth in labour costs. After the crisis, however, profit margins gradually returned to their initial level. Another crucial factor is the structural difference between Latvia and its rivals, which are not captured by aggregated indices. Lower increase of disaggregated relative export price might show that losses in price competitiveness were much less pronounced in the main exporting sectors of Latvia.

Figure 3.2: Latvia's relative export prices



Source: UN Comtrade, author's calculations. Notes: Relative export prices are calculated by cumulating RXP changes from equations (1), (A9) and (A10); 1999 = 100

The comparison of RXP adjusted by changes in the set of competitors with the conventional RXP shows no material effect from changes in the set of rivals. In other words, a rising or falling number of rivals is not an important driver of Latvia's export competitiveness. However, when we look at the RXP adjusted by non-price factors we observe a rather strong impact of changes in quality and tastes on Latvia's export competitiveness. Figure 3.2 shows that this index decreases, indicating that Latvia was gaining non-price competitiveness. Although Latvia's export unit values were increasing relative to those of main rivals, the relative quality of Latvia's exports (or taste for Latvian products) was rising even faster, compensating the price effect and leading to the improvement in overall competitiveness. Unfortunately, our methodology does not allow for disentangling tangible and intangible components of non-price competitiveness, therefore we cannot calculate the contribution of the changes in physical quality of exports. Most probably Latvia was able to improve both, the physical quality of products as well as their image, branding and market placement.

This finding is mostly corroborated by earlier literature on quality performance of Central and Eastern European Countries (CEEC). Dulleck et al. (2005) find an overall evidence for quality increases in CEEC exports between 1995 and 2000, although report serious cross-country differences. For instance, they conclude that quality was to some extent a concern for Baltic Countries. Also Fabrizio, Igan and Mody (2007) state that the gains in market shares of CEEC despite the pronounced appreciation trend of their currencies can be ascribed to a shift in the quality of their exports. The performance of Latvia in terms of quality between 1994 and 2004 was positive, although worse comparing to several Central European countries. Perhaps, some divergence in results may be explained by different time period of analysis, as Figure 3.2 suggests a pronounced improvement in non-price competitiveness only starting from 2001. Finally, Benkovskis and Wörz (2012) use the same methodology and evaluate non-price competitiveness of ten CESEE countries including Latvia at the EU market (based on data from Eurostat Comext). The main conclusions are similar – despite relative export prices increased more strongly in Latvia as compared to their competitors, the average quality and taste for Latvia's goods increased even faster, thus fully compensating for the rise in prices.

Table 3.1: Cumulated contribution of non-price factors to competitiveness of Latvia's exports by main sectors and markets

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Sections												
Wood and articles of wood	100.0	101.8	103.6	106.8	112.1	111.2	110.6	108.0	123.0	121.9	119.0	126.5
Base metals and articles thereof	100.0	96.3	102.6	89.8	94.5	95.3	100.8	102.8	99.7	105.0	98.7	103.0
Machinery and mechanical appliances	100.0	102.2	101.1	106.9	107.1	123.4	134.5	132.3	128.3	147.9	150.6	162.7
Prepared foodstuffs	100.0	111.9	159.5	191.1	220.1	252.7	271.4	290.3	289.4	294.7	305.4	312.6
Chemical products	100.0	93.4	74.2	74.6	69.6	69.0	79.7	83.9	94.4	101.3	115.2	129.8
Vehicles and other transport equipment	100.0	85.1	87.9	77.3	79.0	78.8	76.5	77.0	78.6	79.9	84.5	84.1
Importers												
Lithuania	100.0	97.6	96.1	98.0	93.7	107.8	107.7	108.1	106.1	110.5	117.0	119.1
Estonia	100.0	93.6	72.2	72.1	72.7	71.3	87.7	89.5	96.8	107.9	113.3	122.5
Russia	100.0	115.4	134.5	159.7	187.9	197.3	180.7	191.2	185.4	201.6	195.2	204.3
Germany	100.0	101.5	104.7	94.9	94.9	92.1	95.0	92.1	92.3	94.8	96.5	96.6
Sweden	100.0	98.2	100.8	104.1	106.3	105.1	104.3	102.7	114.5	105.6	110.4	121.8
Poland	100.0	102.6	103.6	101.7	99.6	104.1	105.2	70.6	76.5	77.6	73.3	85.9

Source: UN Comtrade, author's calculations. Notes: 6 largest product sectors are chosen using 2010 export data of Latvia (6 largest export sectors covers 64.9 % of Latvia' exports, 6 largest importers – 62.8%). Calculated using equations (1), (A9) and (A10); 1999=100

Analysis by product sector shows significant improvements in non-price competitiveness for all major export goods, excluding vehicles and other transport equipment (see Table 3.1). The most rapid improvement in quality or shift in consumer tastes is observed for food products and machinery. The role of non-price factors for wood products and chemicals is positive, although to a smaller extent, while quality or taste for Latvia's exports of base metals remained unchanged. The analysis of non-price competitiveness at different geographical destinations states, that the highest contribution of non-price factors to Latvia's competitiveness is observed in Russia (most important destination outside the EU). The non-price competitiveness in Lithuania, Sweden and Estonia is improving, although with a lower speed comparing to results obtained by Benkovskis and Wörz (2012) using Eurostat Comext database. Moreover, Table 1 reports negative changes in quality or consumer tastes for Latvia's products at German market, which contradicts results in Benkovskis and Wörz (2012). Taking into account the similarity of the methodology applied, the only plausible explanation for this inconsistency is difference in input data. Perhaps, the disaggregation level, which is approximately 2 times smaller in UN Comtrade, as well as already mentioned problems with volume and price data produce bias in our results. Taking into account that Eurostat Comext database has higher disaggregation level and therefore the estimates of unit values are more accurate, we can argue that evaluations of Latvia's competitiveness on the EU countries' markets are more precise in Benkovskis and Wörz (2012). From this it follows that our results have tendency to underestimate the effect of non-price competitiveness due to data limitation problem. However, the broader coverage of importing countries gives an important conclusion – we show that the improvement of quality or tastes for Latvia's products at Russia's markets was even more pronounced comparing to EU markets.

IV.Conclusions

The real effective exchange rate is by far the most popular way of measuring cost competitiveness. However, these traditional aggregate indicators have rather long list of drawbacks, including poor proxy for exporting activities, ignoring structural differences of competitors and focusing solely on price competitiveness. Indeed, real effective exchange rates are based on price dynamics and almost ignore changes in product volumes. The abovementioned drawbacks can at least partially be resolved by using price and volume trade data on a disaggregated level.

In this chapter we use a relative export price index developed by Benkovskis and Wörz (2012) which takes into account structural differences and allows us to disentangle the impact of changes in relative quality and taste from changes in price competitiveness. The results show that Latvia experienced a loss in pure price competitiveness over the sample period, although our index signals that losses of price competitiveness were much smaller than suggested by traditional REER measures. This could be driven by various factors including changes in indirect tax rates, differences in export structures and more rapid productivity improvements in export-oriented sectors of Latvia.

When we look at the relative export price adjusted by non-price factors we observe a rather strong impact of changes in quality and tastes on Latvia's export competitiveness. Although Latvia's export unit values were increasing relative to those of main rivals, the relative quality of Latvia's exports (or taste for Latvia's products) was rising even faster, fully compensating the price effect and improving overall competitiveness. Analysis by product sector shows significant gains in non-price competitiveness for all major export goods, excluding vehicles and other transport equipment. The analysis of non-price competitiveness at main geographical destinations shows, that the highest contribution of non-price factors to Latvia's competitiveness was observed in Russia's market (most important destination outside the EU). Contributions of non-price competitiveness in the EU market are positive, although smaller comparing to recent results by Benkovskis and Wörz (2012). Taking into account the similarity of the methodology applied, the only plausible explanation for this discrepancy is different choice of the database. Perhaps, the disaggregation level, which is relatively smaller in UN Comtrade, produces downward bias in evaluation of Latvia's non-price competitiveness.

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Appendix

Table 3.A1: Share of 75 exporters and 75 importers from our database in World imports in 2010

Importers (reporters)	Share in World imports, %	Exporters (partners)	Share in World imports, %
United States	13.51	China	12.71
China	9.59	United States	8.18
Germany	7.33	Germany	8.03
Japan	4.76	Japan	5.15
France	4.12	France	3.56
United Kingdom	3.86	Korea	2.98
Italy	3.35	Netherlands	2.88
Hong Kong	3.03	Italy	2.87
Netherlands	3.02	Russia	2.69
Korea	2.92	Canada	2.64
Canada	2.69	United Kingdom	2.63
Belgium	2.68	Mexico	2.15
India	2.40	Belgium	2.07
Spain	2.17	Malaysia	1.70
Singapore	2.14	Switzerland	1.62
Mexico	2.07	Spain	1.61
Russia	1.71	Saudi Arabia	1.57
Australia	1.30	India	1.47
Turkey	1.27	Brazil	1.41
Thailand	1.25	Singapore	1.41
Brazil	1.24	Australia	1.39
Switzerland	1.21	Thailand	1.34
Poland	1.20	Indonesia	1.16
Malaysia	1.13	Ireland	1.06
Austria	1.03	United Arab Emirates	1.06
Sweden	1.02	Sweden	1.02
Indonesia	0.93	Poland	0.98
Czech Republic	0.86	Austria	0.96
Saudi Arabia	0.73	Norway	0.92
Hungary	0.60	Czech Republic	0.82
Denmark	0.58	Turkey	0.70
South Africa	0.55	South Africa	0.64
Norway	0.53	Denmark	0.60
Portugal	0.52	Hungary	0.60

Finland	0.47	Nigeria	0.55
Slovakia	0.44	Vietnam	0.51
Greece	0.44	Finland	0.49
Romania	0.43	Philippines	0.48
Ukraine	0.42	Chile	0.47
Ireland	0.42	Hong Kong	0.46
Israel	0.41	Argentina	0.45
Philippines	0.40	Qatar	0.45
Argentina	0.39	Venezuela	0.42
Chile	0.39	Kuwait	0.42
Nigeria	0.30	Algeria	0.40
Algeria	0.28	Slovakia	0.40
Colombia	0.28	Israel	0.38
Pakistan	0.26	Ukraine	0.37
Morocco	0.24	Kazakhstan	0.33
Belarus	0.24	Romania	0.32
Venezuela	0.22	Portugal	0.30
New Zeeland	0.21	Colombia	0.28
Peru	0.21	Peru	0.22
Slovenia	0.18	Oman	0.21
Bulgaria	0.17	New Zeeland	0.20
Lithuania	0.16	Costa Rica	0.18
Tunisia	0.15	Egypt	0.17
Ecuador	0.14	Slovenia	0.16
Luxembourg	0.14	Greece	0.15
Croatia	0.14	Azerbaijan	0.15
Oman	0.14	Pakistan	0.14
Lebanon	0.12	Belarus	0.13
Panama	0.11	Ecuador	0.13
Serbia	0.11	Bulgaria	0.13
Jordan	0.10	Morocco	0.13
Dominican	0.10	Luxembourg	0.12
Costa Rica	0.10	Lithuania	0.11
Guatemala	0.10	Tunisia	0.11
Estonia	0.09	Trinidad and Tobago	0.10
Sri Lanka	0.08	Sudan	0.07
Kenya	0.08	Estonia	0.07
Latvia	0.08	Croatia	0.07
Bahrain	0.07	Cote d'Ivoire	0.06
Bosnia Herzegovina	0.06	Latvia	0.06
Ethiopia	0.06	Panama	0.05
Total	96.25	Total	93.01

Source: UN Comtrade, author's calculations. Notes: Share of exporters and share of importers are calculated relative to total World imports.

3.A.1. Import price index

We define a nested, constant elasticity of substitution (CES), utility function of a representative household in country i which consists of three nests. On the upper level a composite import good and the domestic good are consumed:

$$U_{i,t} = \left(D_{i,t}^{\frac{\kappa_i - 1}{\kappa_i}} + M_{i,t}^{\frac{\kappa_i - 1}{\kappa_i}} \right)^{\frac{\kappa_i}{\kappa_i - 1}} ; \quad \kappa_i > 1 \qquad \text{(A1)}$$

where $D_{i,t}$ is the domestic good, $M_{i,t}$ is composite imports, and κ_i is the elasticity of substitution between domestic and foreign good. At the second level of the utility function, composite imported good consists of individual imported products:

$$M_{i,t} = \left(\sum_{g \in G} M_{ig,t}^{\frac{\gamma_i - 1}{\gamma_i}} \right)^{\frac{\gamma_i}{\gamma_i - 1}} ; \quad \gamma_i > 1 \tag{A2}$$

where $M_{ig,t}$ is the sub-utility from consumption of imported good g, γ_i is elasticity of substitution between different import goods, while G denotes the set of imported goods. The third level utility function is the place where variety and quality are introduced into the model. Each imported good consists of various varieties (is imported from different countries of origins, therefore product variety is indicating the set of competitors on the particular market). The taste and quality parameter denotes the subjective or objective quality that consumers attach to a product. $M_{ig,t}$ is defined by a non-symmetric CES function:

$$M_{ig,t} = \left(\sum_{c \in C} d_{igc,t}^{\frac{1}{\sigma_{ig}}} m_{igc,t}^{\frac{\sigma_{ig} - 1}{\sigma_{ig}}} \right)^{\frac{\sigma_{ig}}{\sigma_{ig} - 1}} ; \quad \sigma_{ig} > 1 \quad \forall \quad g \in G \tag{A3}$$

where $m_{igc,t}$ denotes quantity of imports of a good g from country c, C is a set of all partner countries, $d_{igc,t}$ is a taste and quality parameter, and σ_{ig} is elasticity of substitution among varieties of good g.

After solving the utility maximisation problem subject to the budget constraint, the minimum unit-cost function of import good g is represented by

$$\phi_{ig,t} = \left(\sum_{c \in C} d_{igc,t} p_{igc,t}^{1-\sigma_{ig}} \right)^{\frac{1}{1-\sigma_{ig}}} \tag{A4}$$

where $\phi_{ig,t}$ denotes minimum unit-cost of import good g, $p_{igc,t}$ is the price of good g imported from country c.

The price indices for good g could be defined as a ratio of minimum unit-costs in current period to minimum unit-costs in previous period ($P_{ig} = \phi_{ig,t} / \phi_{ig,t-1}$). The conventional assumption is that quality and taste parameters are constant over time for all imported varieties and products, ($d_{igc,t} = d_{igc,t-1}$) and the price index is calculated over the set of product varieties $C_{ig} = C_{ig,t} \cap C_{ig,t-1}$ available both, in periods t and $t-1$, where $C_{igt} \subset C$ is the subset of all varieties of goods consumed in period t. Sato (1976) and Vartia (1976) proved that for a CES function the exact price index will be given by the log-change price index

$$P_{ig}^{conv} = \prod_{c \in C_{ig}} \left(\frac{p_{igc,t}}{p_{igc,t-1}} \right)^{w_{igc,t}} \tag{A5}$$

whereby weights $w_{igc,t}$ are computed using cost shares $s_{igc,t}$ in the two periods as follows:

$$w_{igc,t} = \frac{\left(s_{igc,t} - s_{igc,t-1}\right) / \left(\ln s_{igc,t} - \ln s_{igc,t-1}\right)}{\sum_{c \in C_{ig}} \left(\left(s_{igc,t} - s_{igc,t-1}\right) / \left(\ln s_{igc,t} - \ln s_{igc,t-1}\right)\right)};$$

$$s_{igc,t} = \frac{p_{igc,t} m_{igc,t}}{\sum_{c \in C_{ig}} p_{igc,t} m_{igc,t}}$$

Import price index in (A5) ignores possible changes in quality and variety (set of partner countries). The underlying assumption that variety is constant was relaxed by Broda and Weinstein (2006). According to them, if $d_{igc,t} = d_{igc,t-1}$ for $c \in C_{ig} = \left(C_{ig,t} \cap C_{ig,t-1}\right)$, $C_{ig} \neq \emptyset$, then the exact price index for good g is given by

$$P_{ig}^{bw} = \prod_{c \in C_{ig}} \left(\frac{p_{igc,t}}{p_{igc,t-1}} \right)^{w_{igc,t}} \left(\frac{\lambda_{ig,t}}{\lambda_{ig,t-1}} \right)^{\frac{1}{\sigma_{ig}-1}} = P_{ig}^{conv} \left(\frac{\lambda_{ig,t}}{\lambda_{ig,t-1}} \right)^{\frac{1}{\sigma_{ig}-1}} \qquad \text{(A6)}$$

where $\lambda_{ig,t} = \frac{\sum_{c \in C_{ig}} p_{igc,t} m_{igc,t}}{\sum_{c \in C_{ig,t}} p_{igc,t} m_{igc,t}}$ and $\lambda_{ig,t-1} = \frac{\sum_{c \in C_{ig}} p_{igc,t-1} m_{igc,t-1}}{\sum_{c \in C_{ig,t-1}} p_{igc,t-1} m_{igc,t-1}}$

Therefore, the price index derived in (A5) is multiplied by an additional term which captures the role of new and disappearing variety.

Broda and Weinstein (2006) assume that taste and quality parameters are unchanged for all varieties of all goods ($d_{igc,t} = d_{igc,t-1}$), namely, vertical product differentiation is ignored. Benkovskis and Wörz (2011) introduced an import price index that allows also for changes in taste and quality:

$$P_{ig}^{q} = \left(\frac{\sum_{c \in C_{ig,t}} d_{igc,t} p_{igc,t}^{1-\sigma_{ig}}}{\sum_{c \in C_{g,t-1}} d_{gc,t-1} p_{gc,t-1}^{1-\sigma_{g}}} \right)^{\frac{1}{1-\sigma_{ig}}} =$$

$$= \prod_{c \in C_{ig}} \left(\frac{p_{igc,t}}{p_{igc,t-1}} \left(\frac{d_{igc,t}}{d_{igc,t-1}} \right)^{\frac{1}{1-\sigma_{ig}}} \right)^{w_{igc,t}} \left(\frac{\lambda_{ig,t}}{\lambda_{ig,t-1}} \right)^{\frac{1}{\sigma_{ig}-1}} = P_{ig}^{conv} \left(\frac{\lambda_{ig,t}}{\lambda_{ig,t-1}} \right)^{\frac{1}{\sigma_{ig}-1}} \prod_{c \in C_{ig}} \left(\frac{d_{igc,t}}{d_{igc,t-1}} \right)^{\frac{w_{igc,t}}{1-\sigma_{ig}}} \qquad \text{(A7)}$$

Equation (A7) could be seen as a modified version of equation (A6) whereby the additional term captures changes in the quality and taste parameter.

3.A.2. Relative export price index

Equation (A7) gives us a formula for a variety- and quality-adjusted import price index. However, we can easily interpret $m_{igc,t}$ – which are country's i imports of product g originating from country c – as country's c exports of a product g to the country i. Another problem arises from the need to compare the performance of one particular country relative to its competitors, while equation (A7) gives the aggregate import price from all suppliers. According to Benkovskis and Wörz (2012) changes in the relative export price of good g exported by Latvia to a country i could be defined in the following way:

$$RXP_{ig,t} = \frac{\phi_{ig,t}^{LV} / \phi_{ig,t-1}^{LV}}{\phi_{ig,t}^{-LV} / \phi_{ig,t-1}^{-LV}} = \frac{\left(p_{igLV,t} / p_{igLV,t-1}\right)\left(d_{igLV,t} / d_{igLV,t-1}\right)^{\frac{1}{1-\sigma_{ig}}}}{\phi_{ig,t}^{-LV} / \phi_{ig,t-1}^{-LV}} \qquad \text{(A8)}$$

where $\phi_{ig,t}^{LV}$ denotes minimum unit-cost of good g when exported by (imported from) Latvia, while $\phi_{ig,t}^{-LV}$ is minimum unit-cost of good g when exported by (imported from) all countries except Latvia. After combining (A7) and (A8) we obtain

$$RXP_{ig,t} = \prod_{c \in C_{ig}^{-LV}} \left(\frac{p_{igLV,t}}{p_{igc,t}} \frac{p_{igc,t-1}}{p_{igLV,t-1}} \right)^{w_{igc,t}^{-LV}} \left(\frac{\lambda_{ig,t}^{-LV}}{\lambda_{ig,t-1}^{-LV}} \right)^{\frac{1}{1-\sigma_{ig}}} \prod_{c \in C_{ig}^{-LV}} \left(\frac{d_{igLV,t}}{d_{igc,t}} \frac{d_{igc,t-1}}{d_{igLV,t-1}} \right)^{\frac{w_{igc,t}^{-LV}}{1-\sigma_{ig}}} \qquad (1)$$

where C_{ig}^{-LV} is set of product varieties available in both periods, excluding varieties coming from Latvia, $w_{igc,t}^{-LV}$ and $\lambda_{ig,t}^{-LV}$ are calculated similar to $w_{igc,t}$ and $\lambda_{ig,t}$, again excluding Latvia from the set of exporters (varieties).

Finally, one needs to design an aggregate relative export price as the index in equation (1) describes relative export prices only for one specific product g which is exported to one particular market i. We calculate aggregated adjusted relative export price index (RXP_t) as a weighted average of market-specific indices. Weighting is done on the base of Latvia's export data, as this source of information is preferable for determination of a country's export structure. If we denote the export price and volume of a product g exported by Latvia to country i as $p_{igLV,t}^{x}$ and $x_{igLV,t}$ accordingly, the aggregate adjusted relative export price index can be defined as

$$RXP_t = \prod_{i \in I} \prod_{g \in G} RXP_{ig,t}^{W_{ig,t}} \qquad \text{(A9)}$$

where $W_{ig,t} = \frac{\left(S_{ig,t} - S_{ig,t-1}\right) / \left(\ln S_{ig,t} - \ln S_{ig,t-1}\right)}{\sum_{i \in I} \sum_{g \in G} \left(\left(S_{ig,t} - S_{ig,t-1}\right) / \left(\ln S_{ig,t} - \ln S_{ig,t-1}\right)\right)}$; $S_{ig,t} = \frac{p_{igLV,t}^{x} x_{igLV,t}}{\sum_{i \in I} \sum_{g \in G} p_{igLV,t}^{x} x_{igLV,t}}$.

Equation (A9) shows that the aggregated index is just another Sato (1976) and Vartia (1976) log-change index and its weights are computed using the share of product g exports to country i out of total Latvia's exports.

3.A.3. Evaluation of relative quality and taste

The calculation of the adjusted relative export price index in (1) is a challenging task due to the fact that relative quality and taste is unobservable. As in Hummels and Klenow (2005) we evaluate unobserved quality and taste from the utility optimisation problem in the following way: after taking first order conditions and transformation into log-ratios we can express relative quality and taste in terms of relative prices, volumes and the elasticity of substitution between varieties as

$$\ln\left(\frac{d_{igc,t}}{d_{igk,t}}\right) = \sigma_{ig} \ln\left(\frac{p_{igc,t}}{p_{igk,t}}\right) + \ln\left(\frac{m_{igc,t}}{m_{igk,t}}\right) \qquad \text{(A10)}$$

where k denotes a benchmark country (can be chosen any country).

3.A.4 Estimation of elasticities

To derive the elasticity of substitution, one needs to specify demand and supply equations. The demand equation is defined by re-arranging the minimum unit-cost function in terms of the market shares, taking first differences and ratios to a reference country:

$$\frac{\Delta \ln s_{igc,t}}{\Delta \ln s_{igk,t}} = -\left(\sigma_{ig} - 1\right)\frac{\Delta \ln p_{igc,t}}{\Delta \ln p_{igk,t}} + \varepsilon_{igc,t} \qquad \text{(A11)}$$

where $\varepsilon_{igc,t} = \Delta \ln d_{igc,t}$, therefore we assume that the log of quality and taste is a random walk process. The export supply equation relative to country k is given by:

$$\frac{\Delta \ln p_{igc,t}}{\Delta \ln p_{igk,t}} = \frac{\omega_{ig}}{1+\omega_{ig}} \frac{\Delta \ln s_{igc,t}}{\Delta \ln s_{igk,t}} + \delta_{igc,t} \qquad \text{(A12)}$$

where $\omega_{ig} \geq 0$ is the inverse supply elasticity assumed to be the same across partner countries. The unpleasant feature of the system of (A11) and (A12) is the absence of exogenous variables which would be needed to identify and estimate elasticities. To get these estimates one needs to transform the system of two equations into a single equation by exploiting Leamer's (1981) insight and the independence of errors $\varepsilon_{igc,t}$ and $\delta_{igc,t}$. This is done by multiplying both sides of equations. After such transformations, the following equation is obtained:

$$\left(\frac{\Delta \ln p_{igc,t}}{\Delta \ln p_{igk,t}}\right)^2 = \theta_1 \left(\frac{\Delta \ln s_{igc,t}}{\Delta \ln s_{igk,t}}\right)^2 + \theta_2 \left(\frac{\Delta \ln p_{igc,t}}{\Delta \ln p_{igk,t}}\right)\left(\frac{\Delta \ln s_{igc,t}}{\Delta \ln s_{igk,t}}\right) + u_{igc,t} \qquad \text{(A13)}$$

where $\theta_1 = \frac{\omega_{ig}}{\left(1+\omega_{ig}\right)\left(\sigma_{ig}-1\right)}$; $\theta_2 = \frac{1-\omega_{ig}\left(\sigma_{ig}-2\right)}{\left(1+\omega_{ig}\right)\left(\sigma_{ig}-1\right)}$;

$$u_{igc,t} = \varepsilon_{igc,t}\delta_{igc,t}$$

Broda and Weinstein (2006) argue that one needs to define a set of moment conditions for each good g, by using the independence of the unobserved demand and supply disturbances for each country over time:

$$G(\beta_{ig}) = E_t(u_{igc,t}(\beta_{ig})) = 0 \quad \forall c$$

where $\beta_{ig} = (\sigma_{ig}, \omega_{ig})$ represents the vector of estimated elasticities. For each good g imported by country i the following GMM estimator is obtained:

$$\hat{\beta}_{ig} = \arg\min_{\beta \in B} G^*(\beta_{ig})' W G^*(\beta_{ig}) \qquad \text{(A14)}$$

where $G^*(\beta_{ig})$ is the sample analogue of $G(\beta_{ig})$ and B is the set of economically feasible values of β ($\sigma_{ig} > 1$ and $\omega_{ig} \geq 0$). W is a positive definite weighting matrix, which weights the data such that the variance depends more on large shipments and becomes less sensitive to measurement error. The elasticity of substitution between varieties is estimated using (A14) for all products where data on at least 3 countries of origin were available. Table A2 displays the main characteristics of estimated elasticities of substitution between varieties. For easier interpretation one can calculate the median mark-up, which equals $\sigma_{ig}/(\sigma_{ig} - 1)$.

Table 3.A2: Elasticities of substitution between varieties

	Elasticities estimated	Mean	Standard Deviation	Maximum	Minimum	**Median**	**Median mark-up**
Algeria	3261	22.0	125.2	6492.2	1.05	**5.36**	**23.0**
Argentina	2920	20.6	69.1	2076.8	1.03	**5.49**	**22.3**
Australia	2833	79.3	480.4	14517.1	1.02	**5.83**	**20.7**
Austria	4501	23.8	84.8	4011.7	1.07	**5.89**	**20.5**
Bahrain	2328	19.9	44.1	992.5	1.05	**5.01**	**24.9**
Belarus	3326	22.7	71.7	2023.7	1.10	**5.21**	**23.7**
Belgium	4856	18.4	44.2	905.8	1.05	**5.35**	**23.0**
Bosnia Herzegovina	3282	22.5	61.7	1453.2	1.05	**5.67**	**21.4**
Brazil	3946	21.3	82.5	3745.5	1.03	**5.52**	**22.1**
Bulgaria	3893	19.8	49.1	1096.7	1.07	**4.89**	**25.7**
Canada	3568	42.1	252.9	8201.7	1.03	**8.26**	**13.8**
Chile	3525	43.5	210.2	6564.6	1.01	**5.44**	**22.5**
China	4151	45.4	234.9	7385.5	1.01	**6.71**	**17.5**
Colombia	3718	19.5	64.3	2305.4	1.06	**5.02**	**24.9**
Costa Rica	3142	21.9	45.3	931.7	1.02	**5.69**	**21.3**
Croatia	4029	17.7	40.8	979.8	1.04	**4.58**	**27.9**
Czech Republic	4672	18.1	36.0	673.2	1.10	**5.50**	**22.2**
Denmark	4440	19.1	52.2	2541.8	1.09	**5.90**	**20.4**
Dominican	1053	75.8	482.7	12091	1.01	**10.07**	**11.0**
Ecuador	3064	20.2	50.8	1368.1	1.05	**4.92**	**25.5**
Estonia	3464	18.6	39.2	816.2	1.03	**5.21**	**23.8**
Ethiopia	1778	18.5	43.2	1079.1	1.02	**5.68**	**21.4**
Finland	4209	20.4	78.7	3478.7	1.04	**4.99**	**25.1**
France	4963	24.2	150.0	10020.8	1.05	**5.54**	**22.0**
Germany	4732	21.0	49.6	1695.9	1.02	**5.62**	**21.6**
Greece	4291	18.1	48.7	1112.0	1.03	**4.51**	**28.5**

Guatemala	2904	22.1	75.4	2474.5	1.02	**5.28**	**23.4**
Hong Kong	3555	69.0	917	52025.5	1.01	**6.11**	**19.6**
Hungary	4125	23.8	53.4	1012.6	1.05	**5.56**	**21.9**
India	3835	63.6	421.5	15872.1	1.01	**6.51**	**18.1**
Indonesia	4286	19.5	70.1	3613.6	1.07	**5.58**	**21.8**
Ireland	4171	27.5	234.2	13318.6	1.02	**5.59**	**21.8**
Israel	1418	137.2	1090.9	37958.5	1.02	**9.03**	**12.5**
Italy	4913	19.2	43.5	893.9	1.02	**5.05**	**24.7**
Japan	4349	22.9	90.5	4472.8	1.02	**4.35**	**29.8**
Jordan	2145	19.7	47.6	714.1	1.05	**4.73**	**26.8**
Kenya	2426	28.2	88.5	2177.7	1.05	**5.45**	**22.5**
Korea	4499	18.3	52.3	2650.8	1.01	**5.32**	**23.2**
Latvia	3451	21.0	51.4	1089.1	1.02	**5.13**	**24.2**
Lebanon	3010	21.7	58.8	1469.7	1.03	**4.90**	**25.6**
Lithuania	3673	18.5	45.6	1177.7	1.04	**5.13**	**24.2**
Luxembourg	3598	27.5	112.6	5751.3	1.01	**6.05**	**19.8**
Malaysia	3969	86.9	541.2	14903.0	1.01	**4.59**	**27.8**
Mexico	3548	29.0	92.7	3528.0	1.01	**5.60**	**21.7**
Morocco	3412	21.0	59.3	1857.2	1.02	**4.87**	**25.9**
Netherlands	4193	55.6	329.8	12309.7	1.01	**4.67**	**27.2**
New Zeeland	3949	19.7	49.4	1058.0	1.05	**5.30**	**23.3**
Nigeria	1559	29.6	123.8	4373.9	1.03	**5.18**	**23.9**
Norway	4321	17.3	49.9	1200.1	1.01	**4.50**	**28.6**
Oman	2325	22.6	58.4	1185.7	1.03	**5.12**	**24.3**
Pakistan	2387	56.4	404.5	12883.5	1.01	**9.95**	**11.2**
Panama	2503	21.5	59.5	1661.0	1.00	**5.38**	**22.8**
Peru	3393	17.9	63.7	2902.9	1.02	**5.03**	**24.8**
Philippines	3592	24.0	82.6	2832.5	1.03	**4.74**	**26.7**
Poland	4566	18.6	72.5	4112.3	1.08	**5.34**	**23.0**
Portugal	4338	19.9	51.1	970.9	1.02	**4.86**	**25.9**
Romania	4238	20.5	59.4	2517.7	1.01	**5.56**	**21.9**
Russia	4285	20.0	65.9	3443.2	1.08	**6.35**	**18.7**
Saudi Arabia	3937	19.2	43.2	1270.7	1.01	**5.12**	**24.3**
Serbia	3318	21.7	57.5	1222.5	1.01	**5.81**	**20.8**
Singapore	3068	76.4	438.7	8874.8	1.00	**5.79**	**20.9**
Slovakia	4130	21.0	76.5	3997.3	1.07	**5.80**	**20.9**
Slovenia	4241	19.2	60.0	2002.4	1.06	**5.27**	**23.4**
Southern Africa	4122	39.5	192.4	6241.9	1.01	**6.49**	**18.2**
Spain	4872	17.9	43.8	1142.0	1.04	**5.21**	**23.8**
Sri Lanka	2336	37.8	147.9	2872.4	1.02	**5.75**	**21.0**
Sweden	3986	24.5	56.0	1452.2	1.03	**6.21**	**19.2**
Switzerland	4684	20.0	46.3	1089.3	1.03	**5.33**	**23.1**
Thailand	3754	31.5	207.5	6240.8	1.02	**5.65**	**21.5**
Tunisia	3380	20.6	59.4	2001.7	1.03	**5.02**	**24.9**
Turkey	4206	17.4	98.9	5958.3	1.04	**5.05**	**24.7**
UK	4871	18.0	47.1	1381.1	1.05	**4.37**	**29.7**
Ukraine	3721	20.9	57.2	2206.4	1.08	**6.36**	**18.7**
US	3956	68.2	526.5	23647.6	1.01	**4.98**	**25.1**
Venezuela	3520	23.6	80.6	2825.9	1.04	**5.37**	**22.9**

Source: UN Comtrade, author's calculations. Notes: Elasticities of substitutions are estimated using equation (A14) for all products where data on at least 3 countries of origin are available

Part II – Economic and social impacts of consolidation

Chapter 4 - Fiscal consolidation in the midst of the crisis

Francesco Di Comite
Gabriele Giudice
Julia Lendvai
Ingrid Toming

I. Introduction

We analyse the key aspects of the dramatic fiscal consolidation in Latvia in 2008-11 and the linkages between fiscal policy and short-term economic growth in a small open economy. Amidst financial turmoil and the unwinding of extreme imbalances, the Latvian economy contracted by almost 25% from peak to trough. As the government undertook a massive consolidation (of over 15% of GDP, kicking in mainly in July 2009), the economy bounced back more rapidly than anyone expected. After mid-2010, contraction yielded to sustained growth, while the ambitious fiscal targets under the EU/IMF Balance-of-Payments programme were consistently over-achieved. This experience of large-scale consolidation during a major economic correction provides valuable insights into the mechanism of fiscal adjustment.

Before identifying preconditions and contributing factors to such an outcome, we first need to correctly measure the changes in public finances which took place over the period. However, as a significant part of the adjustment is missed by standard measures of fiscal effort, a bottom-up approach is also needed. A review of quarterly GDP and budgetary results helps understanding the effective sequencing of fiscal adjustment and economic activity. We then review the composition of the consolidation and compare its implementation with the literature on the optimal mix of measures. Subsequently, using the European Commission's QUEST model, we review the short-term multipliers of the main measures undertaken in Latvia and discuss their potential longer-term effect on the economy. The results are compared with the effective economic outturn. To explain differences, we discuss the effects of the external environment, the use of EU funds (as a partial substitute for domestic financing) and confidence effects which could have altered multipliers in the midst of the crisis.

The chapter is organised as follows. In the next section we analyse how fiscal consolidation can be duly measured in periods of high volatility. Section III reviews the consolidation performance of Latvia, considering both its composition and timing, and compares it to its Baltic neighbours. Section IV provides estimates of long- and short-term effects of the fiscal consolidation on the Latvian economy. It also looks at whether non-Keynesian effects may have occurred, offsetting the standard multipliers, and provides a tentative measurement of their relevance. Section V presents the main lessons we can draw from the Latvian experience. Section VI concludes.

II. Measuring fiscal consolidation

In the recent case of Latvia, nobody can really argue about the fact that the budgetary adjustment over the period 2008-11 has been huge. However, nailing down a number to identify the amount of such consolidation is not easy. The problems of measuring fiscal effort have been extensively discussed in academic literature. There are two main approaches to determining the size of fiscal consolidation: one based on changes in the cyclically adjusted primary balance (CAPB),[27] also called "conventional" or "top-down" approach, and one based on policy action, also called "historical" or "bottom-up" approach. These two methods have sometimes led to quite different results in terms of measuring the fiscal effort. For example, the following reasons for deviations are explored in IMF (2010) and Guajardo et al. (2011):

[27] Whenever data is available, using the change in structural balance (cyclically-adjusted balance corrected for one-off and temporary measures) is of course a preferable measure. The change in structural balance, measured following the methodology described in Giorno et al. (1995) and Girouard et al. (2005) is also used in the context of the EU fiscal policy surveillance.

- the change in CAPB does not capture unrecorded one-off and temporary measures and their subsequent reversals (though this bias is removed when structural balances are considered);

- the cyclical adjustment methodology does not sufficiently capture changes in tax bases during periods of sharp contractions of economic activity, notably changes in stock and house prices, fall in consumption or wage bill as a share of GDP etc.

Moreover, the difficulty of determining the cyclical position in real time implies an additional uncertainty when calculating cyclically-adjusted fiscal figures. This is amplified in periods of significant adjustment in the economy, such as the past few years in Latvia.

However, even if measurement problems could be completely eliminated, there are still situations where these two approaches would produce diverging results. Firstly, the policy action approach measures the impact of discretionary fiscal policy against the unchanged policy scenario, while the cyclically-adjusted balance aims at capturing a non-cyclical increase or decrease in the ratio of revenue or expenditure to GDP. The results could in particular diverge for large expenditure items (like social benefits and public sector wage bill) when their recurrent indexation (not captured by policy action) leads to changing their ratio to GDP. Secondly, the cyclical adjustment is based on potential GDP and when the potential output itself (or its measure) changes, this could automatically lead to a change in the cyclically-adjusted balance due to the rigidity of expenditure (or revenue elasticity being different from unity). Thus, in the case of a falling potential output (or its statistical revision) a policy action might be needed just to keep the cyclically adjusted primary balance ratio stable.

Latvia is one of countries where these two measures give particularly diverse results for the period of fiscal consolidation, especially in 2009 (see Table 4.1), therefore the potential sources of difference for that year are discussed in more detail below.[28]

Table 4.1: The extent of Latvian fiscal consolidation, as captured by different measures

	2009	2010	2011
Change in cyclically-adjusted primary balance (CAPB), European Commission 2012 Spring Forecast, % of GDP	0.5	1.3	3.3
Change in structural primary balance, European Commission 2012 Spring Forecast, % of GDP	0.8	1.6	1.9
Consolidation measures as reported by the government (Convergence Programme April 2012), % of GDP	9.5	4.0	2.3

Source: Commission services

A closer look at the developments in 2009 shows that the CAPB suffers from the following set of issues, related mainly to composition effects and changes therein not captured by the established methodology:

- it underestimates the effects on indirect taxes of an absorption boom and bust: The recent cycle was characterised in Latvia (as well as in other Baltic economies, see European Commission, 2010) by particularly large swings in domestic demand: in 2006-2008 the domestic demand exceeded production by around 20% and was reflected in a sizeable current account deficit. This trend reversed sharply in 2008-2009 along with falling confidence and contracting credit supply. Unfortunately, the effect of this extreme domestic demand cycle is improperly captured by the cyclical adjustment of the general government's budgetary position used in the EU budgetary surveillance, which adjusts budgetary components based on fluctuations in *output* rather than *absorption*. The alternative measure, which would allow capturing also the effect of the cycle on the tax base for indirect taxes, is an "*absorption gap*" (see Lendvai et al., 2011), which aims at capturing the effect of the current account being above or below the current account norm determined by fundamentals,

[28] The discrepancy of a similar magnitude, amounting to 7½-9% of GDP depending on the way of measuring the CAPB, was also recorded in Ireland in the same year, see Guajardo et al and European Commission (2011b).

similarly to the way output gap measures fluctuations of output around its potential level. For Latvia, such a correction of the cyclically-adjusted balance would imply higher underlying deficits in 2005-2008, but lower underlying deficit in 2009. Overall, this adjustment could reduce the discrepancy between "top-down" and "bottom-up" measurements of the fiscal effort by **2.6 percentage points** of the difference. An alternative explanation is offered in Sancak et al (2010), where the authors analysed responsiveness of tax revenue and in particular VAT to the business cycle. They found that on average a one percentage point increase (decrease) in the output gap corresponds to 1¾ percentage point increase (decrease) in VAT revenue; the key channels through which the output gap affects the revenue are found to be shifts in consumption patterns towards goods and services with higher (lower) VAT rates and lower (higher) tax evasion during economic expansions (contractions). This approach could explain **1.4 percentage points of GDP** fall in indirect taxes in Latvia in 2009, which occurred against sizeable indirect tax increases in that year, but would still leave ca 1% of GDP unexplained, suggesting that the effect of these shifts in behaviour might have been even stronger in Latvia than for the panel of countries covered in the study.

- it underestimates the effects of a reversal in labour taxes: as already discussed above, the standard cyclical adjustment methodology, including the one used by the European Commission, takes into account variations in GDP but not variations between individual tax bases, therefore large fluctuations among the latter will be omitted by the cyclical adjustment methodology. In Latvia in 2009 a particularly large change was observed in the ratio of compensation of employees to GDP, which dropped from 50.8% in 2008 to 46.7% in 2009. It should be noted that in comparison to average historical levels of the ratio (43.1% in 2000-2010), both years reflected very high wage growth that took place at the peak of the cycle, but it nevertheless helps to explain why the decline in labour taxes is not fully captured by the adjustment. If the ratio of compensation of employees to GDP would have remained the same in 2009 as it was in 2008, this could have resulted in additional labour taxes in the magnitude of **1.2 percentage points** of GDP;

- it underestimates the cyclical impact of increase in social outlays: The change in unemployment benefits in response to changing cyclical conditions (captured by the cyclical component of expenditure in calculations of the cyclically-adjusted balance) suggests an increase in unemployment outlays in Latvia in 2009 by LVL 43 m or 0.3% of GDP. However, actual data indicates that unemployment benefits increased by LVL 83 m (0.6% of GDP) in that year. Moreover, the cyclical adjustment of expenditure only captures an increase in unemployment benefits, while expenditure on sickness and disability benefits similarly increased in 2009 by some LVL 50 m (0.3% of GDP) above its level of 2008, which can be only to a minor extent explained by discretionary policy changes. The possible explanation why the actual increase in crisis-related social spending surpassed the one predicted by the cyclical adjustment by some **0.5 percentage points** of GDP could lie in a behavioural change, as previously inactive part population started looking for job (and/or benefit) opportunities amidst plummeting confidence;

- it does not take into account one-off and temporary factors: As discussed above, the cyclically adjusted budgetary indicators do not take into account one-off and temporary factors and exceptional costs, for which reason it is preferable to use – whenever available – the structural balance when measuring the fiscal effort. Indeed, there have been large exceptional costs related to the stabilisation of the financial sector in Latvia in 2009-2011 related to Parex Bank, with overall impact of 0.9% of GDP in 2009, 1.7% of GDP in 2010 and 0.2% of GDP in 2011. These costs were, however, partly offset by a government's decision to retain in the publicly managed pension system part of the social tax previously transferred to privately managed pension funds. The overall impact of temporary and exceptional measures resulted in a **0.3 percentage points** worsening of the general government balance in 2009.

On the other hand, it is also true that the **consolidation amount expressed by the government does not include all measures which should have been recorded as discretionary policy.** As discussed

above, around half of the difference between the change in cyclically-adjusted primary balance and the policy action approach can be related to factors not fully captured by the conventional cyclical adjustment. However, there are also factors not covered by the government's estimate of discretionary policy that affect the cyclically-adjusted balance. Notably, non-cyclical social benefits (particularly pensions) increased considerably in 2009, by 2.3 percentage points of GDP (Republic of Latvia, 2009a). These increases covered sizeable indexation of pensions due a lagged effect of years of high wage growth,[29] an increase in pension supplement for pre-1996 years of service (which was initially intended only for lowest pensions but eventually extended to all pensioners),[30] as well as some other increases. The largest part of this increase – approximately two thirds – related to pension indexation and did not constitute a discretionary policy change, but the remaining third is simply omitted from the government's policy action estimate. At the same time, the cyclically-adjusted balance likely captures all of this increase in social spending that took place in 2009, offering another sizeable explanatory factor for the difference between two approaches. Moreover, given the limited and unsophisticated nature of the social safety net in Latvia before the crisis, it became clear as the crisis evolved that the system cannot fully cope with the cyclical impact. For this reason, ensuring adequate social safety net has been from the onset an important part of the stabilisation programme, with additional social safety net measures amounting up to 1% of GDP in 2009 (Republic of Latvia, 2009b), although in practice their impact was somewhat lower in that year. The combined effect of these social benefit increases could thus account for another **ca 3 percentage points** of GDP of the difference between the two approaches. Overall, the possible sources of discrepancy between the change in cyclically-adjusted primary balance and policy action approach in 2009 are summarised in Table 4.2.

Table 4.2: Contribution of different items to the discrepancy between alternative measures of fiscal consolidation

	Impact
Cyclical adjustment underestimating fall in indirect taxes	1.4 – 2.6 pps
Cyclical adjustment underestimating fall in labour taxes	1.2 pps
Cyclical adjustment not capturing behavioural changes in social benefits outlays	Ca 0.5 pps
Exceptional financial sector costs net of other temporary measures	0.3 pps
Policy action approach "missing" expansionary elements	Up to 3.0 pps
TOTAL	**Up to 7½ pps**
+ uncertainties related to real time estimates of output gap, differences in measurement methodologies etc.	…

Source: Commission services

Overall, the evidence provided in this section points to the need to be very cautious in using CAPB as the only measure for the assessment of fiscal consolidation, and to duly consider also the 'bottom-up' approach for the analysis and policy conclusions.

III. Fiscal consolidation in Latvia and comparison with the other Baltic countries

As established in the previous section, the Latvian authorities have implemented – in particular in 2009 and 2010 – a very substantial fiscal consolidation, although measuring its magnitude is a complicated issue due to very abrupt changes that took place in the Latvian economy over the period of economic adjustment. Some insights into the mechanism of consolidation could, however, be obtained by going into a more detailed analysis of the adjustments, and by comparing evolution of

[29] Until 2009, pensions were indexed in Latvia twice a year, in April and October, on the basis of CPI and social security benefits' trends. Particularly sizeable indexation of pensions took place in the course of 2008. As a result, an average old age pension in December 2008 was higher by 32% than in January 2008 (according to data published on the website of the State Social Insurance Agency); following the introduction of supplementary pensions from January 2009 an average old age pension increased further by ca 7%. The pension indexation has been suspended from 2009 (until end-2013, according to current plans), although average pensions continue increasing somewhat as the share of new retirees, who tend to have higher pensions, gradually rises.

[30] The government tried to reverse part of this increase through the 2009 supplementary budget, but this was rejected by a Constitutional Court ruling, leaving social benefits at higher level.

fiscal indicators in Latvia to those of the other Baltic economies, given that economic developments have been similar and all three countries have implemented a broadly comparable fiscal adjustment over the period of 2009-2011.

As a starting point, one could observe that total-revenue-to-GDP ratio in Latvia stayed unchanged between 2007 and 2011, while the tax-to-GDP ratio actually declined despite numerous and sizeable tax measures. Broadly similar developments took place in Lithuania, while in Estonia both revenue-to-GDP and tax-to-GDP ratios increased over the same period. The expenditure-to-GDP ratio increased sharply in all three countries between 2007 and 2010, but only Latvia succeeded in bringing the level of government consumption back to the 2007 level already by 2010 (see Table 4.3). These developments are analysed here in further detail.

Table 4.3: Evolution of revenues and expenditures in the Baltics

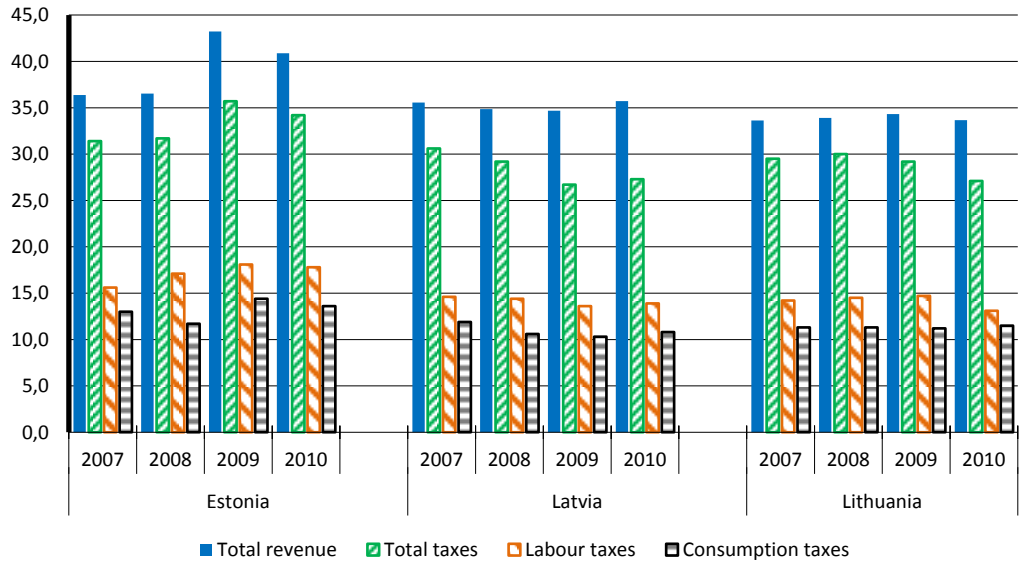
% of GDP	**Latvia**					**Lithuania**					**Estonia**				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Total revenue	35.6	34.9	34.7	35.7	35.6	33.6	33.9	34.3	33.7	32.0	36.4	36.5	43.2	40.9	39.2
o.w. tax burden	30.8	29.7	27.0	27.5	27.9	29.9	30.4	29.8	27.5	26.5	31.5	31.8	36.1	34.1	33.2
Total expenditure	36.0	39.1	44.4	43.9	39.1	34.6	37.2	43.8	40.9	37.5	34.0	39.5	45.2	40.6	38.2
o.w. gov. consumption	17.8	20.0	19.6	17.5	15.6	17.8	19.2	22.0	20.5	18.9	16.4	19.2	22.0	20.9	19.5
o.w. social transfers	7.1	8.1	12.6	12.5	10.8	9.1	10.9	15.2	13.0	11.2	8.5	10.5	14.0	13.1	11.7
General government balance (EDP)	**-0.4**	**-4.2**	**-9.8**	**-8.2**	**-3.5**	**-1.0**	**-3.3**	**-9.4**	**-7.2**	**-5.5**	**2.4**	**-2.9**	**-2.0**	**0.2**	**1.0**

Source: Commission services

III.1. The revenue side of the fiscal consolidation

On the revenue side, it is important to note that the share of tax revenue to GDP declined in Latvia in 2009, compared to 2008, despite very sizeable tax measures that entered into force from the beginning of that year and amounted in total to 3.3% of GDP (ex-ante estimate), of which 2.6% on the side of consumption taxes. While partly explained by falling revenue elasticities discussed above, this contrasts developments in Estonia, where the share of taxes, including consumption taxes, to GDP actually increased in 2009, even though main tax measures only entered into force from the second half of the year (see Figure 4.1).

Figure 4.1: Ratio of total revenue, tax revenue and revenues from main tax categories to GDP in the Baltics



Source: Eurostat, Taxation trends 2012

As already discussed above, the cyclical impact of falling tax elasticities could explain approximately half of "missing" consumption taxes in Latvia in 2009 (while in Estonia this effect seems to have taken place earlier, in 2008). Indeed, VAT compliance dropped very substantially in Latvia between 2007 and 2009 – considerably more than in other two Baltic countries – and still remains the lowest in three countries, even though before the crisis the indicator was above that of Lithuania; similar trends can be observed with regard to VAT C-efficiency.[31]

Labour tax developments in Latvia in 2009 are less contradictory and their fall in relation to GDP can be largely explained by wage bill dynamics discussed above; such a sharp decline in the ratio of wage bill to GDP was only observed in Latvia. Nevertheless, the fall in implicit tax rate on labour in crisis years (to some extent offset by retaining some of revenue that previously was redirected to the mandatory pension pillar from 2009) suggests that compliance rates have fallen with respect to labour taxes as well.

All these factors point to a considerable deterioration of tax compliance in Latvia in 2008-2009, which occurred alongside sizeable measures to increase tax revenue. The resulting level of statutory tax rates is now somewhat higher in Latvia than in other two Baltic countries, but the tax efficiency appears the lowest.[32] To bring the level of statutory rates closer to those of other Baltic economies, the Latvian Parliament passed on 24th May 2012 changes to tax laws that foresee lowering VAT rate from 22% to 21% from July 2012 and gradually lowering the personal income tax from 25% to 20% over the three year period starting from 2013.

EU funds have also played a very prominent role as a revenue source particularly in last years, due to a combination of factors: firstly, major projects related to the 2007-2013 financial perspective became operational with a few years lag and, secondly, intensifying the absorption of EU funds was a deliberate policy to support the domestic demand in crisis years in line with the conditionality of the EU Balance-of-Payments assistance programme. However, this also implies that while it should be possible to sustain comparable level of capital revenue in the short term, in the medium term the amounts will decline as respective financing is exhausted; this might already be the case for current transfers in the short term.

III.2. The expenditure side of the fiscal consolidation

Scaling back expenditure played the crucial part in the Latvian fiscal consolidation strategy – according to the authorities' estimates, savings on the expenditure side amounted to around 10% of GDP over the period of 2008-2011, of which 6.7% of GDP in 2009 alone. The expenditure side consolidation was centred on cuts in government consumption, which mostly cover public sector wages and good and services procured by the government. At the same time, social benefits remained broadly intact throughout the crisis, with an increase in some categories.

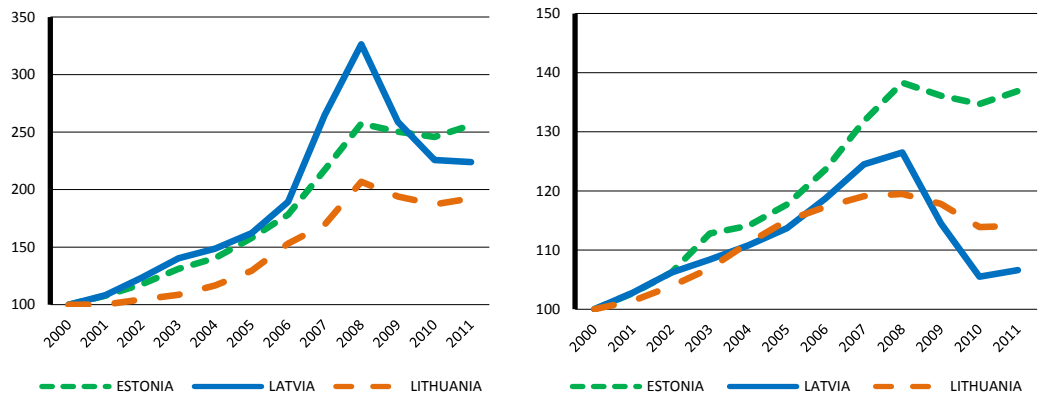
Statistical indicators confirm that the magnitude of consolidation on the side of government consumption was unprecedented and constitutes the most remarkable feature of Latvia's fiscal adjustment, with government consumption contracting by a fifth in real terms between 2008 and 2010 and, even more shocking, by almost a third in nominal terms over the same period. Latvia was the only country in the Baltics to bring the ratio of government consumption to GDP back to the level of 2007 already in 2010, despite a substantial fall in economic activity, underlying that government spending was cut most substantially in Latvia among the Baltic economies (see Figure 4.2). However, consumption also increased most during the boom years in Latvia, in particular on the side of prices. This unsustainable trend prior to the crisis – as well as the fact that very decisive measures were taken in 2009-2010 to bring the government consumption back to sustainable levels – has been acknowledged by Åslund and Dombrovskis (2011). For example, according to the book half of 75

[31] VAT compliance ratio measures proportion of VAT actually collected in relation to theoretically possible collection, based on the value of private consumption and scope of application of standard and reduced VAT rates (using HICP weights). VAT C-efficiency uses only standard VAT rate and overall consumption, thus measuring both compliance and policy gap.

[32] Based on the analysis of consumption and labour taxes; taxation of capital cannot be easily compared across the Baltics, notably due to a different system in use in Estonia, where only distributed profits are taxed.

state agencies (in a country with population of ca 2 million) were to be closed down according to the 2009 stabilisation programme.

Figure 4.2: Evolution of Government consumption in the Baltics, in values (left pane) and volumes (right pane)



Source: Eurostat

Among government functions, health related expenditure, defence expenditure and education expenditure stick out as areas most affected by the cuts in Latvia: between 2008 and 2010, health related expenditure declined by ca 27% (while "only" by 10% and 7% in Estonia and Lithuania respectively) and education related expenditure declined by ca 26% (compared with ca 10% decline in both Estonia and Lithuania). However, in particular in education expenditure also increased most rapidly prior to the crisis in Latvia. The defence budgets were substantially decreased in all three countries, but again most notably – by almost a half – in Latvia, by over a quarter in Lithuania and by around tenth in Estonia. The provision of general government services also declined most notably in Latvia. At the same time, expenditure on economic affairs (which among other things reflect EU funds absorption) actually increased in Latvia over the period of 2008-2010, while declining most notably in Estonia and to a lesser extent in Lithuania.

Both Åslund and Dombrovskis (2011) and World Bank (2010) shed some light on these exceptional developments with regard to healthcare and education sectors: both sectors were in a need of radical reforms to align the provision of services to demographic trends and to improve efficiency. These reform plans were available, but the implementation was delayed due to the lack of political support. The crisis – which revealed the need to bring public finances on a sustainable path – acted as a catalyst for reforms, which were implemented over a very short period of time. The World Bank (2010) later noted that "Latvia has achieved years' worth of difficult structural reforms in the short space of just a few months".

Another area where existing reform plans might have helped to implement the expenditure-side consolidation, was the administrative territorial reform enacted from 1 July 2009. As a result of this reorganisation, one administrative level was completely abolished and the number of territorial units declined from 548 to 119 (110 municipalities and 9 republican cities). The reform had no direct link to the consolidation strategy and had been prepared for years, but is nevertheless likely to have had a positive impact on local governments' finances. Similarly to developments at the level of general government discussed above, expenditure of municipalities increased fastest among the three Baltic countries prior to the crisis in Latvia, but also declined most abruptly in 2009-2010.

III.3. The timing of the consolidation

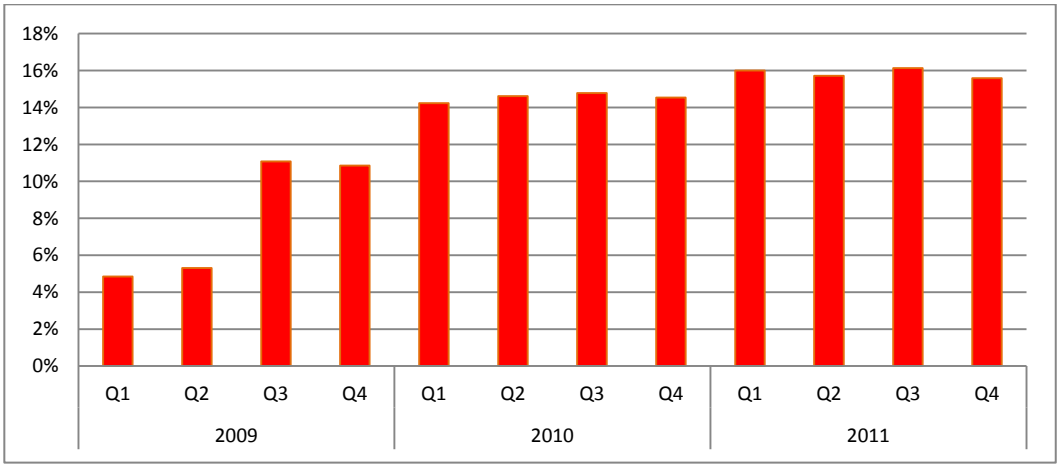
Although fiscal consolidation officially started at the end of 2008, when the Latvian authorities turned to the EU, the IMF and regional neighbours for the financial assistance that resulted into the Balance-of-Payment assistance programme, it was not until the second half of 2009 that the bulk of consolidation actually took place. On February 2009, in fact, the government fell over concerns about its handling the economic crisis and its inability to impose the austerity measures agreed with the

international lenders, leading to the formation of a new government in March 2009 whose explicit mandate was to implement the agreed fiscal austerity.

Given the deterioration of the economy during the first months of 2009 and the inability of his predecessor to actually implement the consolidation measures, the newly appointed government needed to act quickly and decisively to restore confidence and redress the situation. For this reason Prime Minister Valdis Dombrovskis and the international lenders agreed on the need to clearly front-load the consolidation and to adopt the necessary measures as soon as possible, adopting in the supplementary budget of June 2009 all the necessary measures to keep the government deficit below the 10% of GDP, and to implement a progressive consolidation bringing the deficit below the threshold of 8.5% in 2010 and 6% of GDP in 2011, ultimately correcting the excessive deficit (i.e. bringing the deficit below 3% of GDP) by 2012.

In June 2009 a massive set of measures of over 4% of GDP were adopted with the supplementary budget 2009, and in July measures concerning the 2010 budget were already proposed by the government and negotiated with international lenders with a view to reassure about the subsequent steps. Finally, in November 2009 an additional package of fiscal adjustment was adopted, entering immediately into force and defining the key elements of fiscal consolidation in 2010. It can thus be said that the bulk of the consolidation (about 10% of GDP) was actually designed and adopted in less than six months, in the course of the second half of 2009. This represented a strongly front-loaded and credible adjustment, which affected market's perception of the Latvian situation already from the beginning of 2010. In Figure 4.3 we report a tentative quarterly accounting of the effective entry into force of the measures, where the series has been built on the basis of government's ex-ante commitments and expenditures have been checked against ex-post reporting.

Figure 4.3: Quarterly accounting of fiscal consolidation measures in Latvia as percentage of quarterly GDP



Source: Commission services. Note: the series has been built on the basis of government's ex-ante commitments and projections for revenues, with expenditures checked through ex-post reporting

IV. Fiscal consolidation and economic activity

In this section we analyse the interplay between fiscal consolidation and growth in Latvia. Fiscal multipliers of the above-mentioned measures are presented and compared to the actual GDP data. What is remarkable about the Latvian experience is that significant cuts in government expenditures and tax hikes coincided with a robust economic recovery, pointing to the existence of relevant non-Keynesian effects offsetting the contractionary Keynesian effects of fiscal consolidation.

IV.1. Fiscal multipliers in the long and short term

Using the latest version of the Commision-developed dynamic stochastic general equilibrium (DSGE) model, QUEST (Ratto et al., 2009), in this subsection we compare the fiscal multipliers of

various budgetary measures and get some insights on the theoretical impact of composition of the Latvian consolidation measures. QUEST is a large-scale open economy new-Keynesian model used for policy analysis.[33] The model economy is described by optimal decisions of households and firms. There are three production sectors: a construction sector and two manufacturing sectors producing traded and non-traded final consumption goods.

The model features three types of households:

- A share of households are 'Ricardian': they own capital and have unlimited access to financial markets; their consumption decisions are based on the life-time income hypothesis;

- Another share of households are 'collateral-constrained': they have limited access to credit markets and can only get indebted against the value of their collateral (housing stock) up to an exogenously given level;

- The third type of households is so-called hand-to-mouth consumers: they do not have access to financial markets and consume their after-tax labour income and transfer earnings in every given period.

Fiscal policy is described by a rich set of fiscal instruments. The government can raise revenues by a tax on consumption (VAT), on personal income (PIT), on corporate income (CIT) or on immovable property, via social security contributions and finally via a lump-sum tax. The fiscal authority spends on government consumption, government investment, unemployment insurance benefit payments, and transfers. Government consumption is further broken down into intermediate government consumption (unproductive expenditures) and compensation of employees (which equals government output following standard national account practices). The government budget does not need to be in balance every period. Fiscal deficits are financed by changes in the public debt. The model is closed down by a debt rule according to which one of the above instruments reacts endogenously to stabilise debt in the long-run at its target. The presence of non-Ricardian households allows for Keynesian transmission channels of fiscal policy.

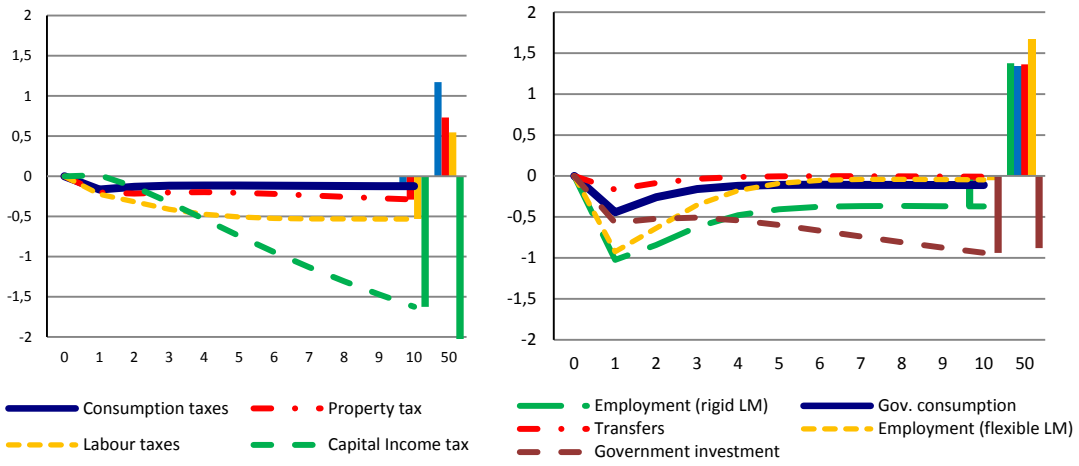
The model incorporates various real, nominal as well as financial frictions to match the dynamic response of the economy to standard shocks. It was calibrated to the Latvian economy for size, openness, trade shares and relative size of each component of GDP. In addition, the monetary policy is characterised by a fixed exchange rate regime.[34]

To evaluate the economic impact of fiscal consolidation, this section looks at the multipliers of fiscal consolidation of a given size achieved by different instruments. In particular, Figure 4.4 displays the impact of different tax hikes and expenditure cuts leading to a permanent budgetary consolidation of (ex ante) 1% of GDP using one instrument at the time. Given the model's assumptions about long-run real and nominal growth rates, a 1% of GDP reduction in the fiscal deficit corresponds to a 27% of GDP reduction in the long-run debt target. In the simulations in this section it is assumed that fiscal space gained by the long-run debt reduction is used to decrease labour income taxes over time.

The simulations suggest that fiscal consolidations have a negative impact on economic activity in the short run. Over time, however, if the fiscal space is used to reduce distortionary taxes (labour income taxes in the simulations), the effect of the consolidation turns out to be positive for most of the instruments. Further, as can be seen in the figure, the results indicate that expenditure cuts may have a larger impact on GDP than tax hikes, although this effect tends to turn around very quickly. The model also confirms that VAT and property taxes are less distortionary than labour income tax, whereas tax on capital income leads to a reduction of the economy's capital stock over time and thereby leads to a significant reduction in production as well.

[33] For a comprehensive review of alternative structural models used for policy analysis, see Cogan et al.(2010) or Coenen et al. (2012), where a comparison of IMF, ECB and QUEST models can be found.
[34] For a detailed description of the model see e.g. Lendvai and Roeger (2010).

Figure 4.4: Annual impact analysis of different tax hikes and expenditure cuts leading to a permanent budgetary consolidation of 1% of GDP, simulated with QUEST II



Source: Commission services

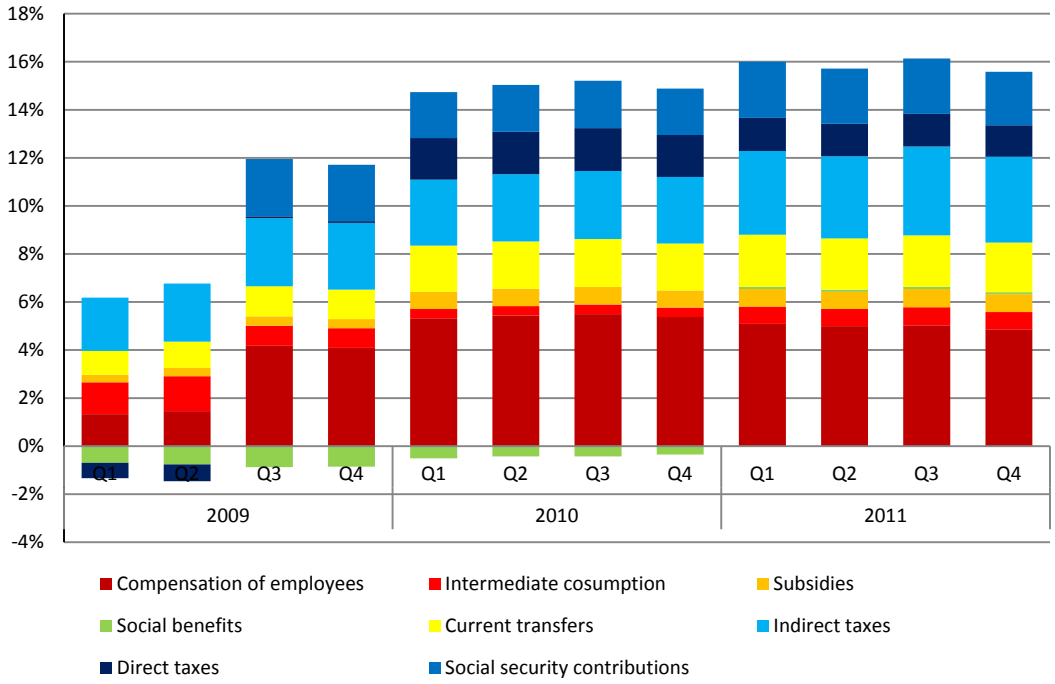
On the expenditure side, a reduction in transfers and unproductive government investment leads to the smallest short-run negative impact on GDP. Reduction in the compensation of employees (either via public wage cuts or by lay-offs in the public sector) may have significant negative effects on total GDP in the short-run. Over time, the reaction of the economy depends on the flexibility of the labour market (wages and movements of employees between sectors): the more flexible the labour market, the more private GDP will pick up in response to the reduction of public employment or public wages – and hence the less negative/the more positive the long-run effect will be. Finally, a reduction in productive government investment spending reduces productivity in the private sector and therefore turns out to be rather detrimental for overall economic activity over a longer horizon.

The simulations provide a benchmark that can be used to assess the impact of the composition of fiscal consolidation on growth in the short and long term (when fiscal space gained through the consolidation can be used to reduce distortive taxes). As the above discussion suggests, an optimal mix of measures would have implied higher consumption taxes on the revenue side and cuts in government consumption and employment on the expenditure side, especially as far as the long-term benefits are concerned. It is important to notice that the actual effects of the cuts in public employment depend on how flexible is the labour market and, more precisely, on how smoothly workers can move from the public to the private sector. In the case of Latvia one could safely argue that labour market institutions are rather supportive of high labour turnover and thus we can reasonably expect the flexible labour market multiplier to provide better guidance than the rigid labour market multiplier in forecasting the effects of consolidation on Latvian GDP.

As we can see from figure 4.5, those measures were indeed prominent in the actual composition of the fiscal consolidation undertaken by the Latvian government under the supervision of the international lenders. In particular, public employment (in the form of both wage cuts and reductions in the number of employees) stands out as the most important single item of consolidation over time, followed by indirect taxes (composed mostly of consumption taxes).

Latvia's fiscal consolidation was therefore clearly designed to maximise long-term gains, but what about the short term effects? A quarterly accounting of fiscal consolidation can allow us to identify how the fiscal multipliers associated with the timing of consolidation may have affected GDP growth in each quarter. It should be kept in mind, however, that it is virtually impossible to have a precise quarterly accounting of the fiscal measures, as it entails a certain degree of arbitrariness in the imputation of policies formally implemented during the year and for which is it not possible to monitor the effective implementation. This implies that also the multipliers' estimation may be affected and should be interpreted as indicators of the order of magnitude of the effects rather than as precise numbers.

Figure 4.5: Quarterly disaggregation of fiscal consolidation in Latvia, by individual measures, as a percentage of GDP



Source: Commission services. Note: the series has been built on the basis of government's ex-ante commitments and projections for revenues, with expenditures checked through ex-post reporting

Figure 4.6 illustrates the economic effect of the Latvian fiscal consolidation undertaken since 2009 based on simulations with the QUEST model. The simulation assumes that the consolidation takes place against a high deficit baseline which is assumed to be long-lasting before the consolidation is announced in 2009q1. Further, it is assumed that the entire set of consolidation measures is announced in 2009q1 and that it is believed to be permanent and perfectly credible. The fiscal space resulting from the consolidation is used to reduce lump-sum taxes – the least distortionary tax in the model. While it may be argued that lump-sum tax is an artificial instrument which is not available in practice to policy makers, this assumption allows us to attribute as little as possible positive confidence effects to the short-run impact of the fiscal consolidation in our simulations.

Figure 4.6: Quarterly impact on GDP (percentage deviation from the baseline) of the actual mix of Latvian fiscal consolidation measures, simulated with QUEST II

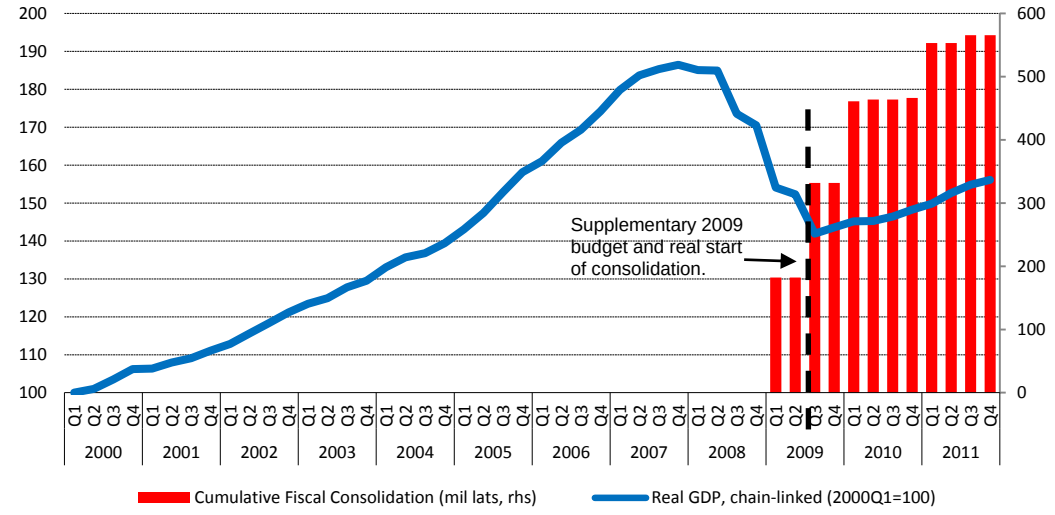
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	2008				2009				2010				2011				2012				2013			
% deviation	0	0	0	0	-2	-2,2	-4,8	-4,7	-6,3	-6,3	-6,3	-6	-5,9	-5,7	-5,6	-5,3	-5,9	-5,6	-5,5	-5,1	-4,7	-4,4	-4,3	-4

Source: Commission services

The simulation results suggests that the negative effects of consolidation were expected to kick in progressively as the consolidation plan unfolded, reaching more than 6% of GDP in the first quarter of 2010 and then fading away slowly, as the effects of additional measures in the following quarters played against the recovery from the effects of the first negative shocks. In a way, this series can be interpreted as showing the theoretical short-term pain the Latvian economy could have endured in the absence of non-Keynesian effects.

However, a quarterly look at the time pattern of total consolidation undertaken and GDP growth reveals that GDP growth reversed to positive almost immediately after serious consolidation started in the second half of 2009 following the supplementary budget measures envisaged in July (see Figure 4.7) and by the end of 2011 real GDP was already 10% higher than 2 years earlier and, remarkably, 56% higher than it was at the beginning of the decade. In order to understand what may have caused such a quick recovery in the presence of significant fiscal consolidation, in the next section we investigate what role non-Keynesian effects may have played in the post-crisis Latvia.

Figure 4.7: Quarterly account of GDP growth and fiscal consolidation measures



Source: Commission services

IV.2. Non-Keynesian effects

Since the seminal contribution of Giavazzi and Pagano (1990), we know that under certain conditions fiscal consolidation can trigger non-Keynesian effects as strong, or even stronger, than standard contractionary Keynesian effects on demand (Giavazzi et al., 2000). When this happens, consolidation may turn out to be expansionary and result in a quick rebound of the economy, of the kind observed in Latvia in late 2009. In other words, the sign and magnitude of fiscal multipliers depend on particular conditions under which fiscal policy is implemented. As noted by Alesina and Ardagna (1998), the main channel through which non-Keynesian effects are activated is aggregate demand: a serious fiscal tightening may indeed increase both consumption and investment, as wealth rises when future tax burdens decline and interest rates decline when credibility is restored and inflation or default risks abate. Indeed, the improvement in the fiscal position may immediately affect consumer confidence, business confidence, and in particular it may lead to a reduction in risk premia which influence the economy's borrowing costs and thereby also the cost of capital. For this effect to produce an expansion, though, the tightening must be sizeable, credible, and occur after a period of stress when the budget is quickly deteriorating and public debt is building up (Afonso, 2010; Giudice et al., 2007). The new EU member states, in particular, seem to be prone to such growth-enhancing consolidation (Rzonca and Cizkowicz, 2005).

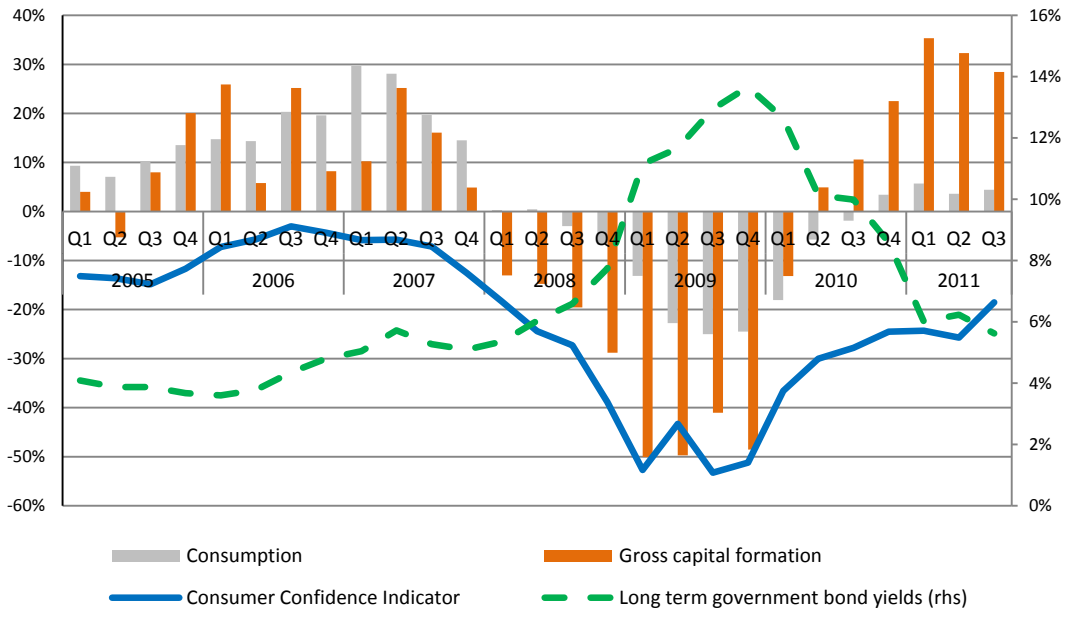
An increase in consumer confidence may raise current consumption through expectation of higher future income and the willingness to consume today part of the expected future gains. Consumers

could both expect taxes to be lower in the future, as a consequence of current consolidation or their gross income to be higher due to an improvement in the fundamentals of the economy. A similar argument can be made for entrepreneurs, who may anticipate higher consumer expenditure and start investing in the economy to have enough capacity to match demand as soon as it picks up. Arguably, these effects are consistently accounted for in the QUEST model, leading to the scenario portrayed in Figures 4.4 and 4.6, where it is assumed that the fiscal space gained by the consolidation over time is used to reduce non-distortionary taxes. However, two key determinants of economic performance for small open economies such as shocks in external demand and in country risk premia due to developments in the international financial markets cannot be introduced endogenously in the simulation, even if their directly affect investments and capital formation. For this reason we analyse them separately and then link them to the results of the simulation to determine their likely impacts.

In addition, if undertaken through spending cuts rather than tax increases, fiscal consolidation is likely to produce growth-enhancing gains in external competitiveness. Cuts in government consumption, and in particular in public wages and public employment can spill over to the private sector and abate the costs of domestic manufacturing, leading to gains in international market shares. The process may be more or less quick depending on the particular labour market institutions of the country undertaking the cuts, but eventually the increased availability of labour and lower wages in the public sector are bound to map into a more efficient production process. However, it is worth noting that while volumes exported increase the effect on value of exports is partly offset by the decrease in export prices, so that in some simulations the overall effect in terms of value added is not necessarily very strong.

In the case of Latvia, there is some evidence on the activation of all these channels of economic expansion triggered by fiscal consolidation, each following a slightly different timing. This could contribute to explain the pace of recovery from the crisis. The connection between the renewed confidence in the Latvian Government and risk premia, investments and consumption can be seen from Figure 4.8. After a constant deterioration of confidence in 2008 and most of 2009, reflecting the impact of the financial crisis first and Government financial sustainability then, it can be seen how the Latvian Government's decision to undertake bold actions to consolidate its fiscal position (mid-2009) was resulted in an improvement in consumer confidence, investments and consumption, whereas risk premia first stabilised and then decreased, at a time in which standard Keynesian wisdom would have predicted further recession due to the contraction in public consumption.

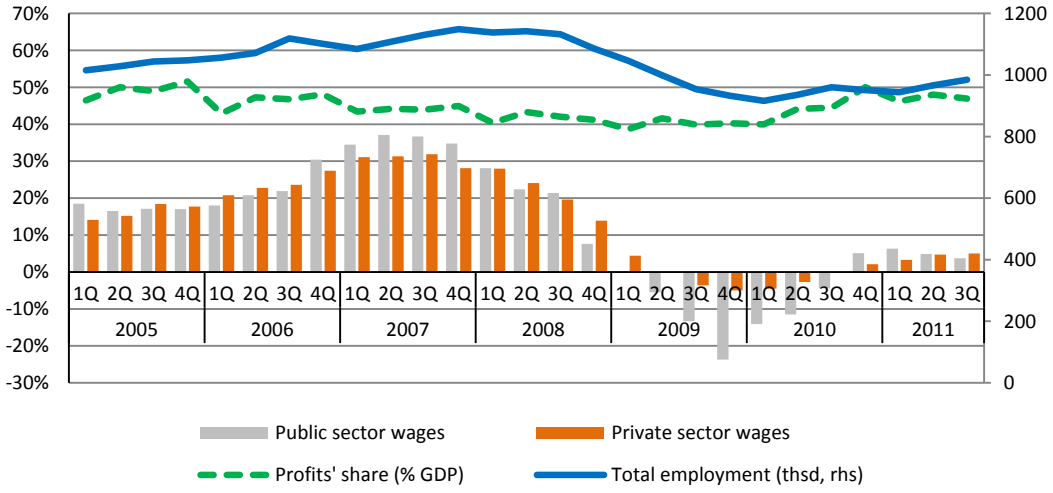
Figure 4.8: Quarterly series of consumption, capital formation, consumer confidence indicator and long-term government bond yields



Source: Commission services

There could be different reasons for the consumption and investments to increase so rapidly between the last quarter of 2009 and the first half of 2010. For example, an increase in consumption and investment could have been driven by higher wages in the private sector or gains in total employment, or also it could have come from a sudden increase value added in export-oriented sectors, due to an increase in Latvian competitiveness or an increase in external demand. We investigate these channels and find no evidence to support them. As a matter of fact, wages and total employment actually decreased as a result of the Government-led internal devaluation strategy, as shown in Figure 4.9. In addition the profits' shares in the economy remained constant while the economy contracted, meaning that lower wage bill didn't lead immediately to higher profits to reinvest in the economy.

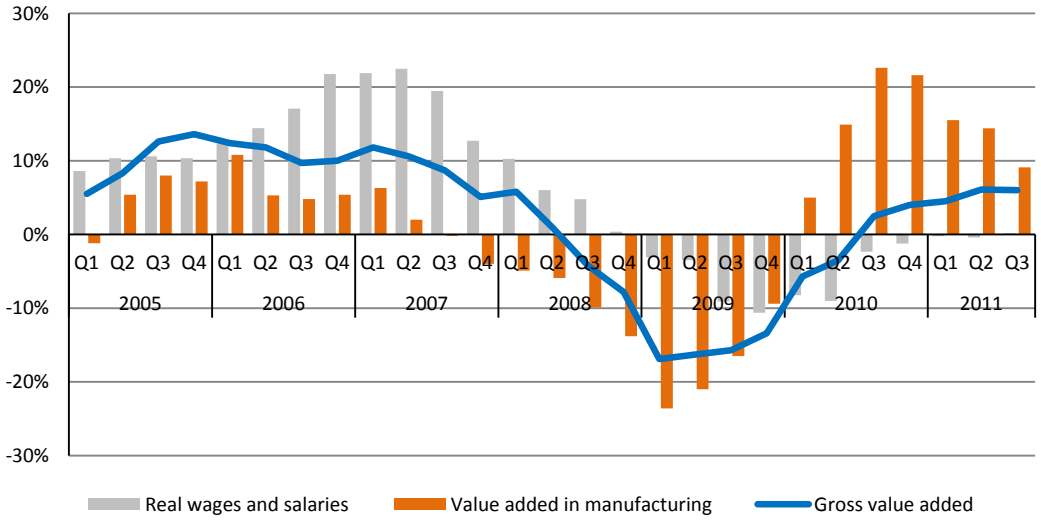
Figure 4.9: Quarterly series of private and public sector wages (annual changes), profit's share of GDP and employment



Source: Commission services

Indeed, the positive impact of lower wages on the growth of value added in manufacturing took some quarters before materialising, as Figure 4.10 shows. Real wages began decreasing in 2009, but value added in the manufacturing sector started to pick up substantially only during the second half of 2010 and in 2011, which means it cannot be used to explain the recovery in real terms of growth of gross value added in the private sector observed since the second quarter of 2009.

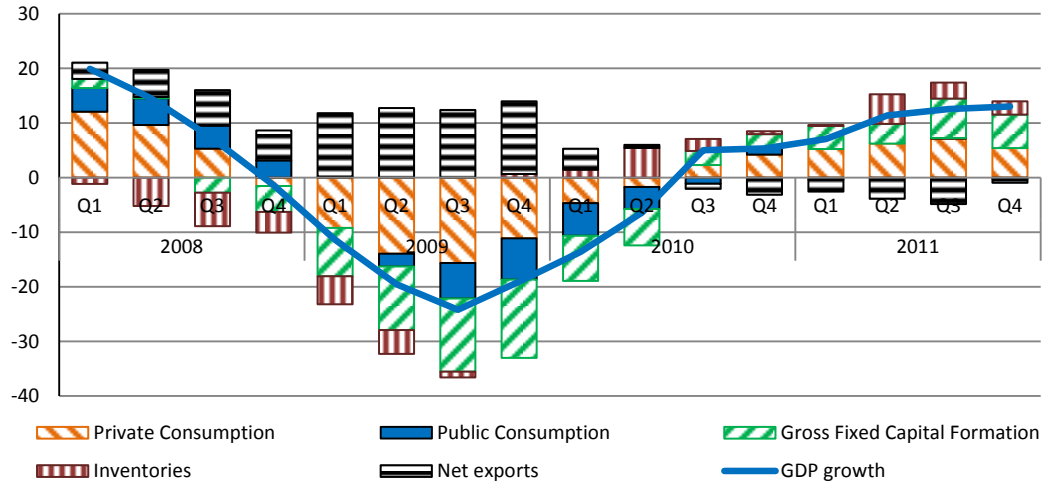
Figure 4.10: Quarterly series of real wages, value added in manufacturing and gross value added (annual changes)



Source: Commission services

If not from higher total wage bill or profits, the recovery in consumption observed since the second half of 2009 may then have been triggered by an increase in exports, as firms may have consumed more intermediate or capital goods to serve foreign markets. This has been typically an important channel in previous cases of growth in the short run after a substantial fiscal consolidation, but again it again does not seem to apply to the Latvian case. In figure 4.11 we show the contribution to nominal GDP growth of different components of GDP and, at first sight, it may appear that the evolution of net exports contributed positively to growth in 2009, reducing GDP contraction by more than 10% of GDP every quarter.

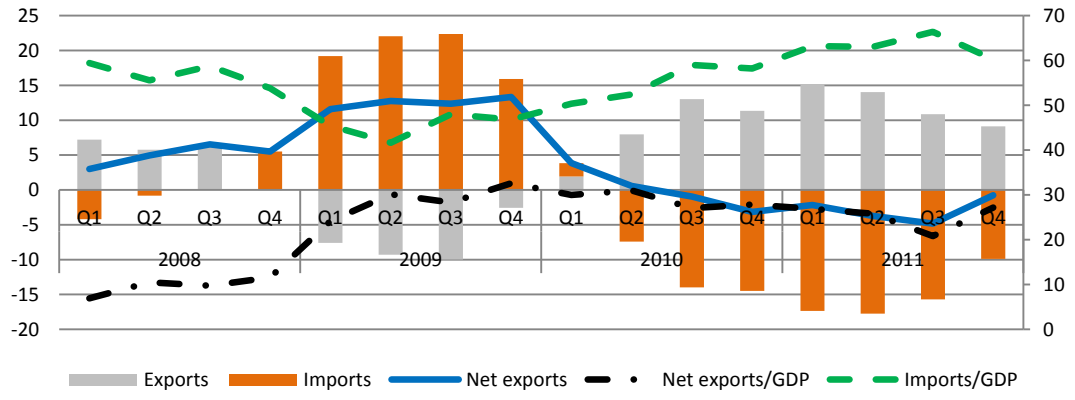
Figure 4.11: Quarterly series of contribution to annual nominal GDP growth of all GDP components



Source: Commission services

Unfortunately, a deeper observation of the dynamics behind the positive contribution of the external sector in the 2009 figures shows that exports contracted significantly and it was just an even greater contraction of imports that tilted the net trade balance on the positive side. This can be seen clearly from figure 4.12, where the contribution to GDP growth of net exports is disaggregated into imports' and exports' contribution. In the second and third quarters of 2009 the contribution of imports' contraction to GDP growth was above 20% of GDP, which accounts for a big share of the contemporaneous contraction in private consumption and gross fixed capital formation shown in Figure 4.11 (between 25 and 30% of GDP). Indeed the ratio of import over total GDP (measured on the right axis of Figure 4.12) shrank from 60% to 40% between 2008Q1 and 2009Q2. It is true that in 2009Q4 Latvian trade balance was positive for the first time in more than a decade, but it was only because between 2008Q1 and 2009Q4 total imports dropped by more than 1/3 and total exports by 1/5, so it would be fair to say that Latvian external adjustment happened despite and not thanks to external demand dynamics.

Figure 4.12: Quarterly series of annual net export's contribution to GDP split into imports and exports, and imports/GDP ratio in percentage points

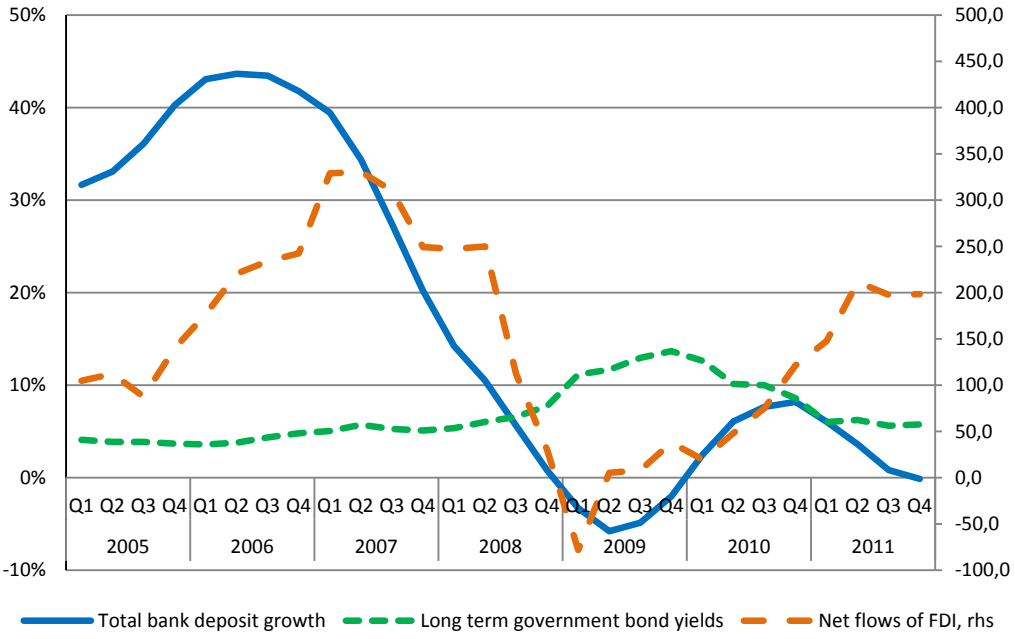


Source: Commission services

Summing up, all the available evidence point in the direction of suggesting that during the second half of 2009 competitiveness gains and external demand did not play a significant role in kick-starting Latvian economy. However, it should be noted that this outcome was probably driven by the extremely weak external demand due to the global spread of the financial crisis and could thus not be directly compared to previous episodes of export-driven expansionary fiscal consolidation happening during more favourable external conditions.

Still, even in the absence of external support, Latvian economy did start to recover as soon as consolidation kicked in, leaving as the only possible explanation a recovery of confidence. A clear sign of this can be seen in the financial sector, as the financial openness of the country allowed capitals to flow easily in and out of the country in response to policy action and confidence in the stability of the economy. As we can see in Figure 4.13, net flows of foreign direct investments and residents' total bank deposits fled the country during the crisis quarters, but came back as soon as fiscal consolidation started. The series clearly mirror the investment and consumption series shown in figure 4.8. As the consolidation measures kicked in, from the second half of 2009, it can be noticed that Latvian residents stopped withdrawing their savings from the banking system and foreigners started investing again in the country. This clearly shows how related are capital flows and foreign investments to the level of confidence in the country, which is in turn closely linked to the government action.

Figure 4.13: Quarterly evolution of long-term government bond yields, total bank deposits and net flows of FDI



Source: Bank of Latvia. Note: Total bank deposits are expressed in terms of millions of lats, total bank deposit annual growth is shown percentage points. Both series show 3-quarter moving averages

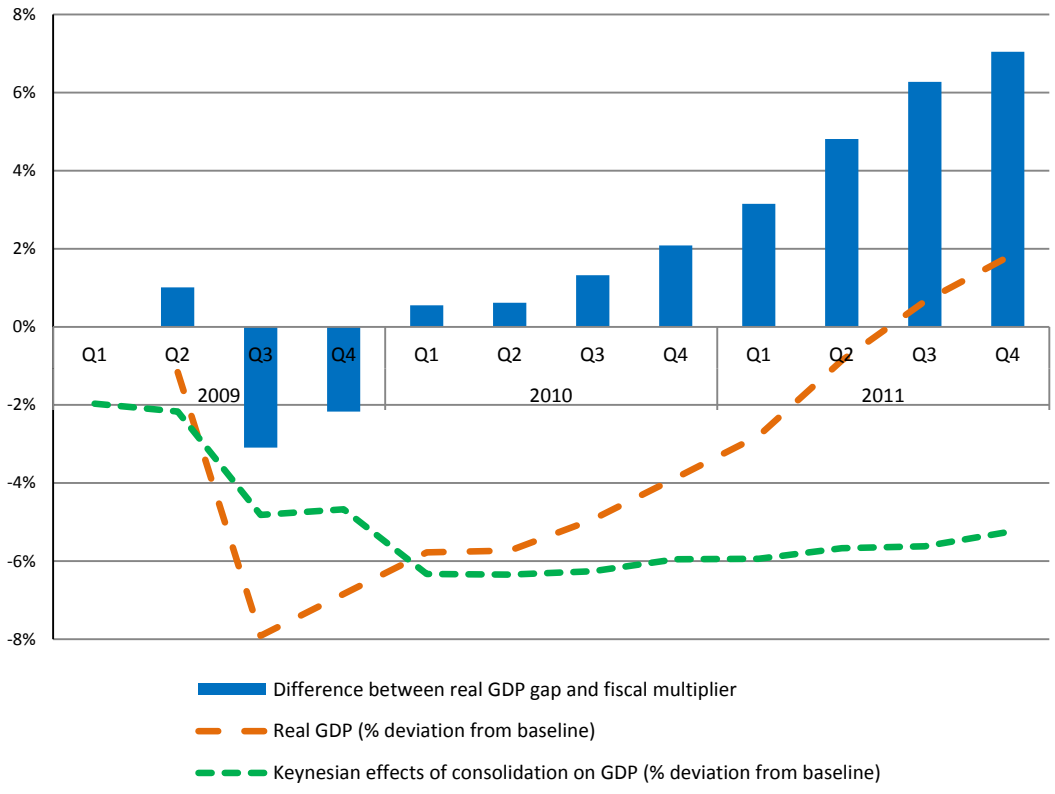
The general lesson we can draw from the impact of fiscal consolidation on the Latvian economy is that in a flexible and open economy a bold intervention by the government and the international community to restore confidence can trigger important non-Keynesian effects which may even completely offset standard Keynesian multipliers.

In addition, the immediate response of the confidence-related channels of non-Keynesian reaction and the lagged response of external competitiveness can have the additional advantage of resulting in a prolonged stimulus as a result of the two effects kicking in at different times. This feature may provide the government a comfortable period of economic growth after a crisis which can be used to enact the due structural reforms.

IV.3. A tentative measure of non-Keynesian effects

As we observed in the previous sections, however, the short term negative effects of fiscal consolidation never fully materialised in the Latvian experience as the economy started recovering just as the bulk of the fiscal consolidation kicked in, from the second half of 2009. In order to give an idea of the unexpected linkages between economic growth and fiscal consolidation, we plot in Figure 4.14 the previously estimated Keynesian effects of fiscal consolidation on GDP against the evolution of real GDP in the quarters following the consolidation. Normalising GDP using the first quarter of consolidation, 2009Q1, and taking it as a baseline, we consider the percentage difference of each quarter from the baseline. Comparing the gap between the deviation of actual GDP from the baseline and the theoretical deviations that should have arisen from the fiscal multipliers of the measures, we can have a rough estimate of the magnitude of the non-Keynesian effects. It can be noted that real GDP contracted up to the third quarter of 2009, but then bounced back between the end of 2009 and 2010, at a time in which the Keynesian effects associated with the additional consolidation should have dragged it down. Even if we know that many additional factors not included in our simulation may have contributed to determine this gap, the difference between these two series point to the presence of significant non-Keynesian effects rising from 1% of GDP in 2010Q1 to 7% in 2011Q4.

Figure 4.14: Difference between real GDP gap and GDP gap simulated with QUEST II considering the actual composition of fiscal consolidation, by quarters

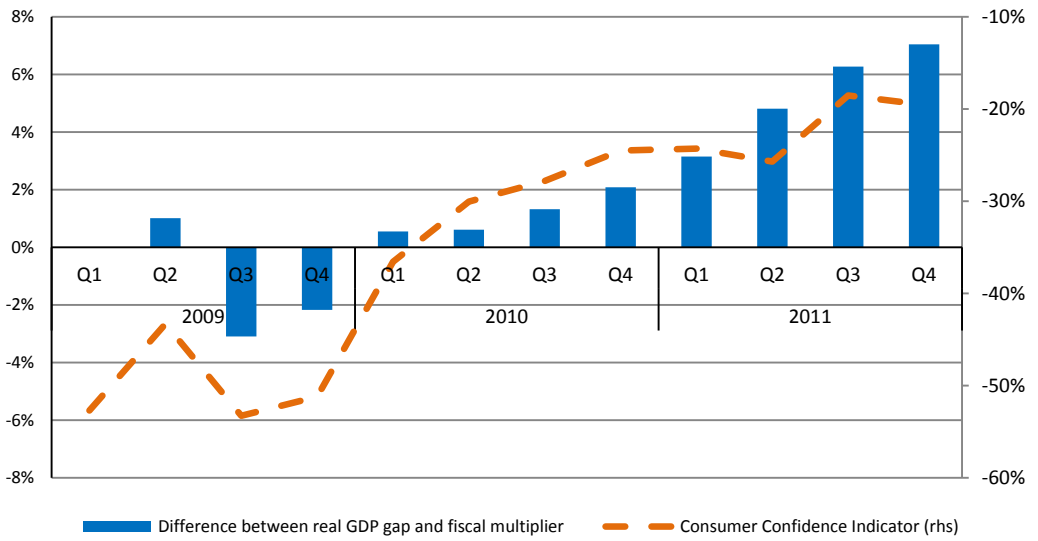


Source: Commission services

We should keep in mind that this is a rather conservative estimate, since in our QUEST simulation external demand was assumed to be stable, whereas in Figure 4.12 we have shown that exports dropped by 9-10% of GDP in 2009Q2 and 2009Q3, even if the overall contribution of trade to GDP growth was positive due to a more than proportional contraction in imports.

Interestingly enough, the evolution of the consumer confidence indicator introduced in section III follows closely our indicator of non-Keynesian impact of fiscal consolidation on the economy, as can be seen from Figure 4.15, this pointing to the relevance of the recovery of consumer confidence as a possible source of non-Keynesian effect.

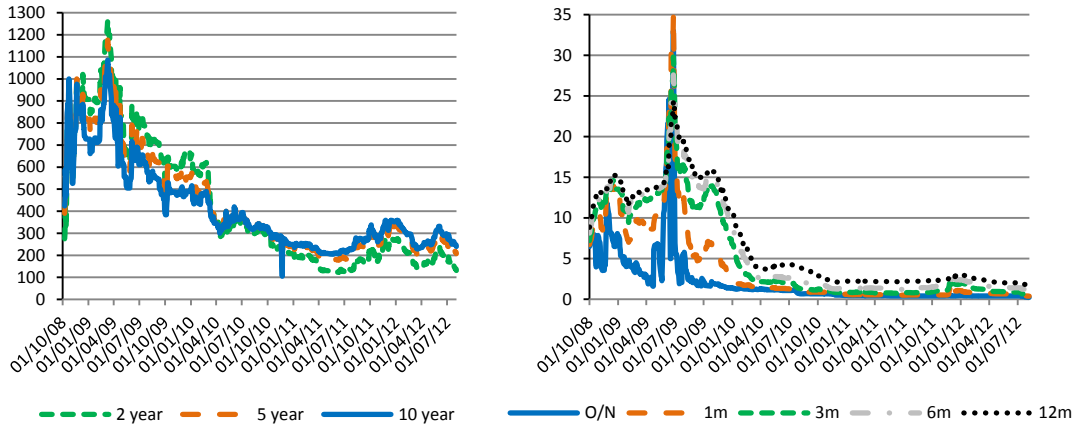
Figure 4.15: Quarterly evolution of the difference between real GDP gap and GDP gap simulation, plotted against the evolution of the consumer confidence indicator



Source: Commission services

In addition, we may notice that a similar improvement, starting from the second half of 2009 and consolidating in 2010, can be seen in the evolution of indicators of financial confidence such as the credit default swap (CDS) spreads and the interbank market rates, shown in Figure 4.16.

Figure 4.16: Evolution of two financial confidence indicators: CDS spreads (left pane) and interbank market rates (right pane)

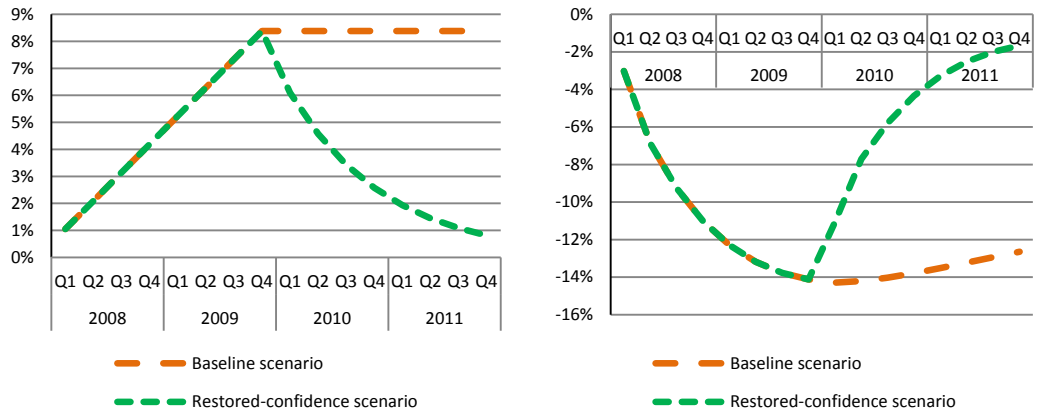


Source: Reuters EcoWin. Note: CDS spread are expressed in basis points. Interbank market rates are RIGIBOR, fixing, in percentages

Since also government bond yields and financial risk premia have been identified in the literature as sources of non-Keynesian effects, we further investigate their potential role in the Latvian case, turning again to a QUEST simulation and showing the results in Figure 4.17. The risk premium in the model drives a wedge between the domestic and the world interest rates and concerns domestic borrowing costs for each the households, the corporate and the public sector. As far as the small open economy is indebted to the rest of the world, this risk premium will also constitute a wealth transfer to external economies. The baseline scenario shows the large negative effect of a persistent annualised 800 basis point increase in the spread starting from 2008Q1. This roughly matches the pattern of government bond yields and CDS spreads for Latvia in 2008 and 2009 with the assumption that, absent the measures taken by the government in 2009, risk premia would have remained persistently high over the following years. The reversal scenario shows the effect of the drop in spreads back from 800 basis points to close to around 100 basis points by 2012. The sudden reversal

has a positive effect on economic activity which converges back to its pre-2008 level relatively quickly following the reversal.

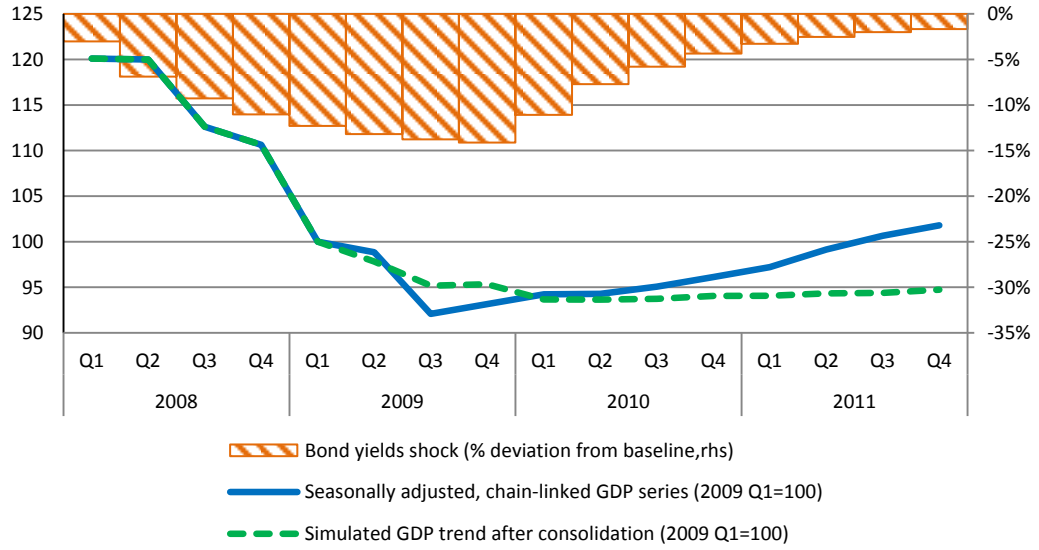
Figure 4.17: Impact on GDP (right pane) of a financial confidence shock of the magnitude experienced by Latvia during the Balance-of-Payment crisis, as captured by the long-term government bond yields spread (left pane)



Source: Commission services. Note: Real data until 2009Q4, long-term government bond yields spread being the deviation from the Latvian average in the previous 10 years, then QUEST simulation

The reversal in the Latvian yields may arguably be linked to the firm fiscal consolidation measures undertaken by the government. As such, the above scenario underlines the likely pre-eminence of the financial channel in triggering the observed non-Keynesian effects. In other words, the consolidation measures helped bring back confidence in the financial markets and allowed Latvia to dispel the negative effects associated with the very high risk premia it was experiencing before the government took action. It is worth noting that the simulated size of the shock is rather significant, reaching 14% of GDP at its peak. The link between the reduction in bond yields and recovery can be seen in Figure 4.18, where we plot the evolution of Latvia's real GDP (black dashed line) against the GDP trend simulated by the QUEST model (red solid line) and the bond yields shock. It seems reasonable to attribute part of the merits of the quick recovery to the normalisation of the risk premia, which allowed firms and consumers to gain a better access to the financial markets.

Figure 4.18: Simulated impact on GDP of the financial confidence shock and of the impact of fiscal consolidation, plotted against the actual series of real GDP

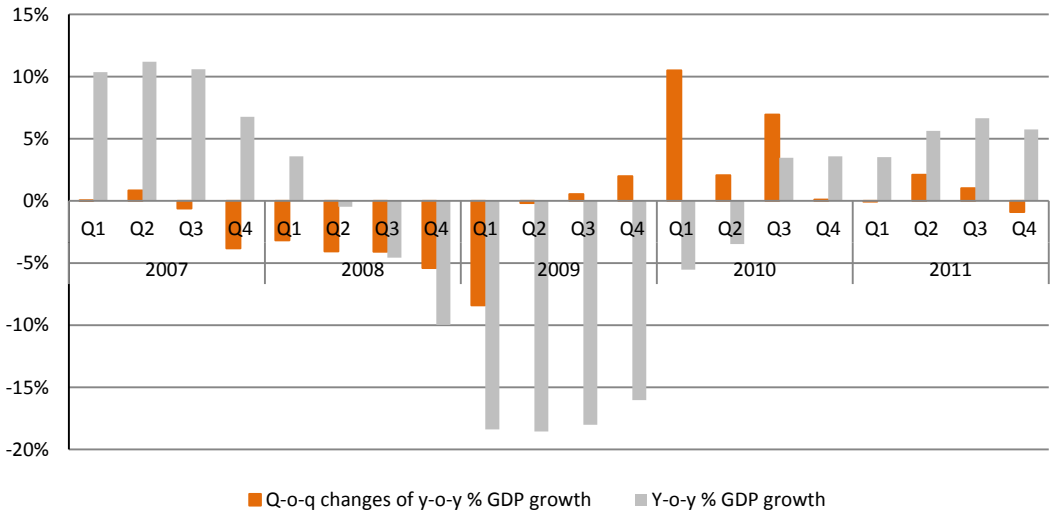


Source: Commission services. Note: QUEST simulation for the simulation for the GDP trend after consolidation starts after 2009Q1 and takes into account the impact of fiscal consolidation but not the impact of the financial confidence shock, thus plotted separately

Since consumer and business confidence has often been identified as the main driver of non-Keynesian effects in the literature, this observation seems to reinforce our intuition that the particular characteristics of Latvian fiscal consolidation managed to offset the short-term negative impact of fiscal consolidation.

As a final remark, it is worth seeing how Latvian economic growth was affected by the consolidation measures not compared to our simulations, but in its own sake. As a complement to the GDP figures in level provided in Figure 4.7, Figure 4.19 shows the year-on-year GDP changes and their quarterly changes. It can be noticed that while the situation keeps on deteriorating for the entire 2007 and 2008, increasingly bad growth performances, the economy reacts to the austerity measures by first stabilising, in middle of 2009 and then rebounding strongly by the beginning of 2010, even if positive year-on-year changes could be observed only by the second half of 2010.

Figure 4.19: Annual GDP growth, by quarter, and quarterly changes in annual GDP growth



Source: Commission services

Summing up, our analysis suggest strongly that credible, bold, front-loaded and well-designed measures managed to convince Latvians and foreign investors, between 2009 and 2010, that the worst was over and the country was back again on a sustainable path. This renewed confidence in the country immediately alleviated the economic pain caused by prohibitive risk premia for government bonds and has triggered the equivalent of a cost-free economic stimulus to the economy when it was most needed.

V. What lessons from Latvia?

Latvia's experience represents a remarkable example of how fiscal consolidation should be undertaken to maximise long-term benefits and at the same time provide relief to the economy in the short term. The foundations of its success lied on the following essential elements:

- **Timing:** a rapid response is crucial when the economy and the budget are getting out of hands, but time is needed for surgical and meaningful action. It is therefore essential to have a large enough financial package and a long enough horizon to avoid across-the-board cuts;
- **Size:** when trends are wrong, everybody, including markets, must be impressed by the size of action. Going big can change mind sets and attitudes. Much of what has been done has been large from the beginning: wage adjustment, employment, reforms in key areas such as education, health and the organisation of the public administration;
- **Trust:** at the end, what drives the economy is the behaviour of agents. This is strongly affected by credibility of policies, but even more by the trust in the counterparts;

- **Country-specific analysis:** the adjustment of Latvia defied much of conventional economics. There must be courage to challenging some of its assertions, when new ground is being broken. Every economy is different at any given time. While there are similarities, one should not overlook key differences;
- **Prudence:** in devising an adjustment, one should not bank on uncertain benefits. Markets and observers have asymmetric reactions. Better results lead at best to a progressive increasing credibility. But any credibility can be quickly lost because of a small negative underperformance. A certain distance must thus always be kept from the edge;
- **Effective Communication:** effective communication is needed to spell out misinterpretation and to persuade actors that the policy objectives are achievable. Telling the 'hard-truth', explaining what needs and can be done, reminding about the final objective, have been key elements of the Balance-of-Payments assistance programme that supported Latvia's fiscal consolidation.

VI. Conclusions

The unprecedented fiscal consolidation efforts undertaken by Latvia in 2009 represent an ideal case study to have a fresh look at the short-term relation between fiscal policy and GDP growth. Especially on the expenditure side, the Latvian consolidation strategy was characterised by a careful design of measures, based on strategic plans rather than across-the-board cuts in several important areas. The bold, decisive, targeted and front-loaded nature of Latvian consolidation appear to have contributed to trigger non-Keynesian effects so relevant as to offset the standard negative Keynesian reaction to spending cut and tax hike (which were in themselves minimised by the growth-friendly composition of the consolidation). Government intervention and international lenders' guidance certainly halted a downward spiral and was accompanied by a sudden recovery in confidence which is likely to have prompted a quick rebound of consumption and investments in the private sector. With negative effects limited and positive ones kicking in in a sequential manner, this consolidation rapidly drove the Latvian economy on a sustained growth path.

There could be several conditions that allowed the consolidation to work so well. First of all, the fiscal sector in Latvia over-expanded so rapidly in boom years preceding the crisis that it could not pose much resistance to its downsizing. Second, even though it grew rapidly before the crisis, the size of the public sector in Latvia and in the Baltics in general has historically been smaller than in the rest of the European Union. This implies that the impact of fiscal multipliers is more limited than in other European countries, as more scope is left for the private sector's behaviour to determine the ultimate effects on growth. Finally, the economic contraction and loss of confidence were so serious at the onset of the crisis years that they could have amplified the effects of the following rebound.

It is also worth mentioning that the availability of EU funds may have offset part of the cuts in public expenditure. A study commissioned by the Latvian Ministry of Finance (SSE, 2011) estimated that the impact EU funds on the Latvian economy amounted to 4% of real GDP in 2009 and 5.2% in 2010. Even if that is not a significant increase with respect to 2008, when the estimated impact on the economy was 3.9% of GDP, it may be argued that the crowding out effects of EU funds should be lower in a phase of economic contraction. Credit should however be given to the Latvian authorities and to the Commission for having secured the co-funding of such expenditure during the consolidation, which was achieved by higher cuts to other current expenditures.

All in all, important lessons that can be drawn from the Latvian experience. Good judgements on country-specific issues, right timing and sufficient size of intervention were key elements for Latvian success, but for their potential benefits to be fully tapped, they had to be accompanied by mutual trust across decision makers, prudence and effective communication. It was this particular combination of features that allowed the consolidation measures to restore confidence and significantly offset the possible negative impacts of consolidation on the economy. Latvia showed that the trade-off between short-term pain and long-term gain can be avoided if intervention is sufficiently well designed.

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Chapter 5 – Fiscal sustainability, demographic change and inequality: the social sectors from crisis to growth in Latvia

Peter Harrold [35]
Indhira Santos
Emily Sinnott

I. Introduction

The aim of this chapter is to examine how spending policy in the education, health and social protection sectors responded to the economic and financial crisis in Latvia. It does this from the perspective of efficiency and equity. The chapter also outlines the medium-term public expenditure challenges facing the country in these social sectors. For optimum efficiency, fiscal policy should be focused on implementing reforms with a medium-term orientation aimed at improving sector outcomes and contributing to overall fiscal sustainability. Given the relatively high levels of inequality in Latvia compared to other EU countries, even after accounting for government transfers and household taxes, this chapter extends its focus to also examine the impact on equity of the recent consolidation and emergency social safety net measures. Finally, the chapter looks at those measures that need to be prioritised in order to deepen structural reforms in the social sectors and to reduce vulnerability within the poorest segments of the population.

In all social sectors, the main medium- and long-term challenge in Latvia is adapting to a decreasing and ageing population. The population in Latvia has fallen by 5.6% since 2000 and is expected to fall by a further 19% by 2060.[36] At the same time, the population is getting significantly older (Figure 5.1). This demographic shift is having and will continue to have significant fiscal and design implications for social sector policy (World Bank, 2007). For example, the rapid aging of the population is projected to lead to a gradual increase in the number of pension-age adults relative to adults of working age, and this is likely to place considerable pressure on the current public pension system and render it unsustainable unless reforms are enacted. In 2010, 79% of the adult population was of working age (aged 15-64) compared to a projected 66% by 2060. The population aged 65 and over was equivalent to 27% of the working-age population in 2010, and this is projected to increase to 51% by 2060 (Figure 5.2**Error! Reference source not found.**). In education and health, infrastructure and staffing will need to adapt to ever-smaller school-age populations and older general populations, respectively. During the boom years, Latvia adapted to demographic changes more slowly than many of its peers, especially in education, and the crisis provided an opportunity to accelerate the necessary reforms.

Not only did spending on the social sectors - education, health and social protection - comprise the largest share of the government's budget in the "boom" years of 2004-2008, but this area of the budget also grew significantly during the same period.[37] While all sectors of general government benefitted from fiscal expansion during the good times, education, health and social protection spending ballooned by 34.1% in real terms between 2004 and 2008.

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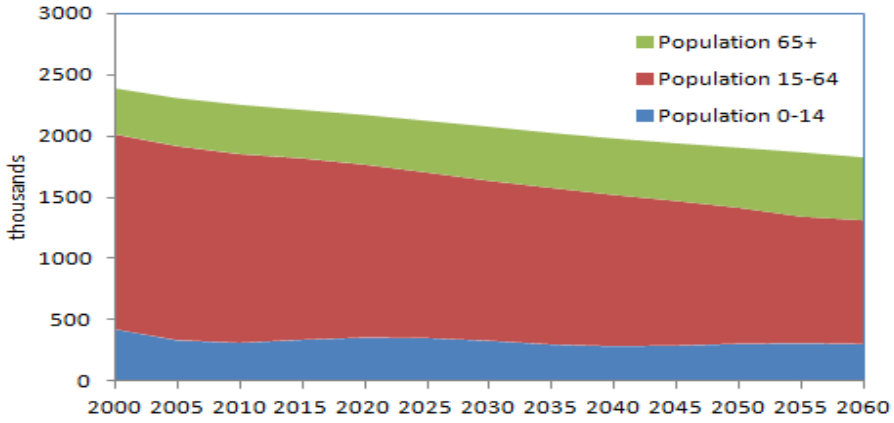
[35] The chapter is based on background work prepared by World Bank staff, including Paul Cahu, Charles Griffin, Nadezhda Lepeshko, Michael Mertaugh, Truman Packard, Indhira Santos, Anita Schwarz, Emily Sinnott, Victoria Strokova, Ramya Sundaram, and Asta Zviniene. It benefitted from the macroeconomic analysis of Emilia Skrok and the background papers of Ihsan Ajwad and Aylin Isik-Dikmelik, and the 2010 World Bank Public Expenditure Review. It also benefitted from a background paper on the Distributional Impact of the Financial Crisis in Latvia by Robert Gillingham.

[36] UN Population Division, *World Population Prospects: The 2010 Revision*.

[37] Dating the boom and bust is constrained by the lack of quarterly data for EU new member states, including Latvia. Instead, we date the Euro area fiscal cycle using the algorithm proposed by Harding and Pagan (2002) as a quarterly implementation of the original Bry and Boschan (1971). We use seasonally-adjusted Euro-area general government expenditure data from the European Central Bank (ECB) for the period Q1 1999 to Q1 2011. This method reveals a spending cycle beginning in Q3 2005, peaking in Q4 2007 and ending (trough) in Q3 2008.

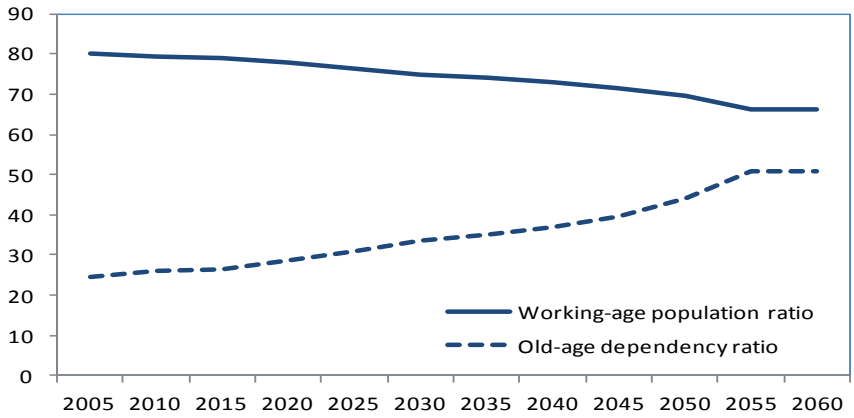
Figure 5.1: The demographic challenge in Latvia: decreasing and aging population, 2000-2060



Source: World Bank staff, calculations based on data from UN Population Division

The social spending boom created some space in which to identify potential savings that could be made quickly. As a result, social sector spending cuts contributed greatly to fiscal consolidation efforts in Latvia in the first year of the adjustment period: spending cuts in education and health explain 61.3% of the total reduction in expenditure in 2009. Social protection spending increased substantially in 2009, and thus did not contribute to the consolidation until 2010, when in nominal terms spending cuts equalled one-fifth of cuts in education and health over 2009-2012.[38]

Figure 5.2: Working-age population and old-age dependency ratios in Latvia, 2005-2060



Source: World Bank staff calculations based on United Nations Population Division's World Population Prospects: The 2010 Revision. Note: The working-age population ratio gives the total working-age population (aged 15-64) as a percentage of the total adult population (15 and over). The old-age dependency ratio gives the number of people aged 65 and over as a percentage of working-age population (15-64)

The heavy focus on the social sectors at the beginning of the stabilisation programme was appropriate in that fiscal sustainability in the coming decades will hinge critically on making the necessary structural reforms in all sectors. The reforms will allow these economies to successfully adjust to the challenge of ageing populations and to improve outcomes in the areas of education, health and social protection.

Despite the large increases in social sector spending during the boom years, the outcomes associated with spending have often not shown much sign of improvement. This is particularly apparent in the health sector, where gaps in health outcomes in Latvia compared to pre-2004 EU member states

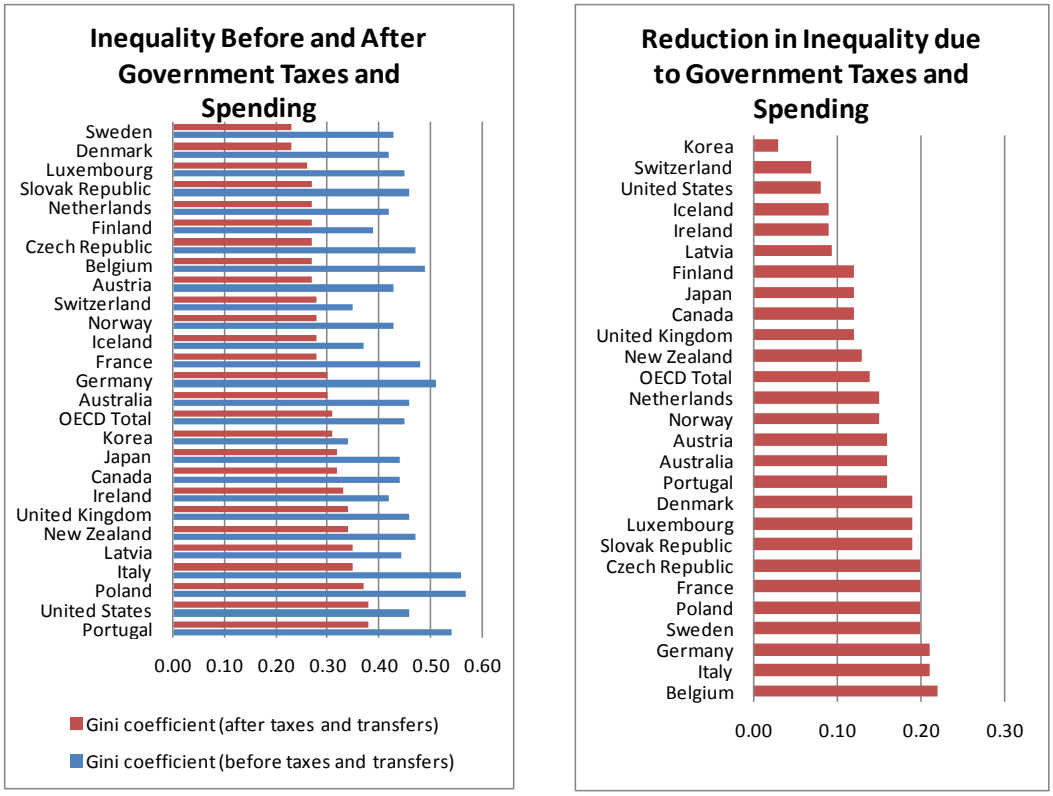
[38] This does not take into account the impact on revenues of the diversion of the second pillar pension contributions.

persist. The difference in mortality rates for men from heart disease and strokes in Latvia is particularly striking. In this sense, the crisis expedited the need to address not only short-term fiscal constraints, but also the unfinished reform agenda.

Similarly, the great expansion of public spending prior to the crisis did not lead to significant improvements in income inequality. In 2007, Latvia had one of the lowest levels of reduction in inequality due to government taxes and spending when compared to high-income OECD countries (Figure 5.3). The Gini coefficient for household income was 0.44 before and 0.35 after government taxes and transfers. This was partly due to differences in the structure of taxation, but it was also due to the relatively low coverage of social benefits and the generosity of social benefits targeted at low-income households in Latvia. Additional equity challenges remain in Latvia in terms of mitigating the social impacts of the crisis; improving social assistance targeting; and providing more equal treatment in pension benefits across age cohorts.

The chapter proceeds as follows: in Section II, we discuss the social spending trends during the boom period prior to the economic crisis. Here, we seek to answer the question of what happened to expenditures in health, education and social protection during this period in terms of overall real spending and composition of that spending; we also look at how these changes impacted sector outcomes. An account of the measures taken to reduce social sector spending during the crisis is given in Section III. This looks at how the social sectors adjusted during the economic crisis, both as a result of automatic stabilisers and as a consequence of policy changes, and, where relevant, it covers the distributional consequences of these developments. Section IV describes the remaining structural reform issues for the social sectors. Section V concludes with lessons learned from the experience of Latvia in the social sectors over the boom and bust periods.

Figure 5.3: Impact of taxation and expenditure on income equality in European and OECD countries, mid 2000s



Source: Staff estimates using data from EUROSTAT and OECD. Note: OECD data for mid-2000s. Data for Latvia is based on World Bank staff estimates using the 2007 SILC

II. Social sector spending during the boom

Social sector spending in Latvia grew significantly during the economic boom preceding the crisis years, with the growth in the share of the budget for social protection being particularly noteworthy. Increases in real spending across the social sectors were larger than that observed in most other countries in the region. The health sector saw real growth of more than 70% between 2004 and 2008, with additional resources focused on inpatient care, secondary ambulatory services, and patient pharmaceuticals, to the detriment of outpatient care. In social protection, spending growth was mostly driven by increased expenditure on pensions, associated with policy changes that led to more generous pensions; it was also driven by high wage bill growth in a strong economic period. Social assistance programmes, especially those which targeted poor households, did not experience similar growth, and remained quite small compared to those of peer countries. In education, additional spending did not always go to the most efficient use, boosting the number of teaching and non-teaching staff despite falling enrolment numbers.

Critically, the rise in social spending did not always translate into better (or more equal) social outcomes. The combination of high spending and inefficiencies in the social sector accumulated during the boom period meant that structural reforms in these sectors has the possibility of leading to significant fiscal savings in the short and medium term as well as to better performance in the health, education and social protection systems. In this section, we look at what happened to expenditures on health, education and social protection during the boom period in terms of overall real spending and the composition of that spending.

II.A. Overall Social Spending

Not only did spending on the social sectors - education, health and social protection - comprise the largest share of the government's budget in Latvia during the boom years, but this area of the budget also grew significantly at that time. In fact, real public spending in Latvia grew faster than in all other EU10 countries or Croatia between 2004 and 2008: by 41.5% in real terms (Table 5.1).[39] This was driven by across-the-board increases in public spending, with all sectors benefitting also from the boom in fiscal spending. Social sector spending in Latvia grew rapidly compared to other countries in the region, rising by 34% over 2004-2008, a growth rate lower only to that in Romania (50.8 percent), Lithuania (50.7%) and Estonia (41.33%). Thus, social sectors contributed to 46% of the overall growth in government spending during this period in Latvia. By 2008, social sectors took up over half (53%) of all government spending in the country (Figure 5.4, left pane). 46% of this spending was for social protection and almost 60% of this went to programmes for the elderly, while 32% was went to education and the remaining 22% to health.

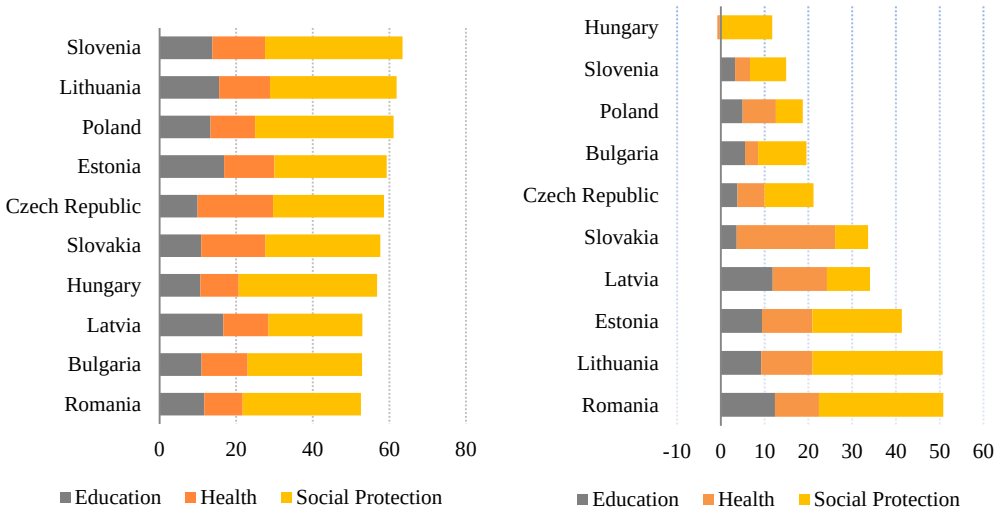
Table 5.1: Percentage growth in real spending in selected EU Countries, 2004-2008

	Total public spending	Total social spending	Non-social public spending	Health	Education	Social protection
Bulgaria	8.0	19.5	31.8	12.4	28.6	19.5
Croatia	14.9	17.7	10.4	42.9	23.3	7.0
Czech Republic	17.4	21.2	12.6	21.2	19.8	21.6
Estonia	44.1	41.3	48.3	58.6	30.5	41.2
Latvia	41.5	34.1	50.9	71.0	38.9	18.9
Lithuania	47.4	50.7	42.4	57.1	32.1	58.5
Hungary	8.9	10.9	6.3	-2.9	-1.2	19.9
Poland	25.2	18.7	36.9	50.3	23.8	9.6
Romania	46.4	50.8	41.8	53.7	58.4	47.3
Slovenia	17.9	14.9	23.5	15.7	15.0	14.6
Slovakia	25.5	33.7	15.6	100.2	19.0	12.9

Source: World Bank staff calculations based on Eurostat data

[39] The EU10 countries include Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Figure 5.4: Social sector spending as a share of total government spending in 2008 (left pane, percentage) and real growth in social spending, with contribution by sub-sector, 2004-2008 (right pane, percentage)



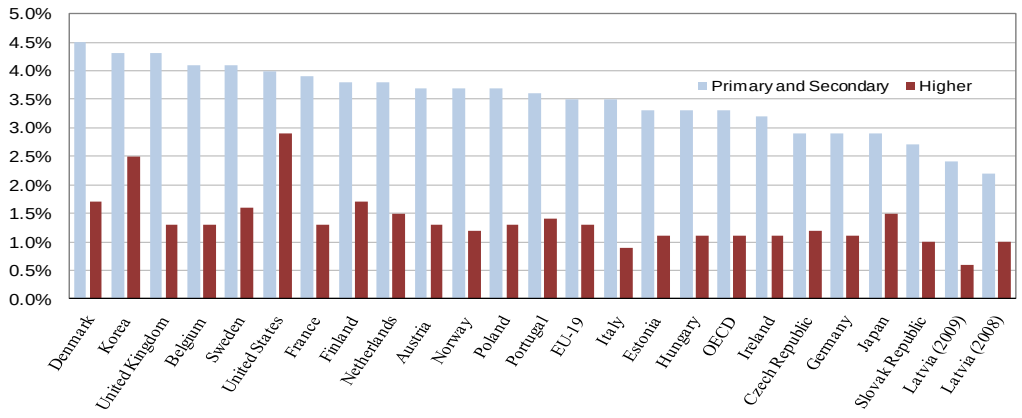
Source: World Bank staff calculations based on Eurostat data

Within social spending, health was the sector that expanded most rapidly in Latvia during the boom years 2004-2008: a 71% real growth, compared to 38.9% in education and 18.9% in social protection. As a result, the health sector accounts for 36.4% of overall social spending growth between 2004 and 2008; increases in education spending account for 34.7%, with social spending explaining the remaining 28.9% of social spending growth in this period (Figure 5.4, right pane). However, social protection, especially pensions, remains the most significant component of social spending in Latvia.

II.B. Education

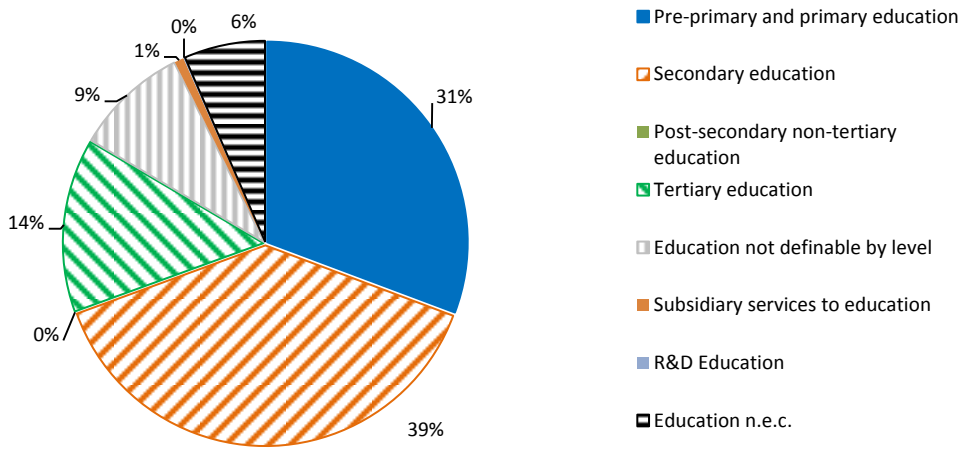
Public expenditure on education in Latvia is low when compared to other European or OECD countries. Figure 5.5 presents the level of government expenditures by level of education, expressed as a percentage of GDP. These expenditures are the lowest in the EU at 2.2% of GDP in 2008, compared to an average of 3.5% in the EU and 3.7% in OECD countries. For higher education, Latvia's expenditure relative to GDP, at 1%, was the second lowest after that of Italy in 2008 and fell even lower in 2009. Figure 5.6 presents the breakdown of education spending in Latvia by education level before the crisis in 2007.

Figure 5.5: Government expenditure on primary, secondary and higher education (share of GDP)



Source: World Bank (2010), based on data from the Ministry of Finance for Latvia and OECD for other countries. Note: Secondary education figures include secondary vocational education. Data for 2006, except for Latvia

Figure 5.6: Functional composition of education spending in Latvia, 2007 (share of total spending on public education)



Source: Eurostat, COFOG database; and World Bank staff calculations

Low public expenditures on education in Latvia are partly due to low teacher salaries. when compared to other public sector employees and with EU/OECD countries This also partly explains the relatively modest share of the education sector in overall public spending. Both the OECD and the EU average teacher pay as a percentage of GDP per capita is more than twice that of Latvia. Only in Estonia was teacher pay relative to GDP per capita below that of Latvia. At the beginning of 2008, before the onset of the economic crisis, the government made a commitment to increase teacher salaries. As the increase in teacher salaries was made before the per capita financing reform was implemented, the pay rise was applied to a still overstaffed network of primary and general secondary schools. Partly as a result of this, government expenditures in education grew by 4.8% in real terms in 2008. In addition to the wage rise, the number of teaching posts and the teaching workload in primary and general secondary schools actually increased in 2007/2008 and 2008/2009, even though enrolment declined by 5.5% (Table 5.2). The key challenge for Latvia in the education sector, going into the crisis and beyond, has been to adapt to the declining student population, the population of 5-14 year olds fell by 40% between 2000 and 2010. Latvia was actually somewhat behind other countries in the region in adjusting to shifting demographics prior to the crisis. For example, until 2007, it was the only country among EU New Member States that had not adopted per capita financing.

Table 5.2: Efficiency parameters in primary and secondary general education, 2007-2009

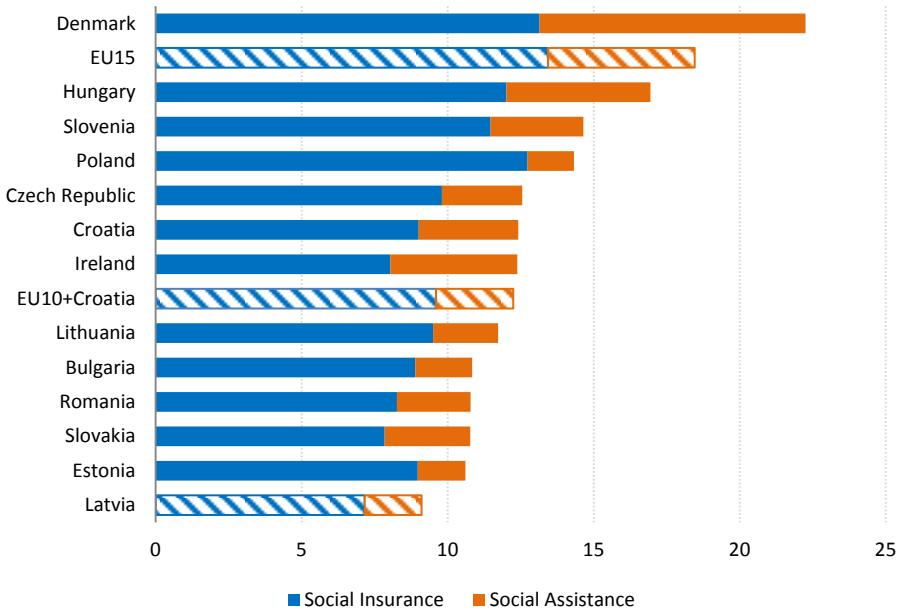
	2007/2008	2008/2009	2009/2010	Percentage change 2007/2008 - 2008/2009	Percentage change 2008/2009 - 2009/2010
Students	263,140	248,647	239,139	-5.5	-3.8
Schools	992	982	877	-1	-10.7
Classes	15,431	14,973	13,858	-3	-7.4
Joint classes	14,399	13,971	12,887	-3	-7.8
Total workloads	45,139	45,783	32,564	1.4	-28.9
Teaching workloads	32,928	33,419	25,099	1.4	-24.9
Share of non-teaching workloads (percentage)	27.1	27	22.9	-0.1	-15.2
Total school staff (number of posts)	33,605	33,321	28,153	-0.8	15.5
Teaching staff (number of posts)	26,537	26,695	23,469	0.6	-12.1
Total school staff (persons)	N/A	28,144	24,091	N/A	-14.4
Teaching staff (persons)	N/A	22,657	20,228	N/A	-10.7
Workloads: total/teaching	1.37	1.37	1.3	0	-5.3
Teaching workloads per teacher post	1.24	1.25	1.07	0.8	-14.5
Total workloads per school staff post	1.34	1.37	1.16	2.2	-15.8
Students/teaching staff (gross S/T)	9.9	9.3	10.2	-6.1	9.4
Students/teaching workloads (net S/T)	8	7.4	9.5	-6.8	27.9
Average class size	19	18.5	19.3	-2.8	4.2

Source: World Bank (2010), based on school census data

II.C. Social protection

Latvia does not have a particularly generous social welfare system when compared to other countries in the EU (Figure 5.7). In 2008, EU 15 countries spent on average 16.9% of GDP on social assistance and insurance; the EU 10 and Croatia taken together spent on average 12.3% of GDP. Latvia spent significantly less at 9.1% of GDP that year.

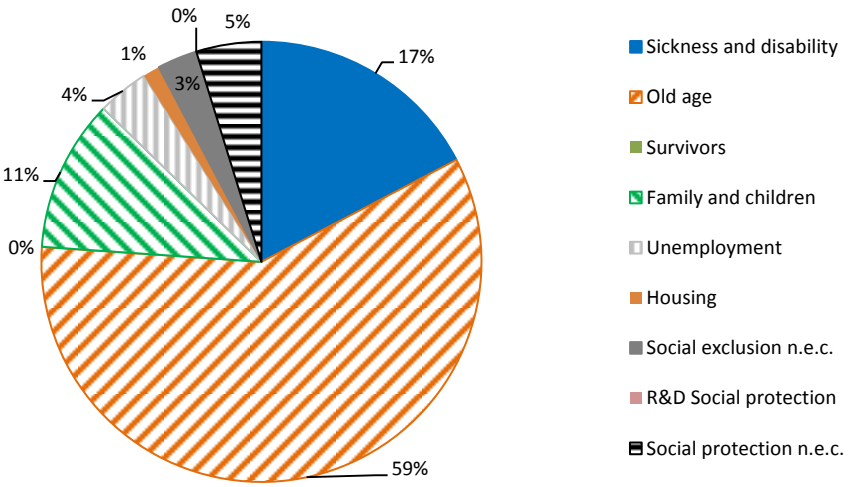
Figure 5.7: Social insurance and social assistance spending, 2008 (percentage of GDP)



Source: WB staff calculations, based on ESSPROS. Note: EU15 and EU10+Croatia averages refer to simple averages

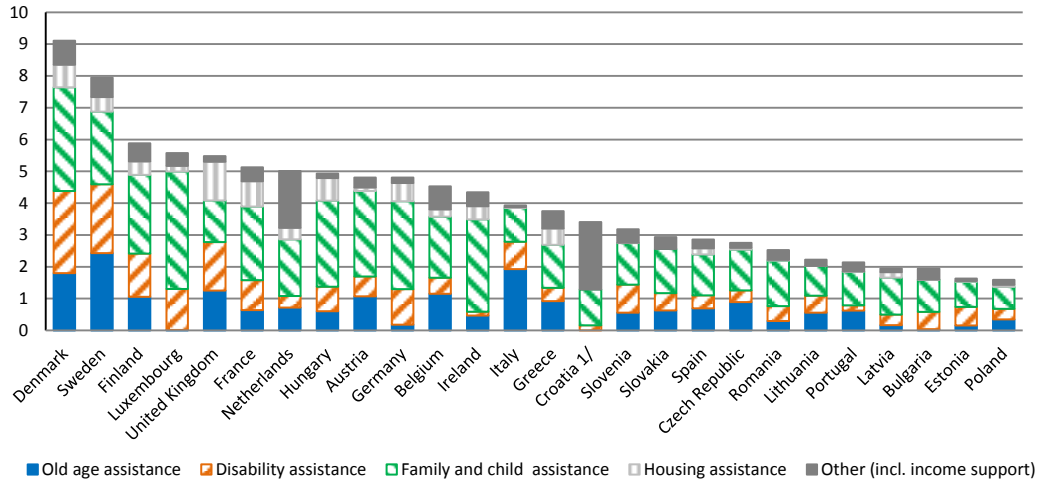
As in other countries in the region, most of the spending on social protection takes the form of social insurance benefits (social welfare spending on old age most illnesses, disability, unemployment, and survivor payments). In Latvia, these accounted for over 80% of social protection spending (Figure 5.8). Non-contributory social assistance takes up the remainder of social welfare spending, with family and child benefits representing the majority of this category. Figure 5.9 presents a detailed breakdown of social assistance spending in Latvia.

Figure 5.8: Functional composition of social protection spending in Latvia, 2007 (share of total social protection spending)



Sources: WB staff, based on Eurostat and COFOG database

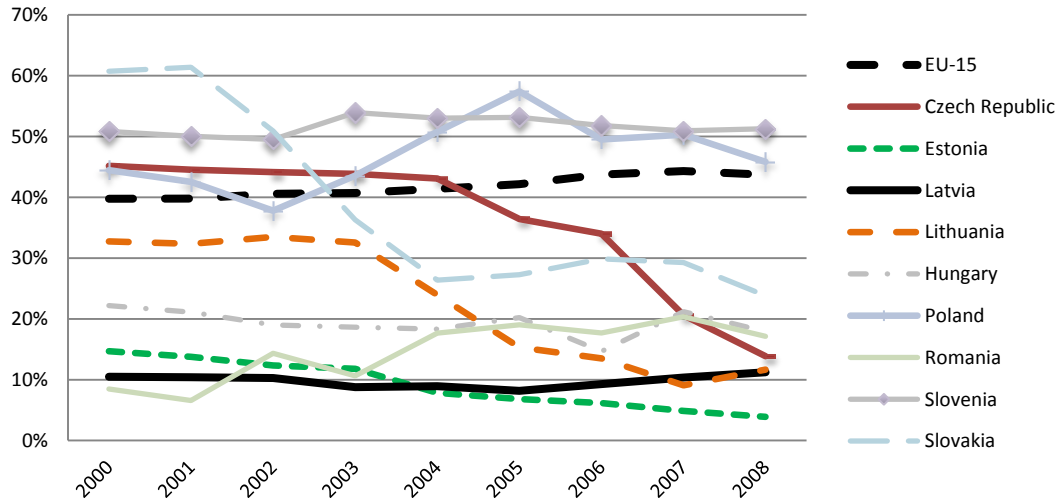
Figure 5.9: Breakdown of social assistance spending, 2008 (percentage of GDP)



Source: WB staff calculations, based on ESSPROS and World Bank Europe and Central Asia Social Protection Database.
Note: The total for Croatia includes spending on war veteran pensions, amounting to 1.4% of GDP under "other" and war veteran assistance to families and disabled veterans under family and disability, respectively

Spending on non-contributory transfers in Latvia is at the low end of other countries in the region, but the contrast is particularly stark in terms of spending on targeted benefits, i.e., on those programmes aimed at the poorest households. Spending on targeted "exclusion" benefits in Latvia is - along with Estonia and Lithuania - the lowest in the EU, and changed very little during the boom years (Figure 5.10). The housing benefit and the Guaranteed Minimum Income (GMI) transfers are the two main targeted social assistance benefits in Latvia.[40] The benefits of the GMI programme, in particular, took up an ever-smaller share of overall social assistance benefits in the period leading up to the crisis (Figure 5.11). The relatively small volume of targeted social assistance focused on poor households could reflect the highly decentralised character of Latvia's social assistance programmes, which are not only administered but also financed by municipal governments, and would reflect the low incidence of GMI and housing benefits in poorer municipalities which are less able to provide these benefits.

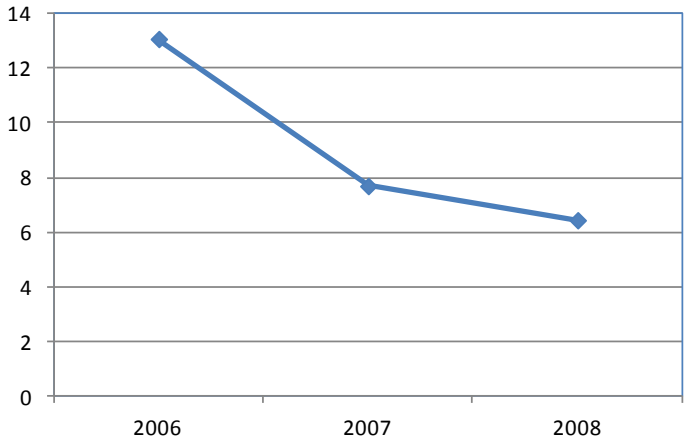
Figure 5.10: Spending on means-tested programmes, 1997-2008 (percentage of total social assistance spending)



Sources: Eurostat

[40] Both of these benefits are administered and financed by municipalities, although by mandate of the national government. Spending on housing benefits are typically, but not uniformly, targeted across municipalities; they became part of the mandatory targeted municipal social assistance only in 2008. Local governments also provide other social assistance benefits on a voluntary basis as well as lump sum emergency benefits to residents who have experienced negative shocks. The latter are for the most part, however, not means-tested.

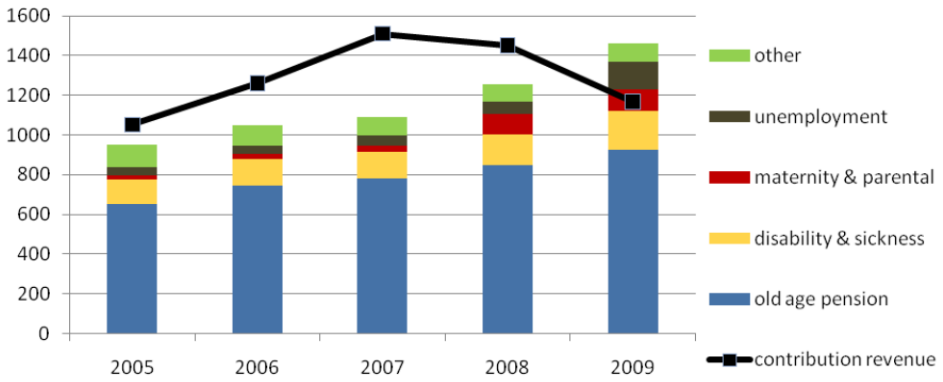
Figure 5.11: Total GMI benefits, 2006-2008 (percentage of total social assistance benefits)



Sources: World Bank staff estimates using data reported by the Latvian Ministry of Welfare

Prior to the crisis, the increase in social protection spending was largely driven by the upswing in social insurance spending. Between 2005 and 2007, revenue from the social insurance special budget grew by 44% in real terms (Figure 5.12). The extraordinary economic growth experienced until 2007 translated into rapid wage growth and increased formalisation and this, in turn, into a significant increase in the wage bill covered by the social insurance system. This boom was reflected in the notional interest rate applied to pension benefits in the public pension pillar (Figure 5.13).[41] Although the notional accounts have been credited with high rates of return since the inception of the system, the rates between 2004 and 2009 were particularly high. Moreover, the rise in government revenues during the boom years of 2004-2007 fuelled reductions in contribution rates (Figure 5.14), and led to additional costly pension policies, such as the indexation of pensions to wage growth and the extension of the pre-1996 service pension supplement to all pensioners.[42] As a result, between 2005 and 2009 the average pension for new retirees grew by 69% in real terms.[43]

Figure 5.12: Social insurance special budget revenues and expenditures, 2005-2009 (in 2009 Lats)



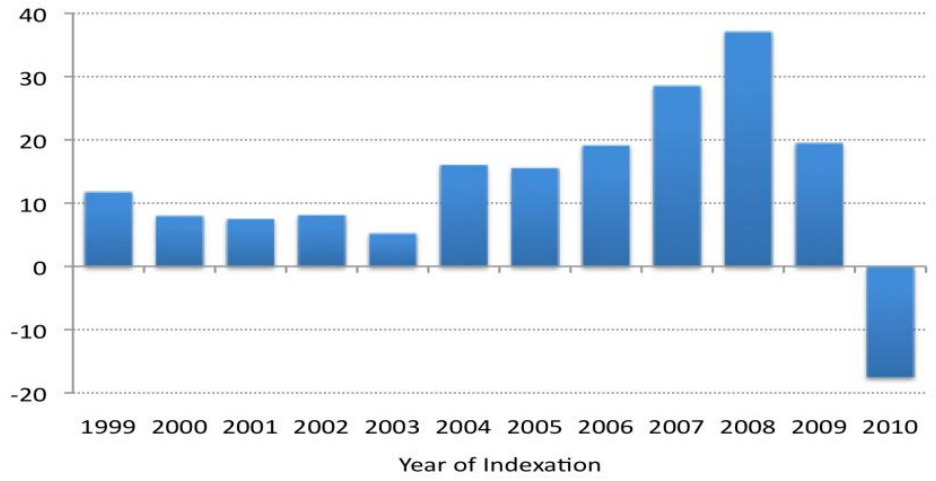
Sources: World Bank (2010), based on data from the Latvian Ministry of Welfare and the Ministry of Finance

[41] The notional defined contribution accounts are credited each January with a rate of return equal to the nominal rate of growth of covered wages between the year ending 17 months prior to the month of the indexation and the year ending 5 months prior to the year of indexation.

[42] The pension supplement pays LVL 0.7 (70 centimes) for each year of service accrued before 1996, and on average amounted to 14% of the overall pension spending. The supplement was originally introduced as a measure directed at pensioners with the lowest benefits. However, in 2008 prior to the onset of the crisis, the supplement was extended to all pensioners.

[43] Rising surpluses in the social insurance special budget also led to increased expenditure in other areas of social welfare spending beyond pensions. In particular, the government introduced a parental benefit in the boom years to be financed from contributions (without any increase in the contribution rate).

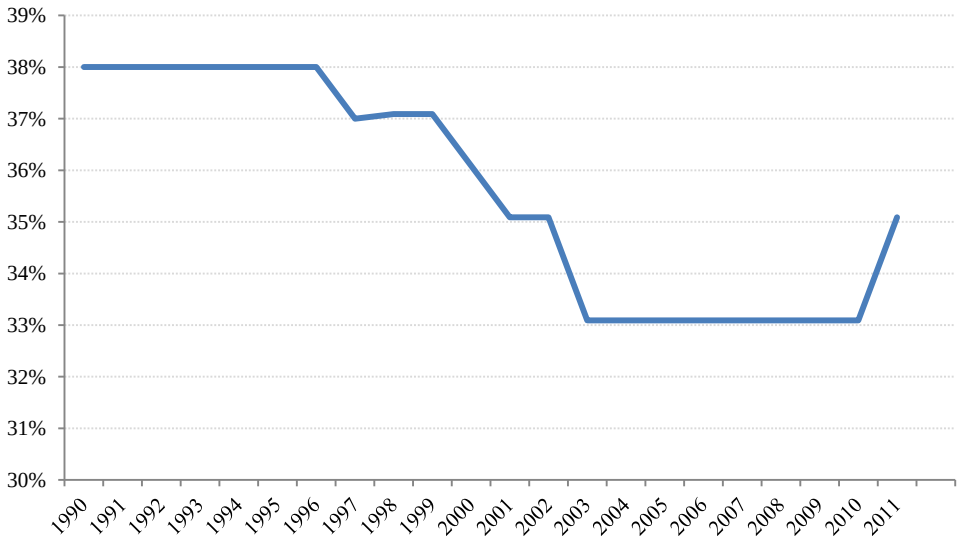
Figure 5.13: Indexation factors for notional accounts, 1999-2010 (percentage points)



Source: WB staff based on Latvian Ministry of Welfare and the Treasury Department in the Latvian Ministry of Finance

Demographic trends, in addition to the increase in the retirement age, wage growth and the increased formalization of the workforce, also favoured growing surpluses in the social insurance special budget, and created a declining old age pensioner dependency rate in the years preceding the crisis. In the boom period, the publicly administered pillar of Latvia's old-age pension system functioned in a very favourable demographic environment. In the four years preceding the crisis, each cohort of 62-year olds had been getting smaller, reflecting a significant drop in birth and survival rates for people born during World War II. An increasing effective retirement age accentuated this trend, leading to lower numbers of new retirees. However, this trend reversed in 2008 and now each subsequent cohort of 62 year olds will be larger than the previous for the next 15 years. Similarly, in the eight years prior to the crisis each subsequent cohort of 18 year olds was larger and larger, bringing higher numbers of new contributors to the plan. Unfortunately, this trend reversed sharply at the same time as baby boomers started retiring. Over the next decade, the number of new entrants to the labour force is expected to drop to half of the 2007 level. Given that pensions consume the greatest share of social spending, pension reforms will play a key role from a budgetary perspective.

Figure 5.14: Contribution rates, 1990-2011 (percentage of gross wages)

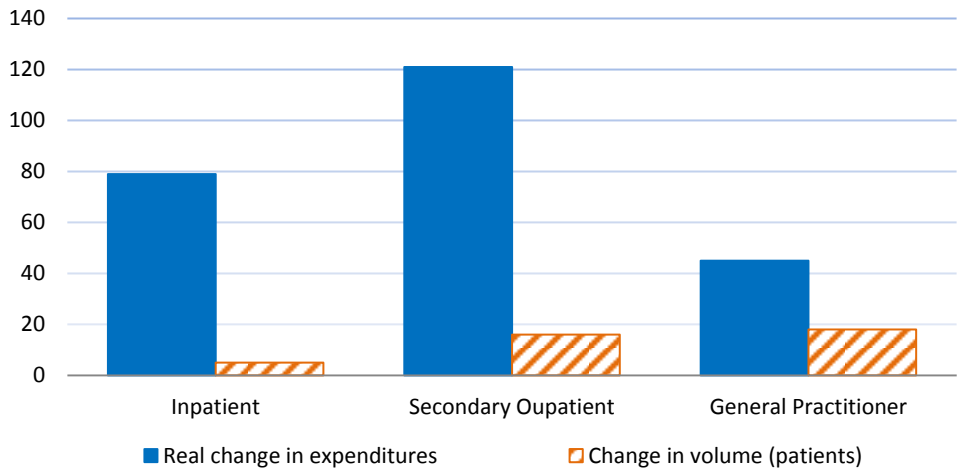


Source: Ministry of Welfare Latvia and OECD. Note: Contribution rates to finance insurance related to pensions, disability, maternity and sickness, unemployment, occupational accident or disease, and parental benefits

II.D. Health

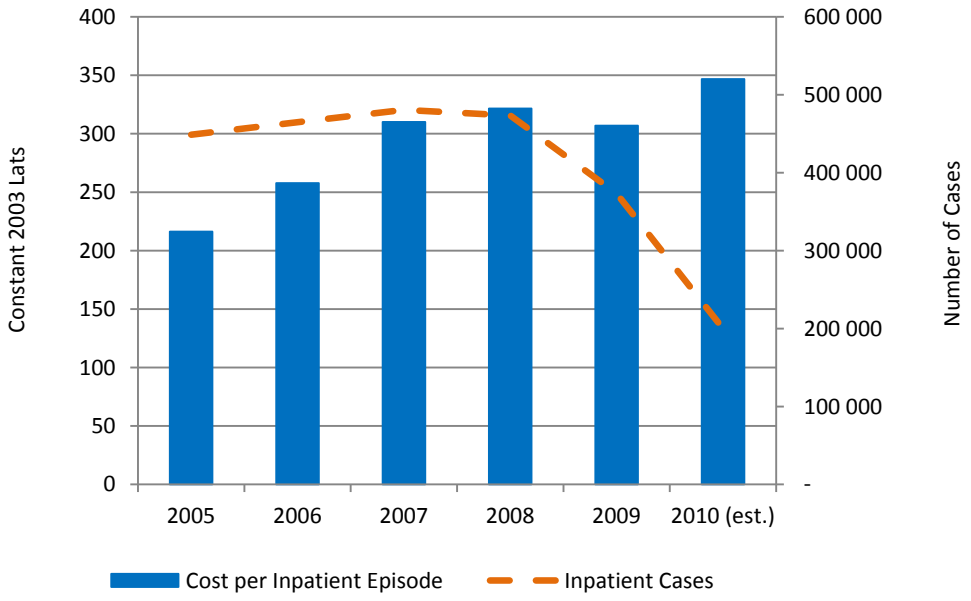
As discussed in Section II.A., health was the social sector that expanded most significantly during the boom period. Increased health spending was driven largely by rising inpatient unit costs. Inpatient expenditures rose by 79% in real terms from 2005 to 2008 (Figure 5.15), and since they represented around half of all health spending during that period, this increase was behind the overall rise observed in health sector expenditures. Most of this increase in inpatient care spending reflected a significant increase in unit costs rather than an increase in the number of inpatient cases (Figure 5.16).

Figure 5.15. Response of the health system to budget increase, 2005-2008 (percentage change)



Source: World Bank staff, based on data from Ministry of Health and the State Compulsory State Agency News

Figure 5.16: Cost per inpatient episode and number of inpatient cases, 2005-2010



Source: World Bank staff, based on data from Ministry of Health and the State Compulsory State Agency News

In addition to inpatient care, in the buoyant pre-crisis years of 2005 through 2008, Latvia focused additional resources on secondary ambulatory services and patient pharmaceuticals (Table 5.3). Secondary outpatient ambulatory payments rose by 121%; general practitioners saw an increase of 45%

over that period; and payments to dentists increased by 28%. Real spending on pharmaceuticals rose by 73%. As a result, by 2008, inpatient and secondary outpatient spending had reached 68% of the total, up from 62% in 2005. All areas of the health budget expanded over the period, but the budget share of basic outpatient services (general practitioners and dentists) fell.

Table 5.3: Distribution of medical care spending, 2005-2010 (percentage of total spending)

	2005	2008	2009	2010
Inpatient	48	50	45	35
Secondary Ambulatory	14	18	18	18
General Practitioners	11	9	11	14
Dentists	2	1	1	2
Emergency Medical Assistance	6	6	6	7
Patient Pharmaceuticals	15	15	16	22
Centrally Procured Pharmaceuticals	4	1	1	2
Settlements with the EU	0	0	1	1

Source: World Bank (2010), based on Health Compulsory Insurance State Agency News for various years and its 2009 report

This relatively high spending in hospitals for inpatient care is closely related to an "excess" number of hospitals and hospital beds in Latvia. Table 5.4 shows that the total number of hospital beds per inhabitant is more than twice the corresponding number in Denmark and almost 1.4 times that of Estonia. The excess of acute care hospitals is of a similar magnitude.

Table 5.4: Hospitals, 2007 (per 100,000 units of population)

	Total Hospital Beds per 100,000	Acute Care Hospitals per 100,000	Acute Care Hospital Beds per 100,000
Croatia	535	1.14	352
Denmark	349	1.16	310
Estonia	557	2.68	380
Ireland	534	1.15	274
Latvia	757	3.08	523
Lithuania	814	2.40	509

Source: World Bank (2010) based on Europe, WHO/Europe European HFA Database January 2010. Note: Ireland data is for 2006

Additional features of the health system in Latvia have further contributed to increases in fiscal costs. Latvia has a relatively high rate of admissions to acute care hospitals at around 20 patients per 100.000 units of population compared to 14 in Ireland and 17 in Estonia, for example. Once a patient is admitted to hospital, the average length of stay is also high at 7.2 days, compared to Denmark's low average of 3.5 days per stay for example. The extraordinary run-up in medical costs does not seem to have come from a large increase in employment in this sector. During the period 2005 to 2008, employment in "human health activities" rose by only 2,631 jobs or 6.4%. Salaries, however, increased substantially, by an average of 21% at the outpatient level and 28% at inpatient institutions.

In short, social sector spending, as with other sectors of the economy in Latvia, expanded significantly during the economic boom that predated the crisis. The additional resources, however, were often spent in an inefficient manner, going mostly to inpatient care. Perhaps not surprisingly, therefore, social outcomes in Latvia did not improve in a manner commensurate with the actual increases in spending.

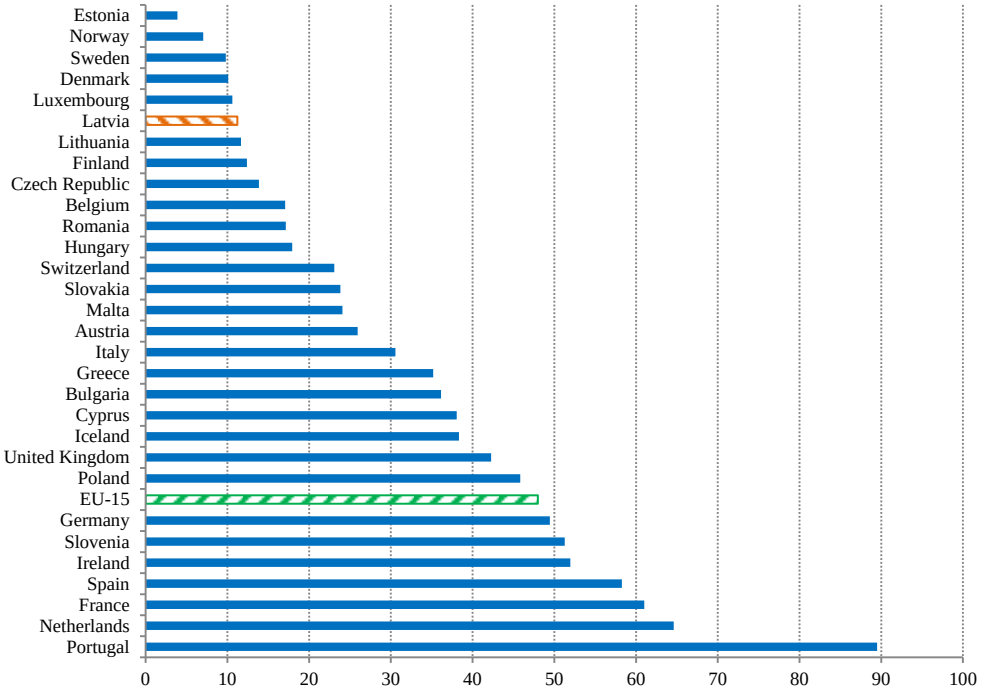
II.E. Did quality improve as spending increased?

Despite large increases in social sector spending during the boom years, the outcomes associated with spending generally did not translate into improvements in Latvia, raising significant questions about the quality of public spending on the social sector during the period.

Even though spending in education increased during the boom years, the sector still appeared underfunded when compared to peer countries at all levels of education. This situation was worsened by subsequent cuts to the education budget. Although establishing causality between spending and outcomes is extremely difficult, this under-spend could be one factor behind the below-average performance of Latvia in international assessment tests. For example, Latvia's mean science score in the PISA before the crisis was 490, ten points below the average for all participating countries. This is in striking contrast to Estonia's performance, which had a mean science score of 531, the fifth highest (OECD, 2007). Estonia spends just more than one percentage point of GDP above Latvia in primary and secondary education. As warned in World Bank (2010), such low levels of support for education could risk putting Latvia at an educational disadvantage vis-à-vis its neighbours.

Similar to the situation in the education sector, the performance of the social protection system in terms of equity, crisis preparedness, coverage, targeting and generosity remained below that of systems in other countries in the region. During the economic boom, social protection spending was not well targeted to the poor, relative to spending in other countries. In Latvia, only 11.2% of social assistance spending went to means-tested programmes in 2008, significantly below most other countries in the region (Figure 5.17).

Figure 5.17: Spending on means-tested Programmes, 2008 (percentage of total social assistance spending)



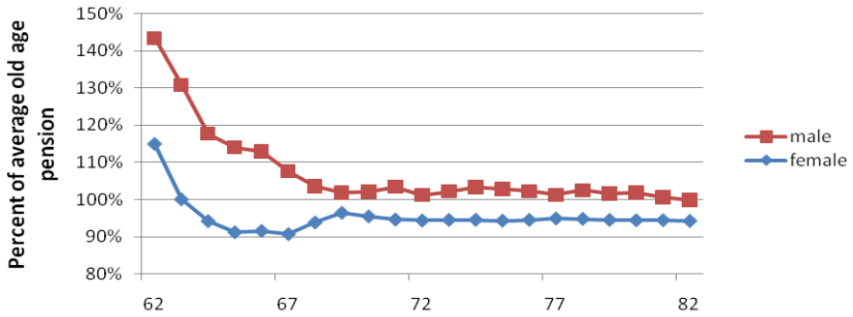
Sources: Eurostat

The economic boom was also accompanied by increasing inequalities among pension beneficiaries. As a result of higher notional interest associated with rising wages and the lagged impact of economic growth on pensions, the level of old-age pensions paid to those who recently retired was significantly higher than the payments made to those who retired in earlier years.[44] As a result, tremendous intergenerational inequality has arisen in pension

[44] The rate of return used in notional accounts is the estimated sustainable rate of return on contributions in a steady state in a pay-as-you-go-system. However, when significant changes take place in the economy – as was the case in Latvia during the boom period with wages and labour force participation increasing far beyond what would be expected in the steady state – the formula used for the rate of return can significantly distort the evolution of benefits. In this case, the appropriate policy response would have been to adjust the notional interest rate.

payments. In particular, the cohorts that retired prior to 2010 benefitted from a windfall from the pre-2007 bubble. For example, the purchasing power of a pensioner who retired in 2009 was 69% higher than that of a person who retired in 2005, more than twice the growth in real wages experienced in this period (28%). Cohorts aged below 68, especially men, benefitted disproportionally from the pre-2008 high growth period, as average pension benefits for this group were significantly higher than for older cohorts (Figure 5.18).[45]

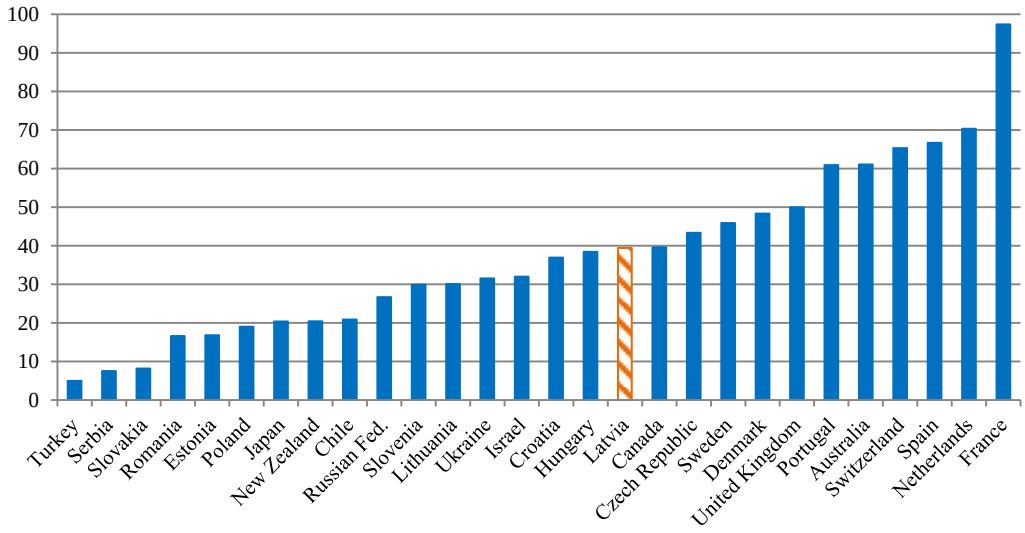
Figure 5.18: Average Pension Benefit of Current Pensioners (by age cohort)



Source: World Bank staff calculations, based on data from the Latvian Ministry of Welfare and the Treasury Department in the Latvian Ministry of Finance

Despite increased real spending during the boom, in terms of the performance of the social protection system, Latvia was relatively unprepared to protect households at the onset of the crisis (Isik-Dikmelik, forthcoming). Since unemployment benefits covered only 39% of total unemployed (Figure 5.19), social assistance had a critical role to play in protecting the vulnerable in the face of the economic crisis.[46] Latvia's targeted poverty programme (GMI), however, was only moderately well targeted to the poor[47] - only 30% of benefits went to the poorest quintile and just over 60% to the bottom two quintiles. Coverage was low and reached only 5% of the poorest quintile; generosity was also very low with only 7% of the post-transfer average consumption of beneficiary households reaching the poorest quintile).[48]

Figure 5.19: Unemployment beneficiaries, June 2008 (percentage of total unemployed)



Source: World Bank staff, based on ILO

[45] World Bank (2010).

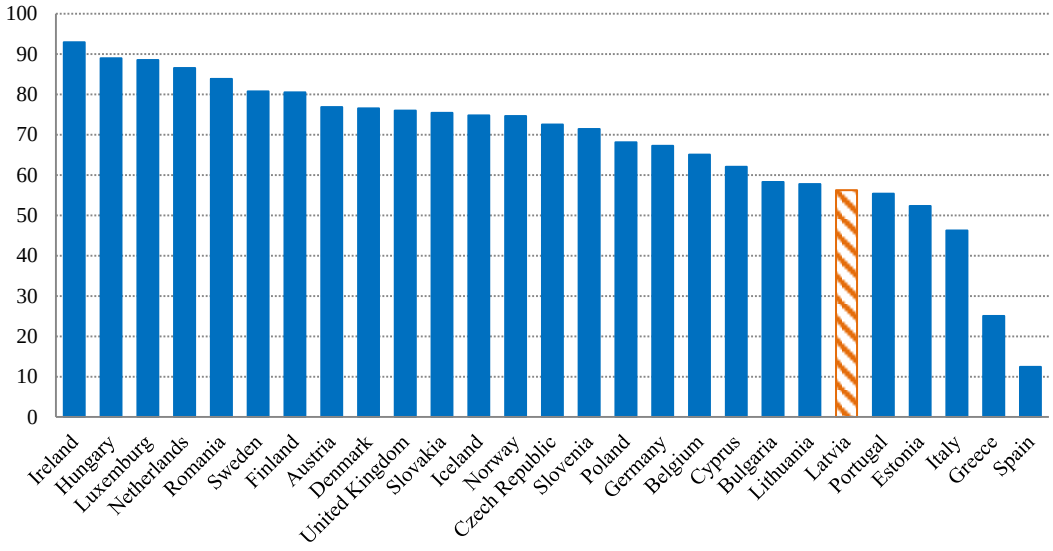
[46] This coverage of the unemployed is higher than in most other EU 10 countries, but lower than in the older EU member states. In addition to differences in eligibility criteria and pay-out periods, this coverage of unemployed reflects the relatively high share of long-term unemployed in EU 10 countries who have exhausted their entitlements as well as first-time job seekers who lack a long enough work history to claim benefits.

[47] For the purpose of this note, the poverty line is defined as the 20th percentile of pre-transfer consumption.

[48] World Bank ECA Social Protection Database.

The performance of the other social assistance programmes was not much better, but since most other programmes are categorical and substantially larger (i.e., non means-tested), they were able to provide better overall coverage (just over 56% of the poor were covered by at least one social assistance programme in 2008, Figure 5.20), although this was at the cost of low targeting (only one fifth of the benefits went to the poorest quintile for overall social assistance benefits, Figure 5.21). There is, therefore, a sharp contrast between the extensive coverage of social insurance and state social benefits, and the meagre coverage of Latvia's main means-tested benefits.

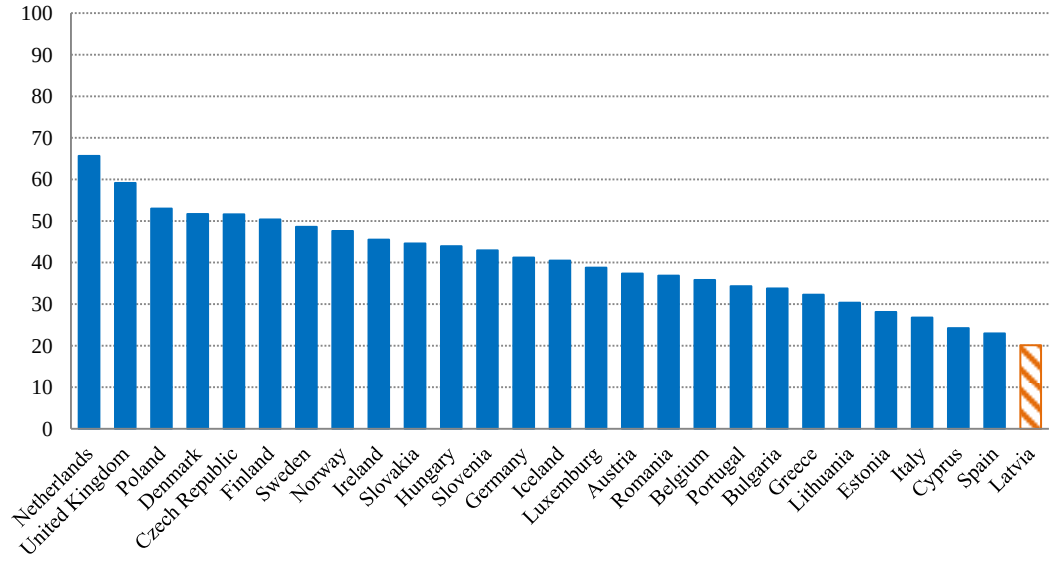
Figure 5.20: Overall social assistance coverage of the poorest quintile, pre-crisis (percentage)



Source: World Bank staff, based on EU-SILC 2008. Note: Individuals are ranked on the basis of per capita equivalised disposable income before all social assistance cash transfers. Social assistance is defined as the following categories in EU-SILC: Education, Housing, Family and children, and Social Exclusion not elsewhere classified

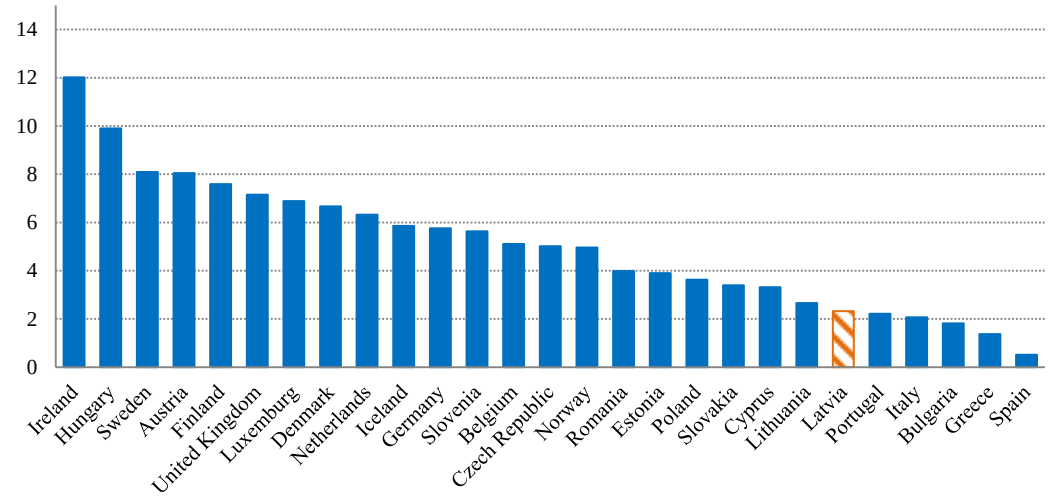
It is estimated that overall social assistance benefits reduced the poverty headcount in Latvia by 2.2 percentage points, among the lowest poverty impacts in the region (Figure 5.22). The potential for poverty reduction could have been enhanced with better targeting of the benefits among the poorest households.

Figure 5.21: Overall social assistance benefits received by the poorest quintile, 2008 (percentage)



Source: World Bank staff, based on EU-SILC 2008. Note: Individuals are ranked on the basis of per capita equivalised disposable income before all social assistance cash transfers. Social assistance is defined as the following categories in EU-SILC: Education, Housing, Family and children, and Social Exclusion not elsewhere classified

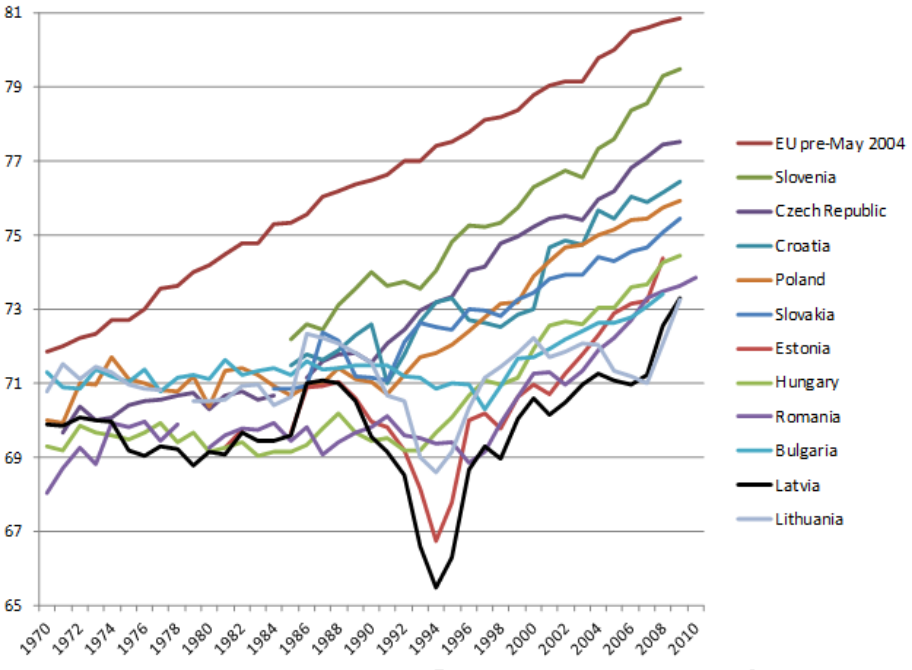
Figure 5.22: Reduction in "at risk poverty" rate associated with social assistance, 2008 (percentage point reduction)



Source: World Bank staff, based on EU-SILC 2008. Note: The at-risk-of-poverty rate is the share of people with an equivalised disposable income (after social transfers) below the at-risk-of-poverty threshold

Probably even more than in education and social protection, improvements in health outcomes have lagged expenditure increases. As discussed earlier, health was the social sector that expanded the most during the economic boom; yet, this is also an area where convergence in outcomes has not kept pace. Large increases in spending prior to the crisis resulted in little change in health outcomes. For example, Latvia lags in health outcomes compared to the rest of the EU, even more than other New Member States due to premature adult mortality. In terms of overall life expectancy, only by 2006 had Latvia recovered levels seen in the 1980s (Figure 5.23). Pre-crisis (pre-2007), life expectancy at birth was 66 years for men and 76 years for women. The gap widened in the early years of the transition and then improved after 2000, however a persistent gap remains with pre-2004 EU members. Having lagged the EU by about two years (72 versus 70) in 1970, the gap had expanded significantly by 2007, to 9 years (80 versus 71).[49]

Figure 5.23: Life expectancy at birth, 1970-2010 (years)

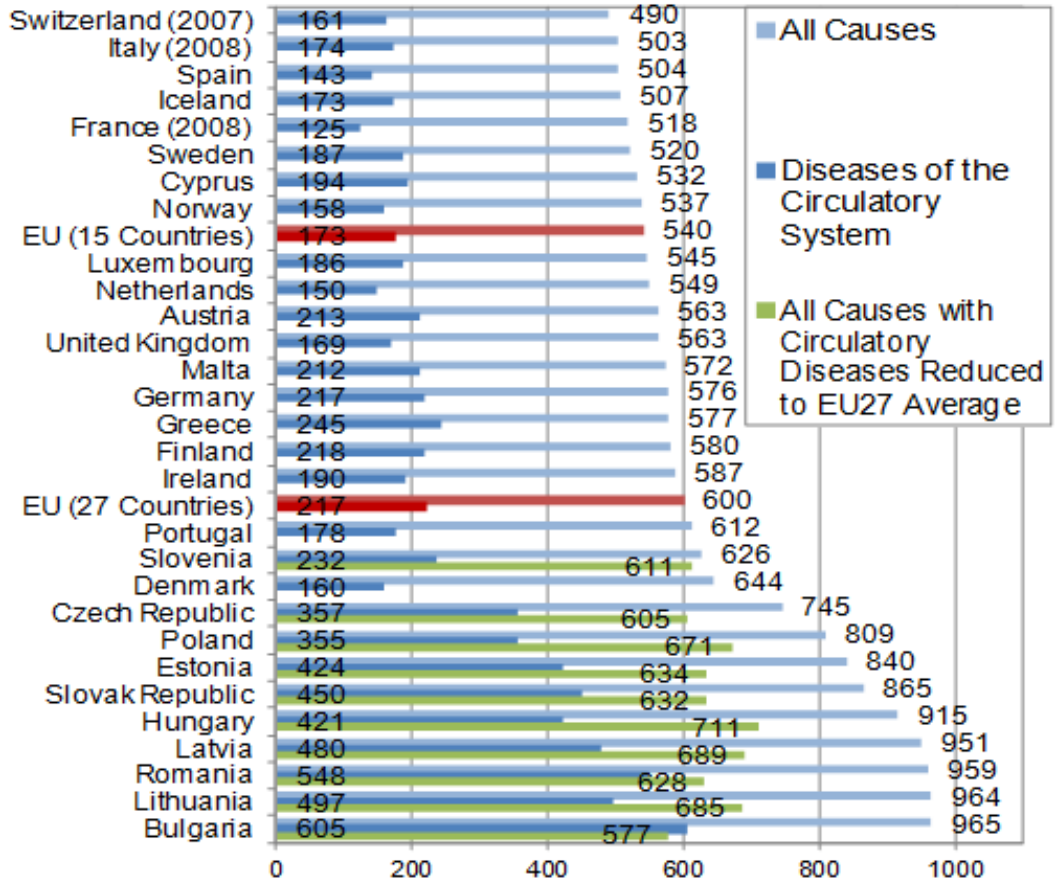


Source: World Bank staff, based on data from WHO/Europe Health for All Database 2011

[49] World Bank (2010).

This gap in life expectancy and mortality rates is fundamentally associated with cardiovascular diseases (e.g., heart attacks and strokes) and external causes (e.g., accidents), especially among men. In fact, 86% of the difference in deaths between Latvia and the EU15 can be explained by deaths associated with the circulatory system and external causes alone (Figure 5.24). Achieving convergence for Latvia would entail matching Finland's progress between 1990 and 2009 in reducing mortality from cardiovascular diseases.

Figure 5.24: Mortality Rates Associated by Cause, 2009 (age-standardised rates per 100,000 units of population)

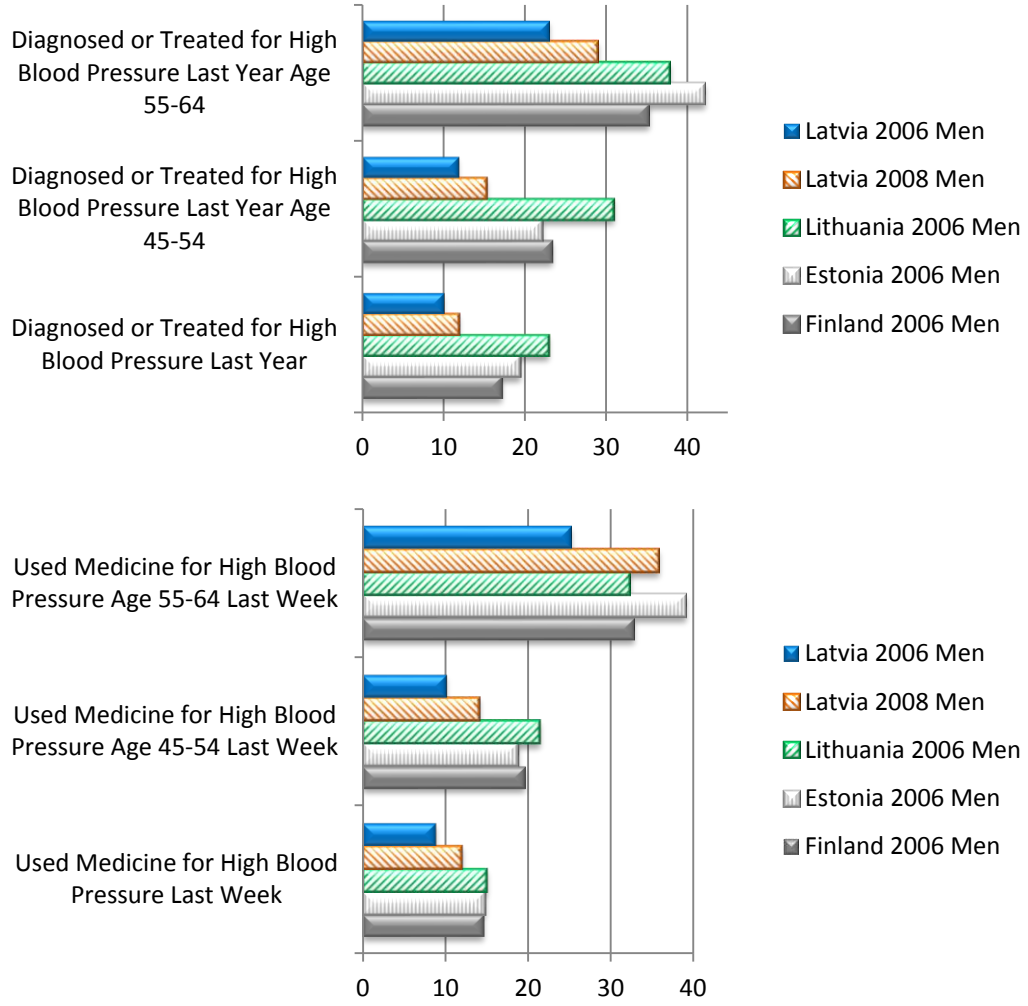


Source: World Bank staff, based on data from WHO/Europe Health for All Database, 2011

Survey evidence suggests that Latvia's health system is not monitoring and treating men nearly as effectively as it could for these diseases. Finablat health indicators show small improvements for Latvia between 2006 and 2008, as was the case in other comparator countries, but Latvia still lags its neighbours in key measures of treatment prevalence (Figure 5.25). There is a serious shortfall in diagnosis and treatment of high blood pressure, despite improvements between 2006 and 2008. The use of medicine for high blood pressure improved, but it is still unusually low, especially for men aged 45-54. From 2005 to 2008, increased spending left the existing system in place and increased the complexity of care: the inflation-adjusted cost per inpatient episode rose by nearly 50%, and real spending on specialist services and diagnostics per outpatient rose by almost 75%.

Increased government spending in health also did not necessarily mean less out-of-pocket spending on health for households. In the 2000s, the government financed only about 60% of health spending, which is low in EU terms. Government support was primarily for catastrophic hospital costs and primary/specialist care, although almost all services carry co-payments. Households in 2008 financed 78% of pharmaceutical costs and 89% of dental costs.

Figure 5.25: Finbalt Treatment Cardiovascular Diseases (percentage)



Source: World Bank staff calculations, based on Finbalt

A similar story emerges if productivity in the health sector is measured in a simpler way, just by volumes and outputs". Table 5.5 shows the increase in expenditures from 2005 to 2008 and the corresponding change in volume for the different categories. On a 79% increase in expenditures, hospitals produced a 5% increase in inpatients and a 4% increase in the number of bed-days. Virtually all of the increased cost was greater intensity of care, or higher cost per patient. For an even larger increase in expenditures on secondary outpatient services, they saw only 16% more patients. As fee-for-service is an important element of reimbursement at these two levels, doctors can increase revenues by doing more for each patient. Spending for general practitioners rose 45% and volume increased by 18%. Since doctors' compensation is through capitation for the most part, the increase in use - similar to the change in volume for secondary outpatient services - is probably a reflection of greater demand for services by the population rather than efforts by the GPs to increase patient visits. For dentists, we do not have a direct measure of output, but from 2005 to 2008, the cost per child treated rose in real terms by 32%, suggesting a small reduction in volume as the number of children declined. An important exception appears to be pharmaceutical spending, which led to broadened coverage of patients and prescriptions. The prescription drug benefit was expanded significantly in 2005 and, as a consequence, the number of patients receiving medicine increased by 43% by 2008, and the number of prescriptions rose by 59%. The cost per patient rose 30% over the period, but the cost per prescription rose by a much smaller 18%.

In short, increased spending on hospitals and secondary outpatient services largely explains the extraordinary expansion of the health sector during the boom period. However, little change in output

and outcomes accompanied the rise in spending. As discussed in World Bank (2010), one possible explanation for this phenomenon would be a revolution in medicine in Latvia, either due to costly new procedures that had never been financed before or an almost overnight increase in the use of technology and diagnostics for care. However, survey evidence from the FINBALT health surveys indicate that this expansion of activity had not, at least by 2006, bought significantly improved screening of at-risk men or management of their cardiovascular risks.

Table 5.5: Response of the health system to budget increases, 2005-2008 (constant 2003 Lats)

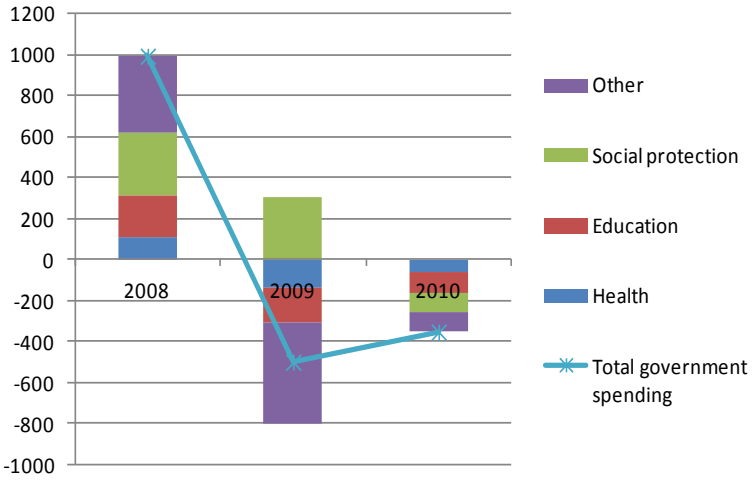
	Change in expenditures 2005-2008 (%)	Change in volume, 2005-2008 (%)
Inpatient	79	5 (unique patients) and 4 (bed-days)
Secondary outpatient	121	16
General practitioners	45	18
Dentists	28	NA
Patient pharmaceuticals	73	43

Source: World Bank staff calculations, based on Health Compulsory Insurance State Agency News for various years and its 2009 operational report

III. Social sector adjustment during the crisis

The fiscal adjustment in the social sectors was large and front-loaded, with most of the measures put in place in 2009. This constituted a rapid and deep reaction to the crisis following years of social sector spending increases (including 2008). The challenge for the government was to sustain these measures over the adjustment period. In 2009 and 2010, there was a substantial fall in nominal spending in health and education, which together comprised 55.1% of the total decrease in government spending in nominal terms (Figure 5.26). The change in spending on education and health from 2008 to 2010 equalled a 24.1 and 23.2% fall in real terms, respectively. By contrast, social protection contributed little to fiscal adjustment. Social protection spending actually increased in real terms by 17.4% from 2008-2010, partly due to automatic stabilisers, i.e., an increase in outlays from unemployment insurance, partly due to discretionary policy aimed at shoring up the safety net in the face of the deep crisis. Decisions taken before the crisis such as the increase in pensions that came into effect in 2008/2009 also added to the rise in social protection spending. Social protection spending did fall in 2010, but cuts in this sector were only one-fifth of those in education and health throughout the crisis.

Figure 5.26: Social sectors' contribution to change in expenditure, 2008-2010 (y-o-y change in million Lats)



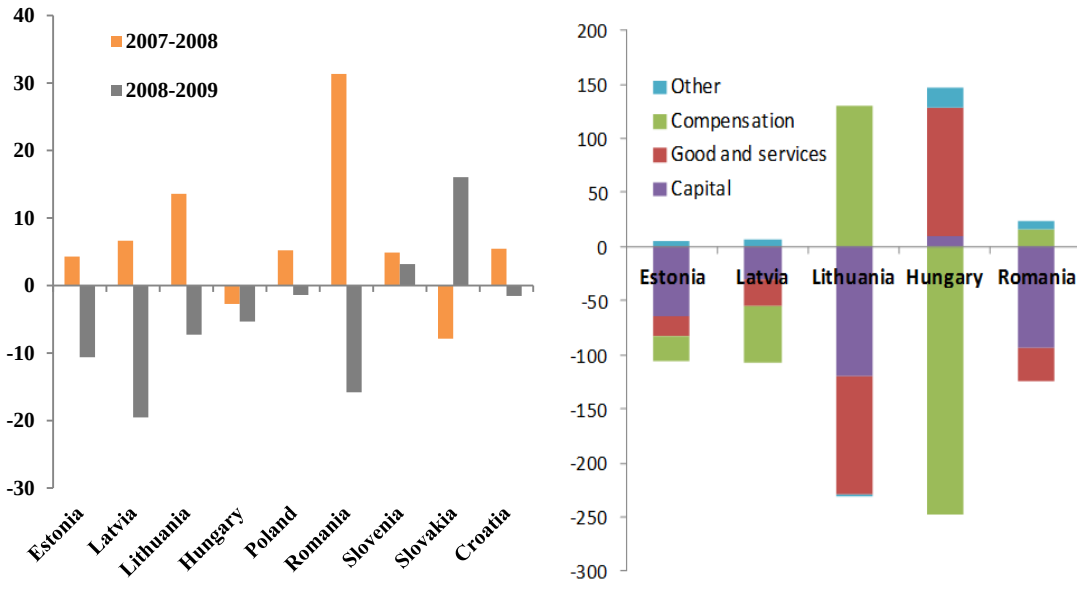
Source: World Bank staff calculations based on data from Eurostat and Latvia's Ministry of Finance

In the education sector, the Government of Latvia moved quickly to implement budget reduction measures. Latvia was the country in the EU with the largest fall in overall education spending immediately after the crisis hit. The education budget was cut by 20% in real terms between 2008 and 2009, mainly associated with adjustments to the existing over-capacity in the system resulting from a decreasing school-age population (Figure 5.27, left pane). The biggest challenge has been adapting to the decline in the school-age population, which has fallen by 40% in Latvia since 2000. Latvia was somewhat behind in adjusting to shifting demographics relative to the other EU12 Member States prior to the crisis. It was the only country that had not adopted per-capita financing.

This situation changed with the implementation of "funds follow the student" per-capita financing for general primary and secondary education for the 2009/2010 academic year onwards. What did this change in financing reform mean? The State education grant to municipalities for teachers and support staff was not focused on inputs (the number of classes being taught in each school), but rather financing for the 2009/2010 academic year was determined by a formula based on the number of students in the jurisdiction with weights for type of students and whether the student was in a major city or the countryside. The shift to this budgeting framework, combined with the sharp reduction in education budgets, provided schools and the local authorities in charge of school management with strong incentives to consolidate staff and school networks, this also assisted in the reduction of over-capacity in the system.

The structure of fiscal adjustment in the education sector in Latvia differed substantially from what happened in other countries in the region, with the possible exception of Estonia: all major categories of spending were affected by cuts: compensation, capital, and goods and services (Figure 5.27, right pane).

Figure 5.27: Real percentage change in education spending (left pane) and decomposition of change in education sector spending, 2009 (right pane, percentage)



Source: World Bank staff calculations, based on Eurostat except for Croatia (Ministry of Finance). Note: Spending is deflated by HIPC (Eurostat). A decrease is a negative percentage change; an increase is a positive percentage change

Latvia's across-the-board spending cuts in education included salary cuts, staff reductions, administrative cost reductions and cuts in investment. School closures were also an important element of the adjustment strategy. However, it was the reduction in teachers' compensation early in the crisis - particularly by reducing the number of teachers - that contributed most to fiscal savings.

Latvia experienced a particularly drastic adjustment to its workforce in 2009, following the huge recession and the fiscal turmoil. At that point the government implemented the most ambitious cuts in the whole region, reducing the number of staff positions in the education sector by about 30% between 2008 and 2009.[50] However, it should be noted that the country was making up for a lack of response to declining student numbers during the previous decade, as discussed above. The other two countries which experienced large cuts in education spending in 2009, Estonia (-11%) and Romania (-16%), focused these cuts on the capital side of the budget. An analysis of municipal education behaviour in Latvia shows that there were substantial efficiency gains due to the initial reforms: average class size went up by almost 5%, and the number of students per teaching workload increased by 13%. Smaller schools with fewer students per teacher and higher costs per student were more likely to be closed or merged. Lifting restrictions on class size; the number of administrative and support staff; and compensated hours, gave school directors more flexibility to manage their budgets and schools, which they used to introduce performance-based pay and to pay more to teachers in larger schools.

A comparison of the efficiency parameters in the education system for school years 2008 - 2010, shows that the reduction in educational staff from 2008 to 2010 exceeded the decline in students during that period, and the reduction in the number of schools and staff was concentrated at the primary level (-21% for schools and -25% for staff) (Table 5.6). Overall, student numbers declined by 10% in only two years. The number of teachers declined less than overall staff, falling 11% between 2008 and 2010 (approximately matching the decrease in students). Teaching workloads, however, fell by 24%, indicating that less work was available for each teacher employed. Therefore, many teachers were able to keep their jobs but with substantially reduced hours. Although this was a large one-time adjustment, there is much more that could be done given the 27% decline in general education for students from 2001 to 2008.

A further adjustment in the 2011 school year would have been expected, given that local authorities had so little time to adjust to the change in incentives in 2010 and that the system has yet to adjust to the decline in student population from 2001 to 2008. In fact, while enrolments continued to drop from 2010 to 2011, only 9 more primary and 7 secondary schools were closed. The number of educational staff, teachers, and workloads actually increased. Hours were expanded for many teachers who were kept on board during the crisis in 2009 and 2010 with reduced workloads. There has also been some catching up by education employees in terms of their hourly pay and total earnings. In 2008, average monthly earnings in public administration were LVL 700; in education, LVL 479 (32% lower). In 2010, earnings were LVL 515 and 395, respectively (23% lower in education) - a narrowing of the gap as all public sector salaries plunged. In 2008, the hourly cost of labour in public administration was LVL6.3; in education it was LVL 5.3 (16% lower). In 2010, it was LVL 4.7 and LVL 4.3, respectively (9% lower in education).[51]

While there is arguably room for further savings in primary and secondary education by continually adjusting to the declining student population, there are strong arguments for reallocating any such spending within the education budget. Overall, few, if any, countries have experienced such rapid and deep cuts in their education budget. Parts of the budget have suffered disproportionately and now have spending levels that would appear inadequate to meet educational needs. There has been a reallocation of spending away from universities, science, and administration; while general, vocational, preschool, special, and interest education have experienced lower percentage budget cuts. General education in 2011 is expected to absorb 52% of a much smaller budget, up from 46% in 2008. Similarly, spending on preschool, special, vocational and interest education has risen. Spending on higher education has fallen from 12 to 7% of total spending, and science has dropped from 4% to 2%. This translates into a decline in spending in higher education of 66% and in science of 67%.

[50] Central Statistical Bureau of Latvia.

[51] Data from the Central Statistics Bureau for occupied posts, average monthly wages and salaries of employees by type of activity by quarter, and hourly labour costs by type of activity by quarter. Comparisons are for the third quarter of the year rather than the full year so we could include 2010, for which all four quarters were not available.

Table 5.6: Enrolments, schools and number of teachers at the start of the school year, 2008-2011

	2008	2009	2010	2011	Change 2008-2010	Change 2010-2011
Students	250,941	236,223	226,034	216,307	-10%	-4%
Regular Schools	241,878	227,463	217,128	207,872	-10%	-4%
Special Schools 1/	9,063	8,760	8,906	8,435	-2%	-5%
Schools	958	948	846	830	-12%	-2%
Primary	516	508	409	400	-21%	-2%
High School	379	377	374	367	-1%	-2%
Special Schools 2/	63	63	63	63	0%	0%
All Educational Staff 3/	32,471	32,236	27,250	27,910	-16%	2%
Primary	11,010	10,945	8,287	8,383	-25%	1%
High School	18,666	18,473	16,469	16,948	-12%	3%
Special Schools	2,795	2,818	2,494	2,579	-11%	3%
Teachers Only	25,567	25,751	22,629	23,108	-11%	2%
Teacher Workloads 4/	31,960	32,331	24,210	27,884	-24%	15%

Source: Ministry of Education and Science data.
Note: 1/ Includes students from special education institutions only and excludes students from special preschool education and general education boarding schools.

2/ Special preschool education schools are not included.

3/ Includes directors, deputy directors, teachers (including day school, boarding, pre-school, special, and others), educational psychologists, speech therapists, librarians, social educators, teaching assistants, health sector staff, coaches, and other staff.

4/ Teacher holding a job in two schools simultaneously, e.g. music teacher, is counted twice. Teachers are paid by a formula based on workloads (21 academic hours per week), and typically manage more than a single workload. Thus, number of workloads reflects quantitatively teaching activity rather than number of actual teachers. Non-teaching workloads, e.g. librarians, included.

III.B. Health

Health cuts, similar to those in the education sector, were front-loaded, mostly taking place in 2009. The challenge was to sustain these cuts, while redistributing spending within the budget to meet preventative care needs.

During the crisis, rather than reducing health spending across the board, however, the Ministry of Health prioritised emergency services, general practitioner services (each Latvian is enrolled with a primary care doctor), subsidised prescription medication, and services for children and mothers. A health safety net was introduced for the first time. As a result, health spending shifted from inpatient to outpatient and to general practitioner care. The biggest cuts to the health care budget affected hospitals and inpatient care. Table 5.7 shows the decline in total government spending (excluding external funds) from 2008 to 2011. This table is divided into two parts, spending for medical services financed through the insurance system (Payments Center in the table) and the amount financed through the Ministry of Health's administrative budget (Ministry of Health in the table). While across-the-board cuts were made, a large share of the cuts from 2008 to 2011 affected inpatient care, communicable disease programmes, and administrative costs. Across-the board salary cuts introduced for civil servants also affected health care sector employees. By 2010, the average monthly salary for a doctor declined by 25% relative to 2008. Adjustments to reimbursement criteria for medical services and pharmaceuticals have also generated savings. For the first time since 2005, the government increased co-payments for most services. In addition, a number of expensive procedures were added to the list of items not eligible for reimbursement.

The large share of health spending going to inpatient care (around 57% compared to 35% in OECD in 2008) and the failure in the previous 5 years to correct the overhang of extra hospitals and beds represented the main challenge in the health care budget for Latvia. Consequently, the funding for 13 hospitals was considerably reduced as they were transformed from emergency hospitals to "care"

facilities. In addition, in January 2010, the government removed the inpatient contract for one of the three major hospitals in Riga and made about two-thirds of its staff redundant. Overall, between 2008 and 2010, Latvia drastically reduced the number of hospitals with inpatient contracts by 50%. The number of hospital beds and beds per 100,000 people dropped substantially. Inpatient stays fell by 32%.

Table 5.7: Government health spending

(In millions of Lats, nominal, unless otherwise indicated)

	2008	2009	2010	2011 Plan	Change 2008-2010	Change 2010-2011
Payments Center	**462.8**	**378.6**	**381.3**	**363.0**	**-18%**	**-5%**
Inpatient	241.8	181.8	154.7	127.9	-36%	-17%
Outpatient	138.1	119.1	118.2	123.8	-14%	5%
Secondary Outpatient	89	71.5	72.9	79.7	-18%	9%
General Practitioner Practices	42.7	41.7	45.2	38.3	6%	-15%
Dentistry	6.4	5.9	5.8	5.7	-9%	-1%
International Accounts	-	-	2.5	3.5		41%
Medicines and Material	71.1	66.6	71.6	67.6	1%	-6%
Central Procurement of Medicines and Vaccines	4.8	5.5	6.8	6.4	43%	-7%
Social Safety Net	-	0.4	24.2	30.3		25%
Other	0.3	0.7	0.3	0.5	3%	79%
Administrative Costs	6.8	4.6	3	3	-56%	2%
Ministry of Health	**100.9**	**82.1**	**80.7**	**80.2**	**-20%**	**-1%**
Communicable Disease	24.1	19.7	14.5	15.1	-40%	4%
Sports Medicine	1.1	0.8	0.6	0.7	-40%	6%
Blood Supply	8.5	6.9	6.4	5.1	-24%	-20%
Emergency Medical Assistance	26.8	26.3	30.8	28.9	15%	-6%
Medical Education	24.6	16.5	16.5	16.2	-33%	-2%
Medical History Museum	1.1	0.8	0.4	0.5	-58%	2%
Administrative, Regulatory, Internation	14.8	11.2	11.4	13.7	-23%	20%
Total Health Spending from Budget (Ignoring European Union Funds)	**563.7**	**460.7**	**462**	**443.3**	**-18%**	**-4%**

Source: Ministry of Health

Note: Emergency Medical Assistance was gradually moved to the Ministry of Health budget from the Payments Center over the period 2008 to 2010.
For this table, the total amount is shown for all years under the Ministry of Health to maintain comparability.

In order to reorient budgetary resources, cuts were made in the number of hospitals contracted for inpatient services (Table 5.8). These reductions bring the key indicator of contracted beds per 100,000 units of population, down to 575 or almost to the European average. However, Latvia cannot support even this level of infrastructure given the current level of its health budget allocation for inpatient care. The government therefore needs to make tough decisions about further reductions in inpatient capacity, even if it is to simply remove or alter contracts rather than closing the excess infrastructure. In 2009-2011, additional resources were added to the budget at the end of the year to finance hospital spending needs, and this may need to happen again unless inpatient infrastructure is cut further or the budget allocation is increased.

Table 5.8: Hospitals and beds with impatient contracts in Latvia, 2008-2010

Contracted	***2008***	***2009***	***2010***
Hospitals	78	72	39
Beds (end of the year)	17,001	15,121	12,929*
Beds per 100,000	749	669	575

Source: World Bank (2011a), based on data from Latvia's Ministry of Health. Note: * denotes start of the year

The number of primary care visits to general practitioners (GP) has been stable for many years, but from a health perspective, these probably need to increase, especially for men. Secondary outpatient specialist visits (for specialists, diagnostics, outpatient surgeries, and so on) fell from 3.22 million in 2008 to 2.93 million in 2009, but were estimated to rise to 3.18 million in 2010. They will likely continue to increase as medical care shifts out of hospitals. A huge drop in hospital inpatients has occurred, from 473.4 thousand in 2008, to 373.3 thousand in 2009, and to an expected 322.3 thousand in 2010, a drop of 32% in just two years. In the next few years, the Ministry of Health expects them to stabilise at around 300 thousand.

The Ministry of Health has been successful in shifting some inpatient stays to outpatient care, with day care or day surgery patients increasing from 26.3 thousand in the first 8 months of 2009 to 50.9 thousand for the same period in 2010. Prior to 2009, this figure was zero. The shift from inpatient to outpatient care will continue, which will further reduce the need for inpatient infrastructure. The Ministry has found that in removing a hospital's inpatient contract, approximately 30% of the inpatient cases disappear, and 70% move to other hospitals, which is indicative of the level of inefficiency accommodated by the excess infrastructure.

High out-of-pocket payments has characterised health finance in Latvia, and the fiscal retrenchment threatened to worsen this situation. In the 2000s, the government financed only about 60% of health spending, which is low for the EU. Government support was primarily for catastrophic hospital costs and primary/specialist care, although almost all services carry co-payments. Households in 2008 financed 78% of pharmaceutical costs and 89% of dental costs. As part of the emergency safety net, Latvia fully financed co-payments and prescription costs for poor households beginning in 2009. The Ministry of Health has created Latvia's first centrally-financed social assistance programme targeted at the needy.

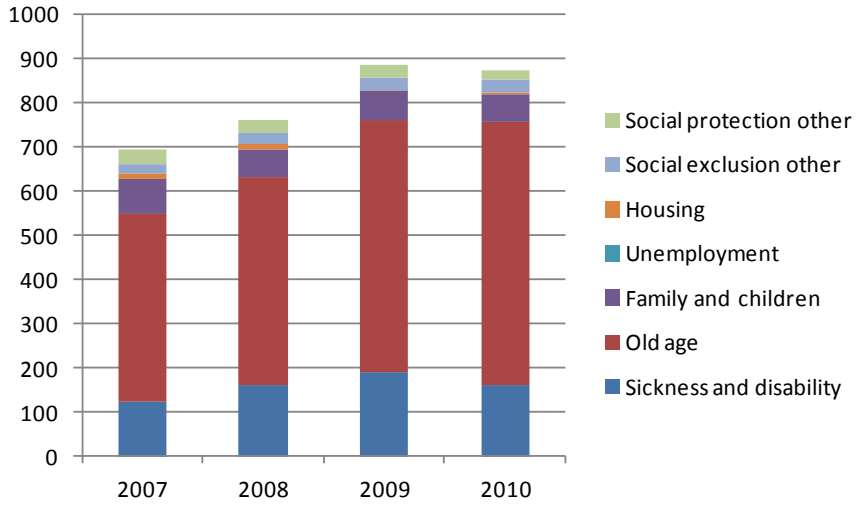
III.C. Social protection

In contrast to the significant costs experienced in the health and education sectors, both social insurance and social assistance programmes were enhanced during the crisis.

The increase in the social protection budget in 2009 is not explained by rising automatic stabilisers due to the increase in unemployment. The rise in unemployment insurance benefits only accounted for 26.3% of the overall real increase in the social protection budget. Most of the increase was explained by the kicking in of policy decisions taken before the crisis to increase social insurance benefits, particularly pensions (old-age benefits). The latter was responsible for 60.5% of the overall real growth. Benefits that would be expected to be a-cyclical, such as sickness and disability, also increased substantially (Figure 5.28). In 2010, an ease-off in unemployment, and sickness and disability benefits translated into a fall in social protection spending relative to 2009. However, pensions spending increased each year, with a rise in real spending of 27.3% from 2008-2010.

Part of the increase in pensions was automatic (in-built into the system). The real notional interest rate for the pension system was 21% and 28% in 2008 and 2009 respectively. Notional interest rates remained high until 2009 due to the lag of about 18 months between the observed wage and benefit bill growth and its application to notional accounts, which meant that pensioners were still benefitting from the pre-2008 boom in 2009. Given that pension insurance spending made up a sizable portion of the budget and had increased substantially during the boom period, one could have expected the government to have found some savings in this area.

Figure 5.28: Composition of social protection spending, 2007-2010 (in 2000 prices, millions of Lats)



Source: World Bank staff calculations based on data from the Ministry of Finance, Latvia

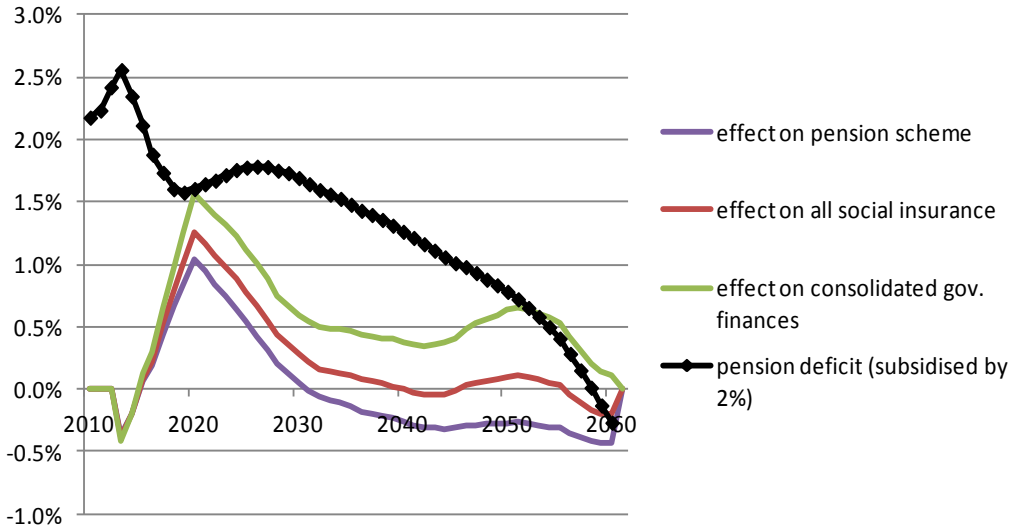
The protection of pension spending put the most immediate, substantial and progressive fiscal savings out of reach. The World Bank 2010 Public Expenditure Review proposed well-targeted measures to recover at least part of the windfall gains made by retirees in recent years, while protecting those with the lowest pensions. These included an increase in pension taxation, as it would recover some resources resulting from costly pension policies during the high-growth period. The threshold for pension income tax exemption could have been reduced to bring it closer to the lower tax exemption for labour income. Another option would have been to move back to targeting the pre-1996 service pension supplement to low-income pensioners. The problem is that rapid adjustments in social insurance, particularly pension spending, are hard if not impossible to implement in a recession. The recent crisis has shown the political economy and often legal difficulties associated with rapid policy reversals in social insurance benefits. The Government of Latvia tried to reduce pensions by 10% in 2009 for non-working retirees and by 70% for working retirees for the period 2009 to 2012. The Constitutional Court overturned this policy, and pension underpayments from 2009 were compensated in 2010. Subsequently, the Unity party - a member of the winning two-bloc coalition - promised not to cut pensions during the 2010 election.

However, the Latvian government did achieve some reduction or containment of expenditures in the area of social insurance. It reduced pension payments through freezes and the adoption of more conservative indexation methods. The government also increased the penalty for early retirement. Although not desirable, the government diverted 6 percentage points of the 8% payroll tax previously paid into mandatory private retirement savings accounts (the "second pillar" of the pension system) to finance existing pensions, leaving only a 2% contribution for the private accounts. The second pillar contribution had originally been scheduled to rise to 10% in 2010, so the change in expected funds in the private accounts was large. There were low-yielding reductions in other social insurance benefits, including maternity/paternity allowances, unemployment/sickness allowance limits, and parental allowance. As of 2011, the social security contribution rate increased from 9% to 11% in 2011. These steps should contribute to the stability of the social insurance budget.

Further pension reforms are expected in the medium-term. The government plans to eliminate the supplementary pension for pre-1996 working years for new retirees in 2012. To address medium-term fiscal challenges and long-term downward pressure on replacement rates, the government is committed to increasing the retirement age from age 62 to age 65. Latvia plans to implement gradual increases to the retirement age as of 2014. The retirement age will be increased by three months in 2014 and 2015, and then by six months each year from 2016 onwards with the goal of reaching 65 for all individuals by 2020. The retirement age for those with the right to early retirement will increase according to the same schedule with the aim of reaching 63 years by 2020.

The expected savings from increasing the retirement age are presented in Figure 5.29 and can be compared with the projected deficit (based on the assumption that reform is to start in 2016). Savings for the pension scheme from a retirement age increase are expected to reach 1.6% of GDP by 2020 as the number of pensioners declines and the number of contributors rises. After this, annual savings start to decline as longer careers start to translate into higher pensions. However, it is reasonable to expect additional benefits from this measure to arise elsewhere: increasing the number of taxpayers could boost revenue not only with additional contributions to the social insurance special budget as a whole, but also to the State budget through the increase in the wage income tax base.[52]

Figure 5.29: Simulation of projected fiscal savings from a retirement age increase (share of GDP)



Sources: World Bank Staff PROST projections

As discussed in Section II, Latvia was relatively unprepared in terms of its social protection system to protect the more vulnerable sectors of society during the crisis. It did however manage to respond quickly by introducing reforms. The government eased eligibility requirements and extended the duration of unemployment insurance benefits; it expanded its targeted Guaranteed Minimum Income Programme (GMI) and introduced a public works programme. The effects of the reforms to social benefits took approximately 5 – 8 months to be felt, but once those reforms were implemented, social benefits expanded significantly. Performance of the GMI programme also improved, with the exception of coverage of the poorest quintile which increased by less than 1 percentage point from 2008 to 2009. In tandem with increasing income support for the most vulnerable, the government also introduced a range of measures including: health care, pre-school education support and transportation assistance for students from schools which had been closed to protect the vulnerable from adverse impacts due to the crisis and structural reform programme in the social sectors. Combined spending on this set of emergency social safety net measures equalled 0.5 and 0.6% of GDP, in 2010 and 2011 respectively.

One of the policy measures the government took to strengthen safety nets during the crisis was to establish a job placement programme (WWS) public works programme (Workplaces with Stipends programme, WWS; simtlatnieku programma). All those who were registered unemployed and who were not receiving unemployment insurance benefits were eligible, and public works were assigned on a first come, first served basis. Stipends were 100 LVL per month and workers were offered up to six months of work. A recent impact evaluation of the

[52] This reform proposal will result in lower fiscal savings than that which was put forward in 2011. The 2011 reform proposal wanted to introduce the pension age increase later (to start in 2016), but would have continued the curb on early retirement that expired in 2011. Under the new policy savings are lower throughout. This is because the early retirement option never goes away, the early retirement age only increases together with regular retirement age, preserving the two year gap between the two.

WWS conducted by the World Bank found that this self-targeting mechanism worked well, with most WWS beneficiaries belonging to the bottom 40% of the income/welfare distribution (poor and vulnerable), with quintile 2 highly represented.[53] Similarly, the evaluation found that administration and implementation of the programme were satisfactory, with payments being made accurately and on time (Table 5.9).

Table 5.9: Key performance indicators of the emergency public works programme (WWS), 2009

	Distribution of WWS beneficiary households	
	% of households that belong to bottom two quintiles	% of households belong to top two quintiles
Quintiles based on asset index		
Currently Participating	65	18
Currently on waiting list	59	24
WWS Completed	73	13
Quintiles based on predicted consumption		
Currently Participating	56	18
Currently on waiting list	50	18
WWS Completed	62	14
Quintiles based on predicted income		
Currently Participating	69	12
Currently on waiting list	70	13
WWS Completed	70	14

Note: The WWS survey covers only a part of population and thus it is not representative of population. To create quintiles, data from Household Budget Survey (HBS) 2009 is used. The quintile cut offs are derived from HBS. To create asset index in WWS, factor-loadings from HBS are used. Similarly a model is fitted using HBS based on common variables in WWS and HBS. The coefficients derived from HBS are used to predict consumption and income in WWS.

Sources: Ferre, Azam and Ajwad (Forthcoming)

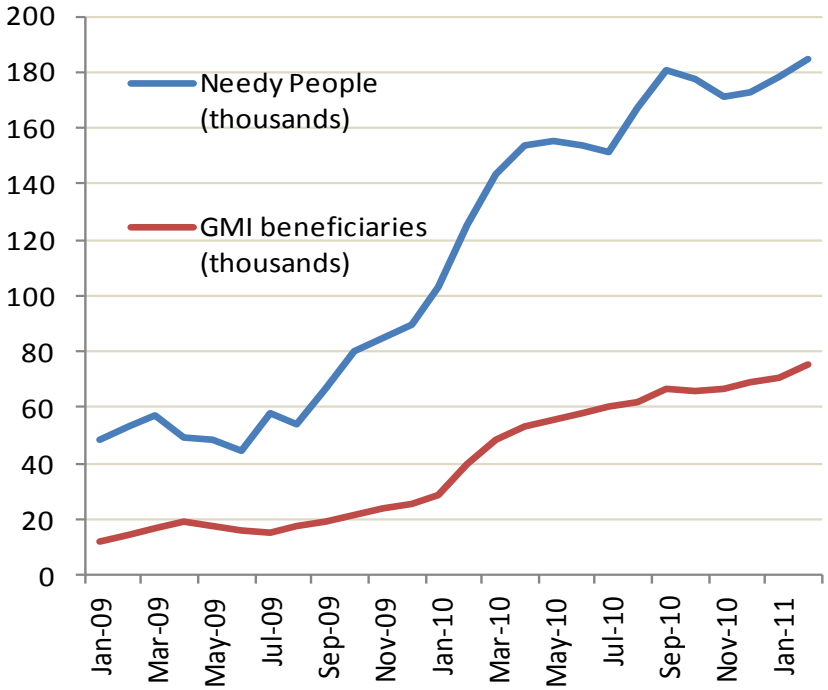
Critically, the impact evaluation also found that WWS did constitute an important safety net for vulnerable Latvians, by mitigating the impact of income shocks for beneficiaries, relative to the control group, and by reducing households' reliance on harmful coping strategies (selling assets, pulling kids out of school, reducing prescription medication, avoiding doctor visits, etc.).

At the same time, however, the impact evaluation found that there were three areas that limited the overall impact of WWS on household welfare: (i) Most of the participants were not aware of the other programmes linked to WWS (health checks and transportation allowances); (ii) the scale of WWS was smaller than the demand for the programme, despite the relatively small stipend and the physical nature of the jobs available; and (iii) WWS appears to have partially crowded-out other social benefits such as unemployment benefits, GMI, pensions and housing allowances, reducing the overall impact of the programme.

Social assistance expanded in Latvia, as in many other EU10 countries during the crisis, but the fiscal impact was generally low compared to increases in pensions and other contributory programmes. For instance, spending on the GMI programme in Latvia more than doubled in real terms between 2008 and 2009. The number of beneficiaries peaked at about 80 thousand (3.9% of the population) (Figure 5.30).

[53] The impact evaluation design was based on a difference-in-difference (DID) approach with a control and a treatment group, and covered over 9,000 individuals. The control group was formed by individuals who applied for the WWS but were on the waiting list and had, therefore, not benefitted from the programme; the treatment group, on the other hand, was formed by individuals who participated in WWS. Since the two groups presented similar initial characteristics, the DID strategy identified the effect of the programme under the assumption that the two groups would have experienced similar outcomes in the absence of the programme.

Figure 5.30: The vulnerable and GMI beneficiaries, Jan 2009 - Jan 2011 (thousands)



Sources: World Bank staff, based on data from the Ministry of Welfare

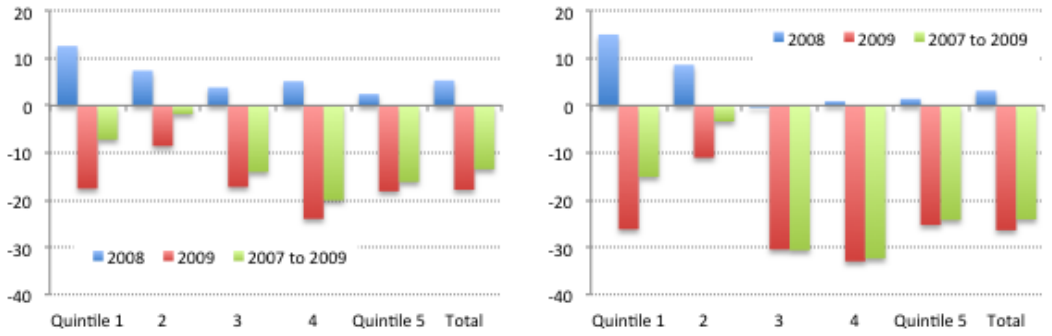
However, even after the increase, spending on the programme only reached 0.1% of GDP, which represents an almost negligible increase in total spending. In contrast, pensions increased by less than 15% in the same time period, although initial spending was close to 6% of GDP, which means that total spending increased significantly more due to this measure. A similar pattern is largely observed in other EU10 countries. The already low safety net spending is due to be decreased by 0.1% of GDP in 2012, despite indicators which show the continued vulnerability of a substantial part of the population.

III.D. Distributional effects of the crisis and the role of social programmes in mitigating its effects

Prior to 2008, real household incomes had been rising in Latvia, in line with growth in real per capita GDP. In 2008, the average disposable income per capita (in 2007 lats) averaged LVL 2,394, having increased by 6.5% between 2007 and 2008, and ranged from LVL 1,308 in the bottom quintile to LVL 4,045 in the top quintile. In 2009, with the economic crisis, average real disposable income per capita fell by 18.2% and by 12.9% compared to 2007 (Figure 5.31, left pane). The relative shocks to disposable income, however, were substantially higher in the richer quintiles than in the poorer, lower quintiles. Between 2007 and 2009, households in the first (second) quintile in particular saw a decrease of 6.5 (1.1)%, while households in the fourth (fifth) quintile saw their disposable income per capita drop by 19.5 (15.6)%. Relative to the top two quintiles, the lower quintiles enjoyed a much larger rise in 2008 and, at least on average, a smaller decrease in 2009. For these two groups, the decrease in 2009 likely only returned them to their income level in 2006.

The impact of the crisis on wage income was much more severe. Average wage income per capita had increased by only 4.2% in 2008, and fell by 26.7% in 2009 (Figure 5.31, right pane), reflecting both changes in wages and changes in hours worked. The decrease from 2007 to 2009 was 23.5%. Again, however, the lower quintiles fared relatively better, with wage income falling by 14.5 and 2.7% between 2007 and 2009 in the first and second quintiles, respectively.

Figure 5.31: Percentage change in real disposable income per capita (left pane) and percentage change in real wage income per capita

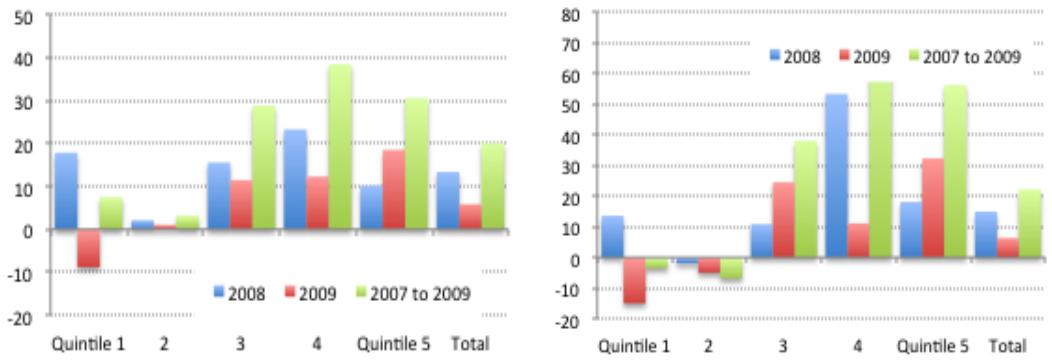


Sources: Gillingham (Forthcoming), based on household surveys

Offsetting the drop in wage income, as a share of disposable income, was the increase in the share of social transfers. As discussed above, income from social transfers increased between 2008 and 2009 in the face of the financial crisis (Figure 5.32, left pane). The increases in transfers went predominantly to households in the higher welfare quintiles. In 2007, households in the bottom two quintiles received 45.6% of total transfers, higher than their proportionate share relative to the population. By 2009, that share had decreased to 40%, an amount that would be expected if transfers were distributed randomly. Although all quintiles received increased real transfers in 2009 relative to 2007, the higher quintiles fared far better.

The reason for this is that almost all of the increase in transfers reflected pension increases that were not related to any counter-cyclical fiscal policy (Figure 5.32, right pane), as seen before from a macro perspective. The bulk of the increase in pensions in 2008 and 2009 went to richer households. The pension income of households in the bottom quintile decreased, not because the benefits for individual households decreased, but rather because the increase in benefits disproportionately benefited better-off households and, in the process, moved many households into higher quintiles. The result, however, is that households in the bottom two quintiles received 11.7% less of total pensions than they did in 2007.

Figure 5.32: Percentage change in real transfer income per capita (left pane) and percentage change in real pension income per capita (right pane)



Sources: Gillingham (Forthcoming), based on household surveys

Pensions account for over 70% of transfer income. Consequently, policy decisions with respect to pensions shape the distributional impact of changes in transfers. Benefits for families with children (family benefits) are the next most important component of transfers, accounting for 11.8% of total transfers and 2.3% of disposable income in 2007. Family benefits as a share of disposable income increased to 2.6% by 2009, even though they had fallen slightly in real terms and as a share of transfers. The bottom two quintiles of the welfare distribution received increases in real family

benefits between 2007 and 2009. The top three quintiles had real benefit cuts. The category "other transfers" on the Household Budget Survey accounts for roughly one-sixth of total transfer income. Its evolution between 2007 and 2010 was very similar to the evolution of family benefits. Again, almost all of the real benefit increases went to the bottom two quintiles of the welfare distribution. Finally, the level of unemployment benefits also increased - almost ten-fold between 2007 and 2009. The benefits were distributed roughly equally across welfare quintiles, presumably reflecting the fact that the higher average benefit in the top quintiles was offset by the higher recipiency rate in the lower quintiles.

In short, the reforms observed at the aggregate level, particularly in terms of social protection implemented during the crisis seem to have had an important impact on households and helped in cushioning the effects of the crisis. Different social welfare programmes, however, appear to have had different distributional effects. More time is needed to be able to fully assess the impact of the crisis measures taken in the education and health sectors on actual household welfare.

IV. Future social sector spending agenda

While the government of Latvia responded swiftly to the challenges posed by the economic crisis, and even adopted structural measures that will serve it well in the future, important structural challenges remain. These relate mostly to: (i) the demographic shift as the number of children and working age population falls relative to the number of elderly in the coming decades, putting enormous pressure on all three social sectors; and (ii) the fiscal and overall economic environment, which is likely to remain dampened at least in the medium term. These challenges are common to many other EU countries, including most countries in Central and Eastern Europe.

Given the fiscal and structural situation of social sectors in Latvia, savings in education and health will be restricted in the future, although there is significant space for the reallocation of resources as part of continued structural reforms. This leaves significant spending and reform pressures on old-age spending.

IV.A. Education

The main challenge for the education sector in Latvia - and elsewhere in the region - is to increase efficiency and quality of education in a shrinking school-age population. There is a significant over-capacity in terms of the infrastructure and staffing in the sector and so far, governments have found it difficult to close schools and terminate teachers' positions fast enough to keep unit costs constant. Most governments, including that of Latvia, have made some progress recently towards fiscal sustainability and have increased efficiency in the sector by introducing per capita financing in general education. However, the impact of this reform on quality is less clear. The international evidence does not point to a direct link between costs and performance in the education sector. Schools' performance depends on certain inputs like teachers' skills, social segregation and curriculum, which can be improved at relatively low costs, but actual costs depend heavily on class and school sizes, teachers' workload and wages. . Governments in the region could therefore try to improve quality and lower costs at the same time by reducing the quantity of unnecessary inputs and improving the quality of teaching. Finding ways to better link teachers' compensation to students' learning outcomes could be part of the reform agenda on education quality.

While making adjustments to funding in the education sector to keep pace with the decline in student population, freed-up resources could be reallocated to other needs, such as early childhood interventions or higher education, areas that today look severely under-funded, as discussed earlier.

IV.B. Social Protection

In Latvia, while radical social security system reforms are not required and its core principles should not be changed, there is a need to make serious adjustments to the system to improve the current situation and to ensure future sustainability of the pension system. As a result of these challenges,

policy-makers in Latvia and in many other EU countries will have to devise ways of reducing the fiscal pressures associated with the pension systems. In order to preserve the dual goal of benefit adequacy and financial stability of social insurance schemes, increasing the effective retirement age is likely to be the main reform measure taken by most countries moving forward. Policy makers may need to devise a set of rules, incentives and penalties to make sure that an older healthy and employable population continues to work for as long as possible while a minimal safety net exists for those who have to retire earlier for health or employability reasons. Part-time work, retraining programmes for older workers, and options to combine minimum retirement income with declining wages, that are reflecting decreased productivity or shorter working hours, are likely to gain in importance. However, as discussed in Section III, increasing the retirement age is unlikely to provide significant savings in the long-term beyond the initial boost, given the structure of the system. As a result, policy makers may also need to tolerate reduced levels of income replacement for younger retirees in order to cajole them into longer working lives. This would allow the government to preserve sufficient resources to be able to offer higher income protection to the very old population, which is no longer capable of supplementing their income. Finally, fiscal pressures in old age spending may also require a move away from wage indexation of benefits and the intergenerational transfers that it implies.

Given the tightened fiscal space, it is important to review whether resources given over to social assistance programmes are well spent and how to reach those who need them most. Resources for poverty-targeted programmes are severely limited, as documented earlier. Maintaining effective protection within the reduced post-crisis fiscal envelope would therefore require significant reforms to: (i) reduce the amount spent on universal or categorical (non-means-tested) benefits, increase uptake and extend the coverage of last resort social assistance programmes; (ii) reduce any work disincentives built into their design; and (iii) make benefits more flexible and more able to respond quickly to crises and policy shocks. These structural reforms are relevant not only for Latvia, but apply to most other countries in the region.

IV.C. Health

Despite efforts over the past 20 years to reduce excess inpatient infrastructure and to strengthen primary and specialist outpatient care, Latvia and all of the EU10 continue to face the problem of an unfinished agenda in both areas. This is exacerbated by local government ownership of the infrastructure combined with national government financing of the services provided. Fiscal adjustment creates an opportunity to restructure these systems, as Latvia has demonstrated, but even then it is extremely difficult and often only partial. In Latvia, the Ministry of Health's medium-term strategy for 2012-2014 is taking important steps in the right direction. Steps to consolidate hospitals and remove infrastructure from the system have so far, however, been partial and have been accomplished mostly through financial means. The infrastructure remains in place for the most part, with politicians retaining the incentive to restore national financing for their local institutions. From a health outcomes standpoint, convergence with the EU will require a broader set of financing reforms in Latvia and the other EU10 to encourage greater efficiency, quality of care, and integrated management of patients. Such reforms include greater use of competitive contracting, prospective payment mechanisms, and financing that encourages integrated care and a focus on results. Developing the analytical capacity to use claims and payment data to analyse and improve health policy would facilitate a much tighter connection between health policies and what is financed. These are reforms that will increase the ability of the health system to dynamically adjust to a shrinking and aging population and to the rapid evolution of medical technology. A fiscal crisis is not only an opportunity to execute reforms put off during easy economic times but to permanently improve the dynamism and responsiveness of the health financing system.

V. Lessons learned

The experience from Latvia's fiscal consolidation and reform process in the social sectors during the past years holds important lessons for the rest of the countries in Central and Eastern Europe as they tackle the demographic, fiscal and labour market challenges of the coming decades. These lessons

reflect general principles rather than specific policies since the latter are likely to require country-specific tailoring.[54] Latvians themselves will benefit from knowledge gained during the crisis as they continue their own process of structural reform in the social sectors.

- **Prioritising and making trade-offs in social sector spending**

Latvia has been bold in its consolidation and reform programme. In the midst of the crisis, governments in the region often opted for cuts in areas where savings could be realised quickly but not necessarily strategically, sometimes postponing further important structural reforms. To some extent, this choice is understandable, given the political sensitivity of some of the required measures (i.e., firing public employees, reducing wages, cutting services, closing schools and hospitals) and the urgency with which decisions needed to be taken. In social protection, for example, countries often chose to expand categorical benefits over poverty-targeted programmes both in periods of growth and during crises. Yet, expanding categorically targeted programmes or pensions during a crisis was much more costly than scaling up poverty-targeted programmes (Isik-Dismelik, forthcoming). Latvia tackled its reform programme head-on during the crisis and the process of prioritisation was facilitated by the depth of the crisis. In addition, the relatively low share of social spending on GDP and the ample opportunities for reform in social sectors going into the crisis enabled them to target areas of real need. Finally, the evidence-based approach to reform that identified the areas where efficiency gains were the highest meant that reforms produced efficiency gains, were well-targeted for the most part and had some lasting effects in the longer term.

- **Overcoming inertia in pension reform**

The reform experience in Latvia has shown that pension expenditures exhibit very high inertia in times of recessions and even extremely reform-minded governments are not able to quickly reduce spending on such programmes. In Latvia, pension spending increased by 27% in real terms between 2008 and 2010; large cuts in education and health were politically feasible, whereas it was not possible to make pension reforms with a short-term impact. Second pillar pensions in Latvia is also an example of a long-term investment programme that lost most of its financing in the midst of the crisis since maintaining current pension spending was perceived as a higher priority. The absence of reform in pension expenditures means that cuts to other sectors need to be much more severe since the latter typically represents a very large portion of the government budget. This brings two important lessons. First, pension reforms have to be enacted well in advance, especially in light of well-anticipated crises such as the future demographic crisis, which is both real and significant. Secondly, countries also have to prepare for the upside of the business cycle when higher revenue growth will inevitably put pressure on increasing current pension spending. Ideally, pension systems should protect themselves against such short term pressures, including fiscal responsibility laws and limits on discretionary decisions. Another approach is to use safety valves to allow such pressures to be released over time in order to avoid more drastic changes, e.g., clauses that allow limited extra benefit increases when economic growth exceeds a given threshold.

- **Taking rapid action where initial weaknesses in social protection systems exist**

Latvia was one of the countries in the region that was the least prepared to cushion the impact of the crisis on household welfare through the social benefits system. Yet, by rapid and ambitious policy action, the country managed to successfully expand and reform social benefits. The adjustments to the poverty-targeted social assistance programme and the relaxation of eligibility requirements for

[54] An important aspect of the Latvian experience during the crisis was a broad political consensus among the many parties on the urgency and necessity of swift and radical reforms. In this sense, Latvia's experience during the crisis may be peculiar, whereby a common understanding and shared goals of moving towards the adoption of the euro and 'getting the economics right' made it possible to carry out the harsh reforms during the crisis in order to improve welfare in the future (Aslund and Dombrovskis, 2011, p.117).

unemployment benefits, for example, played an important role in accommodating the large economic and social shock experienced in Latvia.

- **Effective crisis responses need to be fiscally responsible measures that are timely, targeted, and temporary**

During a crisis, policy measures need to be timely in order to help households manage economic pressures such as unemployment, reductions in salary, etc, but also in order to inject money into the economy and help boost aggregate demand. In addition, measures need to be targeted towards those most affected ensuring support for at least a minimum welfare basket of goods and services for both the existing and "new" poor. Finally, measures should be temporary, and be reduced gradually as conditions improve (World Bank, 2011b). Measures that are directly linked to economic conditions, such as means-tested and unemployment benefits fit this profile and were expanded in Latvia; others, such as public works, have been designed as temporary in nature.

- **Strengthening the ability of social assistance systems to respond during crises**

During the crisis, many countries adopted measures to strengthen social assistance and it is important to continue these efforts in the short term. Reforms need to include a mix of measures aimed at: improving targeting of overall social assistance by means-testing some currently universally available benefits; consolidating any redundant programmes; and simplifying benefit administration. In the medium term, the focus should shift toward improving incentive compatibility (i.e., the reduction of incentives for reduced adult work effort in order to maintain eligibility for benefits) of social benefits and developing activation policies to reintegrate the long-term unemployed welfare recipients into the labour market.

- **Structural reform is a continuous agenda**

Many EU12 countries had been making some progress their long-term reform agenda prior to the crisis, for example: per-capita financing in education; improved targeting of social assistance; increasing the retirement age; hospital consolidation;, and increased focus on primary care provision, among others. These steps, while small, helped those countries better navigate the crisis and avoid some of the severe, sudden cuts that Latvia had to implement. Continuing to push the structural reform agenda throughout the business cycle is strongly recommended. In education, for example, it is apparent that countries which were already adjusting the education system to the real and projected demographic change earlier in the decade were better off. There were two main reasons for this: 1. starting the reforms earlier meant that cuts were not so severe when the crisis actually hit; 2. given that it takes some time for structural reforms to actually take affect and provide some fiscal savings, reforms which had been planned ahead allowed for a smoother and more robust transition. One of the main struggles facing Latvia was that it entered the crisis with a very large supply of school teachers, and they had to lay many of them off precisely at time of high economic distress.

- **Undertake regular reviews of spending and outcomes in the social sectors**

In the case of Latvia, the comprehensive spending review undertaken by the World Bank (2007, 2010) and IMF, in collaboration with the government, helped to inform the fiscal adjustment process and guide reforms. Apart from analysis of overall spending, individual sectors, such as health, have increased data collection/monitoring efforts and often use monthly analysis of reform progress to guide policy and budget decisions. Given the dividends associated with the deepening of expenditure/outcome analysis and the relative low costs of such efforts, the practice needs to become a regular part of the budget process as the country emerges from the crisis. It will then be important to consider long-term impacts of the fiscal adjustment and crisis response policies when planning the direction of further spending.

- **Counter-cyclical fiscal policies in good times ensures more effective response during a crisis**

Automatic stabilisers in the social protection budget - or indeed discretionary responses if required - need to have considerable planning and fiscal discipline. Automatic stabilisers, such as unemployment benefits, can result in a sudden expansion of government spending during deep recessions. Depending on the fiscal position, it may be difficult in certain circumstances to allow automatic stabilisers to operate fully. If fiscal space is constrained, due to concerns about fiscal solvency, limited availability, or high cost, of financing then allowing the budget deficit to increase in response to an output contraction may undermine macroeconomic stability. Fiscal savings built up in good times, for example by reducing public debt, mitigate this risk. They would also provide room for discretionary counter-cyclical policy responses, if appropriate. Given the increased focus on budget rules in the EU, it is important to consider the trajectory of social protection expenditures across the cycle in designing fiscal rules and buffer-stock savings mechanisms.

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Chapter 6 – Focus on selected issues

I. Preconditions for success

Andris Vilks

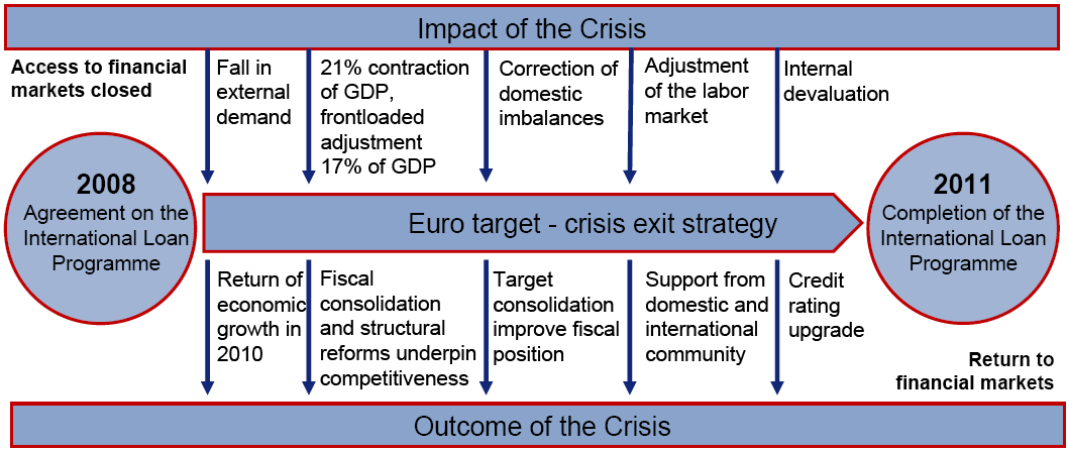
There has been a lot of discussion about what caused the crisis and what were its consequences; here, after a brief analysis of the crisis in Latvia, I will touch more several other important elements which contributed to the Latvian success story.

The Latvian response to the crisis

The Latvian economy was quite overheated already in 2005-2006. However, all the warning signals sent by the Central Bank were twice ignored by politicians: first in 2005 and again, just before elections, in September 2006. Only in February 2007 the Government started to act properly and implemented some decisions to calm down market expectations about the real estate and consumption boom. However, it was already too late. After the outburst of the financial crisis in the global markets in 2008 Latvia had to face almost simultaneously a double shock: an internal shock, generated by the unwinding of the imbalances that we allowed to build up, and an external shock, due to the deterioration of the global economic environment. The shock was too difficult to resist, especially when the largest locally-owned private bank went bust. At that moment Latvia asked for support from international lenders and a Balance of Payment assistance programme was put in place.

As depicted in Figure 6.1, everything happened very quickly in Latvia, differently from other countries: in 12 to 18 months Latvia lost more than 20% of its GDP; unemployment tripled; revenues decreased by almost 35%; real estate prices dropped by almost 70%. Non-performing loans to the banking system were also a huge problem. Despite the situation we decided to go through a programme of internal devaluation and we did so because we understood that with a typical external devaluation we would have only ignored and postponed the existing problems without solving them. We enjoyed quite broad consensus and support for this decision, but we also faced opposition from many economists.

Figure 6.1: A schematic representation of the BoP programme timeline



Latvia went through tough consolidation measures and is now back to economic growth. As we learnt less is more: by cutting some expenditure we generated additional activities from other sides. It was very important to meet targets and to get support both domestically and internationally. As Latvia was the first troubled country in the EU, it was in a very difficult position compared to other countries. At some point, it was almost prohibited to think aloud about measures to stimulate growth and the only instruments still available were the EU funds (which proved to be crucial and will also

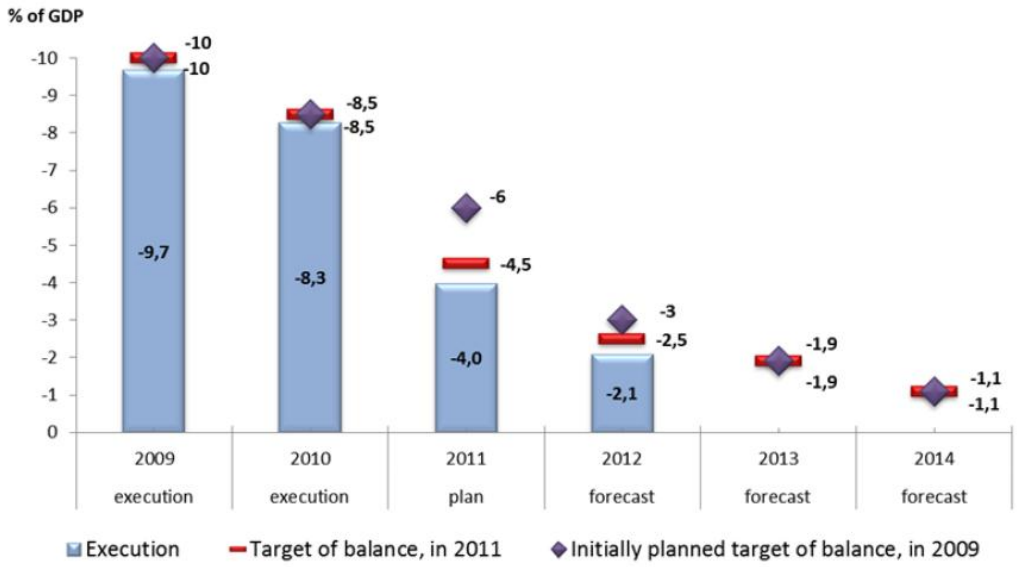
be important in the next few years). Austerity measures have been indeed difficult to present and implement.

Some historical perspective

This was not the first crisis in Latvia. The first one, when the country gained independence, was really dramatic. Between 1991 and 1993 the country lost almost 56% of the total economy: all large state-owned enterprises practically disappeared; there used to be collective farming in agriculture which also disappeared as farmers started to farm independently, often without the appropriate machinery; Latvia experienced hyperinflation and serious massive unemployment; at that time, Latvia also introduced its own currency. It is not difficult to imagine the scope of the challenges in these days. Latvia also suffered another shock in 1995, when the largest bank in the Baltic States went bankrupt. Again, the country was affected by the Russian crisis. Latvia has learnt quite a lot from these experiences and it is possible to draw many important lessons also from this crisis.

When we approached this crisis we were expecting Latvia's GDP to shrink maybe by 5% and we were able to tackle it; eventually it turned out to be in the order of 21%. Still, the situation was such that I believed that Latvia would be able to present a V-shaped development (probably I was the only one at that time: some analysts expected maybe a U-shaped recovery; most of the people expected something closer to an L-shaped development with no substantial improvements for the Latvian economy). I believed that return to growth was possible because I believed in our business environment, in its flexibility and in our people, in their background and mentality. It is important now that we are back to growth, with a better structure of the economy, good export figures, better than expected tax revenues and unemployment. Also the fact that we managed to return to the international monetary markets tells us that investors really like our story and give us strength to complete our mission. I think that a crucial part of this successful story is to perform better than expected. The European Commission and the IMF are becoming more demanding on targets and indeed I think they should be as demanding with other countries as they were with Latvia. As we can see from Figure 6.2, at the beginning we were close to target. But look at 2011: instead of 6% we managed to go down to 4% (and the result may be even better). The same happened in 2012: initially the target was 3%, then it was renegotiated to 2.5% and our intention is to get to 2.1%. This projection is based on a scenario of 2.5% of GDP growth and I would not be surprised to see better results. As the country is on this positive track now, it is possible to expect even better performances in 2013-2014 and Latvia's ambitions to come to a surplus budget have increased.

Figure 6.2: Predicted and achieved budget balance



Source: Ministry of finance, Republic of Latvia

Figure 6.2 is also very important for other countries. Most of the countries involved in consolidation are struggling with its challenges as they may underestimate the necessary amount of consolidation. The amount of consolidation that was achieved in the first and second year in Latvia was impressive. Looking at other countries Ireland is probably doing something similar, other countries are probably not so eager to follow this strategy and this may lead to more problematic outcomes.

The challenge of internal devaluation

Currency devaluation is not a medicine for small countries as Latvia; it is much better to focus on real problems and challenges and go through internal devaluation to fix the imbalances. Fiscal consolidation is important, as the Latvian case shows. Indeed, Latvia did not have a benchmark, but now the Latvian experience can provide some guidance for other countries which are currently struggling with reforms. It is also important to consider the role of public expenditures. Clearly it is generally better to cut public expenditures than to raise taxes. Unfortunately, one might not be able to avoid raising taxes, as very often it is impossible to tackle problems only from the expenditure side, and sometimes bold decisions have to be taken. In any case, it is crucial to look at the public expenditure side, since it is always possible to find positions where efficiency could increase. Latvia is now at the level of expenditure of 2006-2007 and we are going to keep almost the same amount for the next three years. This is indeed a very important challenge, but achievable. International effort should also be appropriate and frontloaded: delaying the process or take less than needed could be an additional source of problems. Public support is very important, also from a psychological point of view.

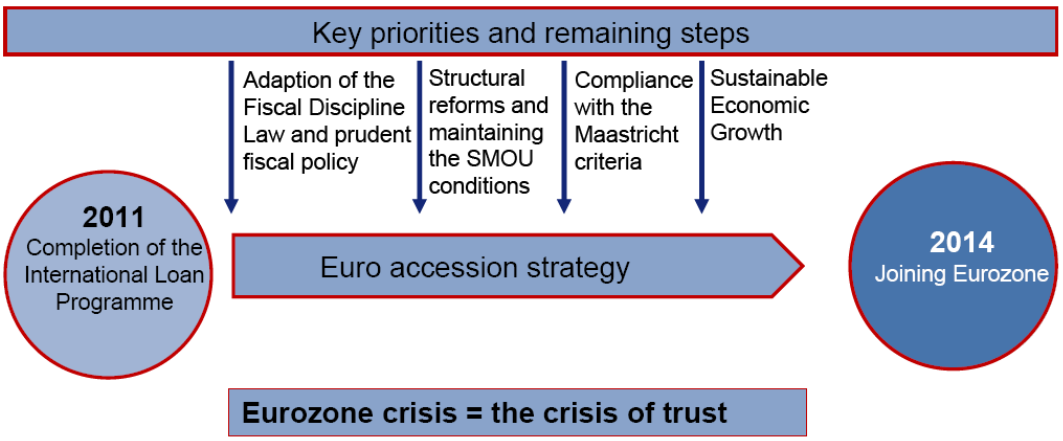
Another relevant issue is the political situation. Consider that in Latvia Prime Minister Dombrovskis had a minority government: no one wanted to take power in Latvia during 2009 with the risk to spoil forever ratings for his party, as everybody had foreseen huge troubles in the years ahead. Dombrovskis was able to handle the situation, also supported by the opposition parties. There is also something that other countries could learn from what we are discussing in Latvia about fiscal discipline. We received support also from some opposition parties as these issues go beyond business-as-usual and politicians should act responsibly. We have seen this in other countries as well: different parties in the parliament are joining forces to push reforms. As for the social dialogue, I would say that there is no place for populism at all. A simple rejection of governmental measures and a complete destruction of what was built before the crisis in such difficult times is not possible: sustainable proposals should be brought forward and Europe is starting to learn this.

On the way to the Euro

Our target is still to join the Euro as we would like to be part of the Eurozone. As I already mentioned, there is support from the opposition to pass the Fiscal Discipline Law, which will be designed according to the Fiscal Compact. Actually we started to talk about it already last year and this shows our commitment towards stability in public finances. The adoption of this Law goes hand-in-hand with structural reforms and, in this view it is really good that our social partners are pushing us to do more and more. If you had the chance to visit our reform management group, you would see how eager and active are our social partners: we are not going to avoid these decisions.

We would like to stick to the Maastricht criteria and, again, to frontload. There is a huge effort to find ways to improve the level of competitiveness of our economy, diminish inflationary pressures, and get closer to a balanced budget. The goal is to achieve sustainable economic growth: Latvia, as the other Baltic States, is now ahead of the cycle and we have to be wise to use the cycle. After such a dramatic experience as the crisis we will be much disciplined in fiscal terms for many years. About the Eurozone and the crisis, there is nothing wrong about the Euro as such; it is about trust. However at this moment, I have seen that there is an increasing effort from the European Commission, the European Central Bank and the national governments to improve the situation. Governments are offering the necessary solutions and this will be beneficial for the whole Eurozone.

Figure 6.3: A schematic representation of the next steps to be undertaken



Still many challenges remain for Latvia, some of which are presented in Figure 6.3. As I mentioned, the focus is now on improving our rankings on business environment and competitiveness scores. We are aware that there is still a lot to do. This is probably the first year that we are really able to concentrate only on structural reforms, as before we had to spend much time negotiating with our social partners and dealing with austerity measures. Now is the right time to focus on the welfare system, the health care system, education and public administration. We will keep our focus on those reforms. I would advise all countries to speed up reforms in these crisis years, because otherwise in better times and easier conditions, it will be very difficult to implement reforms and correct imbalances. We are trying to do everything at the same time.

I would like to conclude with three last remarks. The first one is: *do it fast, as much as possible, in the first few years*. The second is: *have social dialogue*. Of course, we had trade unions and the opposition was not very cooperative, but we got strong support from the business community and this is giving results. The third is: *do the necessary things that otherwise would be ignored during good times*.

II. Lessons for Europe from the Latvian crisis

Mark Griffiths

In what follows I will address three fundamental questions related to the Latvian experience: (1) why did the Latvian programme work? (2) What remains to be done for adopting the Euro? (3) What are the possible lessons of the Latvian programme for Europe? I will try to be frank and to give you an inside perspective of what we went through during these difficult years.

Why did Latvia's Programme work?

There are two broad reasons for Latvia's success with internal devaluation. The first aspect is the strong political ownership that formed around the programme. However, that ownership did not happen immediately: indeed, when the programme started in late 2008, politicians were unprepared and in denial. It is worth remembering that the situation in Latvia was desperate when the Latvian government signed the first programme; I do not think they really understood at the time the commitment they had signed up for or what the exchange rate peg really entailed. As a result, that government soon collapsed. Ownership really only started when Prime Minister Dombrovskis took office, but even at that point complete ownership took time to occur, as the government had to prepare for local elections in June 2009.

It was only after those elections and the meetings convened by President Zatlers and the social partners that ownership materialised. The initial adjustment package was massive, but it had a number of problems: in particular it contained a lot of regressive measures as well as some measures on pension cuts, which were later ruled unconstitutional. In any case, given the huge size of the adjustment and the need to defend the exchange rate, the European Commission went ahead, as did the Fund. Undoubtedly, there were some difficulties at that time, but ultimately those were resolved. Personally, I think that the way we solved those problems actually strengthened the programme itself, making cooperation on this programme one of the strongest and most successful of the last few years (it was difficult to believe it given those difficult debates, but, in the last year or two, cooperation among the different partners has been amazing).

When the Letter of Intent (LOI) was agreed in July 2009, all the government political parties were asked to sign it. They all said they would, then a couple wobbled, but finally they all signed it. That also strengthened the programme, because once they signed up to the LOI, none of the political parties could question anymore the programme commitments. I think that both the IMF and the EC, after that challenging experience, were determined to show their strong cooperation from then on. Commissioner Almunia and Swedish Finance Minister Borg made strong remarks before the 2010 budget to show that the international community was very solidly together and that there were no differences between us. These interventions and this unity of purpose really helped strengthen the negotiations for the 2010 budget. Because the political parties had signed the LOI, it was then really difficult for them to disown the programme. Those who did so later, and who tried to be more populist did not do very well in the later elections.

The other reason for the programme's success, apart from strong ownership, was flexibility. Both the Commission and the IMF showed considerable responsiveness and flexibility throughout the programme. We had a budget deficit target originally of 5% of GDP for 2009, but, once the recession proved extremely severe, both the Fund and the Commission were willing to raise the deficit target to 10% of GDP. When the pension cuts were ruled unconstitutional in 2009 we did not insist right away on corrective measures. We pushed for structural reforms, but if there were good reasons they could not be met we also showed some understanding. Flexibility was there too. This high degree of flexibility was adopted also in recognition of the seriousness of the measures taken by the government. I think in particular this flexibility on some structural reforms was possible because we were pretty sure that the fiscal objectives were being met. So, to conclude on this: strong ownership and cooperation among programme participants played an important role. This took time, but also

because it took time this cooperation was better. Also flexibility was essential, but it was granted only because we knew that the authorities were serious about the adjustment.

Adopting the Euro, what remains to be done?

If you look at the numbers now, they definitely look good for meeting the Maastricht criteria. The deficit last year was well below 4.5%. According to some preliminary numbers on the forecasts of GDP, this year there are good chances to meet the 2.5% target the authorities have agreed on. More measures may be needed in future years, depending on the fiscal compact commitment, in order to reduce the structural balance, but amazing achievements have been reached in terms of numerical criteria. The debt ratio is also very low. Inflation, typically difficult to control under fixed exchange rates, could have been an issue, but we project the target will not be missed. What is even more important is that Latvia is not an inflationary country: Latvia is committed to nominal anchors, like the exchange rate and does not like inflation. That definitely meets what really matters: the spirit of the inflation criterion.

In terms of structural reforms and growth more can be done, like in most other countries. On fiscal policy it has been now three to four years of adjustment, so there are going to be pressures to increase spending, cut taxes or reallocate resources. These pressures will be difficult to resist. Now it is extremely important for the government to look carefully at which areas have been cut back too much in the past and to see if there is scope for adjustment or rebalancing. I think savings can still be found in the social budget, as a lot of the social budget consists in transfers among the middle class without much improvement in fairness: better targeting would help. The strengthening of the social safety net will also be fundamental. Other measures could include residential real estate taxes, and making taxes more progressive (although that may be revenue neutral as this may mean raising some tax rates, but also to raise the tax-free income threshold).

All these measures provide room for some savings as well as for some rebalancing. Another challenge is related to structural reforms. Given the fixed exchange rate the only way to improve competitiveness is through structural reforms. The competitiveness report which is currently being produced is of high quality and has recommendations on equality, infrastructure, education and competition. A key message from that report is to prioritise. It is impossible to have just a long list of structural reforms that need to be done: we need to focus on five or ten issues and carry out those reforms in the coming years.

Thus, on the question of Euro adoption, the good news is about the numerical criteria: they are well on the way to being met. More could be done on structural reforms needed to flourish under a fixed exchange rate or common currency. However, overall, I think the crisis has shown that Latvia is serious about adjusting under a fixed exchange rate: it knows what it needs to do and it has shown the ability to do it. This is the real key test of eligibility for joining the Euro.

What are the lessons for Europe?

Latvia had a choice of exchange rate regime, Euro countries do not. Latvia was very firm in choosing the fixed exchange rate regime, so its experience is relevant for Euro Area countries experiencing high current account or fiscal deficits and it gives an example of what they have to do if they are going to adjust. There could be ways to ease that adjustment – for instance if the Euro was weaker or there were more concessional finance – but if those things are not on the table, then what Latvia has done, other countries have to do. Under fixed exchange rates this logic is inescapable. The positive consequences of a more gradual adjustment are not so clear, as the debt ratio would increase and stay higher for a longer period of time.

Latvia indeed enjoyed some favourable initial conditions. The government debt ratio was very low initially; the financial sector restructuring costs were not so high and we prudently overestimated those costs to be on the safe side; the Latvian economy is very open, so the fiscal multiplier is not so large (and a tighter fiscal policy, which I still believe is contractionary, can be partially offset by higher exports). It is also true that the boom before the crisis was immense and the Latvian people

realised this, so they were ready to accept some cuts in living standards. Migration has also been a safety valve.

To conclude, some general lessons for other European countries can be drawn: strong political ownership and strong cooperation among programme partners played a huge role in Latvia. Frank and difficult discussions, painful at times, also contributed to the success of the programme. To their credit, the Latvian authorities implemented an adjustment that was huge and frontloaded – they used the time provided by official financing to implement difficult reforms. The final key factor has been the resilience of the Latvian people, without which this successful adjustment would not have been possible.

III. Labour market flexibility and fiscal consolidation

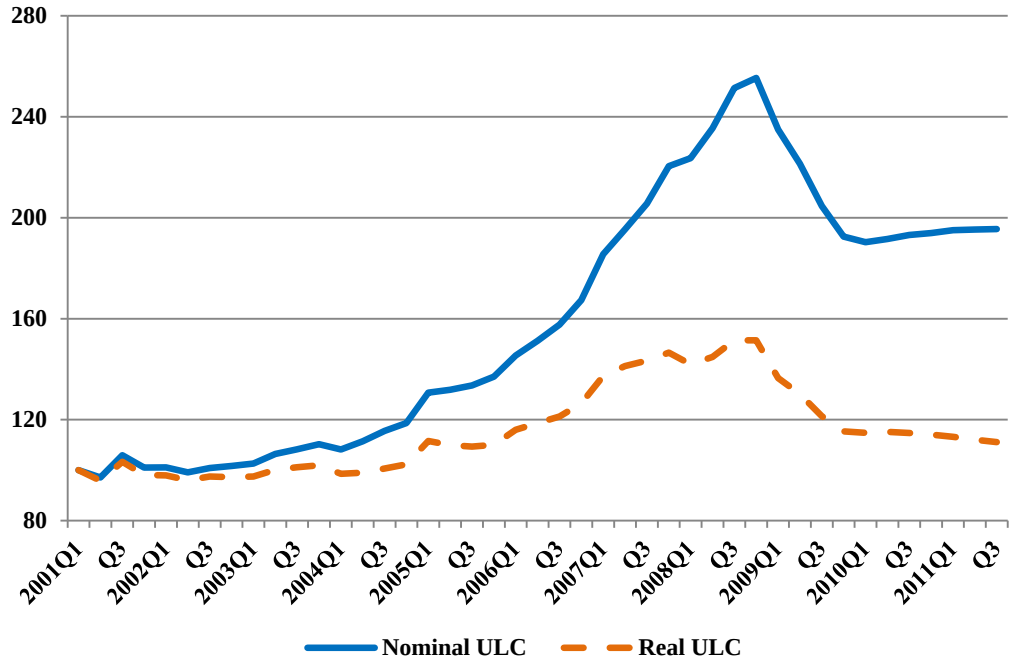
Karlis Bauze

When one discusses the introduction of austerity measures in a country, it is always very sensible to properly assess the social consequences of these measures on the labour market. It is very necessary to analyse the main features of the labour market in Latvia to shed some light on recent trends in unemployment and in particular to explain why unemployment was so high during the crisis, what has changed in the structure of the labour force and what still needs to be done in the next few years.

The Labour Market in Latvia

First of all I want to stress that the labour market is very flexible in Latvia. In particular, the adjustment that took place in wages and unit labour costs (ULC) during the crisis was enormous, certainly also to be seen against a low share of union membership.

Figure 6.4: Evolution of Unit Labour Costs in Latvia (2001Q1=100)

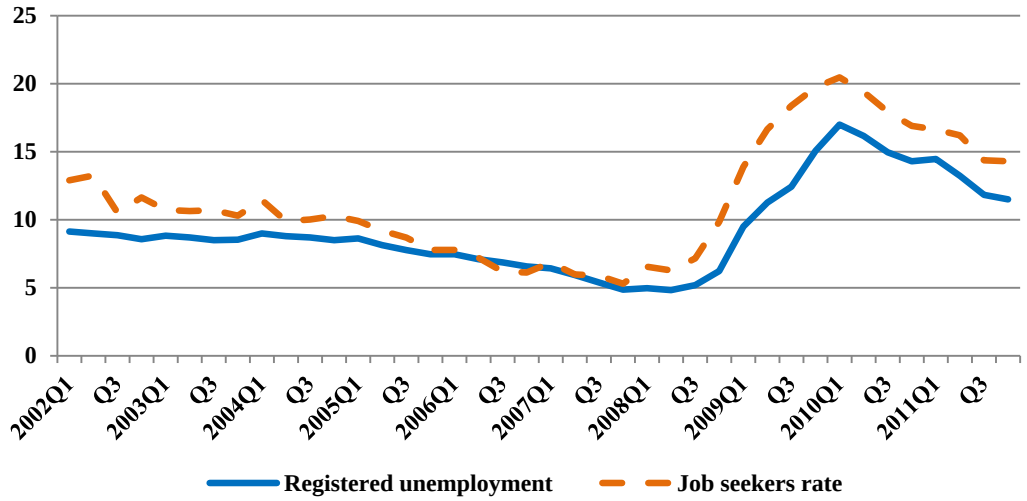


Source: Eurostat data; Bank of Latvia staff estimation

As we can see in Figure 6.4, while wages and ULC increased very rapidly from 2006 to 2008, the adjustment that followed was also quite substantial, both in nominal (-23%) and real terms (-27%). Figure 6.5 shows two indicators of unemployment, namely the job seekers rate and the registered unemployment rate. . Before 2006, job seekers rate was close to 10%, which is close to its natural rate. During 2007 and 2008 the unemployment rate was exceptionally low. Unsustainably high rates of economic development and labour shortage pulled down unemployment well below its natural rate, resulting in wage growth far beyond productivity increase and an escalation of inflation spiral.

High demand for labour was, fuelled particularly by the construction boom. Anecdotal evidence shows that not only low-skilled people were attracted by the construction sector, but even people with higher education moved to the building industry seduced by the high salaries in the industry. In Q1 2010, job seekers rate exceeded 20%; up to now both job seekers rate and registered unemployment rate decreased by about one third (the latest figure for latter indicator is 11.7%).

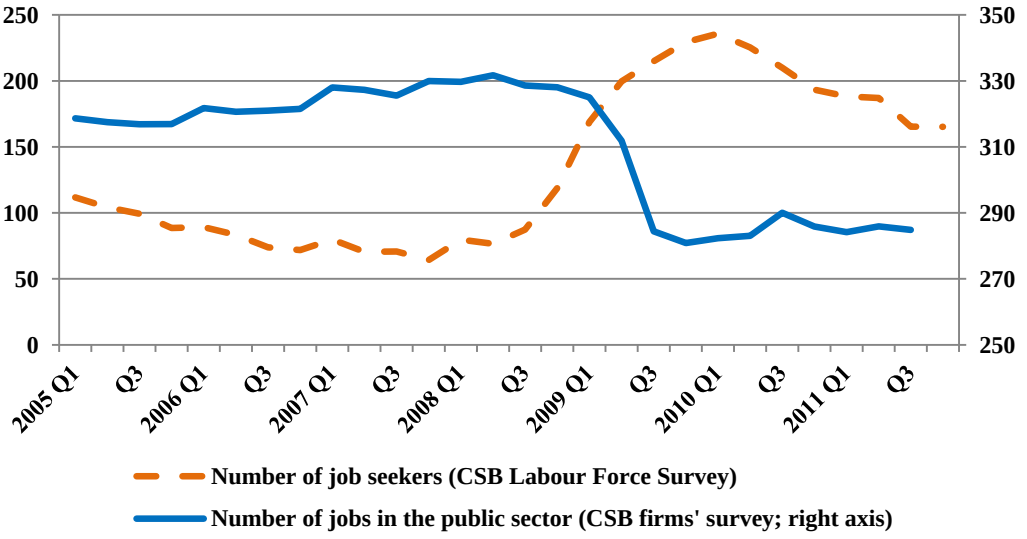
Figure 6.5: Unemployment rate dynamics in Latvia, % of economically active population



Source: State Employment Agency and Central Statistical Bureau of Latvia

Economic cycle and specific country features clearly explain a part of the sudden increase in unemployment that Latvia experienced at that time. However, one should also keep in mind that we did not only go through recession, but also through a tough adjustment process. The solid line in Figure 6.6 shows the slow but constant increase during the boom years of the total number of jobs in the public sector. Indeed, after the crash, many of the jobs in the public sector which were created during the boom years were eliminated (and the net effect was clearly negative); many reforms took place in the public sector as well as in the health sector or in the educational sector and public institutions were consolidated. The adjustment process that took place during the recession was substantial and necessary. However that also meant a parallel increase in the number of job seekers, as shown by the dashed line in Figure 6.6. If a country goes through the necessary reforms and the adjustment is taken serious it is almost inevitable that unemployment increases in the short run.

Figure 6.6: Job seekers and public-sector jobs in Latvia

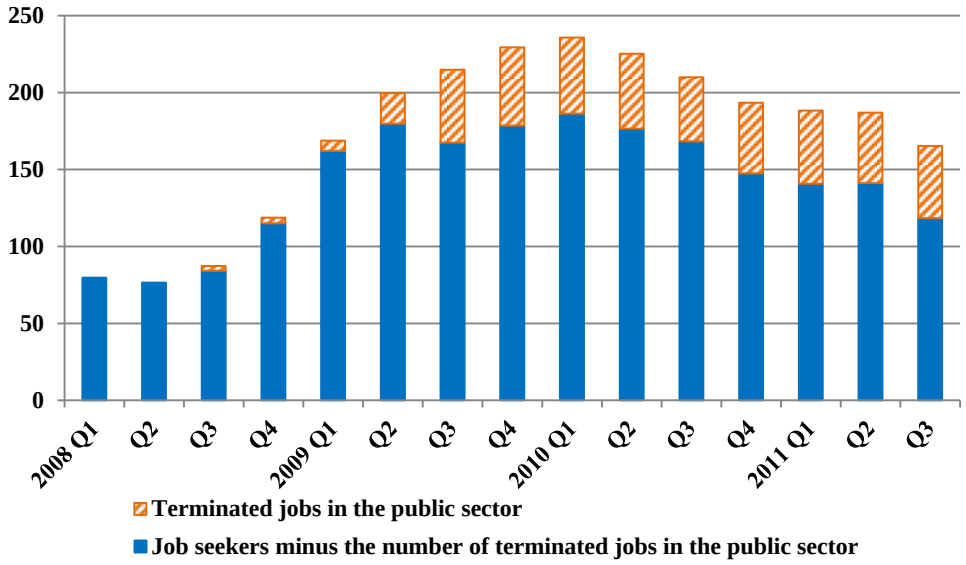


Source: Central Statistical Bureau of Latvia

Figure 6.7 provides complementary evidence that a relevant part of the total number of job seekers actually comes from the public sector. I think this is a good pattern for the economy: inevitably these

are workers switching from the non-tradable public sector to the tradable sector. If you retrain these people, moving them to the tradable sector, this is what is necessary to improve the resilience of the economic system and the prospects of economic growth in the long run.

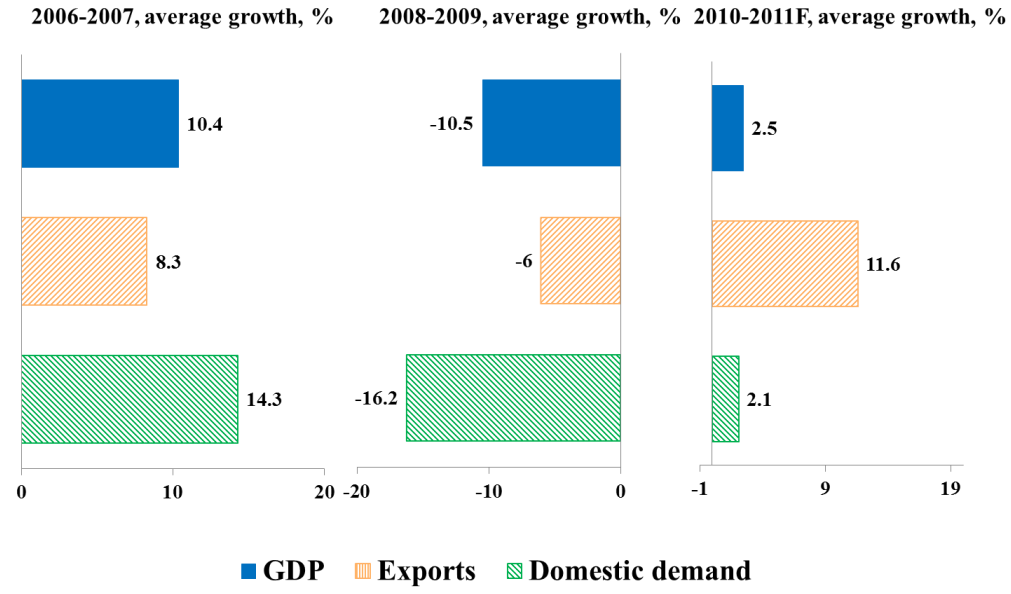
Figure 6.7: Job seekers and terminated jobs in the public sector in Latvia



Source: Central Statistical Bureau of Latvia

It is already possible to see some structural changes in the economy. Figure 6.8 shows how before the crisis, in 2006-2007, GDP growth was mostly driven by domestic demand and, similarly, the sharp fall in domestic demand was also the driver of the recession in 2008-2009. After the adjustment, however, we can see that the main driving factor now is export. Even looking at structural changes in GDP we can see that manufacturing and the transport sectors have increased quite substantially from pre-crisis levels. Indeed the adjustment from the non-tradable to the tradable sector is quite painful, as reflected in the high unemployment rate during the crisis, but necessary in the long run for the economy.

Figure 6.8: Demand, GDP and export growth in Latvia before and after the crisis



Source: Central Statistical Bureau of Latvia

Lessons learnt for Latvia and other countries

I will conclude offering my view on the lessons that we can draw from the Latvian experience from a Central Bank perspective. Indeed Latvia has shown that, for small and open economies a programme of internal adjustment can be done and works well, if the necessary steps are taken. The situation was serious in Latvia, with problematic issues arising in fiscal policy, credit supply and ballooning wages leading to a loss of competitiveness. These were problems we needed to fix and we decided to go through tough structural reforms to resolve them. At the same time we had to leave the right things intact, namely in our opinion the currency peg. Clearly, from a political perspective, it is much easier to find the scapegoat in a currency, but the problems originated from other sources, namely wrong fiscal policies and loss of external competitiveness.

I would like to emphasise again here the flexibility of the Latvian labour market, as a very important precondition for the final success of the adjustment. If you compare the situation in Latvia to other European countries, you can see substantial differences in labour market flexibility. Other preconditions include of course the willingness to do reforms, ownership of the programme by the government and speed. The frontloading of the consolidation effort in the early years was key as well. Here I just want to remind the extent of the consolidation that was achieved in Latvia with two figures. In 2009, roughly 80% of the total consolidation process was done on expenditure cuts; in 2010 this figure dropped to 65% and is now getting lower. It also takes time to do reforms and see the results, so it is necessary to start early and proceed quickly.

As a final point I would like to make clear that the end of the programme must not coincide with the end of reforms. As the discussion has already highlighted further reforms are still needed in various areas, for instance in higher education or in the healthcare system.

IV. From boom to bust and back: the banking system

Martins Kazaks

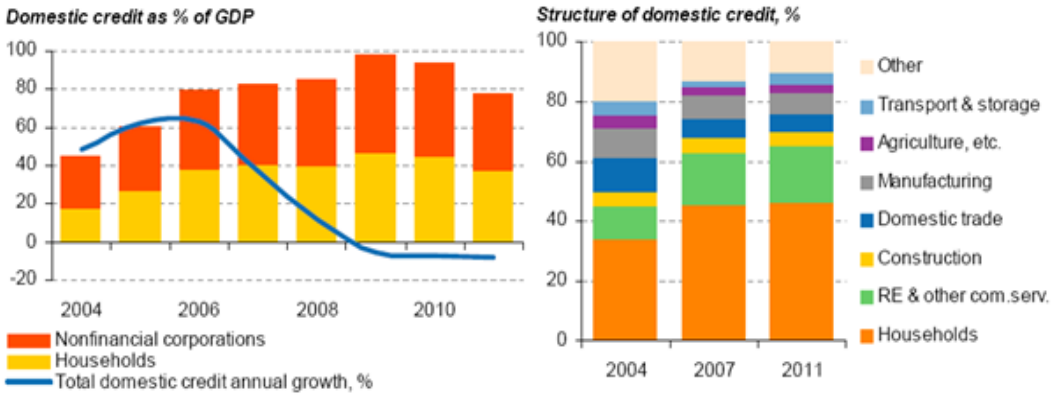
In what follows I will try to present a comprehensive assessment of the role of the Banking System in the Latvian crisis and subsequent recovery. As will be clear soon, banks had their fair share of responsibility, but "it takes two to tango": to have a perfect crash as the one we had in Latvia, we need some kind of input from many different actors.

From boom to bust: Who is to blame?

It is more and more apparent today that this boom was very much based on the false belief that convergence to western standards in central and eastern Europe is simply going to happen no matter what (and at a very rapid pace). Unfortunately this is not the case; the process of convergence is inevitably and strictly related to the ability of national governments to carry out the necessary structural reforms to close the gap. During the boom years there was a widespread belief that convergence in income and productivity would have happened in any case. It was this erroneous belief that fuelled the whole mechanism. Of course, many other aspects added to the boom. Excessive risk taking at a global level; banks' undue optimism both regarding customers' income growth and their own ability to price risk; motivational issues - such as the intense fight for market shares pushed also by sales-based remuneration packages; poor financial literacy and institutional frameworks; the lack of a comprehensive credit register during the boom; the grey economy.

Also national government added to the problem, first of all by conducting pro-cyclical fiscal policies, but also neglecting the imbalances mounting in the economy. In particular, public intervention to correct the imbalances was often delayed because of the political cycle. Wrong or inadequate tax policies, namely real estate being a tax-free zone – which meant that money simply flowed into that area – also added to the boom. It is also worth remembering here that all the mathematical models banks were using were based on a past which was extremely good. All these factors created problems in terms of pricing the risk. Figure 6.9 provides a first description of the imbalances building in the Latvian economy. In the left chart you can see domestic credit as percentage of GDP; on the right total domestic credit is divided into the various components. During the boom period the annual growth rate in domestic credit was indeed impressive, ranging between 40% and 60%. In 2006 total domestic credit jumped to about 80% of GDP, from roughly 40% in 2004. When GDP contracted after the bust, domestic credit got even higher relative to GDP. If you look at the structure of domestic credit shown in the chart on the right, you can see that household credit is largely predominant. This was therefore, by and large, the classical real estate boom and bust scenario.

Figure 6.9: Domestic credit as a percentage of GDP (left pane) and its structure (right pane)

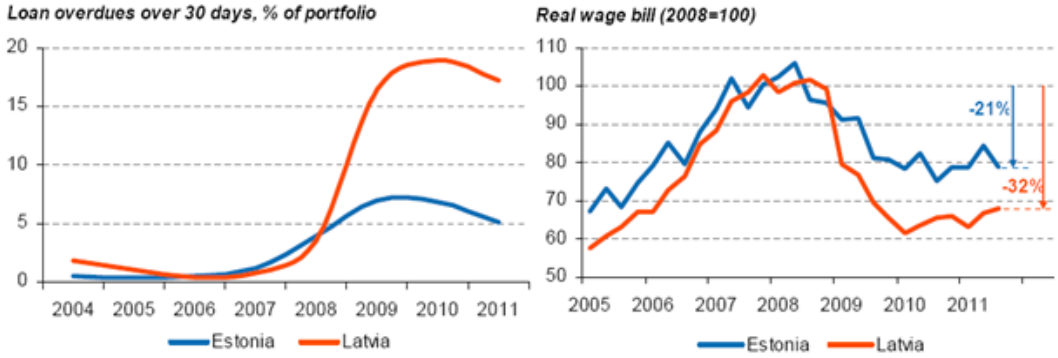


Source: FCMC, Bank of Latvia, CSBL, Swedbank calculations

What happened when all went wrong?

Of course banks were hit massively by the bust. The slowdown of the Latvian economy started already in 2007. Real estate prices started to come down in early summer 2007; recession started in early 2008. But it was Lehmann's bust and the global crash in autumn 2008 that made things worse. At that time there was extreme volatility in the financial markets; this caused recurrent currency attacks, bank runs and an immense liquidity squeeze. The second largest Latvian bank, which was locally owned and did not have backing of a parent outside the country, was bailed out by the government. Within less than two years unemployment jumped to above 20%; GDP contracted by about 24%; real estate prices dropped by about 2/3. Bank losses, up to the end of last year, amounted to about 10% of GDP.

Figure 6.10: Comparison of loans overdue (left pane) and real wages (right pane) in Latvia and Estonia



Source: National banks, Reuters EcoWin

An interesting exercise here is to compare Latvia to Estonia. Looking at Figure 6.10, the numbers are indeed impressive: in Latvia overdue loans jumped to around 20% (in Estonia they peaked at around 7%, about 2/3 less). Considering that Estonia experienced, by and large, a very similar mechanism driving the boom, and the GDP drop was to some extent comparable – in Latvia it went down by 24%, in Estonia by 19% – how could the situation in the two countries be so different? Of course, one possible explanation is non-linearity: there might be some threshold level when things simply get worse (even if this effect is quite difficult to quantify). But non-linearity may not explain everything. The initial position when the crisis set in was important as well. As we can see in retrospect, the imbalances in Latvia were much larger; that meant larger income falls. This explanation is also consistent with what you can see in the chart on the right (wage bill), as in Latvia real wages decreased significantly more than in Estonia. This also implies that the ability to service the debt, for households, also went down much sharper in Latvia. On top of this we know that, in the run-up to the crash, savings rates of Latvian households' were really, really low. Thus, stress tolerance was also very low.

Institutional factors also played a role. The credit register was probably not perfect also in Estonia, but if the major bank is very large, then on the whole, it can mimic itself the credit register, because it knows what is happening with its clients. When the bank shares in the market are significantly smaller (as in Latvia) and the grey economy is widespread, then it becomes very difficult to see what the liabilities of the clients in other banks are. I also want to stress here the role of the judicial system: debt discipline, asset repossession and bankruptcy procedures also added to the depth of the recession and the hit that the banks hard.

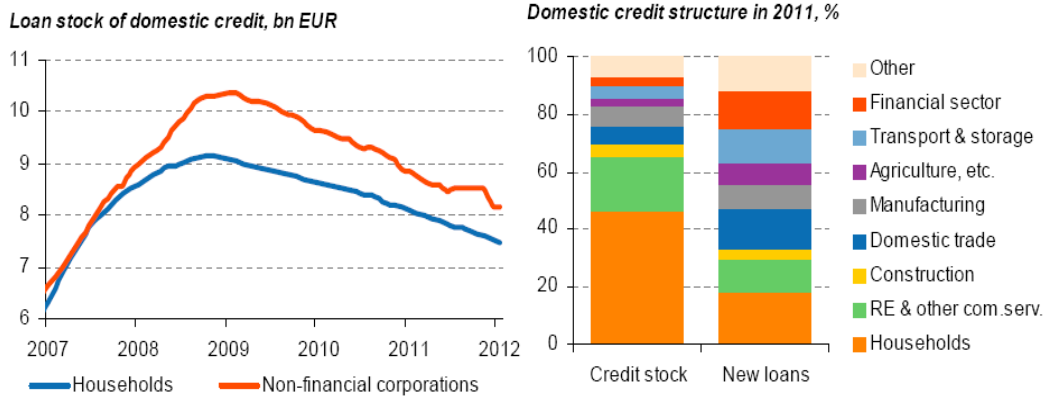
How did banks react during the bust period?

During the bust the response was simply that of damage control. Two central things that I would like to stress here are the central bank's support to the government's chosen exit strategy and the lock-in

by Nordic parents, which was important to create confidence and stabilise capital flows. As the exchange rate remained fixed, the necessity to carry out structural reforms and squeeze the public budget was widely recognised.

The credit crunch caused by the crisis was very sharp, indeed. Credit was by and large impossible to come by and, initially, the banks' behaviour was very aggressive. The reasons were mainly the lack of experience (what we had seen in Latvia was really something unprecedented); the low macro visibility (nobody knew what was coming next), but again important was the weak judicial system and law enforcement. Banks tried to work in a normal way to restructure their assets, by providing grace periods, etc. But because of the weakness of judicial system banks often saw their assets simply being stolen. It was very costly and banks reacted by tightening their behaviour. Another important factor to slow down credit was the reduction of the dependency on external funding (for instance, loan-to-deposit ratios have come down from 260% to 195%). All the boom-year profits were wiped out very quickly. The banking sector has now been fully recapitalised and the current capital adequacy is above 17%. Another important question is whether deleveraging will now continue. With the recovery in the real economy we can see that portfolio quality is improving. In general, there is very strong competition to lend among banks, but still very low risk appetite. This means that there is aggressive selling to a relatively narrow clientele, but for the rest, on the whole, credit is still very much rationed.

Figure 6.11: Evolution of domestic credit for households and firms (left pane) and the structure of domestic credit in 2011, divided into credit stock and new loans (right pane)



Source: Bank of Latvia, FCMC

If you look at Figure 6.11 on the left, you can see that domestic credit has been coming down for some years now, so deleveraging is rife. But I would be very careful when looking at these aggregate data. One thing is the official loan stock data, another one is, what I may call, the effective loan stock data. If you take a look at corporates, probably deleveraging is already over. Even if the risk appetite overall is still rather low, corporates are borrowing (also quite aggressively in certain cases). The credit stock is still sliding down because of the old loans gradually being written-off. If discounted for that, the true or the effective loan stock, it is already rising. For the households the situation is different and we will probably see still for some time the contraction continuing. Thus, in the case of Latvia we can possibly speak of creditless recovery, meaning that household spending growth would rather low for some time and, to my mind, it could only go up with sustained income increases (of course, that needs structural reforms). The chart the right represents the domestic loan structure in 2011: the aggregate composition, as it was at the end of last year, and the new loans issued in 2011. By looking at this graph you can clearly see that the targets of the banking sector have changed; the households' sector is not so dominant anymore in the new lending framework. This change is due on one hand to the new (perceived) level of risk in the households' sector; on other hand due to the significant income loss in the households' sector. On top of this, the decline in households' credit is also the result of a significantly weaker confidence and the unwillingness to take on new debt.

What are the lessons and policy implications?

I think that the world from the banking perspective, at least for the next few years, will be very different. I would say that the key lesson from the crisis is to understand that what happened was not the failure of just one element in the system. It was a failure of the entire system. To make it sustainable one needs to repair the entire system. Thus, what needs to be changed? I will keep it quite narrow, predominantly from the banking point of view. If you take a look at the banking system it seems very clear that banks individually did not appreciate systemic risks fully; this means that there is room for a macro-prudential framework to improve the overall resilience of the system. About banks' risk-taking, it is certainly possible to introduce some rules, but predominantly it is about common sense. Fiscal policy was widely inconsistent with a fixed exchange rate regime; this provides room for additional fiscal rules. As regards parent banks, if you can lock-in strong parent banks, it provides major improvements: it provides capital; limits capital flight; reduces the funding burden on the sovereign. Of course, the grey economy is a threat. It obstructs risk management and exaggerates credit crunch and volatility.

Looking forward let me highlight just three major points. One is that the banking world in Latvia is now different in terms of market size. Are there too many banks chasing a shrinking number of clients? Indeed the macro situation has changed dramatically: emigration has been large; growth is now expected to be significantly lower than it previously was. This means that most likely there will be some changes in the banking system. Another issue is credit growth. One may say that banks should issue more loans to support the recovery, but at the end of the day what is causality of credit vs. economic growth? Banks could (and perhaps should) start to lend more aggressively, but you can lend on a sustainable basis only if there are sustainable growth prospects. If growth will be fast, then there will be more room for lending. This asks for structural reforms with respect to the labour market, regional development, productivity growth and so on. Finally one must understand that banks are not the only ones to finance the economy. Gaps in the market must be filled by other actors, i.e., there is room for a stock market, for risk capitalists and other forms of financing. These market players are very weak in Latvia. Banks will not go back to become risk capitalists any time soon: you need somebody else to do it.

V. Internal devaluation: a cross-country perspective

Ettore Dorrucci

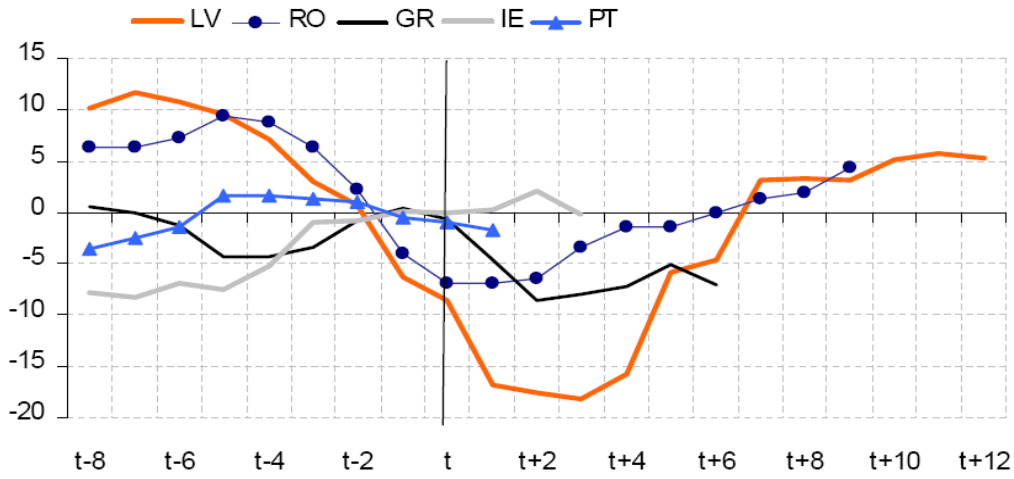
I will focus my remarks on two issues: the first one is an outline of the lessons, if any, that Europe may draw from the Latvian experience; the other is an overview of some remaining challenges for Latvia looking ahead. In doing so I will take a cross-country perspective and concentrate on EU programme countries, which I will use as a sort of benchmark.

Lessons for Europe

In public debates, possibly even during our discussions today, there has been some polarisation about the lessons for Europe that can be drawn from the Latvian experience of internal devaluation. On one side, some economists have argued – this is the "Krugman view" – that Latvia is totally different, so it is impossible to compare Latvia with any other country in the Euro Area. Therefore, according to this – certainly extreme – view there are no specific lessons for Europe. On the opposite side, it has been argued that Latvia is the living example that a strategy of internal devaluation can prove successful: what needs to be done to deliver success also in other countries is just to replicate that experience. As it is often the case when we move from ideology to reality, the truth is probably somewhere in between. Indeed there are some lessons that Europe can draw from Latvia's experience; at the same time the discussion cannot depart from a country-specific examination, as the initial conditions of each country do matter and may significantly differ. This calls for striking the right balance between policy ambition and realism when we try to assess the probability of success of the other on-going programmes.

To make my point, let me reproduce an imaginary dialogue between two economists: a supporter of the "*Latvia is different*" view and a supporter of the "*let's replicate Latvia*" view. These two contenders make their points by looking at a few basic economic variables, in comparative terms, in those EU Member States which are under programme at the moment of this conference: three Euro Area and two non-Euro Area countries. In each chart that follows, t stands for the time when the programme started in a given country. Indexes are used to make proper comparisons. Latvia is the country for which we have more observations, followed by Romania, Greece, Ireland and Portugal.

Figure 6.12: Comparison of real GDP growth in the programme countries

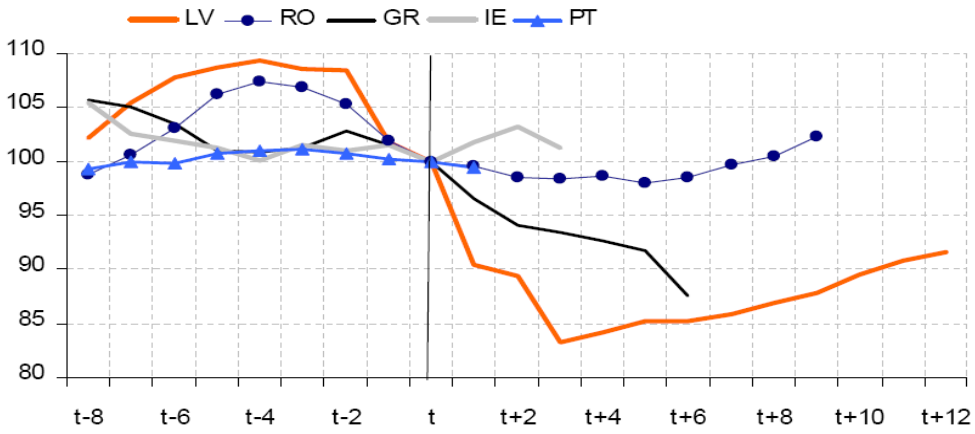


Source: Eurostat. Notes: Quarterly frequency; year-on-year growth rates; t stands for the quarter in which the programme started in the respective country: LV 2008Q4, RO 2009Q2, GR 2010Q2, IE 2010Q4, PT 2011Q2. Latest observation: LV, GR 2011Q4; RO, IE, PT 2011Q3. Data for LV, RO, IE, and PT are seasonally adjusted, for GR they are not seasonally adjusted

Starting with *real GDP growth*, from Figure 6.12 the "Latvia is different" party will argue that the crisis in Latvia was much stronger and steeper than in the other four countries. GDP contraction in Latvia was in fact so unprecedented that it made easier to enforce deep and unpopular reforms. There was something we can call a "crisis effect", the extent of which one cannot really compare with the other countries in the chart. On the opposite side, the supporter of lessons for Europe would argue that the real asset for Latvia, at the roots of this impressively V-shaped recovery, was the frontloading of the policy responses alongside all other good features of the programme designed to address the imbalances.

Turning the analysis to *GDP levels* (Figure 6.13) – but the same could be said in terms of GDP per capita or unemployment – the first group would probably note that, given the strong adjustment it will still take several years before the total level of GDP can come back to pre-crisis levels: according to ECB calculations, depending on the assumptions this could happen between 2015 and 2020.[55] The second group, on the contrary, would react that this is a partial analysis and, comparing the Latvian adjustment to what is happening in Greece, real GDP in Latvia is already above the comparable level where Greece currently stands. Therefore, a frontloaded, V-shaped approach is preferable to a downhill line with a lower slope, but no clear ending. To complete the analysis they would probably also argue that Latvia has grown quite significantly if one looks at the last ten, instead of five years.

Figure 6.13: Comparison of real GDP levels in the programme countries

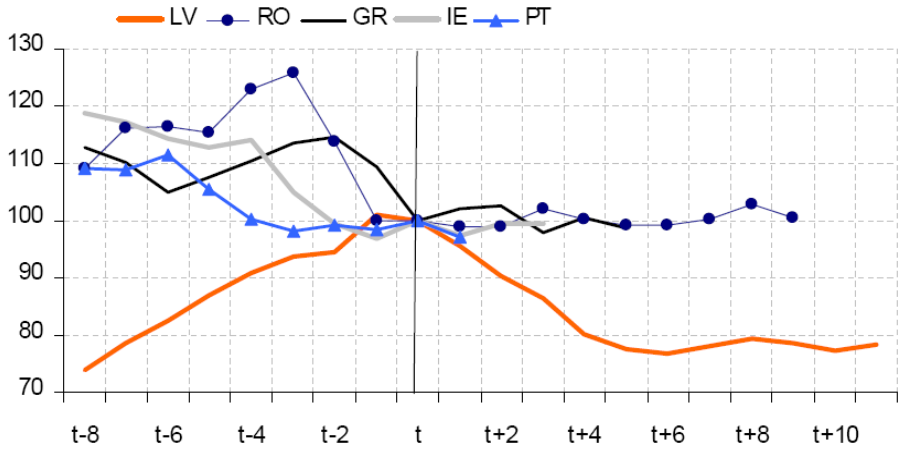


Source: Eurostat. Notes: Quarterly frequency; index, t=100; t stands for the quarter in which the programme started in the respective country: LV 2008Q4, RO 2009Q2, GR 2010Q2, IE 2010Q4, PT 2011Q2. Latest observation: LV, GR 2011Q4; RO, IE, PT 2011Q3. Data for LV, RO, IE, and PT are seasonally adjusted, for GR they are not seasonally adjusted

Let's now turn to *competitiveness*. In Figure 6.14 I use the real effective exchange rate (REER) deflated with total economy hourly labour costs, a standard indicator of competitiveness (even if the use of other, more sophisticated, would be preferable). The first party would probably draw attention to the left side of the chart and look at the pre-programme years, when we can see that the REER had dramatically appreciated. This happened not only as a normal by-product of the catching-up effect, but certainly also due to serious overheating of the economy. This party will conclude that overshooting was clearly stronger than elsewhere and, therefore, it is no surprise that the adjustment was sharper. However, looking at the right side of the chart, the other party would reply that a strategy of internal devaluation is not at all an illusion and can perfectly work. Indeed, when I showed this graph to my colleagues in the Greek team, they were really impressed.

[55] Latvia's real GDP declined by a cumulative 24% between 2007-Q4 and 2009-Q3, and then picked up by a cumulative 10% until the fourth quarter of 2011. At the moment of this conference, Latvia's real GDP stood close to where it was in 2009-Q1, i.e. still 16.3% below its pre-crisis peak in 2007-Q4. Looking ahead, regaining the pre-crisis level of GDP will take a considerable amount of time, depending on the level of potential output growth. If one assumes that potential output growth is 4% (which was the assumption underlying the IMF's public debt sustainability framework for Latvia), it would take until early 2017 before the pre-crisis level of output is reached again, i.e. around ten years after the peak. In a more pessimistic growth scenario of 2% per annum, it would take until 2020. By contrast, if output growth were to pick up to pre-crisis rates (say around 6%), the pre-crisis peak in real GDP would be reached again in mid-2015, though one may wonder about the sustainability of this achievement.

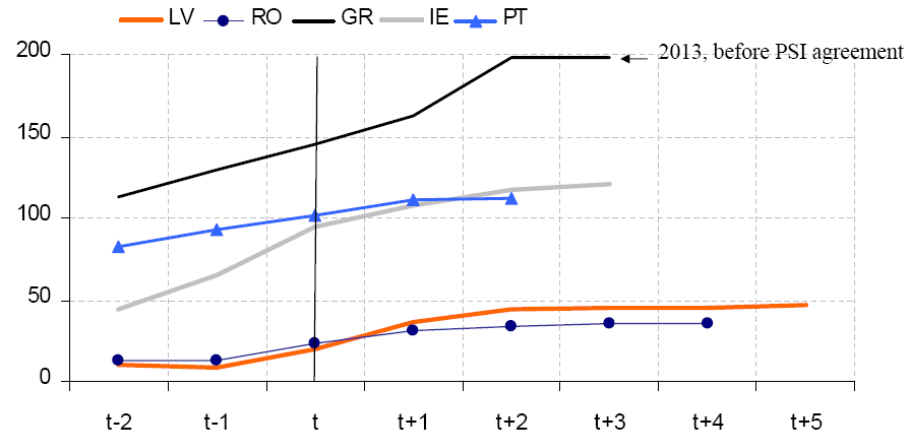
Figure 6.14: Comparison of real effective exchange rate dynamics (deflated with total economy unit labour costs) in the programme countries



Source: Eurostat. Notes: Quarterly frequency; index, t=100; t stands for the quarter in which the programme started in the respective country: LV 2008Q4, RO 2009Q2, GR 2010Q2, IE 2010Q4, PT 2011Q2. Latest observation: 2011Q3

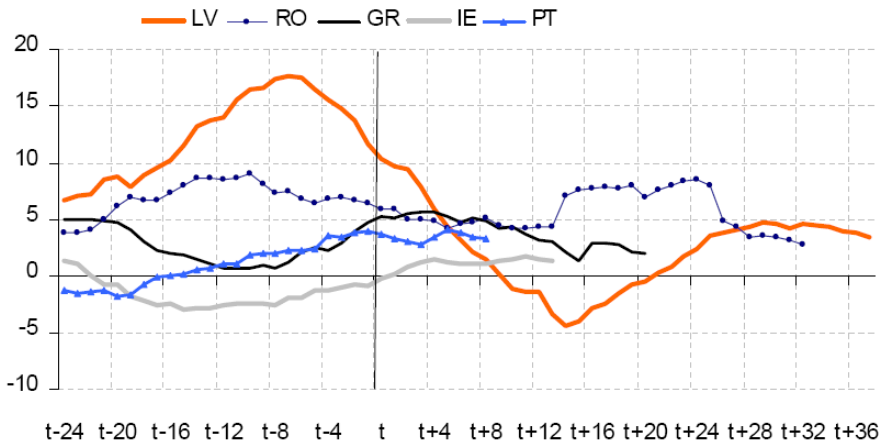
Regarding *public debt* (Figure 6.15), the first party would focus on the fact that Latvia, compared to other programme countries and especially Greece, entered the programme with one of the lowest stocks of general government gross debt in the EU (7% of GDP in 2007). While factors such as the widening of the budget deficit and GDP contraction led public debt to increase strongly, its level currently still stands at a comfortable level, around 45%. Therefore, this party would probably argue that the lessons from Latvia on using the public debt as a shock absorber are not really replicable – at least not in Greece, which entered the programme with a much higher debt level. It is true that both Greece and Latvia could not avoid a worsening of their debt level, but in Latvia this created much less of a burden given its favourable initial conditions. The "let's replicate Latvia" view would instead emphasise that the extent of adjustment in Latvia was comparatively very big. Bank of Latvia estimates Latvia's fiscal adjustment (that is, a comparison with where the budget deficit would have gone in the absence of austerity measures) at around 15% of GDP in 2009-10. This compares with "only" 7% in Ireland (2010-11) and with 16% in Greece (2010-11), where, however, the debt level and hence the adjustment need was much higher. Latvia would therefore, according to this opposite line of interpretation, show that the extent of fiscal adjustment can be very sizeable, thereby setting an example for other countries.

Figure 6.15: Comparison of debt dynamics, as a percentage of GDP, in the programme countries



Source: European Commission services, Autumn 2011 forecast. Notes: Annual frequency; t stands for the year in which the programme started in the respective country: LV 2008, RO 2009, GR 2010, IE 2010, PT 2011. Latest observation: 2013. Data after 2010 are forecasts

Figure 6.16: Comparison of price dynamics (Harmonized Indices of Consumer Prices) in the programme countries



Source: Eurostat. Notes: monthly frequency; year-on-year growth rates; t stands for the month in which the programme started in the respective country: LV Dec2008, RO May2009, GR May2010, IE Dec2010, PT May2011. Latest observation: Jan2012

Finally, looking at *prices* (Figure 6.16), the "Latvia is different" party would probably note that Latvia went through a major deflationary shock, but then there was a rebound – which started already in the second quarter of 2010 – and this lowered real interest rates significantly (which, on the one hand, may have helped lower the debt burden of the country and on the other may have contained the contraction of domestic demand in 2010 and sustained it in 2011). This major drop and rebound in inflation is, at least for the time being, peculiar to Latvia as the figure shows. The other party would probably note that Latvia is not an inflationary country and also this spike in inflation was transitory in nature, as it was mainly driven by temporary factors such as the increase in commodity prices and indirect taxes. The latest inflation projections suggest indeed that Latvia would have good chances to meet the related Maastricht criterion next year.

Table 6.1: Exogenous and endogenous factors underpinning Latvian success

	EXOGENOUS FACTORS		**ENDOGENOUS FACORS**
	"Countries' initial conditions"		***"Right policy does deliver"***
	Very country-specific	**Possibly in common with other countries**	**Appropriate EU/IMF conditionality, WB support**
Factors that played in favour of Latvian success	**Magnitude of crisis shock and pre-crisis imbalances** **Perceived lack of alternatives** **Magnitude of loans denominated in a foreign currency** **Collective memory of past crises that were successfully overcome**	**Small open economy** **Low stock of public debt at the beginning of the crisis** **Prospects of euro adoption**	**Frontloading of measures ("Big bang" approach)** **Proper communication strategy** **Overall government credibility**
Factors whose effects were mixed		**Degree of market liberalisation**	**Distribution of costs**
Factors that played against Latvian success		**Electoral rules, form of government** **Degree of party fragmentation and political (in-)stability**	**Government's cohesion**

The debate between the two parties could continue for long on other aspects, but, all in all, the real issue is that the probability of success of the implementation of an internal devaluation strategy in one country really depends on two groups of factors: (i) factors that are totally exogenous to the incumbent policy-maker (we can call them the "initial conditions" and we can further divide them into two groups: those which are very country-specific and those which can be shared with other countries if they are lucky enough); and (ii) factors that are endogenous to the policy-maker and indeed support the conclusion that the right policies do matter for the success of the strategy. By following this taxonomy, in Table 6.1 I have summarised those factors that have been underpinning the success in Latvia, those which played against it and those whose effects were a bit mixed. As you can see, in the Latvian case there were many facilitating factors, but also some difficulties which may be shared by other programme countries. However, a similar table would have to be replicated for each of the other programme countries, as each one has its own specificities and challenges, so it is just meant to clarify that many endogenous and exogenous factors have to be taken into account to draw an effective policy response.

Lessons for Latvia

Looking forward, a few remarks are due. Here, again I will use some cross country comparisons, but this time through the whole EU27. I think that the core challenge for Latvia looking ahead will be locking in the competitive gains that have been achieved in recent years. This will be absolutely crucial to achieve sustainable convergence in a context where there is a lot of catching up and the monetary policy instrument is not available to prevent boom/bust cycles. How to achieve this objective? I think we all agree that the scope for wage and price adjustments, to the same extent as it happened in 2009-2010, is much more limited and there are several other factors that matter for competitiveness that are not price factors. This suggests that the focus should be on further structural reforms to enhance productivity, create the right environment for price and wage moderation and keep unit labour costs under control. But structural reforms are essential also to foster non-price competitiveness and reduce structural unemployment.

This is not to deny neither that Latvia has already been improving a lot on non-price competitiveness – in particular in the quality of its exports - nor that Latvia has been improving a lot in the World Bank's "ease of doing business" indicator. Latvia now ranks 7th in this indicator among EU countries and 21st in the world, which is remarkable. But there are also several other reports that still point to the need to achieve further improvements in various areas. For instance, if you look at the World Economic Forum's "global competitiveness index" or the "corruption index" compiled by Transparency International, or the overall "governance indicator" compiled by the World Bank Institute, you can see that, looking at the average of these most common indicators, Latvia ranks only 21st among the 27 EU countries.

Some important gaps still exist, therefore. There is room for improvement, for instance in reducing labour taxes, fighting corruption, improving access to finance and so on. To conclude, let me highlight a very interesting point. If you look at the whole sample of 27 EU members, Latvia is the country which displays the strongest dispersion of ranks. This shows at the same time that Latvia can deliver on structural reforms (as shown by the "ease of doing business" indicator) but there is still significant scope for improvement – maybe starting from the labour market.

Part III – Political dynamics

Chapter 7 – Fiscal austerity, structural reforms and re-election: explaining the "possible trinity" in the case of Latvia

Marion Salines [56]
KristapsBērziņš

I. Introduction

One crisis may hide another one… It is not rare that an economic crisis is accompanied by a political crisis. In 'stormy' times governments are often required to adopt tough economic policy measures, which are politically costly in line with the oft-repeated claim that 'good economics is necessarily bad politics' (Tompson, 2009). The current economic crisis largely confirms this conventional wisdom. Italy, Greece, Ireland, Portugal, just to name a few: in all those countries the fall of the government was directly linked with its handling of the economic crisis. Even though not having such extreme implications everywhere, the crisis has weakened a number of governments across Europe, notably by contributing to the rise of populist parties (e.g. Finland, France).

Compared to these developments, the case of Latvia seems rather peculiar. It is one of the countries that has been most severely affected by the financial crisis in Europe, if not in the world. Among the 184 member countries of the IMF, Latvia suffered from the largest cumulative output loss from 2007 to 2010 (22%) (Darvas, 2011), while recession temporarily pushed unemployment up to over 20% (Purfield and Rosenberg, 2010). Latvia had to turn to the EU, the IMF and regional neighbours for financial assistance, not least because it stepped in for its second largest bank, Parex Banka, in December 2008. It carried out a cumulative fiscal adjustment of 17.5% of GDP between 2009 and 2012.

The policy strategy followed by the government was based on maintaining the exchange rate arrangement (i.e. peg to the euro) and pursuing internal devaluation through contractionary fiscal and nominal wage policies as well as some structural reforms. Notwithstanding these stringent measures, Prime Minister Dombrovskis was re-elected in October 2010 with an even stronger parliamentary majority. Not only did he not fall, but he also displayed the best individual score ever in the electoral history of the country (Kalniete, 2011). The legislative elections of September 2011 have also broadly confirmed this finding: even if his party did not score such a good result, Dombrovskis was still the most popular candidate for the post of Prime Minister among eligible voters (IR, 2011). He remained Prime Minister, though with a different ruling coalition.

By defying conventional wisdom, the case of Latvia has attracted a great deal of attention from international commentators and policy-makers. A journalist of The Economist wrote for example with a certain sense of humour that "the Houdini award for political survival goes [in 2010] to Valdis Dombrovskis, the prime minister of Latvia, who imposed the most swingeing austerity programme seen anywhere in Europe in past decades – and got reelected. Should he tire of Latvian politics, he faces a warm welcome in Ireland" (Lucas, 2010). Dombrovskis also earned much respect from fellow politicians across Europe: "MEPs told me [Sandra Kalniete, Latvian Member of the European Parliament] of the admiration that Western Europe's leaders have for Dombrovskis because of the courage and calm determination he showed" (Kalniete, 2011). As Prime Minister Juncker used to say, "we all know what to do, but we don't know how to get re-elected once we have done it" (The Economist, 2007). How did Dombrovskis succeed in being the exception to the rule?

[56] The authors would like to thank Ettore Dorrucci, Martin Bijsterbosch, Gundars Ostrovskis, Beatrice Scheubel, Livio Stracca, Gabriel Glöckler, Stefan Huemer and Demos Ioannou for their useful comments. Any errors or omissions are exclusively the responsibility of the authors.

Getting a better understanding of the Latvian experience is in so far interesting as Latvia, though not being member of the euro area, chose to strictly stick to the peg and was thus de facto subject to the constraints of a monetary union. At a time when a number of euro area countries need to undertake drastic fiscal consolidation, it is useful to understand how austerity measures could be associated with electoral victory.

A review of the existing commentary shows that the reasons for the apparent 'paradox' of Dombrovskis' re-election have so far not been thoroughly explored. According to critical observers (Hudson and Sommers, 2011), the absence of massive protests and the political success of Dombrovskis could be attributed to ethnic voting - which limited the possible choices of voters -, the absence of strong labour movement and the fact that Latvians preferred emigration to political protest. As these factors are largely country-specific, no lesson could allegedly be drawn from the Latvian case for other European countries such as Greece or Portugal. Though partly valid, such arguments overplay the importance of the Latvian context and fail to explain why the predecessor of Dombrovskis did not succeed in imposing austerity measures. In January 2009 violent riots broke out in Riga and led to the resignation of Prime Minister Godmanis.

The purpose of this chapter is to close the analytical gap by undertaking a comprehensive assessment of the possible explanatory factors of Dombrovskis' re-election. In other words, it aims to identify those relevant factors that allowed Dombrovskis to carry out an ambitious internal devaluation strategy without encountering large-scale social resistance and eventually to win the subsequent elections.

To that end, it resorts to the political economy literature covering both fiscal consolidation and structural reforms. The literature has identified a number of economic, political and institutional factors that affect the implementation of a stabilisation policy and structural reforms. They are usually subdivided into factors that are exogenous to the political process (i.e. country-specific factors) and factors that can be influenced by government actions (i.e. incumbent-specific factors) (Hoj et al., 2006). Even though they interact with each other, exogenous and endogenous factors are examined separately for analytical purposes. After reviewing the theoretical propositions of the political economy literature, we investigate whether they played a relevant role in the Latvian case.

As a caveat, it is important to highlight that our analysis does not assess whether the measures taken by the Dombrovskis government have been appropriate and effective from an economic viewpoint. Even though the Latvian economy has rebounded faster than expected and grew by 5,3% in 2011, the long-term structural effects cannot be fully assessed yet. In the same vein, we do not assess whether the action of Prime Minister Dombrovskis has been fair from a social viewpoint.

The chapter is structured as follows. Section II investigates the effects of exogenous factors and thereby assesses the extent to which the country context explains the successful implementation of the internal devaluation strategy. Section III analyses incumbent-specific factors and discusses to what extent the political outcome can be attributed to the specific strategy followed by Prime Minister Dombrovskis compared to his predecessor. The concluding Section attempts to draw lessons from the Latvian experience for euro area countries.

II. Latvia in the late 2000s, an "easy" country to stabilise and reform?

This Section focuses on the reform context, i.e. on how economic, institutional and political conditions have affected the government's capacity to implement austerity measures and structural reforms. In other words, it focuses on exogenous factors that were beyond the control of Prime Minister Dombrovskis and could either facilitate or impede the successful implementation of his internal devaluation strategy. It first looks into structural economic factors such as the openness of the country and the degree of flexibility of its markets (1). It then turns to political and institutional factors such as electoral rules, the form of government and the degree of political instability and fragmentation (2). Finally, it investigates the extent to which the prevailing macroeconomic conditions facilitated the public acceptance of the stabilisation programme of the Latvian government (3).

II.1 Economic factors

- Propositions of the political economy literature

The underlying economic structure of a country can influence its government's capacity to implement fiscal and structural reforms in several ways. The first set of determinants consists of the size and openness of the country.[57]

It can be expected that the pressure for reforms increases with the openness of the economy, as the latter raises the costs of inaction and thereby strengthens the incentives of governments to undertake reforms (IMF, 2004). This is confirmed by empirical evidence. Independently of the monetary policy regime, small economies seemed to be more active reformers over 1985-2003 (Duval and Elmeskov, 2006). This can be explained by the fact that the slack resources created by reform are more quickly taken up through changes in net trade in small open economies. In larger economies, by contrast, trade is less powerful as a mechanism for "crowding in" the added supply capacity (Duval and Elmeskov, 2006). A complementary microeconomic explanation is that domestic firms are usually subject to significant competitive pressures from openness to trade and FDI in a small open economy and can thus be expected to be more vocal in pushing for product and labour market reforms (Hoj et al., 2006). However, the field of taxation warrants special attention. According to an IMF study, more open economies certainly tend to be more active in the area of labour market, but appear on average more reluctant to reform their tax systems (IMF, 2004). This may be due to the fact that small open economies generally tend to have larger governments and stronger automatic stabilisers as they are more vulnerable to economic shocks (Rodrik, 1998).

A second factor relates to the initial structural conditions in the labour, product and financial markets, i.e. the degree of liberalisation of these markets. Empirical evidence is rather mixed in this regard. The results of the IMF study suggest that countries with more restrictive initial conditions were on average more active reformers, with the notable exception of product markets (IMF, 2004). A possible explanation is that, in highly regulated and heavily taxed economies, the costs of inaction are significant, which should favour mobilisation for reforms (IMF, 2004). At the same time, Buti et al. found out that the chances of re-election of a government decrease with the degree of rigidity of product and labour markets, suggesting a 'rigidity trap'. In those rigid countries, the categories benefiting from rents through heavy regulation are determined to maintain the status quo (Buti et al., 2010). Reforms are strictly opposed by such vested interests and prove therefore politically costly.

As regards more specifically financial markets, the existence of liberal financial markets seems to diminish the electoral costs of reform by smoothing consumption and income and by helping to absorb possible short-term losses (Buti et al., 2010).[58] Financial market liberalisation also provides a stronger incentive to implement domestic reforms that attract foreign capital (Hoj et al., 2006).

- Latvian case

With just above 2 million inhabitants, Latvia is obviously a very small country. In order to compensate for its small size and – most significantly – its past 45 years as command economy within the Soviet Union, Latvia embraced from the early 1990s onwards the path of free-market reforms and integration with the West. It proved an "early and avid reformer" (Purfield and Rosenberg, 2010) by following the 'Washington consensus' and embarking on wide-ranging price and trade liberalisation and privatisation. In particular, it pursued an open trade policy by signing numerous free trade agreements in the 1990s, becoming a member of the WTO in 1999 and eventually joining the EU in 2004. It thereby became largely oriented towards Europe (above 80% of

[57] These two determinants are closely interrelated: given the limited size of their domestic market, small countries need to adopt open trade policies to be economically viable (Alesina and Wacziarg 1998: 307).

[58] This finding of the literature has been partly questioned by the experience of the current financial crisis which has most hardly hit those countries with well-developed and globally integrated financial markets. It remains valid when the causes of the crisis do not lie in the financial sector and when structural reforms are conducted.

total exports in 2002-2007) (European Commission, 2010). In the Index of Economic Freedom 2011 Latvia displays a very high score as regards trade freedom (87.6).

Beyond this openness to trade, Latvia also based its economic development strategy on openness to foreign investors. Massive capital flows to Latvia and the quick integration of Latvia into the global financial markets were a key driver of the catching up process, while at the same time constituting a source of vulnerability. Between 1999 and 2007 Latvia's financial openness had more than doubled (European Commission, 2010). Foreign direct investment inflows were a substantial source of capital.[59] But even more striking are the dynamics of other investments (i.e. loans to banks and to other sectors), which became five times larger than FDI (European Commission, 2010). The level of foreign ownership of banks' assets reached around 65% in 2007 (European Commission, 2010), while in 2008 more than 80% of loans to the private sector were foreign currency denominated loans, mostly in euros (European Commission, 2010).

Both the openness to trade and FDI and the penetration of the Latvian domestic market by foreign financial institutions have been stimulated partly by the existence of a currency peg to the euro since 2005. This arrangement has not only been perceived as an anchor of macroeconomic stability and as an essential ingredient to attract foreign investors.[60] Combined with the EU membership, it is also seen by the mainstream political class as a key element of Latvia's firm political anchoring in Europe (away from Russia). In addition to the economic considerations, it is thus important to bear in mind the (geo-) political dimension of the euro peg.

All these elements play a role in explaining the path followed by the Latvian government. When the crisis hit Latvia, the IMF was ready to consider exchange rate depreciation (IMF, 2010). This was categorically rejected by the Latvian government, who remained determined to protect the currency peg and decided instead to follow an internal devaluation strategy. Even in extremely difficult economic circumstances, the utmost priority was to maintain investors' trust and to join the euro area as a means of being fully integrated – both economically and politically – into the EU (Reinert et al., 2010). This view was supported by a strong national consensus: in August 2009 almost two-thirds of Latvians wanted the peg to the euro to remain unchanged (IMF External Relations Department, Morning Press, August 4, 2009, quoted in Aslund, 2010). This broad support might be explained by the collective memory of the painful currency reforms and the associated high inflation (up to 1000%) after the collapse of the USSR that wiped out most of the population's savings.

Another specific economic feature outlined above played an even more important role in this policy choice. As the vast majority of bank loans to corporates and households were denominated in euros, a devaluation would have dramatically reduced private sector net worth. This would have had negative feedback effects on the financial system and the economy as a whole (Purfield and Rosenberg, 2010). In political terms, external devaluation would have been rather unpopular among all those households indebted in euros. This would have been also resisted by the influential foreign-owned banks present in Latvia.

To sum up, the openness of the Latvian economy and the existence of an external anchor largely conditioned the policy choice of the Latvian government (internal vs. external devaluation), helped it to justify its strategy towards the public opinion and thereby facilitated its painful implementation.

As regards the second factor identified by the political economy literature (i.e. degree of flexibility of markets), Latvia has proven its overall flexibility and its ability to overcome crises on several occasions in the recent past. During the 1990s, Latvia saw large swings in output and inflation and experienced periods of crisis followed by prosperity (the post-USSR recession, stabilisation and rapid recovery and then the Russian crisis). This has certainly increased the economy's (and more generally also the population's) resilience to economic shocks (Purfield and Rosenberg, 2010).

[59] They accounted on average for 22% of fixed capital formation over the period 1995-2006 (European Commission, 2010).
[60] In the run-up to the financial crisis ECB policy-makers have expressed concern that the euro peg may be a 'straightjacket' for catching up economies in Central and Eastern Europe. Keeping inflation under control becomes particularly challenging in those countries which have given up monetary policy independence such as Latvia (see e.g. Bini Smaghi, 2007).

A good proxy of a country's regulatory environment is the Ease of Doing Business indicator (World Bank),[61] where Latvia ranked 21 in 2011 (7th in the EU).[62] In particular, Latvia is usually considered to have flexible labour markets. In fact, while wage setting is among the most flexible in the world, there is a relatively high degree of de jure rigidity in employment contracts (IMF, 2010), significant skill mismatches and a high level of long-term unemployment. This explains why the labour freedom component of the Index of Economic Freedom 2011 is only moderate (61,3). The Latvian labour market responded to the crisis through substantial adjustment in wage costs in public administration (-26%), while the change in hourly labour costs seemed to be much more modest in the private sector (e.g. -2% in manufacturing) (Darvas, 2011). However, this official data must be interpreted with caution given the widespread grey economy and the amount of undeclared income. In the 'boom' sectors (e.g. construction) the actual income of workers has probably decreased much more dramatically than indicated in the official statistics, though it is of course difficult to have precise estimates. In any case, given the magnitude of the recession, nominal wage falls were not sufficient to absorb the effects of the crisis, and employment fell by 17% between 2007 and 2010 (Darvas, 2011).

As regards financial markets, a process of bank restructuring, privatisation and deregulation (i.e. removal of government control on credit markets) was initiated in the late 1990s. During the 10-year period starting in 1997, domestic credit was multiplied by 9 in Latvia (European Commission, 2010). According to the propositions of the literature, this rapid financial market development should have helped to smooth consumption and income and absorb possible short-term losses. On the contrary, when the crisis unfolded, Latvia was rapidly faced with a credit crunch. In fact, the crisis had been mainly caused by the build-up of financial sector vulnerabilities linked to the real estate sector, in particular excessive credit growth which, in combination with the global financial crisis as a trigger, led the bubble to burst. Widespread 'deleveraging', flight to safety in global financial markets and falling asset prices in Latvia led to a progressive tightening of lending standards by banks. This resulted in very limited access to foreign credit and very high risk premia on financial assets denominated in local currency (European Commission, 2010), reinforced by the ever-present devaluation risk. Even after the government decided to follow the internal devaluation path, speculation was rife that it would fail to implement this scenario.

To put it in a nutshell, the overall flexibility of the Latvian economy as a result of previous crisis experience has only partly helped the Dombrovskis government to implement his strategy. Even though labour and financial markets were relatively liberalised and flexible, this was far from sufficient to smooth out the effects of the crisis. In the latter case, this has even aggravated the severity of the crisis. The government was confronted with the most severe output contraction ever since the 1930s, a significant credit crunch and very high unemployment, which made the implementation of its strategy more challenging and risky in political terms.

II.2. Institutional and political factors

- Propositions of the political economy literature

Institutions can influence a government's reform capacity in the way that they structure and mediate political processes. Prominent research on the influence of the constitution on economic performance has been carried out by Persson and Tabellini (2004). Their overall finding is that constitutional rules systematically shape economic policy.

The first channel through which institutions can do this is a country's electoral rules. Governments elected in majoritarian systems can be expected to enjoy more flexibility to design 'first best' reforms than those elected under proportional rules, because their (usually) strong parliamentary majority helps in overcoming the resistance of small constituencies to reforms (IMF, 2004). This is empirically confirmed. According to the IMF study, governments backed by a strong parliamentary majority – which occurs more frequently in majoritarian systems – undertook on average more

[61] A high ranking on the Ease of Doing Business index means that the regulatory environment is more conducive to the starting and operation of a local firm. This index averages the country's percentile rankings on 10 topics.
[62] Latvia ranked 29 in 2009 when the Dombrovskis government took office.

reforms (IMF, 2004). As regards spending, a similar effect can be observed: legislatures elected under plurality rule spend about 10% of GDP less than legislatures elected under proportional representation (Persson and Tabellini, 2004).

At the same time, it can be argued that proportional elections tend to better serve the interest of broad majorities than majoritarian elections (Persson, 2003). This could imply that proportional systems favour moderate and gradual policy changes with a low risk of reversal, whereas majoritarian systems sustain more ambitious reform agendas but with a greater risk of reversal (IMF, 2004).

The second channel is the form of government, for which the arguments and empirical evidence very much mirror those on electoral rules. Presidential systems seem to display more effectiveness in terms of policy implementation than parliamentary ones. In particular, stabilisations of budget deficit and inflation are more successful and easier to come by in presidential systems (Alesina et al., 2006). The year after a country enters a crisis, the average response to a budgetary deficit in presidential systems is about as twice as large as in parliamentary systems. Consistent empirical results exist for public spending in general: there is a very strong negative correlation between government spending and presidentialism (Persson and Tabellini, 2004). This is because presidential systems tend to empower large and homogenous constituencies (Persson, 2003). The strength of the executive is further increased by the absence of confidence motion and fewer veto players, which helps it to overrule political opposition to reform.

However, presidential systems, precisely because of this concentration of power in the hands of the executive, may generate very uneven distribution of costs of the stabilisation (Alesina et al., 2006). Moreover, in those political systems fiscal policy tends to be more procyclical (Persson and Tabellini, 2004) and more volatile (Andersen, 2011).

Finally, structural features of a country's political system such as the degree of political fragmentation and the extent of ideological polarisation do matter for the smooth implementation of reforms. They are key in mediating (or exacerbating) conflicts between vested interests and in facilitating (or hindering) the formation of broad and stable coalitions needed to support ambitious reforms (IMF, 2004).

- Latvian case

Under Latvia's parliamentary Republic, the unicameral Parliament (Saeima) is elected for a four-year term by proportional representation with a 5% threshold. The Prime Minister and the Cabinet need to be confirmed by a confidence vote of the Saeima before taking up their functions. They can be dismissed through a vote of no-confidence. The President is elected by the Parliament and, though he is entrusted with some important institutional prerogatives (e.g. rights to initiate legislation, to return draft laws to Parliament for reconsideration and to call for a referendum to dissolve the parliament), his role is closer to the German than to the French or American President. According to the findings of the political economy literature, both the electoral rules and the form of government prevailing in Latvia do not seem to be conducive to the implementation of an ambitious anti-crisis agenda.

This preliminary finding is confirmed by empirical data. The past two decades since the independence have been characterised by a high degree of instability and fragmentation of Latvian politics. On average, governments have taken a long time to form and, once in office, have failed quickly (Conrad and Golder, 2010). Between 1993 and 2008, the average government duration in Latvia was less than one year, i.e. 325,1 days. It is by far the lowest figure among Central and Eastern European countries.

Most of the sixteen governments in place over this period were coalition governments, which could only rely on a slim majority or even no majority at all. Out of the sixteen, seven were 'minority coalition governments' (multiple parties in government that together do not control a parliamentary majority), and four were 'minimal winning coalition governments' (each party in government is needed to maintain a parliamentary majority) (Conrad and Golder, 2010). Figure 7.2 cannot illustrate better the complexity of Latvian politics.

Moreover, the political landscape has been deeply fragmented since the independence. In the first elections held in 1993, 23 political parties were registered (Central Elections Commission). Even though some consolidation has taken place, not least under the effect of the 5% threshold, this figure has remained high. For example, 16 political parties have been in government between 1993 and 2008 (Conrad and Golder, 2010). One important reason for this political fragmentation is the persistence of a double dividing line, i.e. of ideological and ethnical nature. The Soviet-period legacy of a sizeable Russian-speaking minority has given rise to regular quarrels on the language and citizenship issues, and explains the division of the political landscape between parties representing ethnic Latvians and parties drawing their support from the Russian-speaking population.

According to some observers, this persistent ethnic cleavage would largely explain the re-election of Dombrovskis. Hudson and Sommers argue that voting patterns in Latvia are still mainly shaped by ethnic divisions, and that the ideological differentiation within each camp hardly exists: ethnic Latvian parties would be mostly neoliberal, while the Russian-speaking population could only vote for a "loosely Keynesian" party (Hudson and Sommers, 2011). As the ethnic Russians are a minority, the outcome of elections in terms of economic policy would be pre-determined. This argument ignores the fact that the available choice among predominantly Latvian parties covers a rather diverse spectrum of economic ideologies, ranging from liberals to social democrats. If anything, it holds true only for the predominantly Russian parties, where indeed policy issues relevant to the Russian minority are usually coupled with left-wing economic policies. In any case, the electoral campaign in Fall 2010 had been mainly dominated by economic rather than ethnic issues.

It is also worth mentioning an important feature of the Latvian political life: elections are quite often won by "white knights", i.e. newly formed political parties presenting themselves as genuine alternatives to the government in place. Contrary to more established political systems, it is relatively easy to found a new political party in Latvia. In the run-up to legislative elections, popular figures have thus often created their own party to challenge the incumbent government and have enjoyed high political capital. This happened for example in 1998 and 2002 when respectively the People's Party (led by Andris Šķēle) and New Era (under the leadership of Einars Repše) won the elections. In a context where the government had to take unpopular decisions, one could have easily imagined the repetition of such experiences through the emergence of populist movements - as elsewhere in Europe. Even though this finally did not happen in 2010, this was a permanent threat to the political survival of Dombrovskis.[63]

At the same time, Dombrovskis could benefit from the benevolent support of the President, who engaged actively to facilitate the government's efforts towards an economic stabilisation of the country. President Zatlers used his constitutional powers to convene and to preside over extraordinary meetings of the Cabinet – which had been done very rarely in the past. Upon his own initiative he participated in the Cabinet meeting on 11 June 2009 and helped to strike a deal on the amendments to the budget for 2009, on which the disbursement of the EU/IMF loan was conditional. His role was deemed crucial by some participants of the meeting (e.g. Minister of Justice Mareks Segliņš) (Diena, 2009c). He publicly supported the Dombrovskis government at critical junctures e.g. by condemning the departure of the People's Party from the coalition in March 2010. Finally, in the run-up to the parliamentary elections of 2010, he made clear that a key criterion for the nomination of the next Prime Minister was the successful continuation of the EU/IMF programme (Zatlers, 2010).

Notwithstanding the benevolent attitude of the President, all in all, the structural characteristics of the Latvian political system did not offer a favourable context to the conduct of an austerity programme.[64] In view of the track record described above, one may have expected a political crisis to emerge besides the deep economic crisis.

Interestingly, Aslund and Dombrovskis put forward a counterintuitive argument according to which "parliamentary systems with many parties, leading to coalition governments and frequent changes,

[63] A somewhat similar scenario unfolded in 2011, when President Zatlers initiated a referendum to dissolve the Saeima just a few days before a vote on his own reelection as President. After the referendum resulted in the dissolution of the Parliament, he founded a new party and came second in the following early elections.

[64] The structural characteristics of the Latvian political system may have also contributed to the build-up of economic and financial imbalances and vulnerabilities. This would deserve to be assessed under a separate study.

may be beneficial for the resolution of macroeconomic crisis" (Aslund and Dombrovskis, 2011). It is true that the political system allowed Latvia to quickly switch government during the crisis without requiring the organisation of elections: the crisis contained the seeds for its own solution. As a matter of fact, early elections would have cost valuable time and, by increasing the level of uncertainty, would have made financial markets and international creditors even more nervous. At the same time, one may argue that, due to the climate of recurrent political instability, a 'sword of Damocles' was permanently hanging over the Dombrovskis government. This has partly impeded his action, as will be shown in Section III.2.

Apart from the traditional political and institutional factors, another important exogenous factor relates to the role of the Constitutional Court during the crisis. The Court enjoys much respect among the population.[65] It is also quite liberal as far as possibilities to launch a case are concerned: not only state institutions but also individuals may turn to the Court if they deem that their constitutional rights have been violated. The Latvian Constitution guarantees a number of fundamental social rights (e.g. right to social security). This has enabled the persons concerned by the austerity measures to contest them through legal channels instead of taking to the streets.

Under the first term of Dombrovskis constitutional challenges against government decisions have been numerous. The most significant complaint was against the 10% reduction of pensions and a 70% cut for working pensioners. By July 2009 more than 9 000 applications contending the constitutionality of the measure had been submitted, leading to an official appeal by the Court's press service to stop sending applications as the staff was overwhelmed by their sheer amount (Diena, 2009d). Finally, the Court found the pension cuts to be a violation of the Constitution (Constitutional Court, 2009).[66] While, on the one hand, the Court impeded the government in its strive towards fiscal consolidation, on the other hand, it offered a rules-based forum to settle disputes and thereby contributed to avoid social unrest.

Last but not least, the external pressure exerted by international creditors played a crucial role. The implementation of the EU/IMF financial assistance programme was governed by strict conditionality: disbursement of loan tranches was made conditional upon strict compliance with the agreed budgetary commitments. Latvia was subject to thorough monitoring: as former President Zatlers expressed it, Latvia had a "coach" (i.e. the EU), a "policeman" (i.e. the IMF) and a "nanny" (i.e. the World Bank) (Deutsche Welle, 2010). Some have argued that the involvement of these international institutions has provided a certain "smokescreen" for the Latvian government for unpopular measures (Reinert et al., 2010). As a matter of fact, the Prime Minister exploited this external pressure to his benefit to convince his coalition partners and the public opinion. For example, when the Parliament was reluctant to accept the LVL 500 million (€ 720 million) deficit cut agreed for the 2010 budget, the European Commission and some national governments which had promised bilateral loans (e.g. Sweden) stepped up pressure on party leaders, thereby contributing to a positive voting outcome. This has also allowed to partly shift the blame from the government to external actors and has thereby facilitated the task of the Prime Minister. A prominent politician of the People's Party declared that: "Nothing else is left other than to fulfil the unreasonable demands of the international lenders" (EU Observer, 2009).

II.3. Macroeconomic conditions

- Propositions of the political economy literature

According to a widespread assumption, it is easier to reform and to stabilise in times of crisis. "If there is one single theme that runs through the length of the political economy literature it is the idea that crisis is the instigator of reform" (Rodrik, 1996). Alesina et al. find empirical support for this

[65] In fact, the Constitutional Court is the most trusted institution of Latvia. About 70% of Latvians trust the Constitutional Court, only 19% trust the Parliament (NRA, 2010)

[66] The pension cuts were struck down because the Constitutional Court found that the government had not explored the less burdensome alternatives, and therefore deemed it a violation of the right to social security. The cut for working pensioners was rejected also because it violated the legitimate expectations of pensioners by not giving them sufficient time to assess the changes introduced by the law on their financial situation and quit their employment contracts if necessary.

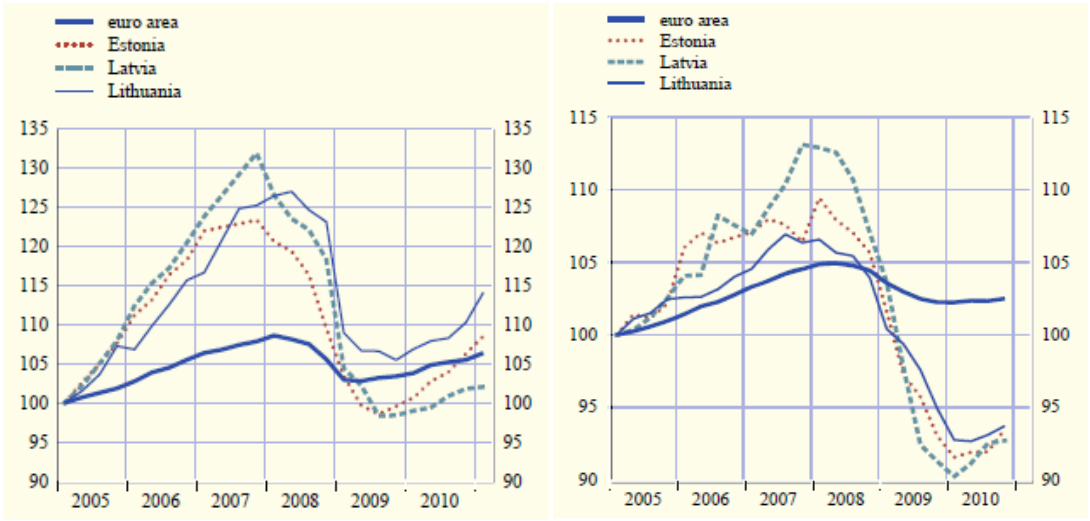
hypothesis both for inflation and budget deficits, and explain it through the "war of attrition" model.[67] when a crisis emerges, the relative costs of waiting and fighting the war tilt towards concession (Alesina et al., 2006). Other research found a U-shaped relation between crisis and reform intensity: reforms are weakest when a country experienced "medium crisis" in the previous period as compared to deep or no growth crises (Pitlik and Wirth, 2003).

However, in practice, it can be difficult to undertake fiscal adjustment – which is most frequently required during a crisis – and structural reforms simultaneously (IMF, 2004). In fact, according to an OECD study, fiscal consolidation is usually accompanied by a slowdown of overall reform, while a sound government budget balance is associated with higher reform activity (Hoj et al., 2006). This is due to the fact that a weak fiscal position deprives the government of resources that are needed to provide adequate compensation of "losers" (see Section III.1) and diminishes its political capital (Tompson, 2009). Therefore, the most favourable "window of opportunity" to undertake difficult structural reforms seems to be at the end of a crisis. At that point in time policy-makers and voters are still fully aware of the costs of slow growth, while short-term adjustment costs can be mitigated by economic recovery (IMF, 2004).

- Latvian case

Figure 7.1 (ECB, 2011) amply illustrate the severity of the economic crisis that hit Latvia in Fall 2008. The swing in GDP and employment compared to the previous boom period is striking. Drawing on the findings of the literature, Latvia should thus be situated at the extreme right and top of the "U", i.e. experience a high level of reform intensity.

Figure 7.1: GDP (left) and employment (right) trends in the Baltics and the euro area



Source: Eurostat. Notes: Seasonally and working day adjusted data; index: 2005Q1=100

The government was clearly faced with an "up against the wall" effect, especially in the fiscal realm. The fall in GDP engendered a fall in the government's revenues, which made the financing of the previously planned level of public expenditure unsustainable (European Commission, 2010). On top of that, Latvia had to support its banking sector, notably by taking a 51% stake in Parex Banka (later extended to 85%). Latvia was left with few available options apart from a prompt and extensive fiscal consolidation (European Commission, 2010). In November 2008 the Latvian authorities had even to seek balance of payment support from the IMF, the EU and Nordic countries.

[67] "Delays in the stabilization emerge from political conflict between two different groups in this society. The essence of the war of attrition is the following: the passage of time will reveal which of the two groups is the weakest, i.e. it has the highest costs of waiting. In each instant each group chooses to wait if the marginal cost of waiting is lower than the marginal benefit of waiting. The game ends when for one of the groups the marginal benefit becomes less than the marginal cost, and this will occur sooner for the group with the higher cost of waiting. So in the end the weaker group (i.e. the one that suffers more from the delays) will concede". (Alesina et al., 2006)

The crisis was so severe that it went beyond the economic realm to revive political fears. Many felt that the very survival of the nation was at stake, not least due to the accelerating emigration trend. Well before the outburst of the financial crisis, the problem of emigration was already perceived as a serious challenge for this very small country with an ageing population. According to a recent study, it is estimated that around 200 000 Latvians (i.e. around 10% of the population) have left the country between 2000 and 2010. During the implementation of the internal devaluation strategy emigration has significantly increased: while 80 000 Latvians have emigrated between 2004 and 2008, the same number left within two years (2009 – 2010) (Hazans, 2011).[68] According to some calculations, the broader measure of unemployment – including those who are involuntarily working part-time and those who have given up looking for work – could be as high as 29% in the third quarter of 2011 without this massive emigration (Weisbrot and Ray, 2011).

One may therefore argue that emigration has acted as a "pressure relief valve" containing social unrest during the crisis. According to the "exit" or "voice" concept (Hirschman, 1970), members of a community or organisation have essentially two possible responses to express their dissatisfaction: they can either exit or voice. It seems that a number of young Latvians preferred to emigrate rather than taking to the streets, not necessarily to express disagreement with the current policy choices but by awareness of lack of economic opportunities. Hudson and Sommers even provocatively argue that "neoliberal austerity has created demographic losses exceeding Stalin's deportations back in the 1940s" (2011). This would be yet again another country-specific reason explaining the success of Dombrovskis. However, this argument may be partly questioned given that emigration to the UK and Ireland was already at a very high level during the "boom years", i.e. right after the accession of Latvia to the EU.

In any case, by making the emigration issue even more acute, the crisis reinforced the existential doubts about the future of the nation which had fought so hard for regaining its independence and sovereignty.

The government did take advantage of this sense of political and economic urgency to foster public acceptance of the huge sacrifices it was demanding. The lack of alternative figured prominently in the public communication of Dombrovskis: "Very unpopular measures will be necessary, no doubt about it. The question is: do we have any choice? In the current situation we do not have many choices" (Aslund and Dombrovskis, 2011). The government thereby discarded any other option such as external devaluation, while it was presented by some economists and politicians as a credible alternative. Moreover, the government could count on the collective memory of recent crises which the country had successfully overcome. The collapse of the USSR and, to a lesser extent, the Russian crisis in the late 1990s had also deeply affected the economy of Latvia and had been followed by far-reaching reforms. These two episodes have surely helped Dombrovskis to convince the population of the need for swift and radical adjustment. The dramatic macroeconomic conditions and, most importantly, their public awareness thus facilitated the government's ambitious strategy of internal devaluation.

This "crisis effect" was favourable not only for fiscal consolidation, but also for structural reforms. A number of reforms aimed at streamlining the public sector, which had been so far strongly resisted and thus postponed by previous governments for fear of unpopularity, were launched with the technical support of the World Bank. For example, important reforms in health and education were initiated and notably consisted in cuts by over one third in schools and hospitals to reflect demographic trends and come closer to international standards (European Commission, 2011b). Optimisation efforts of the central administration have also been undertaken: for example, the Ministry of Regional Development and Local Government has been incorporated into the Ministry of Environment, and the number of state agencies has been reduced by 50% (Latvian Ministry of Economics, 2011). A public service reform has also been initiated and consisted inter alia in harmonising remuneration across ministries and institutions and reviewing employment classifications (IMF, 2010a).

[68] Hazans (2011) also finds that the number of highly educated migrants has risen in 2009 – 2010 compared to the previous period, that Latvian migrants have become more oriented towards long-term or permanent emigration and leave more often with their families.

In parallel, the government adopted a series of measures to promote SMEs and to boost competitiveness. Since 2010 new companies can be established with a reduced minimum equity capital requirement – starting from LVL 1 (€ 1,43). A special reduced tax for micro-enterprises (9%) was introduced. Legislative changes also helped to make the insolvency process easier, cheaper and faster (European Commission, 2011a).

All of this suggests that the crisis has opened a window of opportunity for the government. Using the straightforward argument that "reforms start where the money runs out" (Aslund and Dombrovskis, 2011), Dombrovskis was able to seize this opportunity and partly overcome the status quo. According to the World Bank, "Latvia has achieved years' worth of difficult structural reforms in the short space of just a few months" (World Bank, 2010).

At the same time, the crisis also imposed constraints on the reformist course of action and has limited what could be achieved. Some measures were guided by an accounting logic rather than by long-term considerations and did not necessarily entail effective reforms. While recognising that "Latvia has taken promising first steps in implementing structural reforms" (Purfield and Rosenberg, 2010), the IMF staff writes that "there has been excessive reliance on across-the board cuts rather than removing unnecessary functions to find savings" (IMF, 2010b), and that "some measures were low quality and not sustainable" (IMF, 2010b). A number of reforms remain to be pursued or even initiated with a view to closing the remaining competitiveness gap of around 10% (IMF, 2010b) and boosting growth. In its Public Expenditure Review, the World Bank warns that they will "have to be prepared with more time giving consideration to their quality and sustainability" (World Bank, 2010).

In line with the findings of the political economy literature, the crisis conditions are partly responsible for these shortcomings. Given the level of emergency, the government did not have much time to overcome political and administrative obstacles and to prepare the ground for structural change. The very weak fiscal position prevented it from providing adequate compensation to the "losers", while Dombrovskis had already spent most of his political capital on fiscal measures. Nevertheless, these deficiencies in the field of structural reforms are not only the result of exogenous factors. They may be also attributed to the inability of Dombrovskis to garner sufficient parliamentary support around them, as will be demonstrated in Section III.2.

To sum up, a nuanced picture emerges from the empirical investigation of the main exogenous factors identified by the political economy literature (see Table 7.1). Dombrovskis could certainly benefit from some favourable economic factors: in particular, some structural features of the Latvian economy and the macroeconomic conditions under his term were conducive to the conduct of an ambitious internal devaluation strategy and its public acceptance. At the same time, the Latvian political system and its track record of recurrent instability and fragmentation were far from being favourable to the implementation of politically very difficult measures. This already indicates that the successful experience of Dombrovskis cannot be entirely explained by the Latvian context, but that an examination of incumbent-specific factors is warranted.

The need to look at endogenous determinants is reinforced by the negative experience of the previous government. The cabinet of Godmanis failed precisely because of the economic crisis, as it was attempting to impose radical austerity measures. On 13 January 2009, violent riots broke out in Riga, leading to a political crisis that prompted Godmanis' resignation in February. Most interestingly, the ideological differences between the governments of Godmanis and Dombrovskis were very thin. Dombrovskis himself describes his government as a "slightly different center-right coalition" (Aslund and Dombrovskis, 2011). In fact, three parties from the previous government were also in the new coalition. The course of action of the two cabinets was also broadly similar. Godmanis had negotiated the adjustment programme with the EU and the IMF, while Dombrovskis implemented it. Dombrovskis had even criticised Godmanis' stabilisation programme for falling short of what was required by the circumstances, and had called for more radical measures – which is intuitively not a recipe for popularity.

The next Section addresses the puzzle of why one government succeeded while the other failed, i.e. what did make the key difference between these seemingly similar cabinets.

Table 7.1: Overview of the effects of exogenous factors in the Latvian case

	Main exogenous factors identified by the literature	Effects on the success of the anti-crisis policy in Latvia
Economic factors	Size and openness	+ **(small open economy very much attached to the peg to the euro)**
	Degree of liberalisation of markets	+ **(relatively liberal economy which has shown its flexibility and resilience during past crises)**
Political and institutional factors	Form of government and electoral rules	- **(parliamentary democracy with proportional representation and high number of parties)**
	Political instability and fragmentation	- **(history of short-lived heterogeneous coalition governments)**
	External pressure	+ **(constant pressure to respect commitments vis-à-vis international creditors)**
Macroeconomic conditions	Intensity of crisis	+ **("up against the wall" effect and shared sense of urgency)**
		- **(detrimental short-term effect on quality and sustainability of structural reforms)**

Notes:

+: positive pre-condition (did facilitate the conduct of anti-crisis policy and a speedier adjustment)

-: negative pre-condition (did hamper the conduct of anti-crisis policy)

III. The Latvian experience, the outcome of a skilful political strategy?

This Section investigates the effect of incumbent-specific factors on the success of the government, i.e. the extent to which key choices made by Dombrovskis as regards designing his anti-crisis policy (1), garnering political support (2) and shaping public communication (3) have differed from those made by his predecessor and have facilitated or complicated the conduct of his internal devaluation strategy.

III.1 Policy design

- Propositions of the political economy literature

From a political economy perspective, a key factor to look at is the distribution of the costs (and benefits) of reforms across the economy. Looking at stabilisation, Alesina and Drazen find a crucial role for the distribution of the costs of adjustment. Stabilisations may only occur when a political consolidation leads to a resolution of the distributional conflict (Alesina and Drazen, 1991).[69] The empirical study by Stix (2011) also reveals that intragenerational fairness has a substantial impact on the demand for consolidation. Policy measures which are perceived as fair have a significantly higher chance of obtaining citizens' approval.

Distribution also does matter for re-election. The electoral impact of different types of reforms is very much influenced by the distribution of costs and benefits. Empirically, reform measures that hurt large and well-organised groups of insiders – such as pension and employment protection reforms – appear electorally damaging. By contrast, reforms reducing the tax wedge or unemployment benefits are electorally rewarding (Buti et al., 2010).

Two further factors deriving from this broad determinant of distribution of costs are the compensation strategy and sequencing vs. bundling of reforms. As regards the former, governments may attempt to overcome reform resistance by compensating potential losers to smooth losses that are temporary or circumscribed (Hoj et al., 2006). As an example, increasing the requirements in terms of job-search activities can be combined with measures expanding the safety net for the unemployed. According to empirical evidence, compensation measures are usually necessary to sustain political support for adjustment (Haggard and Webb, 1993). However, it can prove hard to target effectively compensation measures, as the target groups themselves are often difficult to identify (Hoj et al., 2006). Moreover, compensation should not be designed in such a way that it runs counter the rationale and objectives of the reforms (Haggard and Webb, 1993). Finally, as explained above, a weak fiscal position makes it harder to find the necessary resources for the appropriate compensation of losers (Tompson, 2009).

Of particular importance for the successful implementation of reforms is also the choice between sequencing and "bundling", i.e. whether reforms should be undertaken in stages or all at once. As regards the mix between fiscal adjustment and structural reforms, it was explained above that it was difficult to conduct both simultaneously. A more nuanced analysis of the interaction between structural reforms and fiscal adjustment shows that some structural reforms facilitate the fiscal consolidation effort, while others hamper it. Tagkalakis (2009) finds that a less generous unemployment benefit system and weaker forms of bargaining coordination and centralisation facilitate the adjustment effort, while product market deregulation and more flexible employment protection legislation do not contribute positively to fiscal consolidation. On the sequencing of structural reforms themselves, the literature is not entirely conclusive, as it very much depends on the specificities of the individual countries (Hoj et al., 2006). On the one hand, individual reforms can be easier to pursue where they form part of a structural policy shift (Tompson, 2009). Due to the complementarities between reforms areas, measures in one policy field may amplify the beneficial effects of measures in other fields (IMF, 2004). Bundling reforms also allows a government to offset the losses associated with one component of the programme with the gains from another (Haggard

[69] According to the "war of attrition" model outlined above, the more uneven is the expected allocation of costs, the more delayed is stabilization. This is because the gain from waiting in the hope that one's opponent will concede is larger. Hence, each group holds out longer (Alesina and Drazen, 1991).

and Webb, 1993). On the other hand, tackling the easiest issues first can generate a political momentum that opens the way for further change in more protected policy fields (Tompson, 2009). In any case, empirical evidence demonstrates that adequately combining and sequencing reforms, also taking into account the country-specific interaction between policy areas, can make some reforms politically more acceptable (IMF, 2004).

Last but not least, the overall credibility of the reform plan plays a decisive role. Empirical work by Stix (2011) shows that the low credibility of medium-term fiscal policy plans can be a serious impediment to voters' support for consolidation.

- Latvian case

The design of the anti-crisis policy has proved to be of utmost importance in the Latvian case as the negative experience of the previous government demonstrates. One of the main reasons for the fall of the Godmanis government lay in the design of his austerity plan, i.e. the perceived unfair distribution of costs and the lack of compensation strategy. The population agreed in principle to the adoption of harsh austerity measures, but asked for cuts in the privileges of senior officials (Aslund and Dombrovskis, 2011). This can be explained by a very high measured and perceived income inequality. Latvia has the second highest Gini coefficient in the EU (i.e. 36,1 in 2010) (Eurostat). According to Eurobarometer data (2010), 96% of Latvian people are dissatisfied with the overall level of inequality – the highest figure in the EU. 85% are of the view that the government should take action to ensure a fair redistribution of wealth and reduce inequalities.

In the design of his fiscal consolidation package in December 2008, Godmanis did not sufficiently respond to this demand, at least in the public opinion's view. He was perceived as sparing the elite the adjustment effort and as shielding vested interests. The general public perception is well reflected by the following statement of an opposition's politician (Stokenbergs): "Godmanis found tens of reasons not to end tax holidays for dividends, not to introduce capital gains tax and not to tax magnificent villas (…) This government defends only the rich, who need endless tax holidays" (Aslund and Dombrovskis, 2011). Partly as a result of this perceived unfairness, Godmanis failed to garner public support for his stabilisation programme. This brings us to the question of whether and how Dombrovskis succeeded in designing a politically more acceptable anti-crisis strategy.

In line with the EU/IMF programme negotiated by Godmanis, the Dombrovskis government followed an expenditure-led adjustment strategy. The 2009-2010 fiscal correction of 13,3% of GDP consisted of 10,4% of expenditure cuts and only 2,8% of tax policy changes (World Bank, 2010). This reflected a broad national consensus prevailing since the independence to maintain low levels of taxation (Purfield and Rosenberg, 2010). The chosen composition of adjustment had also economic motivations: empirical work has demonstrated that expenditure-based consolidations have been economically more successful than revenue-based ones in Central and Eastern European countries over the period 1991-2003 (Afonso et al., 2006).

In his public communication the government emphasised "that it was even-handed" (Aslund and Dombrovskis, 2011). For example, the Minister of Finance Repše argued that the budget "does not specifically favour anyone – employers, employees or state officials" (Latvian Institute, 2009b). As a matter of fact, the government applied its austerity policy across the board in the public sector (e.g. health care, education, central administration). Massive reductions in the budgets of the Ministries were achieved both through cuts in public wages (by more than 20% in 2008-2010) and reduction in public jobs (by around 25% in 2008-2011). As the government demanded sacrifices to all parts of the public sector, the protest by vested interests could not count on the broad support of the public opinion. However, the distribution of costs was far from being as even as suggested by the public communication of the government. The austerity measures did not genuinely differentiate between income categories. For example, the general increase in VAT and excise taxes affected all the population and, due to the traditionally regressive nature of VAT, proportionately burdened most the low-income categories. The same holds true with regard to the increase in personal income tax given its flat rate. The initial cut in pensions – which was later on reversed by the Constitutional Court – also did not protect the vulnerable categories of the population, bearing in mind that a large proportion of pensions are below the subsistence level.

At the same time, the government adopted specific measures targeted at the two extremes of the income scale, not least to avoid social unrest against the EU/IMF programme. On the one hand, the government decided to curb some of the privileges of top officials e.g. by reducing the salaries of ministers, managers of state corporations and members of boards of public companies. Supervisory boards of state companies, often filled by politicians and persons close to political parties, were abolished. One may critically argue that these measures were mainly of a symbolic nature and did not fundamentally tackle the income inequalities prevailing in Latvia. Reforms of the taxation system such as the introduction of a progressive personal income tax or the much needed overhaul of the real estate tax would have had much more far-reaching effects. Dombrovskis himself recognised that "each of these measures might not have saved much money" (Aslund and Dombrovskis, 2011). Despite these limitations, they were instrumental in fostering consensus around the anti-crisis policy of the government.

On the other hand, upon the insistence of the European Commission and the IMF (Latvian Institute, 2009a), the government pursued a "compensation strategy" in favour of the most vulnerable parts of the population. Given the budgetary constraints, there was of course little fiscal room for manoeuvre to compensate the (very numerous) losers. However, the government did attempt to smooth losses for the most dramatically affected by the crisis, in particular the unemployed. Under its Emergency Social Safety Net Strategy, the duration of unemployment benefits was increased to 9 months, a minimum floor introduced (a quarter of the minimum wage), and eligibility criteria were relaxed (Purfield and Rosenberg, 2010). Moreover, the Workplace with Stipend (WWS) programme provided full time work for 24,000 registered unemployed not receiving unemployment benefits at 55% of official minimum wage, while also granting free access to health care. To help promote re-entry into the labour market, European Union funds were also used to boost training for job seekers and assist business start-ups (Purfield and Rosenberg, 2010). One may here again discuss whether these measures were sufficient to alleviate the social effects of the crisis. According to a simulation conducted by World Bank staff, the measures taken by the Latvian government have helped to cushion the impact of the crisis for some of the hardest hit households (Ajwad et al., 2010). At the same time, the study concludes that the scale of the crisis was far too large for such programmes to fully offset the negative impact. Irrespective of their real impact, these measures have been successful in maintaining social order: there has been no major upheaval under the government of Dombrovskis.

Another important strategic choice of the government regarded the distribution of costs over time, i.e. whether the measures should be adopted simultaneously or sequenced. Following the advice of the European Commission, Dombrovskis opted for a 'front-loading' approach. Needless to say that this was largely required by the gravity of the economic situation. There was no alternative to restore international credibility and convince lenders that it would be worth defending the peg and keeping paying the tranches of the loans (Aslund and Dombrovskis, 2011). But this had also political motivations. The underlying assumption was that it would be politically easier to ask the parliament and the public opinion a significant adjustment effort once and for all – at a time when a sense of urgency was widely shared – than to introduce additional cuts every three months. The government indeed benefited from a "window of opportunity" during the most acute phase of the crisis, which helped to foster social acceptance of the structural reforms being implemented, often as a means to generate the necessary budgetary savings (see above). Even though the "big bang" approach was initially the preferred option of the government, further action was obviously required over the following years. The design of the stabilisation programme was not entirely in the hands of the government, but was highly contingent on the economic developments – which were themselves very uncertain. Statistics were evolving very quickly, and the fall in GDP was finally far greater than anticipated (Aslund and Dombrovskis 2011), which required to adjust accordingly the budget. In total, three packages of fiscal adjustment had to be adopted under the Dombrovskis government (June 2009, November 2009 and December 2010). As far as structural reforms were concerned, not all of them could be introduced at the same time, mainly for political reasons (see Section III.2). As pointed out by the World Bank and the IMF, a lot remains to be done.

Despite these limitations, the 'front-loading' approach of the government certainly contributed to its success. This has been demonstrated ex post by the emergence of an "adjustment fatigue": garnering political support for further fiscal adjustment – even though much more limited than in the most acute

phase of the crisis – has become increasingly challenging (IMF, 2011; Aslund and Dombrovskis 2011). Had the government followed a gradual fiscal consolidation path with a view to distributing the costs of adjustment over a longer period of time, it would have probably encountered a much stronger resistance due to this "adjustment fatigue".

III.2. Political support

- Propositions of the political economy literature

Political factors can also affect a government's reform capacity. The first determinant relates to the election timing. Also in line with the political business cycle's theory, it can be expected that the proximity to elections hampers the implementation of unpopular reforms, whereas the political capital of a government is highest in its first years of office (IMF, 2004). This is confirmed by empirical evidence. According to Mierau et al. (2007), the likelihood that a rapid adjustment takes place is negatively influenced by upcoming elections. Alesina et al. (2006) find that stabilisations are more likely to occur immediately after an election. In terms of re-election, a reformist government is more likely to be re-elected if the incumbent is in his first term of office (Buti et al., 2010).

A second factor, which is largely linked with the election timing, is the government's electoral mandate to introduce reforms. One of the strongest findings of the latest research by Tompson (2009) is the crucial importance for a reform-minded government to have an electoral mandate. Nevertheless, crisis circumstances may constitute an exception to this rule. Even without a recent electoral mandate, governments may find a political window of opportunity for reform in times of crisis. By exposing weaknesses in the status quo, a crisis can be an "action-forcing" event and lead to a higher acceptance of reforms (Tompson, 2009).

A third factor of critical importance is the cohesion of the government behind reforms. Empirical research suggests that cohesion matters more than other political factors such as the state of the opposition or the government's parliamentary strength (Tompson, 2009). Large and heterogeneous coalitions usually find it difficult to reach agreement on highly salient issues, namely how to allocate tax increases or expenditure cuts among the constituencies represented (Alesina and Drazen, 1991). Illera et al. (2008) also find that stronger fiscal adjustments are more likely to end when the spending authority is divided amongst more members of the cabinet and when a large number of political parties, in all likelihood having very different budget priorities, comprise the ruling government coalition. If the government does not stand united behind the reformist course of action, opponents will exploit its divisions, and the public opinion will not be convinced of the necessity to carry out painful reforms (Tompson, 2009).

Even though to a lesser extent, other political factors such as the *government's parliamentary strength* or the *state of the opposition* may also affect the likelihood of successful reform implementation. Alesina et al. found out that stabilisations are more likely to occur when governments are strong, i.e. unified and relying on a large parliamentary majority (Alesina et al., 2006). In other case studies, governments were successful reformers when the main opposition parties were divided (Tompson, 2009).

- Latvian case

Besides the tactical design of the anti-crisis strategy, political factors also played an important part in the Latvian case, as the experience of the previous government again illustrates. The fall of the Godmanis government was mainly caused by the lack of cohesion of his cabinet. Godmanis had been in power since December 2007. However, with the outburst of the financial crisis, his government became increasingly paralysed by internal tensions (Aslund and Dombrovskis, 2011). As an example, Godmanis spent much time to solve a dispute within the cabinet over the reduction of ministries. The lack of cohesion of government resulted in the inability to implement the EU/IMF programme that it had just negotiated and signed, and was also responsible for the distrust of the public opinion. President Zatlers and the two biggest coalition parties finally withdrew their support, resulting in the fall of the government. Against this background, and in view of the recurrent political instability

described above, it is interesting to analyse to what extent Dombrovskis succeeded in garnering sufficient political support for his policy.

The first factor identified by the literature (i.e. election timing) played a certain role in the Latvian case. Though the next parliamentary elections were scheduled for October 2010 (i.e. one and a half years ahead), the next municipal (and European Parliament's) elections took place just four months after the beginning of Dombrovskis' term. Gaining control of Riga – which concentrates a large proportion of the country's economic power – is a highly contested price in Latvian politics. The imminent municipal elections did influence the reform process of the government. As the economic outlook was constantly deteriorating and further consolidation measures seemed inevitable, the question of possible pension cuts figured prominently in the electoral campaign. Up until the elections the government kept denying the need for a significant fiscal adjustment and had presented a draft supplementary budget falling short of what the deepening crisis was requiring. As regards specifically prospective pension cuts, the Prime Minister's advisor explained that such rumours were "part of a cheap electoral campaign or a sign of carelessness of the responsible officials" (Diena 2009b). Just a few days after the elections, and following very intense negotiations with international lenders and coalition parties, the government passed an austerity package in the amount of LVL 500 million (around €720 million). These measures included a 70 % cut in pensions for working pensioners and a 10 % cut in all pensions. This goes to show that the pre-electoral period in Spring 2010 did delay the implementation of the fiscal consolidation strategy and led to deviations from Dombrovskis' "speaking the truth" policy. Interestingly, however, a similar scenario did not unfold in the run-up to the parliamentary elections of October 2010.[70]

The second factor identified by the literature initially hardly mattered in the Latvian case. For the first part of his austerity course (March 2009 – October 2010), Dombrovskis had no electoral mandate since his government was not formed after an election. However, as pointed out by the literature, the severe economic crisis did compensate for this lack of mandate. First, after the resignation of Godmanis the Latvian political class did not count many volunteers to take up the functions of Prime Minister, as the implementation of the EU/IMF programme was widely considered as a "political suicide". Hardly any politician was ready to assume the responsibility vis-à-vis the electorate of introducing costly reforms. Dombrovkis argued that *"power has been thrown to our feet. The previous coalition has thrown it there (…) It was just not ready to take the decisions that must be taken."* (Dombrovskis, 2009). Second, the status quo was clearly not an option, and the public opinion expected the government to act swiftly and decisively to tackle the situation. In this regard, Dombrovskis benefited from having spent the past years in the opposition and criticised the boom-bust cycle in the 2000s as well as Godmanis' stabilisation programme as insufficient (Aslund and Dombrovskis, 2011). He thus did embody change in the eyes of voters.

In fact, as surprisingly as it may seem, one may argue that Dombrovskis received an electoral mandate after the toughest decisions had been made and implemented. The majority of Latvian voters confirmed ex post that it agreed with the basic thrust of Dombrovskis' economic policies. The electoral campaign in Fall 2010 had been mainly dominated by the economic crisis and the EU/IMF programme. While the two main opposition parties criticised the government's austerity policy, Dombrovskis announced his intention to pursue the same path if he were to be reelected (Aslund and Dombrovskis, 2011). His party scored an excellent electoral result by receiving 31,2% of the votes and 33 seats in parliament. The sitting coalition government even increased its majority in parliament from 47 to 63 seats. This is the ultimate evidence that the absence of electoral mandate did not disadvantage Dombrovskis.

By contrast, the cohesion of the government in 2009-2010 proved to be much more problematic for the successful implementation of the stabilisation programme. Dombrovskis faced the challenging task of drawing together five parties within a coalition government (i.e. the three big center-right parties, New Era, People's Party, and the Union of Greens and Farmers, as well as two small center-right parties). Following the unfortunate experience of Godmanis, Dombrovskis attempted from the very beginning to bind the coalition parties by putting forward a "memorandum on immediate measures to ensure the solvency of the state". This document was prepared with the support of the Ministry of Finance and contained a range of specific measures to reduce the 2009 budget deficit

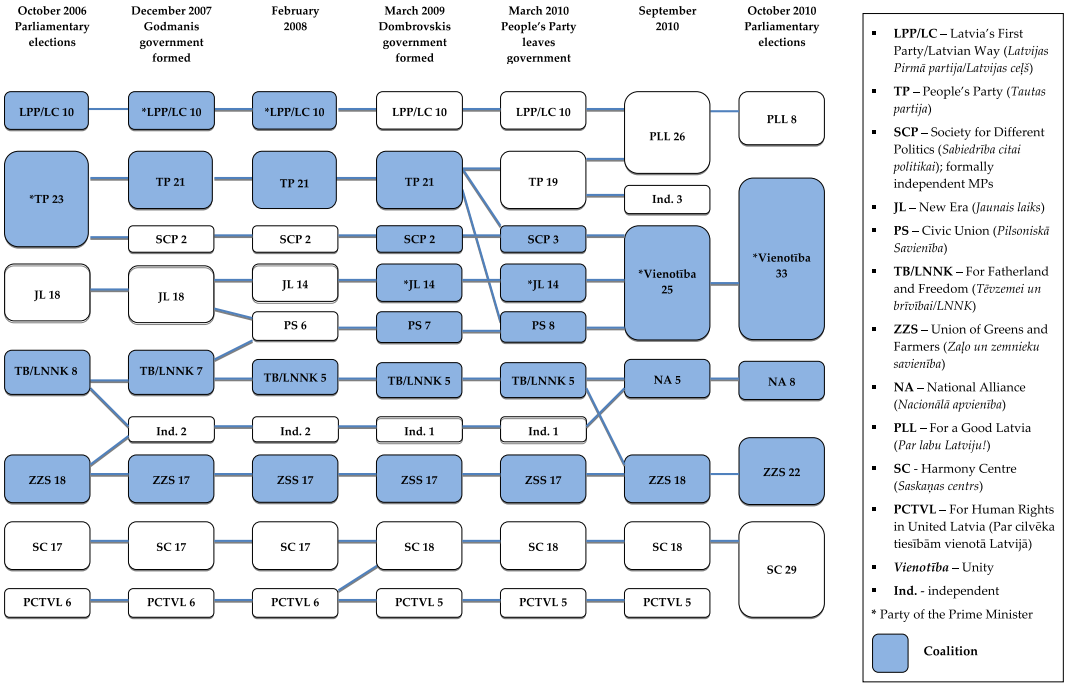
[70] One possible explanation is that the size of the fiscal consolidation to be undertaken after the elections was agreed beforehand with international lenders and communicated upfront to the public opinion.

below 7% of GDP. All coalition members of parliament signed the memorandum to ensure their support prior to the vote on the new government (Aslund and Dombrovskis, 2011).

Dombrovskis was also helped by a very loyal and close collaboration with his Finance Minister. Unlike in the Godmanis government, Prime Minister Dombrovskis and Finance Minister Repše were from the same party and knew each other for a long time.[71] Repše voluntary took the blame in some occasions, thereby preserving the political capital of Dombrovskis. For example, in June 2009, when the amount of the necessary fiscal adjustment became evident, he admitted during a TV debate that *"we have wasted several months (..) I blame myself very much. I really cannot forgive myself. Even if I understood what was necessary I did not insist on it more categorically (..) I blame myself for not categorically insisting on a consolidation of 500 million."* (Repše, 2009).

However, these efforts did not prevent the emergence of tensions and dissident voices within the government as time went by. One source of tension came from the biggest party of the coalition, the People's Party. While it had led the ruling coalition in the years of rapid economic growth after Latvia's EU accession and had won the previous election in 2006, its score in public opinion polls dropped to around 3%. In view of the upcoming elections, the party was desperate to re-boost its popularity and increasingly turned to populist initiatives (e.g. in favour of devaluation, against increasing taxes). The turning point came in October 2009 when the party's long-time leader Andris Šķēle officially returned to politics. From the outset, while still in the backstage, he had been arguing for devaluation (Diena, 2009a). He adopted a rather aggressive stance against the government. The design of the annual budget in October 2009 became also subject to a serious quarrel between members of the coalition. In January 2010 the People's Party voted against the mandate of the government to conclude talks with the IMF. The vote turned out favourably only thanks to the support of opposition. The lack of cohesion of the government dramatically came to the fore in March 2010 when the People's Party (TP) left the coalition. Dombrovskis found himself heading a four-party minority government (ZZS; JL; TB/LNNK; PS) with only 47 of the seats in the 100-seat parliament (see Figure 7.2).

Figure 7.2: Evolution of the parliamentary support of the ruling coalition (2007-2010)



Notes: The number of seats in the Saeima is indicated after the abbreviation of the party. Authors' compilation

[71] Dombrovskis had worked under Repše at the Bank of Latvia. Repše brought Dombrovskis into politics and made him Finance Minister in his government from 2002 to 2004.

This weak parliamentary support partly undermined the successful implementation of Dombrovskis' anti-crisis policy, in particular as regards structural reforms. The government found it increasingly more difficult in the course of 2010 to secure backing in the relatively strong parliament which had the final say in a number of areas (Reinert et al., 2010). While Dombrovskis ultimately managed to get his budgetary cuts through, he failed to propose much needed structural reforms such as the reform of the real estate tax. A number of reforms were even not put forward because Dombrovskis knew in advance that it would be impossible to garner sufficient parliamentary support, or because he did not want to excessively undermine his re-election chances. Dombrovskis also faced several attempts by the opposition to destabilise his cabinet. On a couple of occasions, the two main opposition parties (Harmony Centre and People's Party), though being ideologically rather distant, united their forces against the government. For example, they tried to halt the plan of restructuring of Parex Banka through legislative proposals; in May and June 2010 they attempted to dismiss the Minister of Interior and the Minister of Economy in repeated votes of no confidence (Aslund and Dombrovskis, 2011). Even though their efforts failed, the attitude of the opposition undoubtedly created complications for the action of Dombrovskis.

III.3. Public communication strategy

- Propositions of the political economy literature

A number of studies have found a link between strong communication of the need for and aims of reforms and successful implementation (Tompson, 2009; Cabanero-Verzosa and Garcia, 2009). In the most successful episodes, major reforms have been accompanied by consistent coordinated efforts to persuade voters and stakeholders. Explaining the costs of the status quo is especially important when reform entails high distributional costs. The effectiveness of communication can be enhanced by strategically targeting critical actors in the reform process (Cabanero-Verzosa and Garcia, 2009). It can also be helped by politically neutral institutions such as independent agencies, research centres or national central banks lending their credibility to the reforms and fostering consensus through depoliticisation (Tompson, 2009). Clear and transparent communication aimed at reaching a higher level of accountability can also reinforce the political credibility of the reform process (Olofsgard, 2003).

- Latvian case

The differences in the political background of Godmanis and Dombrovskis – and most importantly, the public perception thereof – played a key role as regards the public acceptance of the austerity measures. Godmanis was a long-standing figure in Latvian politics. He had been the first Prime Minister of Latvia since the country regained independence and had led it through the turbulent economic times following the fall of the USSR. At the same time, a number of corruption scandals had affected his party and government. Some of his party members had held jobs in Parex Banka, i.e. the bank whose fall had largely caused the fiscal problems of Latvia. As a result he was perceived by a large share of the population as being part of the old, untrustworthy political establishment. By contrast, Dombrovskis represented a new generation of politicians, which was considered as being educated, honest and not corrupt (Kalniete, 2011).

This key difference between Godmanis and Dombrovskis could also be observed in terms of public communication regarding the causes of the crisis. When the economic downturn affected Latvia, the government of Godmanis portrayed the country's problems as being part and parcel of the global financial crisis. Even though it was admitted that the some of the problems were home-made, they were always coupled with the global financial crisis in order to shift the blame. One such example is the New Year's address of Godmanis on 31 December 2008: *"Today we find ourselves in the middle of the global recession. The toughest period is yet to come and not solely in Latvia."* (Godmanis, 2008). Godmanis' communication was not received well by citizens, who knew for the most part that the Latvian crisis had been largely caused by the improper action of previous governments. The IMF itself, as a neutral observer, is rather severe with the action of Latvian authorities during the 'boom' period: "between 2001 and 2007 government spending doubled in real terms. (…) The authorities

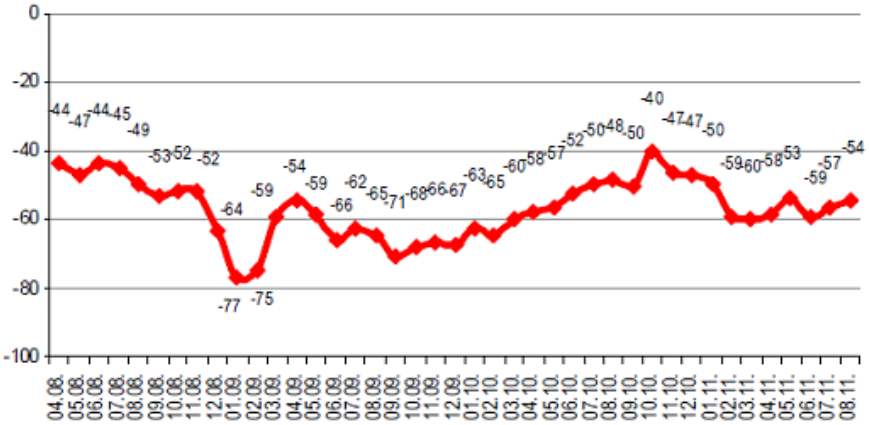
maintained a stimulative fiscal stance until late in the boom despite double-digit growth and inflation" (IMF, 2010b). The memorable TV interview given by the former Finance Minister Atis Slakteris finally ruined the credibility of the Godmanis government: when asked by a Bloomberg journalist what was happening to the Latvian economy – which had experienced a free fall since September 2008 –, he just replied *"Nothing special"*.

When Dombrovskis took up office, a different communication strategy was implemented. As his party had spent a large part of the 'boom' years in opposition, Dombrovskis did not have any political constraint to introduce a different narrative. He did not hesitate to use his previous outsider's position to put most of the blame on the previous governments which failed to implement sound and sustainable macroeconomic policies: *"The previous years' policy – "Top Gear!" – has failed. The story about seven "good years" seems tragicomic"* (Aslund and Dombrovskis, 2011) He thereby turned the anger of the population towards the political establishment to his advantage.

Second, Dombrovskis was deeply aware of the crucial need for communication on his own anti-crisis policy and put much emphasis on it. *"In both design and promotion, the government had to try to explain austerity so that the public understood and accepted it"* (Aslund and Dombrovskis, 2011). 'Speaking the truth' was at the heart of his communication strategy, though some notable deviations from this principle happened such as in the run-up to the municipal elections (see Section III.2.). When conveying his stabilisation policy to the population, he generally privileged transparent and straightforward communication. Rather than hiding the gravity of the situation and the measures taken, he was keen on making people aware of the dramatic reality and on underlining the lack of alternative. *"I emphasised that Latvia had no choice but to fulfil its obligations to the IMF so that the country could receive international financial aid. (..) My first public comment after being assigned the task of forming a new government was that Latvia was on the verge of bankruptcy"* (Aslund and Dombrovskis, 2011). He could thereby also rely on the support of respected neutral authorities such as the central bank, which also strongly emphasised the need for fiscal adjustment.

Thirdly, he also attempted to give a sense of direction throughout these turbulent times. He emphasised again and again key goals: maintaining a fixed peg to the euro, bringing the deficit down in order to continue receiving international financial assistance and, ultimately, joining the euro area. This was important for the population to understand that these austerity measures were not an end in themselves but fitted within a broader political context and were decisive for the political destiny of the country. All in all, Dombrovskis succeeded in explaining the absolute necessity of the measures taken (Kalniete, 2011) and was able to build the required social consensus. This transparent and straightforward communication did bear tangible results as regards the popularity of the government (see Figure 7.3). While the public opinion support for Godmanis experienced a free fall from mid-2008 onwards to reach its lowest point in January 2009 (-77%), the government of Dombrovskis first enjoyed the traditional 100 days grace period. After a short period of decrease, the popularity of the government regularly increased from -71% in September 2009 to – 40% in October 2010.

Figure 7.3: Evolution of the public opinion support for the Latvian government (2008-2011)



Source: Nord LB (2011). Notes: The chart represents the evolution of the weighted difference between the total of positive and the total of negative opinions on the Latvian government

However, a clear caveat was the lack of consistent communication from the government as a whole. Given the lack of cohesion of his parliamentary majority, Dombrovskis was not able to enforce verbal discipline among his coalition partners. Some politicians regularly made statements on the need for devaluation (see above).

To sum up, the strategic approach followed by Dombrovskis largely contributed to the success of the Latvian experience (see Table 7.2). The design of his anti-crisis policy (in particular the perceived broad distribution of costs through the adoption of measures targeted at the two extremes of the social scale) as well as his generally transparent public communication strategy were key in building social consensus around the stabilisation programme. At the same time, his relative political weakness hampered his action, especially in the field of structural reforms.

Table 7.2: Overview of the effects of the endogenous factors in the Latvian case

	Main endogenous factors identified by the literature	**Effects on the success of the anti-crisis policy in Latvia**
Policy design	Distribution of costs	+ **(broad scope with symbolic targeting of the most privileged categories)**
	Compensation strategy	+ **(specific measures to alleviate the effects on the poorest)**
	Frontloading	+ **(took advantage of the sense of urgency)**
Political support	Election timing	- ***(delayed the implementation)***
	Electoral mandate	**No effect during his first term**
	Cohesion of government	- **(did not manage to keep the government united behind course of action)**
	Parliamentary Strength/Attitude of opposition	+/- **(managed to continue ruling despite minority government, but could not pass all the desired reforms)**
Public communication strategy	Differentiation from previous government	+ **(Dombrovskis as a publicly accepted figure)**
	Transparency	+ **("spoke the truth" with some notable exceptions)**
	Sense of direction	+ **(set clear goals)**

Notes:

+: positive effect (did facilitate the conduct of anti-crisis policy)

-: adverse effect (did hamper the conduct of anti-crisis policy)

IV. Conclusions

This chapter aimed to explain how Prime Minister Dombrovskis successfully passed a set of very unpopular measures without major upheaval and even won the next elections – without judging the economic and social efficiency of his action. In particular, we aimed to question the often mentioned argument according to which such a far-reaching internal devaluation strategy could only happen in Latvia, and could not be applied elsewhere.

First, we do find that *country-specific factors* – such as the size and openness of the country, the degree of liberalisation of markets, the electoral rules and form of government, the intensity of the crisis – have an explanatory value in the case of Latvia. While some of these factors facilitated the conduct of Dombrovskis' anti-crisis policy, others made it even more challenging. The fact that the Latvian government operated in a rather specific political, institutional and economic environment prevents an excessive generalisation on the basis of the Latvian example: the action of every national government is embedded in a unique setting and cannot be automatically replicated in another country. At the same time, national specificities should not be overemphasised. While some of the exogenous factors identified are very much specific to Latvia and the two other Baltic States (e.g. 40 years as command economy), others are shared by a number of countries (e.g. small size, high proportion of foreign exchange denominated loans, emigration propensity).

Second, *incumbent-specific* factors did play a significant role in the case of Latvia. Dombrovskis differentiated himself from his predecessor Godmanis notably through the design of his anti-crisis policy and his communication strategy, while he was less successful in keeping his cabinet united and cohesive around the EU/IMF programme. This shows that national policy-makers can make the difference and that the destiny of a country does not merely follow a path-dependent trajectory dictated by the structural starting conditions. In a context where a number of euro area Member States have to go through a painful fiscal consolidation process and to complete structural reforms to boost their growth potential, the Latvian experience represents an interesting example and deserves to be thoroughly investigated and discussed.

The following five key lessons can be drawn both in policy-making terms and with regard to the political economy literature:

1. Austerity measures do not necessarily imply a "political suicide".

The Latvian experience confirms the empirical findings of the most recent literature on fiscal adjustment and re-election. Contrary to conventional wisdom, Alesina et al. (2010) did not find any evidence that governments which quickly reduce budget deficits are systematically voted out of office. They come to the conclusion that many governments can reduce deficits decisively while avoiding an electoral defeat. Another empirical study by Stix (2011) on Austria shows that a majority of voters favours fiscal consolidation, and that voters even prefer a stronger consolidation than they expect the government to implement.

2. Not all political economy factors identified by the literature are required.

At the same time, the Latvian example partly defies the findings of the traditional political economy literature. Dombrovskis succeeded in carrying out its anti-crisis policy despite a context of structural political instability and without having an electoral mandate and a cohesive and strong government – all factors which are generally assessed as highly unfavourable for the conduct of stabilisation and reforms. Another empirical finding of the literature is that reforms reducing unemployment benefits are electorally rewarding (Buti et al. 2010) and facilitate the fiscal adjustment effort (Tagkalakis 2009). Dombrovskis did the very contrary in order to alleviate the effects of the crisis on the most dramatically affected parts of the population. This demonstrates that there is no "one-size-fits-all" policy, and that not all conditions identified by the literature are required for a successful stabilisation or structural reforms. The various country-specific and incumbent-specific factors interact with each other, whereby the weakness of one can be compensated by the strength of another.

3. The current crisis circumstances can compensate for unfavourable structural starting conditions.

The Latvian example shows that, even though the starting conditions do not seem conducive to the successful conduct of an anti-crisis policy (e.g. climate of recurrent political instability), the crisis circumstances may compensate for these weaknesses. The current crisis provides a window of opportunity by propagating a sense of urgency among the population. This public awareness of a deep crisis – which by now largely prevails in euro area Member States – can be used by the government to build the necessary social consensus around difficult sacrifices. As this public awareness may vanish over time, and a certain reform fatigue may emerge, a "front-loading" approach seems to be most effective. At the same time, precisely because of this emergency situation, the quality and sustainability of structural reforms can be somewhat neglected and thus require the utmost attention of the government.

4. The political willingness and strategic choices of national policy-makers do make the difference.

Political leaders can be certainly handicapped or advantaged by some country-specific factors, but they have the ability through a proper policy design and communication to steer their country out of a deep economic crisis. Therefore, the government should carefully design its policy by looking in particular at the distribution of costs across the population. The sense of fairness is absolutely crucial for the public acceptance of reforms. As the Latvian example demonstrates, perceived measures – which do not deeply affect the measured income inequalities – may even matter more than actual ones. Secondly, not only should the policy be appropriately designed, but it should be also properly explained and justified to the people. A transparent and straightforward communication approach is of the essence.

5. The perspective of joining the euro area remains a powerful incentive for conducting sound economic policies.

The Latvian experience confirms the effectiveness of the Maastricht convergence process. This has been already demonstrated in the 1990s when most of Western European countries undertook a number of fiscal and structural reforms in the run-up to the euro. The perspective of joining the euro area – which, in the case of some Eastern European countries, is as much about economics as about (geo-)politics – allows policy-makers to articulate all necessary reforms around a clear goal, which is easy to communicate to the public opinion. It thereby facilitates the public acceptance of reforms. As has been revealed by the current crisis, the main shortcoming of the EMU governance framework so far is that neither "carrots" nor credible "sticks" are provided once a country joins the euro area. This difference of incentives may partly explain the different trajectories of Greece and Latvia in the face of economic challenges of comparable magnitude. This could be the subject of another empirical investigation.

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Chapter 8 – Conceptualising the EU/IMF financial assistance process

Samuel Dahan [72]

I. Introduction

When the financial crisis erupted in 2008, the International Monetary Fund (IMF) and the European Union (EU) were called upon to provide critical financial assistance to a number of EU Member States. For instance, the Hungarian, Latvian, Romanian, Greek and Irish governments, facing an urgent balance of payments need, appealed to the IMF and the EU for emergency financial assistance in 2009 and 2010. The IMF and the EU entered into a multilateral negotiation process with these recipient governments to define the fiscal adjustment and financial and structural reforms which the governments needed to undertake to receive emergency funds.

Previous studies have investigated the influence of IMF loans on the content of national policy reforms and found some evidence that loan conditions shape policy in borrowing countries. Our study will take a different angle and will investigate the joint EU/IMF financial assistance process by providing an analytical approach to the financial stabilisation negotiation in Latvia. This project is about the process of decision-making and negotiation. It is this focus on process—rather than the structure of power or interests shaping any given outcome—which distinguishes the study of economic negotiation and, more specifically, of financial assistance negotiation.

The argument is that process matters. We do not claim that it somehow matters more than other factors. Rather, we argue that success or failure is often due to the way negotiations are conducted. Indeed, in many instances outcomes differ between two negotiations even when the power and interests structures are identical. Accordingly, decision-makers engaged in financial assistance negotiations might need to place a high priority on pinpointing the difference the process makes, net of other influences, to the outcome.

This approach to analysing structural adjustment negotiation is inductive. There is no general theory of the politics of adjustment. Rather than specifying a theory a priori, we investigate concepts of both dependent and independent variables and specify more precisely some of the causal mechanisms at work. Furthermore, individual or process negotiation strategies and tactics are unlikely to be explicitly stated and may well never be written down or consciously designed. They may be implicit, the result of several actions and choices by the actors. This reality clearly presents difficulties for any research and explains the reliance of our country case study on ex-post interviews with actors involved in the financial assistance negotiation process in Latvia.

Evaluating decision-making processes first requires choosing a conceptual framework for the analysis. Such a framework would allow for testing hypotheses concerning the negotiation process, based on evidence from actual experience in addition to laboratory evidence. Our objective is not to develop a universal lenders-debtors model capable of predicting outcome in a mechanistic sense. Rather, we aim to establish a *two-level model* which offers a better understanding of EU/IMF assistance negotiation strategies and outcomes. Accordingly, we examine the Latvian assistance programme as a *complex two-level game* in which each of the two main negotiators—the Latvian authorities and the lenders (i.e., the European Commission and the IMF)—must satisfy its own constituents whilst trying to negotiate a sensitive adjustment. This model presents lenders and debtors with negotiating 'constraints' and 'assets' at both the international level and the internal levels. These variables are also referred to as *negotiating capabilities*.

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The literature on politics of adjustment tends to investigate either internal politics of stabilisation or the interactions at the international level. We argue, in contrast, that interactions between domestic and international levels as well as actors' *capabilities* at both levels must be understood to explain the choice of strategies and, thereby, the result of international aid negotiations.

The chapter is structured as follows: the first part constructs an analytical framework for conceptualising financial assistance negotiations. It first investigates the various international negotiation strategies which borrowers and lenders can adopt to affect the outcome. It also discusses the importance of actors' *'negotiation capabilities'* from a two-level perspective to understand what shapes negotiation strategies and outcomes in a time of financial crisis.

The second part presents findings on the Latvian case, with a brief description of the EU/IMF process and outcome in the form of a review of policy interaction with policy circles and a review of core areas of policy conditionality. The chapter then explains the factors which account for the negotiating strategies adopted by the IMF, the EU, and the Latvian government, as well as their influence on the outcome of the financial assistance programme. Finally, it analyses the programme outcome in light of negotiation theory and discusses lessons which might be learnt from the negotiation process surrounding financial assistance in Latvia and applied to other programmes.

PART 1 – A FRAMEWORK OF ANALYSIS FOR FINANCIAL AID NEGOTIATIONS

This model does not present a new model of lenders-debtors relations which may predict the outcome of financial assistance negotiations. Rather, it offers a means to discuss issues of policy interaction in the context of large economic and financial adjustment in an individual country recipient of emergency international assistance. Our contribution does not start from the assumption that a 'best interaction model' exists. Instead, we argue that in various interaction models, process affects—if not determines—the outcome. Accordingly, this model identifies the possible policy strategies and their impact on the programme outcome. It also identifies a set of variables which shape these policy strategies and, ultimately, the outcome of a financial assistance programme.

II. Process and Strategies: Strategic and Methodological Considerations

Strategies are the part of the process of negotiation which encompasses a sequence of actions in which parties address demands and proposals to one another to reach an agreement changing the behaviour of at least one actor (Odell, 2002; Odell, 1999). Tactics are particular actions which comprise a strategy. A strategy will not necessarily manifest exactly the same tactics in every application; it will adapt to the special features at hand.

In this section we will discuss three strategic considerations which shape the dynamic of the negotiation process: (1) *interpersonal orientation*, (2) *strategic dilemma*, and (3) *methodological direction* (Zartman, 1978).

II.A. Interpersonal Orientation: A Taxonomy of Strategies

Two types of interpersonal orientations influence the process (Walton and McKersie, 1965, 1991; Rubin, Brown, and Deutsch, 1975; Lax and Sebenius, 1986). Suppose the behavioural options vary along a spectrum between two polar ideal types: *value-creating* or *value-claiming* behaviour.

At one pole is the *pure distributive* or *value-claiming strategy*, a set of actions which help attain one party's goals. Concretely, strict value claimers see the preferred outcomes as zero-sum and engage in competitive behaviour in which they negotiate with each other to gain the optimal portion of the final sum. Claiming is not restricted to the most powerful actors: *defensive claiming* is common to all. A poor country requesting a concession and declining to reciprocate, for instance, is attempting to shift value from one party to another. As we will see below, mutual claiming often ends with an unequal split.

At the other extreme is the *pure integrative* or *value-creative strategy*. It involves actions which help attain mutual gains—actions designed to extend value rather than distribute it (Mnookin, Peppet, and Tulumello, 2000). Value-creative parties see the preferred outcome as positive sum in which the agreement generates new goods, and they negotiate with each other cooperatively.

In practice, bargainers rarely choose one of these pure polar strategies. The ideal of a pure integrative behaviour has not often been documented in international economic negotiations.[73] Negotiators often mix distributive and integrative tactics, because using pure polar strategies can put the negotiation process seriously at risk. On the one hand, pure cooperative parties can be exploited if the counter party does not reciprocate. On the other hand, pure competitive parties may block the process with excessive demands. This situation is what William Zartman calls the *'Negotiator's Dilemma'*.

II.B. The Negotiator's Dilemma: Cooperation vs. Competition

According to William Zartman, the negotiation process is ruled by a paradox termed the *'Toughness Dilemma'* or *'Negotiator's Dilemma'*, which makes it characteristically indeterminate (Zartman, 1978; Lax and Sebenius, 1986). The dilemma claims that the tougher the negotiators' behaviour is, the more likely they are to gain a larger part of the outcome but the less likely they are to achieve any outcome (agreement) at all. The dilemma also claims that the softer the negotiators behave, the more likely they are to reach agreement but the less likely they are to reach a large part of the agreed outcome.

In the context of financial assistance, let us consider an interaction model (Table 8.1), in which the lenders (i.e., EU/IMF) and a borrowing country must choose between only two actions:

- The debtor may choose a flexible attitude and agree to sharply adjust its economy, or adopt a tough line and refuse to adjust its economy;

- The lenders may adopt a flexible approach and help the debtors deliver the key objectives of the programme whilst minimising domestic cost, or they may adopt a tough line and push for adjustment at any cost.

According to the Negotiator's Dilemma, this lenders-debtor interaction model may yield the following outcomes:

- If lenders adopt a tough line they are less likely to reach any agreement at all but, if they do, they are likely to negotiate a greater adjustment for the debtor. However, if they adopt a flexible approach they will likely reach an agreement but are less likely to obtain a significant adjustment;

- The same applies to the debtors: if they adopt a tough line they are less likely to achieve any agreement at all, but if they reach one they will likely obtain a significant loan with minimum policy conditions. However, if the debtors adopt a soft tactic they will likely ensure the success of the programme but might obtain tough policy conditions in exchange for the loan.

More concretely, combining each actor's strategies may result in the following four possible outcomes:

1. *'Successful programme'*, whereby they both adopt a cooperative approach; the lenders provide new money and help the debtor deliver the key objectives of the programme whilst preserving other key aspects (e.g., growth/social);
2. *'Debt Repudiation'*, whereby the debtor adopts a competitive approach whilst the lenders adopt a cooperative approach; the debtor refuses to adjust whilst the lenders keep the debtor liquid by providing additional capital;

[73] For example, see Winham 1986, 169-174, on the unusual process by which EU and U.S. negotiators broke a deadlock over rules on subsidies and countervailing measures during the Tokyo round.

3. *'Forced Adjustment'*, whereby the debtor adopts a cooperative approach whilst the lenders adopt competitive approach; the lenders push for the adjustment at any cost;
4. *'Deadlock or Breakdown of the programme'*, whereby they both adopt a competitive approach; the borrower repudiates its obligation and the lenders do not provide additional funds.

Table 8.1: EU/IMF financial assistance possible strategies and outcomes

		LENDERS	
		Flexible Strategy (Cooperation)	**Rigid Approach (Competition)**
BORROWERS	**High Adjustment (Cooperation)**	**Successful adjustment** (lenders help to deliver the key objectives of the programme whilst preserving other key aspects e.g. growth/social), country back on its feet, loan eventually repaid	**Forced adjustment** (risk of internal political fall out, subsequent collapse of the programme, animosity towards lenders)
	Low Adjustment (Competition)	**Debt Repudiation,** Loan risks turning into a Bail-out (funds are received but debt may not be not repaid as the country does not recover from the crisis)	**Deadlock** (negative outcome for both parties), no funding, country goes in negative spiral, debt explodes and growth collapses, contagion

II.C. Methodological Direction

Finally, the dynamic of the process (competitive or cooperative) is also influenced by the definition of the main components of the negotiation: the (1) *formula* and the (2) *details* of the agreement (Zartman, 1977, 1981, 1986, 1991). The first component encompasses the overarching framework which sets the items to be covered or the sense of justice governing the exchange. The second comprises distributive details, ideally implementing the general terms which the formula establishes. The general formula is the heart of a negotiation. It must not only identify a shared perception, reference structure, and idea of justice, but also be comprehensive and relevant to the needs of all parties.

Defining the formula is cooperative by nature, whereas the detail phase is competitive. According to William Zartman, parties should be more conciliatory when specifying the general formula, but be firm when negotiating details (Zartman, 2005). Furthermore, negotiating an agreement under a well-defined formula is crucial to facilitating competitive discussion over the details and thus to increasing the chance of success. Experience shows that agreeing first on the general framework and the overall objective of the negotiation may help create a bond between the parties, which they can refer to during the details phase if tensions arise. As a result, sequencing the negotiation—the order in which parties define these two components—influences the nature of the agreement. Negotiation which begins by establishing a clear formula will tend to produce a more positive-sum or integrative result, whereas negotiation in the reverse order will tend to be more zero-sum or distributive (Zartman, 1983). Effective negotiators will logically and optimally define, first, a formula or the framework of the negotiation process before negotiating the detail at stake.

In the context of financial aid negotiation, the *formula*—that is to say, the lending framework on which details of the financing are negotiated—could comprise:

- The amount of money needed and available, or the size of the loan;
- Lending frameworks under which money is borrowed, such as bilateral funding agreements, the European Financial Stability Facility (temporary emergency fund for euro-area members), the European Stability Mechanism (a permanent rescue funding programme to succeed the temporary EFSF in the 17-member euro-area), or the Balance of Payment Facility (emergency funding facility for non-euro-area members);
- The overall adjustment strategy: Internal devaluation or currency devaluation.

As argued above, a well-defined formula is crucial to facilitating the distributive/competitive discussions over the *details* of the loans, which are in principle contentious. Major disagreements may surround important sensitive issues, including currency realignment, money supply, capital movement restriction, fiscal adjustment, liberalisation, and income adjustment (Spector, 2010).

However, we will see in Part 2 that defining a clear formula can prove quite challenging, as it is constantly affected by the fast evolving economic context. For instance, the amount of money needed at the beginning of the programme may need to be renegotiated in the middle of the programme if the global economic environment deteriorates. Similarly, certain actors can question and renegotiate the adjustment strategy as economic conditions evolve.

This section highlighted the possible strategic dynamics (competition vs. cooperation) of financial aid negotiations. It also showed that the interaction between competition and cooperation is a key determinant of outcomes (Bartos, 1974, 1978, 1987) and hence a major parameter for our case study. A confrontational strategy—by either the Fund, the Commission or, for that matter, the debtors—could yield markedly different results than a conciliatory one. However, a question remains: what is shaping these strategies?

III. Resources and Strategy: Two-Level Game Strategy

A key step is to develop a robust understanding of the resources and contextual factors which debtors and lenders can use to shape their preferences and select their strategies (Spector and Wagner, 2010; Whitfield and Fraser, 2010). Such factors do not determine strategies and outcomes in a mechanistic sense. Rather, they present lenders and debtors with 'negotiation constraints' to consider in deciding what they think can be achieved through negotiation, and with 'negotiation assets' to draw on to make their case in a compelling way so the other considers their preferences seriously. We use the concept of *'negotiation capabilities'* to refer to the leverage which lenders and debtors can derive from the context.

We shall investigate these *negotiation capabilities* in light of Robert Putnam's *two-level game model* (1988) to understand the two-level mechanisms of influence better. According to Putnam, international negotiators represent constituencies (or principals) which must approve a negotiated agreement before it can be successfully implemented. Similarly, financial aid negotiators both have a mandate and negotiate on behalf of their principals. They must satisfy two imperatives simultaneously:

- The debtor's government must find a bargaining strategy which addresses the concerns of both the lenders (Level I) and domestic interests (Level II);
- The lenders must find a strategy which addresses the concerns of the debtors (Level I) and other lenders, other creditors and their own constituencies—Sovereign Member States (Level II).

The result is two sets of game with their own constraints and assets at two different levels. The following paragraphs will investigate these two-level capabilities and their strategic implications for financial aid negotiation.

III.A. Debtors' Two-Level Capabilities

Debtors and lenders resources are, by their very nature, asymmetrical. Debtor countries are typically in a subservient position. They may need assistance desperately due to immediate crises and cash shortage and may be offered very little latitude concerning the amount, form, or delivery of assistance. As assistance providers, lenders tend to maintain the ultimate power to provide or withhold funds, and as such hold a more powerful position in negotiations.

According to Zartman and Rubin (2000, 2002), such asymmetry of power creates potential for exploitation, but empirical data demonstrate that weaker parties often have significant resources available at two different levels. At Level I, sources of leverage include the size of the economy, the strategic importance of the debtors, and the extent to which the lenders have alternative sources of funding. At Level II, resources are usually drawn from the internal bargaining space of the government.

III.A.1. Level I Capabilities: International Politics and Structural Power

Stephan Haggard and Robert Kauffman (1989, 1992, and 1993) suggested that debtor governments have three sets of resources which they can draw upon to improve their negotiation with lenders and creditors: size, strategic significance, and *alternative sources of funding*.

Large debtor countries such as Brazil, Mexico, and Argentina have pioneered more unorthodox adjustment packages. Big debtors have received concessions on conditionality restructuring which are unavailable to smaller debtors. Big debtors have also proven more successful in securing additional forms of relief, including bridging loans, co-financing agreements, and the maintenance of trade credits. Large debtors have tended to obtain better deals, in part because they have been in a position to threaten the international financial system as a whole. The mere possibility that a large country may resist orthodox policy reforms might constitute a credible threat and therefore a strong 'BATNA' (best alternative to a negotiated agreement).

Dur and Mateo argue (2010) that possessing *large structural power* facilitates the use of hard bargaining tactics. Theoretically, however, the opposite is also possible. Hard bargaining tactics are often the weapons of the weak, as the weak must employ all tactics within their reach, including even the most contentious ones (e.g., threats) to protect their interests. In contrast, large countries may assume that their interests will be protected without having to resort to hard bargaining tactics.[74]

Even more important may be the *strategic significance* of debtor countries to major creditors and the *risk of contagion*. As Haggard and Kauffman assert, small countries have been able to extract concessions by exploiting the lenders' political concerns about the stability of a region (e.g., risk of contagion effect).

Finally, the availability of *alternative sources of funding* constitutes a great BATNA. It makes a country less willing to accept lenders' conditionality and more likely to experiment with heterodox alternatives. We will not detail this alternative, however, since it does not relate directly to our analysis. EU countries experiencing economic difficulties have little or no alternative but to seek IMF or EU help. This EU/IMF funding is, for them, a last resort.

[74] Recent findings (Naurin 2009) from counsellors in EU working groups show that large Member States are more likely to use soft bargaining tactics than are smaller Member States.

III.A.2. - Level II Capabilities: Internal Bargaining Space

Contrary to the international bargaining arena, in which the balance of power is weighted primarily on the creditor side, at the domestic level the dynamics are typically reversed. International financial negotiations are highly politicised because stabilisation and adjustment have distributional consequences for various social groups and thus political consequences for governments in power. Therefore, we argue that a country's internal bargaining space is crucial to understanding the strategy the negotiators adopt and the terms they receive in international financial negotiations. We begin by considering the ways in which the power of *social groups* influences debtors' negotiation capabilities. We also consider *preferences* and *ideology* as influential factors for debtors' strategies.

- *Societal Factors* – Some literature maintains (Ikenberry, Lake, and Mastandano, 1988) that *social groups* compete to shape policy strategies in international negotiations. Analyses of how they interact and leverage pressure in international negotiations provide valuable insight into the forces shaping financial assistance programmes. These mechanisms can manifest themselves at different levels. For instance, labour plays a critical role in stabilisation and adjustment negotiations. Labour has constituted a powerful constraint for assistance programmes because of the credible threat of rioting. Unionised workers in both the public and the private sectors are well equipped to oppose structural adjustment measures. One might therefore expect that the level of unionisation and the likelihood of adopting orthodox stabilisation and structural adjustment measures would be inversely correlated (Haggard, 1989). One might also expect governments relying heavily on working-class support to be more likely to tolerate inflation experiment with heterodox programmes (Hibbs, 1977) and adopt tough bargaining positions, since the cost of stabilisation to continue repayment is more likely to fall on their core constituents (Agénor, 1996). Furthermore, labour may agree to refrain from rioting during stabilisation programmes when it is represented by powerful peak agents (associations) and understands the more adverse implications of the programme's failure. However, where strategic labour sectors are weak and penetrated, the burdens of stabilisation policies are easy to impose, although the government may encounter long-term costs in terms of losing legitimacy (Kauffman, 1989).

- *Institutional and Political Factors* — Institutional settings and the political context within which decisions are taken have an important bearing on the choice of strategy in financial assistance negotiations. We need to consider the intra-governmental policy-making process. For instance, who decides on national policy preferences: elected representatives or civil servants in the administrative branch of government? Who exactly within the government? Moreover, the government capacity to generate informed and objective analysis of economic problems is a crucial factor to consider as it influences the speed and coherence of the adjustment response (Nelson, 1990). Finally, we should consider the instruments and institutions which permit implementation as the decision-makers' authority may be sharply circumscribed by constitutional and legal allocations of power to operative ministries, the legislature, or lower-level government. In addition to the institutional settings, the political context marks a significant factor of influence in the financial aid process. More specifically, domestic political legitimacy marks a crucial negotiation resource for the debtors. Governments agents (the Prime Minister or Finance Minister) who have a high degree of political legitimacy and a large degree of manoeuvre at home may thereby have greater negotiation capabilities. Nonetheless, governments which lenders consider to be constrained by domestic political considerations, such as finely balanced coalitions, powerful interest groups, or a weak electoral mandate, may also prove able to use this constraint to gain leverage in negotiations. Besides political legitimacy, we should consider political cycles since short-term shifts in the political context affect adjustment policy-making. We expect that incumbent governments may hesitate to impose unpopular measures as their tenure in office grows shorter or less secure (Haggard 1989).

- *Ideology* – In addition to social interests, bargaining strategies are guided by broad set of norms and agendas. Certain economic negotiation experts recognise that underlying ideological positions can influence policy process (Goldstein, 1988; Woolcock, 2011). For instance, a government with a long history of attacking business and property rights might prove more reluctant to agree on more flexible business environment reforms during crises, since that approach might place them in an awkward position with their core constituents. In contrast, a government with a culture of entrepreneurship might adopt a proactive attitude toward business during crisis and

therefore, during negotiation, might choose a more integrative strategy with the lenders regarding business reforms.

- *Preferences* – A country's position preference to the status quo may also shape its bargaining strategy. Countries will be more likely to engage in distributive negotiation if constituents prefer the status quo and perceive the cost of implementing the agreement with lenders to be too high. Deborah Elms (2008) argued that countries in a position of (perceived) loss are likely to opt for a hard bargaining strategy. This hypothesis is grounded in the following theory: losers—those who expect in the future to be worse off than the status quo—are likely to accept risks. Hard bargaining tactics tend to involve risk. They can produce substantial gains, by enabling a favourable deal, or considerable losses if they intensify a conflict. As actors' risk acceptance increases in the face of losses, they should exhibit a great willingness to use hard bargaining tactics despite the associated risk. In the context of the EU crisis, structural adjustment may be perceived as a significant loss for countries with a large social welfare system which needs to undergo a serious revision and/or downsizing. If constituents and decision-makers see structural adjustment as generating a greater loss than the status quo—that is, no financial assistance—they are likely to adopt hard bargaining tactics.

III.B. Lenders Two-Level Lenders' Capabilities

Although lenders play a fundamentally different game than the debtor, they must also contend with a two-level game. As argued above, they must address concerns of the debtors, other lenders, other creditors and Member States. We therefore expect lenders to shape their strategies based on their calculation of their capabilities at two different levels.

III.B.1. Level I Capabilities: Lenders' Relative Strength

Lenders' capabilities are proportional to the debtors' resources at both the international (debtor size, risk of contagion) and the domestic levels. At the international level, the size of a country's debt and the threat to the economic stability of a region each constitutes a source of leverage for the debtors to obtain easy access to funding. As a result, a large debt and high risk of contagion significantly restrain lenders' room to manoeuvre. The lenders' bargaining strength is thus proportional to the relative size of the debt and the risk of contagion. At the domestic level, a debtor with flexible room to manoeuvre (e.g., high degree of political legitimacy, weak labour) may become a source of leverage for the lenders, as the government can implement adjustment measures whilst preserving political stability. However, a government with a strict mandate at the internal level (e.g., strong labour, lack of understanding of the programme's necessity at the domestic level) can use the risk of social unrest as a source of leverage to block the programme.

III.B.2. Level II Capabilities: Internal Constraints

Lenders will also shape their strategies according to their own internal bargaining space. This space depends first on their *funding capacity*, or the amount of money they can provide. A lender with a large funding capacity will obviously play a pivotal role in the programme. For instance, big lenders can exert pressure on the debtor by withholding the loan tranches if the mission chiefs consider the debtor progress to be insufficient. Moreover, they will play a leading role in front of other lenders and creditors.

The strategic significance of the debtors to *major creditors* and the *number of creditors* involved in the process also increase pressure on lenders. The lenders may need to grapple with opposing interest between creditors which have extensive foreign loans and those with less extensive loans. The former have a greater incentive to remain committed to accommodating with debtors, whereas the latter often seek to defect from their debt agreement (Lehman, 1990, 1992 and 1993). This internal game may grow more complex as the lenders must also *cooperate* and *act collectively* to pre-empt debt default. In the case of the EU sovereign debt crisis, the cooperation between the EU Commission and the IMF generally marks a source of leverage as they offer complementary resources. However, cooperation among lenders can sometime prove challenging.

Finally, the *bargaining skills* and *credibility* of the negotiators, the *experience* of the lending organisations in bailout or debt negotiations and the *institutional capacity* will also shape the overall lenders' negotiating strategies.

III.C. Implications of Negotiating Strategies: Financial Aid Strategic Dilemma

As argued above, negotiators must choose between two basic strategies: they can either adopt a competitive approach and risk blocking the process, or adopt a cooperative approach and risk reaching a poor agreement. In the context of a financial aid process, the strategic dilemma proves slightly more complicated since rational moves at one level may be impolitic at the other (Putnam, 1988). For a debtor government, the dilemma is as follows: if the government refuses to offer acceptable concessions and to adopt sharp structural adjustment measures, it risks retaliation from the banks, the lenders, and the international institutions community, who may cease lending or treat the debtor country more harshly on other fronts; if it accepts the lenders' policy measures, it risks polarisation and political mobilisation by the domestic groups whom the cost of the agreement affects.

The lenders also face a strategic dilemma in financial aid negotiations. If, on the one hand, they adopt a distributive strategy by pressing debtor governments to meet their debt obligations and to implement sharp adjustment policies, they risk retaliation from the debtor through debt default. If, on the other hand, they make too many concessions to reach a negotiated solution, they risk retaliation from creditors. To maximise the chance of success, negotiators therefore must increase the likelihood of a ratifiable agreement by influencing the preferences of constituents of Level II. This influence—or in Putnam's words, 'reverberation'—may occur as Level I actors develop a strong communication strategy about the overall benefits of the programme in an attempt to win the support of both lenders' and debtors' constituencies.

Due to this dilemma, negotiators may choose a bargaining strategy by calculating both their respective strength relative to that of their opponents (Level I) and their internal constraints (Level II):

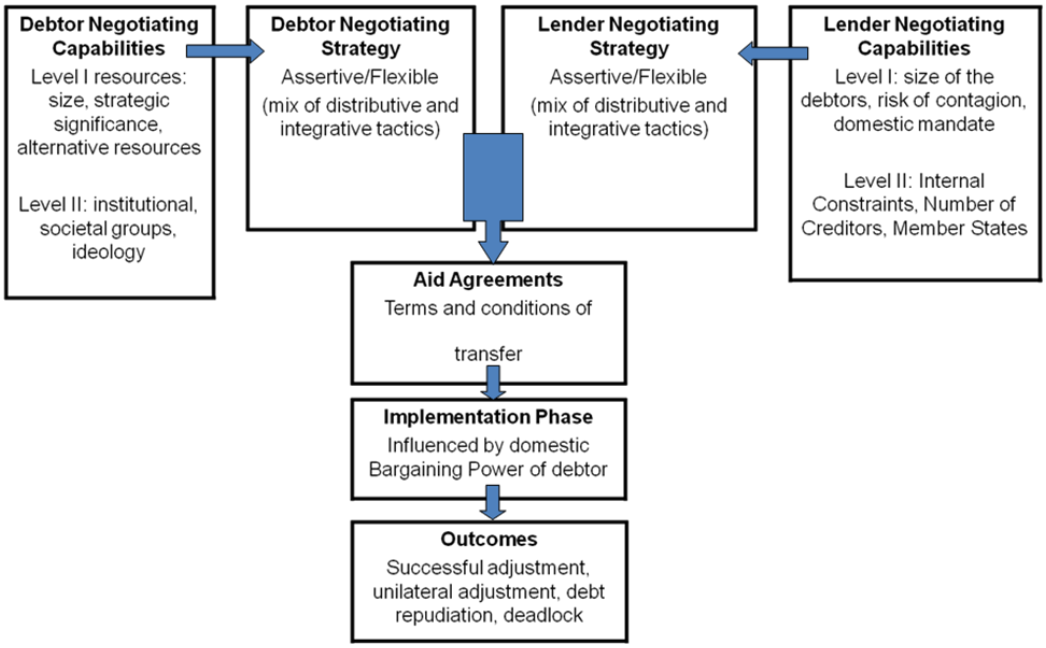
- Negotiators with strong resources at Level I and weak resources at Level II may adopt a competitive approach. High pressure at the internal level (Level II) coupled with powerful structural resources (Level I) increases the chance of their using Level I resources as source of pressure to pursue the interests of their constituencies;
- Negotiators with strong resources at both levels usually produce mixed results, depending on the cost of not reaching an agreement;
- Negotiators who perceive themselves to be in a weak position at Level I may shape their strategy based on their strength at Level II. For instance, governments with limited bargaining space at Level II may turn this weakness into a strength at Level I by claiming that the proposed programme will never be implemented at the domestic level (Putnam, 1988, p.440);
- Negotiators who are strong at Level II (flexible bargaining space) but weak at Level I may adopt a cooperative approach as they will likely obtain concessions at Level II.

The relative strength (Level I) and flexibility of the internal mandate (Level II) thus mark important variables in explaining the chosen strategies and in predicting the chances of reaching an agreement (see Figure 8.1). However, empirical data demonstrate that even if bargaining strength strongly influences the negotiator's choice of strategy it does not prevent parties from combining tactics (i.e., integrative and distributive). For instance, lenders with strong resources could adopt an assertive strategy but still deploy integrative tactics to help the debtors in the domestic debate. Adjustment experience shows that lenders' power pressure may not suffice to ensure a programme's success, as pressure may cause negotiations to break down. The aim, therefore, is to design a strategy which can withstand the tension between excessive pressure on the debtors and too many concessions.

As argued above, despite negotiators' bargaining power, their main strategic tool cannot be only pure power pressure or pure cooperation. Negotiating strategies necessarily comprise multiple tactics (e.g., assertive tactics aimed to exert pressure and creative tactics aimed to provide support). For instance, our data on Latvia show that lenders can adopt an assertive strategy but still facilitate the negotiation process by providing crisis management support and guidance to the debtor country throughout the programme. In effect, financial institutions and debtors can find a zone of possible agreement (ZOPA) and a credible response to the crisis only through constructive dialogue, regardless of any power asymmetry.

This *two-level capabilities* model thereby offers an adequate framework to investigate how assistance programmes in Latvia and elsewhere are elaborated in terms of process (see Figure 8.1). However, this model provides a limited picture of the mechanisms of influence in financial aid negotiation. Empirical research confirms that parties' capabilities significantly influence their choice of strategy, but it proves difficult to determine a universal theory on politics of adjustment which exactly predicts the choice of strategy. The framework discussed above offers only a limited picture, which laboratory evidence must complement.

Figure 8.2: Two-Level Capabilities Model



PART 2 – FINANCIAL AID NEGOTIATION IN ACTION: THE LATVIAN CASE

This section will investigate the Latvian aid negotiation process in light of the model described above. This framework will help construct a comprehensive analysis of the mechanisms of influence and the strategic choices in the Latvian programme. It will not, however, elaborate a full and accurate picture of the resources and tactical decisions, elements which can be understood only through fieldwork research. As such, the following paragraphs will investigate the Latvian case through the two-level framework and will corroborate our analysis with empirical data (collected through observations and interviews) on the Latvian and lenders' capabilities and strategic choices.

IV. The Latvian Committed Response

To explain the strategy which the Latvian authorities adopted we will first examine the contextual factors which may have influenced their choice of strategy. Second, we will consider the government's actual policy actions based on our empirical data to see whether these data confirm the framework predictions.

IV.A. Latvian Flexible Capabilities

In line with our framework, the following paragraphs will investigate the Latvian constraints and assets at the international and domestic levels.

IV.A.1. International Resources

Based on a resource analysis of the Latvian case we can claim that the government had limited resources at Level I. First, the relative *small size* of the Latvian economy constitutes a significant challenge to leverage influence in international economic negotiations. As with many other small economies, Latvia's limited structural power restricts its room of manoeuvre at the negotiation table. Compared to larger countries, governments of small states grow dependent on external drivers of growth and have less bargaining space with respect to economic policy adjustment during a systemic crisis. More specifically, states with smaller populations are more likely to struggle to stimulate demand to prop up economic growth or to soften the effect of a recession. This situation arises during a balance of payment crisis, and especially in the context of significant capital outflows.

Latvia's *strategic importance*, however, may stand as a crucial leverage in economic negotiations. In particular, the country's *strategic importance* to major power creditors on the IMF's Executive Boards or the EU Council may make them more likely to gain an EU/IMF loan (Lehman, 1993). Furthermore, the *potential default* of Latvia—or other relatively small Member States such as Greece—has raised serious concerns for the EU and IMF about European economic stability as a whole or, in the case of Latvia, for a large region such as Scandinavia and Eastern Europe. Such contextual conditions constitute significant leverage for these small countries and therefore can be used as a worst-case scenario argument to negotiate minimum adjustment. At the same time, a debtor's strategic significance may cause a larger number of actors to become involved in the rescue, thereby increasing the pressure which lenders might exert.

Finally, the lack of *alternative funding* marks a major constraint for Latvia—or any other small debtors—as the EU and the IMF are lenders of last resort. However, as the role of the EU and other creditors in Latvia, Greece, Portugal, or Ireland, reveals, involving *multiple financiers* creates leverage since it increases debtors' ability to play off lenders against each other.

IV.A.2. Government's Internal Bargaining Space

As argued above, economic negotiations show influence from not only the structural power of the debtor states. The debtors' response also depends highly on the agents' flexibility vis-à-vis the domestic constituencies. According to our data, the distinctive flexibility and resilience of Latvia's domestic context seemed to give the country significant bargaining slack during their negotiations with the EU and the IMF.

First, the *flexibility of the labour market* – the hallmark of the Baltic labour markets – has eased wage and employment adjustment. In Latvia and other Baltic states, unionisation is very low and weak, private labour law governs public administration contracts, and dismissal rules are flexible toward the employers (Kohl, 2004; Eamets, 2004; Tāre, 2010). This particular context may have facilitated the government's implementing sharp adjustment measures, as it generally faces little risk of riot.

Moreover, a significant negotiating resource appears to result from *favourable institutional conditions* such as the maintenance of Latvia's civil service, high calibre staff, capable planning institutions and a centralised decision-making process. These aspects of the state infrastructure, developed by many post-Soviet countries, have instilled credibility in the eyes of the lenders. The only difficulty for Latvia—or any other EU countries undergoing a sharp adjustment—is the *fragmentation of the financial aid negotiation resulting from the weakening of the civil service* (Whitfield and Fraser, 2010). Empirical data show that financial aid often follows 'civil service cuts' and the weakening of several government departments. This fragmentation of the aid negotiation makes it difficult for recipient governments to manage lenders during adjustment era negotiations. In such circumstances, ministers and civil servants in weak positions pick only the most important battle, such as the exchange rate.

More important than institutional conditions in explaining Latvia's adjustment strategy is the *political context* under which the adjustment occurred (Haggard, 1994). In that regard, the Prime Minister of Latvia, Mr. Vladis Dombrovskis seems to have benefitted from being out of the government and having opposed his predecessor's stabilisation programme for allegedly being insufficient. According to empirical evidence (Nelson, 1990), new governments often benefit from periods of acute political turbulence in which the previous government had been increasingly isolated and ineffective. For instance, in Chile in the mid-1970s, Jamaica in 1980, Ghana in 1982, and the Philippines in 1986, many people viewed previous governments' poor economic records as an intrinsic result of those government's ideologies and/or political structures. New prime ministers represent not only new leadership and direction but also changes in regimes. As Finance Minister of Latvia in 2002-2004, Dombrovskis became known as a classical liberal and fiscally conservative politician. Moreover, he greatly critiqued the 'boom-bust economics' and thus represented the *new figure* able to repair the previous governments' mistakes. Accordingly, the Latvian government enjoyed a significant legitimacy which translated to a flexible mandate at the international level.

Furthermore, Latvian officials have argued that people understood the emergency of the situation at hand (personal interview, November 7-8, 2011). Alongside the EU/IMF negotiations came a strong public awareness of the gravity of crisis. All of Eastern Europe had enjoyed nearly a decade of high economic growth, from 2000 to 2007, but no nation experienced higher growth than Latvia. Many Latvians perceived that something was wrong with their economy and that a severe setback was inevitable (Aslund and Dombrovskis, 2010).

Finally, adjustment experience (Whitefield and Fraser, 2009) demonstrates that the balance of negotiation involved *ideological elements*. In that respect, Latvia and the other Baltic nations seem to be a unique case. Foreign loans saved Latvia in Spring 2009, as did a tough programme of budget cuts unparalleled in modern-day Europe. Latvia, still aiming to join the euro, has maintained a fixed exchange rate of the lats to the euro (European Commission, 2012b). They therefore have had to cut public spending significantly. Without much protest, state employees lost roughly one-third of their income, if they were able to keep their jobs.

As many Latvian officials have argued, the main source of the adjustment programme's success seemed to be the Latvian mentality (personal interview, November 7-8, 2011). Much of Latvian society remembers the misery of Soviet occupation. They remember the post war era and Siberian prison camps, which they term 'grave crises'. As Anders Åslund observes: 'The vicious 1990s post-Soviet slump made Latvians hardily resourceful' (2010). Built on this reasoning, some of the actors have argued that the 2008 financial crisis was not a crisis as such but rather a normal adjustment. We therefore suggest that the Latvian experience with adversity may explain to a certain extent how Latvian society has proved so adaptive and resilient to the 2008 economic drama (Spector, 2006). In that regard, developmental psychology research suggests that international negotiations can learn from the concept of resiliency. *Resilience* is a human competency which experiences of extreme adversity can strengthen. We claim that negotiators faced with an impasse are able to mobilise resiliency to bounce back from impasses if they have the capacity to bounce back from adversity in their personal lives (Spector, 2006, 2009). In the Latvian context, the adverse Soviet experience has strengthened this human competency and may have helped avert the programme's failure.

According to this two-level analysis, the relatively limited strength of the Latvian government at Level I and their flexible capabilities at Level II predict a flexible strategy on their part. Let us confirm in the following paragraph whether the Latvian government adopted a flexible strategy in practice.

IV.B. Latvian Committed/Flexible Strategy

Our empirical data on the government's strategic choices fit into our two-level model analysis. The Latvian authorities opted for a flexible strategy with the lenders and a committed approach at the internal level. We must note, however, that even if the Latvian government was committed to the programme, overall the situation proved slightly more complex in reality. As argued above, a negotiation strategy cannot be purely integrative or distributive. A strategy comprises multiple

tactics. We therefore must examine the tactical responses which the Latvian authorities adopted at several stages of the programme.

IV.B.1. Cooperative Tactics

The Latvian authorities and general public remained strongly committed to the main features of the programme (i.e., long-standing monetary exchange rate arrangement and eventual joining of the euro), despite many warnings that the internal adjustment path entails substantial employment and welfare losses. In fact, the Minister of Finance and the Prime Minister kept a *stronghold on budgetary decisions* to frontload sharp adjustment measures at a rapid pace. They also engaged in constant *dialogue with the coalition and social partners* to achieve some consensus or at least to avoid social unrest. They even undertook an *internal communication process* to convince the general public about the need to adjust.

Only one serious backlash occurred against the government, in January 2009. A peaceful protest turned into rioting, but even that incident related more to concerns of government corruption than to measures 'imposed' by the lenders. Instead of the riots and political instability which many experts had predicted, the political process under the programme showed uncharacteristic stability in Latvia's parliamentary system.

IV.B.2. Creative Tactics

We should clarify that at the beginning of the negotiation the Latvian government did not quite commit, as they faced difficult internal divisions on the question of internal devaluation (Aslund and Dombrovskis, 2011). This disagreement caused competitive tactics aimed at softening conditionality. To that end, the government initially hesitated to implement harsh adjustment measures and therefore made few attempts to play on the lenders' weaknesses (especially on the Commission):

- For instance, that the Commission appeared more lenient than the IMF negatively affected the lenders' strategy. From the Latvian perspective, the Commission and the IMF played a Good Cop/Bad Cop game in which they perceived the Commission as the soft part of the programme. The Latvians therefore used this apparent weakness *to bypass the mission chief level* and speak with the higher political level (i.e., Mr. Barrosso, Mrs. Merkel) to exert a more lenient approach. Eventually, the Latvian counterpart realised this leniency would not come;

- The government also played a *defensive game*. Latvian representatives formally agreed on the terms and conditions at the negotiation table so as to receive the funds, but they then delayed consolidation;

- The Latvian government accepted *onerous conditions* to receive loan tranches immediately, but once the agreements were signed, the negotiators initiated post-agreement talks to renegotiate the timeframe for fiscal adjustment; for instance, they disagreed about LVL500m adjustment and multiple deadlines for mortgage and land bank restructuring;

- Finally, we noticed some attempt to *play off* lenders against one another. The Latvian authorities tried to exploit tensions between the IMF and the EU through separate meetings in Brussels and Washington.

These creative moves aimed at influencing the lenders did not prove very successful. We must also acknowledge that Latvia used them on an exceptional basis and they did not affect the relationship between the lenders and the government.

V. The EU/IMF Game: Dealing with Complex Negotiations

Many studies have focused on the debtors' perspective and their ability to control financial programmes. To give a comprehensive picture of these financial aid negotiations, our research also

explores the situation from the lenders' perspective. First we will suggest that the lenders must play a two-level complex game and should consider their negotiation capabilities - constraints and assets - to elaborate an effective strategy. Second, to corroborate this two-level analysis, we will use empirical data to define which types of tactics the lenders use in practice.

V.A. Lenders' Capabilities

As argued above, the lenders' capabilities are relative to the debtor's assets and domestic constraints.

V.A.1. Flexible Counterpart as a Source of Leverage

The *relative small size* of Latvia's economy and *the lack of alternative funding* both constitute sources of leverage for the lenders to push forward the programme at a rapid pace. Small economies generally have little choice but to follow the adjustment path which lenders advise. As the Latvian Prime Minister argued, the question is not whether Latvia needed to adjust or whether economic adjustment implied sacrifice (Aslund and Dombrovskis, 2011). Rather, the question was how to ensure adjustment whilst mitigating the economic crisis with lenders' support. Encouraging the programme to fail is always an option, but a very difficult one. In the absence of financial aid, the economic environment may simply force adjustment and thus make it even more painful.

At the domestic level, *government flexibility* proved a crucial asset for the lenders to ensure the programme's implementation. Typically, domestic interactions represent a major obstacle for lenders. Governments with a limited mandate cannot adopt adjustment measures without losing credibility and facing massive riots. As argued above, the Latvian government had a flexible mandate to implement sharp adjustment measures. This flexibility at the domestic level gave strong resources to the lenders to enact adjustment measures without risking that the agents (i.e., Prime Minister or Minister of Finance) might be acting outside their political mandate and cause social unrest. The government even opted to frontload difficult reforms without damaging excessively its credibility (IMF, 2012). The Prime Minister did suffer from negative consequences of the reforms, but despite the measures' severity he still benefitted from a significant legitimacy: he was re-elected in October 2010 after a sharp wave of austerity measures.

V.A.2. Lenders' Internal Bargaining Space

Besides the capabilities which arose from Latvia's relative bargaining strength, lenders had to consider various internal constraints to shape a strategy suitable to the situation.

V.A.2.i. Dealing with Powerful Principals and a Strict Mandate

As argued above, EU/IMF Financial aid programme constitutes a principal-agent negotiation (Susskind and Mnookin, 1999). The Commission and the IMF representatives negotiate on behalf of multiple principals. In fact, these agents have a strict mandate from their respective organisations. At the same time, they represent powerful creditors who have a strong interest in the programme's success. Even if they do not instruct the lenders officially, they act as form of principal in significantly influencing the lenders' agendas.

- **Hierarchical and Organisational Mandate**

The Fund and the Commission have had to navigate strict *deferential mandates*, i.e., the kind of hierarchical relationship which often includes a vertical relationship. IMF agents and especially Commission agents both negotiated on behalf of a large and hierarchical organisation. As a result, these representatives often had a strict mandate with limited room to manoeuvre (Cini, 1996).

Representatives also considered actors who had no vertical power but who could exert 'soft power' (*influence*) through peer pressure, such as the Member States or other Directorates. For instance, though no deferential relationship exists between the Directorates General of the European Commission and Member States, an *influential/organisational relationship* enables the actors of this relationship to ask for information or favours. Since force and authority are useless in these cases,

they instead require means of persuasion. It is all about the "art of graceful manners" (Lempereur and Colson 2008, 2010).

Along similar lines, the agents' *personal channels* can also affect the decision-making process. For instance, the Commission Mission Chief for Latvia had a flexible agent slack based on a long-term relationship with the Commissioner, then Joachim Alumina. Internal trust within the institution helped the Commission mission team to make decisions quickly in case of emergency. Their ability to accelerate the decision-making process and to ensure the closeness of the lenders proved a significant factor in deciding issues of negotiation and establishing clear channels of communication among the principals.

- **Involvement of Various Creditors**

Latvia's *strategic significance* to major creditors—mainly Sweden—and the *involvement of various creditors* in the programmes tremendously increased the complexity of the negotiation and the pressure for the programme to succeed. On the one hand, a debt default could have negatively affected the Swedish banks as they represent one of the major investors in Latvia. As a result, Sweden had a great interest in ensuring the programme's success. Economic adjustment experience shows that powerful creditor nations put immense political pressure on the IMF to resolve debt conflicts in favour of their respective countries' citizens. As Scott argues, the ties between IMF leadership and G7 countries are unquestionable (Neal and Weidenmier, 2003; Ko 2003).

On the other hand, the gross external financing necessary to stabilise Latvia (EUR 7.5bn) prompted several creditors to join the negotiations, as the EU and the IMF were not ready to fill the financing gap alone (European Commission, 2012a; IMF, 2008a). Traditionally, the IMF had limited its lending to three times the quota which a country held with the Fund; yet the IMF had already participated in exceptionally large stabilisation programmes. In Latvia's case, however, non-European IMF members were not prepared to accept more. The IMF commitment of credits, which reached EUR 1.7bn, therefore filled only 22 % of the financing cap of EUR 7.5bn. The World Bank contributed to social safety nets at EUR 400m, and the EBRD contributed EUR 100m as an investment in the share capital of Parex Bank, a Latvian Bank. Amid this situation, the Commission played a crucial role in the stabilisation programme by committing to no less than EUR 3.1bn, almost twice as much as the IMF. Latvia benefited from the Hungarian and Romanian precedent, in which the Commission had proved a pioneer in framing the first EU financial stabilisation programmes. Yet the Commission did not commit to more since the budget cap for Balance of Payments programmes at that time was EUR 20bn and Romania and Hungary were already in the pipeline. The Commission did not want to deplete the Balance of Payments funds by just three countries, because other requests may follow. The total from these international organisations came to EUR 5.3bn, which left a gap of EUR 2.2bn. The Swedish Minister of Finance, Anders Borg, thus stepped in—along with Denmark, Norway, and Finland—to contribute to the overall plan.[75] They committed collectively to total credits of EUR 1.8bn. In addition, three new EU members outside the euro area made their own commitments: the Czech Republic, EUR 200m; Poland, EUR 100m; even small Estonia, EUR 100m.[76] Having so many creditors and lenders involved in the process had many implications for the EU and IMF, notably regarding the complexity of the negotiation and the internal pressure they had to handle.

These creditors generally behave as principals during the negotiations: they attempt to shape the agents' mandate and thereby protect their interests. Such a complex situation usually causes significant tensions, as the agents' and the principals' respective interests diverge. We see three ways in which agents may have differed from the creditors and other principals. First, the agents may have

[75] The reluctance of the EU/IMF to cover the Latvian financing needs seems at first rather surprising as the amount of money required is trivial in comparison to other programmes (Greece for instance). However, there seems to be several reasons that the EU/IMF did not cover the financing needs completely. First, the lenders are not willing cover any funding needs completely as this would take away incentives to reform from national governments. Secondly, national co-funding is also important for national ownership. Finally, Latvia was financed by the Balance of Payments mechanism that is only for non-eurozone members and the financing capacity of this mechanism is not as big as EFSF, ESM that apply to Greece and other eurozone members.

[76] Commission (EC), Economic and Financial Affairs, 'Latvia' (*Economies of the Member States*, 27 June 2011) http://ec.europa.eu/economy_finance/eu/countries/latvia_en.htm accessed 19 June, 2012.

different preferences from their principal, such as the type of reforms to push through. Second, agents may have a different stake in the outcome. Third, they may have information which is unavailable to the principal, or vice versa. These kinds of divergences create problems related to monitoring, coordination, and strategy and consequently place tremendous pressure on the Commission and IMF agents (Moffitt and Bordone, 2005).

V.A.2.ii. Lending Capacity of the Funding Framework

The lenders' relative lending capacity can also mark a significant constraint. For instance, the limited lending capacity of the Commission at the beginning of the Latvian programme proved problematic. The *European Stabilisation Fund*, a balance-of-payment facility meant for non-euro area countries, had already reached its maximum capacity (EUR 12bn) when the EU and the IMF were called in to Latvia (Article 143 of the Treaty on the Functioning of the European Union, Council Regulation (EC) No 332/2002). Notably, the fund was first used for Hungary and Romania and appeared to be insufficient for Latvia. With limited financial resources, the Commission could only exert a limited influence on the negotiation process or achieve an outcome compatible with the EU interests. The Commission therefore negotiated at the internal level, with Member States to increase the fund's lending capacity. As a result, in early December 2008, the European Council doubled the balance-of-payment to EUR 25bn to give the Commission an ample leverage in the negotiation.[77]

V.A.2.iii. Institutional Capacity and Experience in Bailout

Unlike the IMF, the Commission had few *administrative* and *institutional resources*, namely limited support facilities to work on the programme. More important, the EU had almost no *superior knowledge* of how to implement a surveillance and bailout process (Sjösted, 1999). This situation differs markedly from the IMF, which has bailed out countries for several decades. At the start of the Latvian programme the IMF was very clearly in the 'driver's seat' vis-à-vis the authorities and general public (Schadler, 1995; De Vires, 1987; Abed, 1988).

V.A.2.iv. Cooperation among Lenders: Tensions over the Negotiation Formula

Overall, the relationship between the IMF and the Fund was an asset, yet it also proved challenging in certain situations. The Commission's and the IMF's objectives are typically identical or complementary. In some cases, however, important differences may arise. The IMF is more short- to medium-term orientated, as its loans are usually repaid in 3 years, whereas the EU is involved with Member States on a long-term basis and also takes stock of solidarity principles, risk of contagion, and other Member States' views. In some cases, the IMF's short-term outlook may conflict with long-term interests, such as urging fire sales of state assets when the environment proves unfavourable (Henning, 2011). Moreover, the Fund is sometimes ignorant of EU legal and institutional complexities (e.g., state aid, procurement, EU fund rules and regulations) and devotes little attention to growth-enhancing structural reforms.

This divergence of interests caused tensions and lengthy debate about (re)defining the negotiation's general framework. As argued in section I, every negotiation takes place under an overarching framework, or formula. Agreeing the formula first typically facilitates the distributive discussions on the *details* of the negotiation. In the case of Latvia, the agreed formula had three dimensions: (1) the lending facility, or the *Balance of Payment Facility*; (2) the amount of money required (EUR 7.5bn); (3) the programme's overall adjustment strategy, i.e., joining the euro and internal devaluation. Choosing the lending facility did not prove problematic since it was clearly foreseen by the Treaty (Article 143). However, evaluating the amount of money needed and the choice of adjustment strategy marked more challenging questions, as they depended greatly on the changing economic environment. Ultimately, they managed to agree on these three dimensions by the end of the first negotiation round, in 2008. However, when the economy began to collapse early-2009, major tensions arose around the question of the adjustment strategy as both lenders saw the evolving situation and potential solutions increasingly differently. It seemed clear that some external economic

[77] Based on a proposal by the Commission, the Council decided in early-December to raise the overall financial assistance ceiling in Regulation 332/2002 to €25 billion from the original €12 billion (see IP/08/1612).

factors required the lenders to readjust the negotiation formula. If the parties did not readjust it, the market would. They had to find the right approach to handle these unforeseen changes. The problem in Latvia was that the EU and the IMF did not share the same perspective on how to re-adjust the formula.

In the first half of 2009, the economy was free-falling with an -18% GDP drop as opposed to -5% projected in December 2008. In addition, the government had resigned in February and there were concerns that the new government of Prime Minister Dombrovskis had taken insufficient action (IMF, 2009a, 2009b; European Commission, 2012b). Latvia came under financial scrutiny in June 2009, and the path to euro adoption (2012) was being questioned. In this context, the IMF started scrutinising this strategy whilst the Commission wanted to keep the original one. From the very start of the programme, many in the IMF opposed or questioned the internal devaluation scenario which the authorities had chosen; the Program initially did not secure the confidence of domestic and international markets, a crucial element of economic stabilisation. The IMF seemed unwilling to help the authorities bestow this confidence in 2008 and 2009, and markets perceived that IMF staff was questioning the viability of the authorities' strategy (Aslund and Dombrovksis, 2011).

Assessing the situation substantially differently, the European Commission believed in a possible adjustment kick-started by a 'June package' and in the necessity of acting quickly to preserve the original strategy and avoid failure. Ultimately, the Commission 'broke the line' and acted ahead of the IMF for the first time: they disbursed to Latvia a 'life-saving' EUR 1.2bn in July 2009 (European Commission, 2012b).[78] The Commission readjusted the negotiating formula by *anchoring* first with a convincing number. This decision established a strong framework of reference and reinforced confidence in the original strategy. By *anchoring* with a large second tranche, the Commission sent a clear message of support for the original formula which had to be readjusted according to changing economic factors.

Thankfully, this audacious decision did not excessively damage the relationship between lenders. Making such a decision at a critical stage of the process, without consulting the IMF, might have put the entire programme at risk. It might have been optimum for the Commission not to bypass the IMF; yet, negotiation is not always about optimality. Rather, it is about finding an adequate agreement based on the actors' resources and the conditions of the situation. In emergency situations, when leadership is lacking, someone must make a first move to reach the best solution possible considering the urgency of the situation.

V.B. Implications for Strategy: Assertive/Flexible Strategy

As argued above, lenders face a strategic dilemma in financial aid negotiations. On the one hand, if they adopt a hard line by pressing the debtor to implement sharp adjustment policies, they risk retaliation through non-implementation or debt default. On the other hand, if they make too many concessions to reach a negotiated solution with the debtor, they risk retaliation from other lenders, other creditors, and their own constituencies. Lenders' strategy will therefore be based on calculating the relative strength of the debtor (Level I) and their own strength and constraints (Level II).

In Latvia, lenders enjoyed significant resources at Level I due to the flexibility of the Latvian government at the domestic level and the country's relatively limited resources at the international level. However, they had to consider various constraints at their own internal level. Based on the calculation of these strong resources at Level I and significant internal pressure at Level II, our framework predicts a competitive and assertive approach on the part of the lenders.

However, empirical research shows that our framework of analysis gives only a partial picture of the reality. The situation proves more subtle than it appears. Although lenders enjoyed significant resources, their strategy was not strictly assertive and based on pure power pressure. Our data, collected through observations of the programme, confirm that the lenders adopted overall an

[78] Joint statement by the Commission and the Presidency of the EU on the disbursement of the 2nd instalment of the Balance of Payment loan assistance to Latvia.

assertive strategy, but one based on various crisis management instruments and cooperative tactics aimed at mitigating the difficulty of the economic downturn.

V.B.1. Raising Positive Expectations about the Programme

The Latvian case and structural adjustment experience more broadly reveal that the actors' expectations regarding the predicted outcome of the programme may influence the programme's actual result. Expecting failure can yield a self-fulfilling prophecy. The parties feel that they cannot justify making any concessions—to either themselves or their constituents, who are urging them to hold fast—and they respond with caution and scepticism to proposals from the other side (Ross, Liberman and Anderson, 2009). The asymmetry between the value placed on possible 'gains' vs. 'potential losses' heightens this weakness (Kahneman and Tversky, 1979, 1984, 1995). Our thesis is that positive expectations, whatever their source, increase the likelihood of success because they change the negotiation process and the attributions made during that process.

Little evidence exists about how perceiving failure or success in negotiations might affect the outcome. However, some relevant literature dealing with self-fulfilling prophecies claims that raising expectations may have the following impact (Merton, 1948; Snyder and Swann, 1978; Word, Zanna and Cooper, 1974):

- First, positive expectations can change *thresholds for acceptance*. Without positive expectations, the reference point is non-agreement or the status quo, and loss aversion becomes a barrier to the concessions necessary for agreement;
- Second, positive expectations and the motives they give rise to allow one to anticipate that any concessions one makes will be appropriately valued and even reciprocated.

Finally, positive expectations can foster more *positive attributions* regarding one's counterpart. Without positive expectations parties are apt to adopt a zero-sum approach: 'if they made this offer it must be good for them, and if it is good for them it is bad for us.' Positive expectations create, or at least permit, more positive attributions. For example: 'the reason they are making this offer is that it might be good for us'. We argue, then, that *managing expectations* in Latvia likely helped create positive dynamics in the negotiation process. We see this effect most notably in the ways that the Latvian counterpart and the EU/IMF representatives interpreted each other's actions and in the inferences they made about the programme's outcome. We will thus investigate the steps that the lenders in Latvia have taken to create positive expectations and to handle the classical challenges of a highs stakes negotiation.

V.B.1.i. Efficient Communication Strategy

Communication on sensitive matters plays an important role in influencing public opinion. How communication is handled can matter greatly. Experienced negotiators understand that the way a message is delivered can matter as much as its content. Unpleasant outcomes can prove acceptable if the news come across in a way that seems fair (Colson and Lempereur, 2010). For example, providing credible information can shape domestic public opinion in the target country. Information can also be directed at the key 'principals', such as legislators in the debtor country, though informal communication would need to complement this tactic.

Financial assistance programmes entail huge economic, financial, and social adjustments which place a heavy burden on the people. It is only fair to expect the Commission and the Fund—especially the mission chiefs—to interact closely with the key stakeholders on what needs to be achieved, why, and how. The occasional dry press releases may not help much and may even backfire, as messages can fail to resonate among ordinary people.

It was crucial for Latvia's lenders to elaborate an efficient communication strategy and to consider the following measures to shape a positive public opinion: thorough *stakeholders' assessment* and engaging in a *consultation process* at all levels and all times; engaging in regular *press contacts*; extending communication during the *drafting process*.

- **Stakeholders' analysis and consultation at all levels: Building Consensus**

Financial assistance negotiation is a multilateral and multilevel process. Most influential actors are physically involved in the actual negotiation process (e.g., the Commission, the IMF, the debtor government representatives). Beyond the negotiating table, however, many actors are physically absent but can interfere in the process before, during, or after (e.g., parliamentary coalitions, major creditors, Bank of Latvia, social partners).

Accordingly, the EU/IMF set multilevel *communication channels* and held *caucuses* with the stakeholders to reach various decision-making spheres and influence their perspectives on the programme's outcome.[79] It was crucial for the lenders to identify and meet people who were not necessarily present at the negotiating table to hear their views, to tell the 'hard truth', and to explain the goals and tasks of the programme. As a result, the consultation process undertaken by the lenders has positively influenced the actors' expectations and thereby facilitated the programme's implementation. For instance, in June 2009, not everyone expected that the consolidation effort would succeed, but through dedicated lenders' communication with key stakeholders on the aims and deliverables of the programme, a common agreement was achieved on the measures to take.

The Latvian experience highlights the importance of designing a reiterative communication which is directed at a large spectrum of actors and which could influence the programme somehow. Many people affected by, but not necessarily involved in, the programme could facilitate or hinder its enforcement. It therefore proved crucial to hold caucuses with key actors to review the measures being undertaken, to stabilise their economy, and to ensure they understood the implications of the programme and did not strongly oppose the adjustment reforms. Obviously, such communication strategy does not aim to reach a strong unanimity among stakeholders. People cannot support fully a government or any organisations which make budget cuts. An experienced negotiator cannot expect to reach *unanimous* support in such a difficult situation. The objective, instead, is to reach a more realistic aim—*consensus*, a form of silent non-objection from the stakeholders (Susskind, 1999, 2000, 2007, 2009).

- **Communicating with the press**

Latvian experience shows that, if lenders intend to reach the public through the press, the mission chief should engage in regular press contacts such as interviews, articles in newspapers, and on-and off-the-record journalist briefs. The chief should also stress, *inter alia*, that the Commission and the Fund are there to help with valuable advice (and money), that fiscal consolidation should be fair and just across the levels of society, and that the measures taken will help the country grow more competitive (like Sweden and Germany). Often, a number of misconceptions about the programme also exist and must be dispelled before they grow. In this case, for example, the lenders requested as collateral all Latvian forests or demanded cuts to small pension incomes.

The problem is that financial assistance programmes attract such large public interest that journalists will report about them whether or not they have the relevant background. Thus, it may ultimately be more advantageous to 'put words in their mouths'. At the start of the programme, the lenders did not communicate much with the press and therefore had no control over what press reported about the programme. Lenders therefore should treat journalists well by giving occasional interviews or briefings (Susskind, 1996). They may help in amplifying desired messages or abstaining from unnecessarily negative portrayals of programme-related issues.

- **Drafting the memorandum of understanding**

Communication and consultation do not stop when an agreement arises/occurs. Drafting is *still* negotiation and can prove a nightmare if the parties cannot translate in writing what they agreed at the table. It is therefore crucial to consult and involve key stakeholders, such as other Directorates General, some domestic stakeholders, and government officials, when drafting the policy conditions.

[79] *Caucuses* are meetings which *mediators* or *facilitators* hold separately with each side in a dispute.

In the context of Latvia, other Directorates General (e.g., Employment, Region, Competition, Market, Enterprise) were eager to get involved, as they realised that Memoranda provided a chance to put EU-2020 issues high on the government's agenda (i.e. smart growth, sustainable growth and inclusive growth). Having more rather than fewer conditions is preferable, especially on structural reforms where the Commission takes a lead vis-à-vis the IMF. Also important, involving key actors in the drafting process, especially at the domestic level, helped increase the Latvian ownership of the programme and therefore the likelihood of the programme's implementation.

V.B.1.ii. Building Trust and Credibility through Persuasion and Support

Contrary to what some circles assert, the basis of the lenders' strategy is more than drawing up tight conditions which governments must meet at a rapid pace in exchange for financial support. Our data stress the role of *persuasion* and *support* over simple bargaining (Ulbert and Risse, 2005; Naurin, 2007; Thompson, 2008).

- **Persuasion vs. Power Pressure**

Building trust and credibility comes from showing detailed knowledge and understanding of the complexity of the situation and using persuasion based on objective criteria rather than coercion. Persuasion has the advantage over bargaining or coercion in that the negotiating partner 'buys into' the agreement. This factor matters when it comes to implementation. Obliging a debtor to sign up to sharp structural adjustment policies by using inducements and threats may not pay off in the end, since the debtor may not feel committed to implementing the agreement (Stiles, 1990; Kaufman, 1985).

Thus, when negotiators put forward a particular position, they should support it with reasoned justification criteria, not merely self-serving arguments. Justification criteria are benchmarks which help legitimate objectively an option and therefore enhance persuasion (Majone, 1999; Schmidt, 2001; Mosley, 1995). In the case of Latvia, *structural adjustment* was put forward as the optimal approach to restore financial stability and the long-term growth of the country—and, by extension, the entire European Union. EU/IMF entered into dialogue with key actors about the benefits of structural reforms in such sectors as education, health, and welfare. Mission chiefs engaged in a high degree of complexity and a broad range of issues to build convincing analysis and provide maximum support. They did so by providing information and analysis on the current situation, policy implications, and studies on other programmes, which suggest that an agreement will enhance the welfare of the debtor permanently.

This kind of persuasion mostly took place out of the glare of publicity, in exploratory meetings or working groups set up to consider a particular subject more frankly. Technical working groups were usually established once the negotiations had begun, or they were used to identify key facts before the negotiations began. These specialist groups are used to sound out the positions of the various partners to explore potential deals or integrative moves. They also provide a forum in which objective and credible arguments are used to convince the debtor to act in line with the programme.

- **Mediating Role of the Lenders: Supporting Debtors on other Fronts**

Incentives, guarantees, or support provided by the lenders also increased the programme's perceived credibility. For instance, the Commission committed to using its influence to help the Latvian government in other negotiations in exchange for transparency. Instead of focusing only on the issues strictly on the agenda, the Commission took a more dynamic approach by helping Latvia in other negotiations with DG Competition, Region, and even the rating agencies. The Commission's strategy was to raise Latvian perceptions about the lenders' power to influence other counterparts. The lenders used their pivotal status to enhance their credibility in exchange for Latvia's cooperation in the adjustment process.

Pressuring debtors to the brink does not seem to be the lenders' only available strategy. A solid argumentation process may also facilitate the negotiation process. If debtors are convinced that

structural adjustment will positively affect the economy they may commit to full implementation, and they can even undertake their own communication and persuasion campaign vis-à-vis the domestic consistencies.

V.B.2. Perceived Cost of Failure and Deadline Effect

A major problem with the current debt crisis is that some stakeholders believe that financial and economic calamity is not occurring (Melling, 1994; Shapiro, 2006). These actors, who include lawmakers, social partners, and some academics, underestimate the on-going developments and thus the cost of not reaching an agreement on assistance programmes (i.e., in Greece, Latvia, Ireland, and Portugal). However, the cost to all parties—debtors, lenders, and creditors alike—can/may prove extremely high. Lenders and debtors' agents must educate their constituencies and convince them that the status quo might be more damaging than reaching an agreement. In other words, negative expectations about the failure of the programme can be used to increase the chance of success. As we argued above, raising positive expectations about the programme can mark a great incentive to reach an agreement; in some instances, however, influencing the perceived cost of failure can prove even more powerful.

For instance, in early-June 2009, Latvia's international reserves hit their nadir of only EUR 2.644m, and the Riga three-month interest rate peaked on 26 June 2009 at 19.8 % per year. June was thus a critical month, with very high stakes. The government needed to react quickly and make a radical decision to calm the situation. At the same time, various influential actors (e.g., former Prime Minster Mr. Skele and famous economists), underestimating the gravity of the situation, were betting that the lats would devaluate (European Commission, 2009). The government tried to be reactive by taking 'unprecedented austerity measures', but on 4 June the European Commission and the IMF deemed the measures insufficient and asked the government to make further cuts (Aslund and Dombrovskis, 2011). At that stage, the government entered into a difficult internal debate about the possible alternative options in case the lenders refused to make any further payments. The government realised quickly that there was no viable Plan B, as the IMF and the EU are lenders of last resort. The Prime Minister therefore came to the following conclusion: 'There are two options: One is making unpopular cuts in order to obtain further loan payment from international lenders. The second is making more unpopular cuts anyway by the end of June. So it is not a question of how we are willing but of what options we have' (Cabinet Minister of the Republic of Latvia, 2009). The government thus concluded, on 11 June, an agreement between the five coalitions, the government's social partners, and other key stakeholders. The negotiations proved particularly difficult and sensitive but were designed to ensure international support so that the nation could escape the significantly direr scenario of default.

This scenario indicates that underestimating the *cost of failure* can cause deadlock. The parties broke through the impasse only when they realised that there was no alternative and that the status quo could bring more dramatic consequences. Only after the '4 June electroshock' did they realise that economic calamity was occurring and that they had to comply with the lenders' advice to avoid a worst-case scenario. Such brinkmanship, though alarming, is actually a healthy characteristic of high-stakes bargaining. Some have the sense that people do not put everything on the table until late in the game. If a negotiator cuts a deal before the deadline and says to his principal: 'I got a deal' the principal might say: 'No, you did not get a good deal because you did not wait until the very last moment'. In the case of financial aid programmes, the 'agents'—government representatives—may cause temporary deadlocks by trying to please their constituencies too soon.

Eventually, a ***deadline***, whether real or self-imposed, can offer disputing parties an incentive to top overcome the impasse. This so-called ***deadline effect*** catalyses the deadlocks (Shell, 2011). But the majority of the parties must see this deadline as credible, with solid reasoning behind it, to conclude the negotiation around it. If one side believes it is arbitrary, very little will happen. This scenario is a classic *game of chicken* (Aggarwal, 1996). Let us imagine two cars speeding toward each other. The question is: who will swerve first? The parties use their dramatic statements to suggest/imply that they have thrown the steering wheel out of the window, forcing the other side to make a move to avert a crash. What happens next? Usually, in situations so conspicuous that both sides would be better off with various kinds of compromises, one of the parties is likely to make a positive move.

However, this is not always the case. Sometimes, in a *game of chicken*, neither side blinks. Labour unions strike; governments shut down.

In the case of Latvia, the parties proved ready to compromise substantially at this particular time of the year because the perceived cost of failure was at its apex for all parties. The '4 June EU/IMF request' added impetus to the existing stalemate, and provided a credible deadline for escaping the conflict. This is what William Zartman calls the *'ripeness effect'*. The '4 June request' sent a clear signal that calamity would come if nothing was done soon; it made the conflict ripe for the parties to make a decision. The Commission and the IMF created a window of opportunity by implicitly imposing a looming deadline to act (Zartman, 2000, 2006). This deadline helped bring convergence in the negotiation schedules of the various partners.

V.B.3. Managing Public Negotiation in a High-Stakes Context

As described above, communication about sensitive matters proves crucial to affecting public opinion. Nonetheless, the flow of information must be controlled in some way as public diplomacy can prove unpredictable, especially in the current debt crisis. On the one hand, making information public tends to improve the quality of discussion and argument, since parties must make the case for a given policy in terms of the wider public good rather than their own vested interests. On the other hand, transparent publicity of the talks may be the enemy of fruitful negotiations, since governments and lenders may prove unwilling to concede arguments made in public, even if they would do so in private. Moreover, revealing the specifics of negotiations may lead the public to unwarranted conclusions, and thus negatively affect the negotiation itself. The more negotiators go public, the more they risk raising the stakes. Such scenarios often lead parties to use counterproductive tactics, such as drawing a line in the sand, issuing ultimatums, threatening to walk out, belittling the opposition, and negotiating in public. They thereby risk becoming political theatre, a performance for an audience of partisans and voters (Perry, 1994; Stasavage, 2004).

For instance, whenever a crisis erupts, a choir of famous experts claims to have the universal answer; they take Ronald Dworkin's '*right answer thesis'* to a new level. In the case of Latvia, an army of economists claimed that it was exactly like some other recent crisis: the worse the crisis, the more popular the parallel (Aslund and Dombrovsksis, 2011). When the Icelandic economy collapsed in early-October 2008, a herd of economists asserted that the same would happen to Latvia even though Iceland had a floating exchange rate, a high interest rate, and an overblown domestic system (Krugman, 2008; Hugh, 2008; Harrison, 2008; Roubini, 2008; Hudson, 2009; Magnusson, 2009). This allegation caused a public macroeconomic fight among high-profile experts over the devaluation of the national currency, among other matters. This typical example of *Public War Negotiations* obviously did not help the government and the lenders to conduct fruitful negotiations; it only favoured hard bargaining tactics.

To lower the stakes and facilitate the discussion, a suitable solution was to make the debate more private, to engage in ***closed-door negotiations*** **(**Gilboa, 2000). Negotiation is like courtship: it involves a period of private exploration and preparation before the parties are ready for public commitment (Lewicki, 1997). Governments make tentative proposals to see what responses they produce—and may later withdraw and modify them. All this proves harder if conducted in public, since 'politicians only know how to grandstand in public and capitulate in private' (Chris Voss, CNN, 2011). Having some privacy does not mean that information should not be communicated to the public or that relevant stakeholders should not be involved. In Latvia, it was also relevant at times to include more actors, especially those who can influence the process (meetings with the Greens and Farmers in 2011). Closed-door negotiations simply help to build trust and to reduce the pressure from the media before going public. For instance, it helped to avoid running a press conference before coordinating or pre-agreeing Prime Minister/Commission/IMF Mission chief statements.

PART 3 – CONCLUDING SECTION: RESULT ANALYSIS AND LESSONS FOR FINANCIAL AID NEGOTIATIONS

Latvia is now much less vulnerable than it was before the 2008 global economic crisis. It is subject to post-programme surveillance until it repays a large part of the EU-funded loans. However, a crucial

question remains: can we really talk about success? Growth has returned but high unemployment persists, and the social safety net remains important (IMF, 2012; European Commission, 2012). It might therefore be open to debate whether the Latvian programme has led to a successful adjustment, especially if we consider its human and social cost. However, the government has made difficult concessions in an effort to avoid an even more painful economic adjustment in the absence of external support.

We must clarify that our analysis did not investigate the Latvian programme from a socio-economic perspective. We only attempted to evaluate the negotiation process by offering a reflexion on the choice of policy strategies and on their effects on the result of the programme. In that regard, we argue that both parties adopted a ***flexible approach*** aiming toward a satisfying outcome (upper left side of Table 8.1). It is therefore important to investigate the extent to which we can qualify this outcome as being satisfying for the parties, especially Latvia.

In negotiation terms, outcomes are usually assessed against (1) the parties' motivations and (2) their best alternative to a negotiated agreement (BATNA). On the one hand, the parties shared a common motivation: to stabilise the economy whilst mitigating the social cost of the economic downturn. On the other hand, we claim that the current outcome is better that the Latvian BATNA. Latvia had no viable alternative to the current negotiated solution (Ministry of Finance, 2008). According to Fisher and Ury (1991), the BATNA is the true measure by which to judge any agreement. It is the only standard which can protect parties from both accepting terms which are too unfavourable and rejecting terms which are not in their interests. In this instance, the alternatives were:

- Debt default or repudiation, a worst-case scenario for all the parties. This option greatly damages the lenders' reputation and pains/harms the debtor;
- Alternative source of funding. This option was not an option since the IMF and the EU are lenders of last resort;
- Not keeping the peg. No one can say definitively if this alternative was better than the current solution.

On the basis of this analysis, we can define the Latvian outcome as being the *best result possible* considering the current economic context. Furthermore, from a *strategic* perspective, we conclude that adopting a flexible strategy was a suitable approach to ensure the successful completion of the programme. However, the question is whether we can draw lessons from this experience or whether the Latvian result is simply related to contextual factors. This research does not purport to be a definitive, quantitative determination of the debtor-lender interactions, yet it expects to draw lessons applicable to other adjustment cases.

Our data claim that the choice of strategy can help predict the outcome in some ways. But can we predict the result scientifically? Repeated efforts to establish a normative foundation for negotiations have not resolved this dilemma. One cannot use a statistical description of the country to determine why a nation has adopted a particular strategy (Braithewaite, 1955; Barry, 1963; Nicolson, 1963). Moreover, no algorithm can predict the net effects of behavioural strategies on international economic negotiations' outcomes. Although we have scattered relevant findings, extrapolation has its perils; lessons from select case studies cannot be universal and are closely tied to the corresponding case at hand (Odell, 1999). Each programme tends to be unique to the nation in question and may vary from year to year depending upon which individuals sit in the Fund, the Commission, or the borrowing nation, and whether they learn as they proceed.

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Concluding Remarks

Matthias Mors

In this volume we offered an extensive overview of the Latvian programme of internal adjustment and of the assistance by EU, IMF and others. We tried to identify which features contributed to its success, what practical policy implications can be drawn from it and what still needs to be done to build on these early achievements and transform them in a story of long-lasting success. From the analysis carried out in the volume we can conclude that the Latvian experience does not only provide an interesting starting point for further theoretical research on fiscal consolidation, resource misallocation and external competitiveness, but can also offer practical guidance – or at least some benchmark - for policymakers facing similar problems, provided that some necessary initial conditions are met. Indeed, the successful completion of the Latvian programme could prove to be extremely relevant for other European countries. This is particularly true in light of the recent economic developments in the Euro Area as other countries are struggling with reforms and do not see yet the light at the end of the tunnel.

The volume has highlighted and clarified the role several factors played in the boom and bust scenario the Latvian economy experienced between 2005 and 2011. As we saw, during the boom years, easy credit conditions, poor or erroneous financial regulation and strong international capital inflows inflated Latvian wages at a higher rate than productivity, threatening external competitiveness. These factors favoured resource misallocation, pushed internal consumption on an unsustainable path and eventually fuelled asset bubbles - in particular in the housing sector. The late recognition of the imbalances mounting in the economy and the sudden deterioration of the external financing conditions, when the international capital markets froze after Lehman Brothers' bankruptcy, eventually forced the national government to ask for support from international lenders. However, it must be noted that easy credit conditions and strong capital inflows were not the only relevant factors behind the crisis. Short-sighted economic and fiscal policies, private banks' undue optimism about customers' income growth, financial intermediaries' inability to price risk adequately, excessive risk-taking at a global level and poor surveillance also added to the boom-bust-cycle.

Despite the critics from various international players and some major economists, the programme partners made the decision to keep the currency peg with the Euro and go through a process of internal devaluation. Internal devaluation and structural reforms were in fact considered by the Latvian government the only way to unwind the existing imbalances and restore long-term competiveness and sustainable economic growth. This approach was successful. After a substantial drop of around 18% of GDP at the peak of the crisis in 2009, the Latvian economy is now back to a promising and more sustainable path of economic growth and job creation with a different structure of the economy.

The analysis also identified several areas where more needs to be done and which should be on top of the policy agenda in the years to come – among them social security, the education system and the health care system. In any case, it should be clear that the end of the programme must not coincide with the end of reforms: more needs to be done to consolidate the recovery. Now that the country is back to a very promising path of, hopefully, sustainable economic growth and job creation, the Latvian authorities should avoid giving in to temptations as the risk of complacency is very high.

The Latvian experience provides interesting insights for policymakers worldwide.

First of all, the Latvian case provides a good example of how policymakers worldwide missed to recognise growing imbalances. This did not happen only in Latvia, but also more broadly, on a global scale. Clearly more needs to be done in order to increase the resilience of the system. This makes the point for improvements in the functioning of fiscal surveillance and financial regulation. The development of better indicators and a wiser use of them, also to assess systemic risk, must be on top of policymakers' agenda for the next few years. To respond to this challenge the EU has introduced a new macroeconomic imbalances procedure.

Second, the Latvian experience has shown how success cannot be taken for granted, but comes only as a result of serious work and the ability to carry out the necessary structural reforms. This lesson might sound particularly true for the Euro Area, as probably in the original design of the single currency too much emphasis was put on the numerical prerequisites to enter, but not enough on how to control and take advantage of the new opportunities. What really matters eventually is not only the ability to meet some numerical criteria, but the attitude towards reforms to address the policy challenges ahead.

Third, "mission impossible", growth-enhancing consolidation and painful reforms in the midst of a severe crisis, turned out to be possible through speed, ownership, commitment, good judgement, optimism, prudence, and solidarity. A quick policy response was crucial to show the willingness to change, but this could only work in presence of strong ownership and serious commitment of the national authorities to push through the necessary reforms to address the imbalances in the medium-run. In addition, the intervention has been so quick as to impress markets and change mind sets and attitudes, quickly regaining trust and confidence.

Fourth, it is particularly interesting to note that what happened in Latvia also defies much of the conventional economics thinking; therefore, as the reliance on orthodox models was limited, good judgement and prudence were crucial to assess policy consequences. Indeed, in devising an adjustment, one should not bank on uncertain benefits, as markets and observers have asymmetric reactions. Better results lead at best to a progressive increasing credibility, but that can be quickly lost soon because of negative developments. A certain distance must always be kept from the edge.

Fifth, in a country already presenting one of the highest levels of inequality in the EU, this ambitious consolidation programme had necessarily to take into account elements of equality and solidarity. Hence, one of its most important challenges was to pair consolidation with an efficient plan to support growth and jobs and reduce vulnerability of the poorest segments of the population. As the economy is now back on a growth path, additional work in this area would be extremely beneficial to ensure both future fiscal sustainability and a better response to policy needs.

From a political point of view, finally, it is also worth noting that harsh austerity measures and unpopular decisions did eventually not prevent an electoral success. Various factors, some of them country-specific, some of them incumbent-specific, can be detected in the Latvian case. However, of decisive importance for the public acceptance of reforms in this case were the design of a clear anti-crisis policy and the strategic use of political communication, the latter being an area too often underestimated by policy makers. Telling the ‘hard-truth’, explaining what needs and can be done, reminding about the final objective, have been key elements of the Balance-of-Payments assistance programme that supported Latvia's fiscal consolidation.

The Latvian experience shows that fiscal consolidation and growth are not antithetic concepts. Consolidation can indeed turn out to be expansionary, but some key conditions are needed: governments must be able to act resolutely and at an early stage of the crisis, they must focus on expenditure cuts rather than on tax increases for the programme to unleash the potential of the economy, they have to calm markets and attract investment to generate enough confidence to restart the growth engines. Latvians did it, and now their experience deserves to become part of our shared stock of knowledge to address the next crises. Surely their legacy has to be adapted to different contexts, but it deserves to serve as a benchmark for success in any future programme implementation.

List of contributors[80]

First Name	Family Name	Affiliation and position
Kārlis	*Bauze*	Head of the monetary policy department, Bank of Latvia
Konstantīns	*Beņkovskis*	Head of the monetary research and forecasting division, Monetary policy department, Bank of Latvia
Kristaps	*Bērziņš*	DGT, European Commission
Marco	*Buti*	Director General, DG ECFIN, European Commission
Samuel	*Dahan*	Senior associate, IRENE (Institute for Research & Education on Negotiation), ESSEC, University of Cambridge
Francesco	*Di Comite*	DG ECFIN, European Commission
Valdis	*Dombrovskis*	Prime Minister, Latvia
Ettore	*Dorrucci*	Head of convergence and structural analysis section, EU Countries Division, European Central Bank
Gatis	*Eglitis*	DG ECFIN, European Commission, Latvia Desk
Elena	*Flores*	Director, DG ECFIN, European Commission
Gabriele	*Giudice*	Head of unit, Economies of the Member States: United Kingdom, Estonia, Latvia, Sweden, DG ECFIN, European Commission
Mark	*Griffiths*	Latvia mission chief, International Monetary Fund
Peter	*Harrold*	Country Director for the EU Member States, World Bank
Mārtiņš	*Kazāks*	PhD, Deputy group chief economist, Chief economist in Latvia, Swedbank
Radoslav	*Krastev*	DG ECFIN, European Commission, Latvia Desk
Julia	*Lendvai*	DG ECFIN, European Commission, Models and databases
Daniel	*Monteiro*	DG ECFIN, European Commission, UK Desk
Matthias	*Mors*	Director, DG ECFIN, European Commission
Ilmārs	*Rimšēvičs*	Governor, Bank of Latvia
Marion	*Salines*	Economist, EU Institutions and Fora Division, European Central Bank
Indhira	*Santos*	Economist, Human development sector unit, Europe and Central Asia Region, World Bank
Emily	*Sinnott*	Senior economist, Human development sector unit, Europe and Central Asia Region, World Bank
Karsten	*Staehr*	Professor of international and public finance, Tallinn University of Technology, Estonia
Ingrid	*Toming*	DG ECFIN, European Commission, Latvia Desk
Andris	*Vilks*	Minister of Finance, Latvia
Christian	*Weise*	Deputy Head of unit, Economies of the Member States: United Kingdom, Estonia, Latvia, Sweden, DG ECFIN, European Commission

[80] The views expressed are the authors' alone and do not necessarily correspond to those of the institutions they are affiliated to.

Conference agenda

Joint ECFIN-Bank of Latvia seminar, 1 March 2012

EU balance-of-payments assistance for Latvia: foundations of success

Venue: *Brussels, Berlaymont Building, Schuman Conference Room*

Welcome (9:00-9:10)

Elena Flores, Director, DG ECFIN, European Commission

Opening Remarks (9:10-10:00)

Marco Buti, Director General, DG ECFIN, European Commission

Valdis Dombrovskis, Prime Minister, Latvia

Ilmars Rimsevics, Governor, Bank of Latvia

Session I (10:00-12:30)

The economics of the crisis and of internal adjustment

Chair: *Uldis Rutkaste*, Chief Economist at the Bank of Latvia

"How Imbalances Were Created: Capital Flows, Competitiveness and Economic Growth in Latvia"

Karsten Staehr, Tallinn School of Economics and Business Administration, Tallinn University of Technology

"Competitiveness Factors during a Successful Adjustment"

Radoslav Krastev, DG ECFIN, European Commission

Coffee break (10:45-11:15)

"Latvia's Competitiveness before and after the Crisis"

Konstantins Benkovskis, Bank of Latvia

"Banking Sector Adjustment"

Martins Kazaks, Swedbank Latvia

"Fiscal Consolidation in the Midst of the Crisis: Lessons from Latvia"

Ingrid Toming and Francesco Di Comite, DG ECFIN, European Commission

LUNCH (12:30-14:00)

Session II (14:00-15:15)

The political economy of adjustment: why could it succeed?

Chair: *Ake Tornqvist*, Ministry of Finance, Sweden

"Fiscal Sustainability, Demographic Change and Inequality: Social Sectors from Crisis to Growth in Latvia"

Peter Harrold, Emily Sinnott, and Indhira Santos, World Bank

"Conceptualising EU/IMF Financial Assistance Negotiations in Latvia"

Samuel Dahan, Institute for Research & Education on Negotiation, ESSEC

"Fiscal Austerity, Structural Reforms and Re-election: Explaining the "Possible Trinity" in the Case of Latvia"

Marion Salines, European Central Bank

Coffee break (15:15-15:30)

Session III (15:30-17:15)

Roundtable: Lessons from Latvia and the way forward

Chair: *Matthias Mors*, Director, DG ECFIN, European Commission

- Adopting the euro: what remains to be done?
- How to ensure the economy's sustainability, competitiveness and strong external position in the future?
- What could be the potential growth after recovering from the crisis?
- Structural reforms (education, labour mismatch, business climate, etc.)
- What lessons for Europe?

Panel speakers:

Andris Vilks, Minister of Finance, Government of Latvia

Gabriele Giudice, DG ECFIN, European Commission

Mark Griffiths, International Monetary Fund

Karlis Bauze, Bank of Latvia

Ettore Dorrucci, European Central Bank

Wrap-up and concluding remarks (17:15-17:30)

Matthias Mors, Director, DG ECFIN, European Commission

List of participants

First Name	*Family Name*	*Organisation*
Inese	*Allika*	Bank of Latvia
Oskar	*Andruszkiewicz*	GHK
Cyril	*Audrin*	Moody's Investor Services
Sanita	*Bajare*	Ministry of Finance, Latvia
Fabio	*Balboni*	UK Treasury
Alise	*Balode*	Government of Latvia
Baiba	*Bane*	Ministry of Finance, Latvia
Alpona	*Banerji*	Moodys Investors Service
Sabine	*Berger*	European Commission, DG ECFIN
Romain	*Berline*	EFC Secretariat
Carsten	*Bermig*	European Commission, SG
John	*Berrigan*	European Commission, DG ECFIN
Martin	*Bijsterbosch*	European Central Bank
Piotr	*Bogumil*	European Commission, DG ECFIN
Aija	*Braslina*	BNS Latvia
Sudharshan	*Canagarajah*	World Bank
Chiara	*Capello*	European Commission, DG ECFIN
Pedro	*Cardoso*	European Commission, DG ECFIN
Maija	*Celmina*	Government of Latvia
Barbara	*Coppens*	Belgian Federal Public Service Finance
Giulia	*Costantino*	IDP European Consultants
Lorenzo	*Costantino*	IHF – Institut de Haute Formation aux Politiques Communautaires
Carlos	*Cuerpo*	European Commission, DG ECFIN
Andrea	*Da Costa Oliveira*	European Commission, DG BUDG
Daniel	*Daco*	European Commission, DG ECFIN
Zsolt	*Darvas*	BRUEGEL
Armands	*Eberhards*	Ministry of Finance, Latvia
Aaron	*Eglitis*	Bloomberg News
Sven	*Eide*	German Ministry of Finance
Ronalds	*Fisers*	Ministry of Finance, Latvia
Miroslav	*Florian*	European Commission, DG ECFIN
Balazs	*Forgo*	European Commission, DG ECFIN
Stephan	*Freitag*	German Ministry of Finance
Ricardas	*Gaurys*	Bank of Lithuania
Agne	*Geniusaite*	European Commission, SG

Nikolay	*Gertchev*	European Commission, DG ECFIN
Oleg	*Goryachev*	First Baltic Channel
Martins	*Gravitis*	Bank of Latvia
Dalia	*Grigonyte*	European Commission, DG ECFIN
Antje	*Hildebrandt*	OeNB - Austrian National Bank
Alexandr	*Hobza*	European Commission, DG ECFIN
Laura	*Iesmantaviciute*	Ministry of Finance, Lithuania
Stella	*Ilieva*	World Bank
Diana	*Jablonska*	European Commission, EAC
Andrejs	*Jakovlevs*	Tv-channel "The First Baltic channel"
Alexandra	*Janovskaia*	European Commission, DG ECFIN
Anton	*Jevcak*	European Commission, DG ECFIN
Ilze	*Juhansone*	Permanent Representation of Latvian to the EU
Satu	*Kahkonen*	World Bank
Gitana	*Kaminskiene*	Permanent Representation of Lithuania to the EU
Katrin	*Kask*	Eesti Pank
Janis	*Kesans*	HansaMedia TV
Taavi	*Kimmel*	Bank of Estonia
Corinna	*Knobloch*	Deutsche Bundesbank
Bozhil	*Kostov*	European Commission, DG ECFIN
Mladenka	*Krasteva*	Bulgarian Permanent Representation to the EU
Juris	*Kravalis*	Bank of Latvia
Aleksandra	*Kronberga*	European Commission, DG COMP
Asta	*Kuniyoshi*	Permanent Representation of Lithuania to the EU
Peter	*Kvarfordt*	Ministry of Finance Sweden
Sandris	*Laganovskis*	Ministry of Justice
Liene	*Laimina*	European Commission
Tatjana	*Lapunova*	European Commission, DG TAXUD
Alexander	*Lehmann*	European Bank for Reconstruction and Development
Ulle	*Lohmus*	European Commission, CAB
Erki	*Lõhmuste*	European Commission, DG ECFIN
Domenico	*Lombardi*	European Commission, DG ENTR
Mariya	*Marinova*	Ministry of Finance,Bulgaria
Larijs	*Martinsons*	Ministry of Finance, Latvia
Juliette	*Mathis*	GHK
David	*Moore*	International Monetary Fund
Michele	*Napolitano*	Fitch Ratings

Iris	*Nelissen*	Deutsche Bundesbank
Plamen	*Nikolov*	European Commission, DG ECFIN
Eduard	*Oplatek*	Czech permanent representation
Edijs	*Ostrovskis*	European Parliament
Marta	*Ostrowska*	Ministry of Economy, Poland
Ieva	*Ozolina*	Ministry of Finance, Latvia
Ioannis	*Papadakis*	Bank of Greece
Dimitris	*Papakonstantinou*	European Commission, DG ECFIN
Paolo	*Pasimeni*	European Commission - DG EMPL
Edgars	*Peterlevics*	News agency LETA
Rolands	*Petersons*	European Parliament, ECR group
Gérald	*Petit*	European Commission, DG ENTR
Marinela	*Petrova*	Ministry of Finance, Bulgaria
Savina	*Princen*	European Commission, DG ECFIN
Dana Adriana	*Puia Morel*	European Commission, DG ENTR
Alexandra Elena	*Putinelu*	European Commission, DG ECFIN
Lucia	*Quaglietti*	HM Treasury, UK
Grzegorz	*Radziejwski*	Permanent Representation of Poland to the EU
Pauls	*Raudseps*	Weekly magazine "Ir"
Luis	*Rego*	Diario Economico
Dirk	*Reinermann*	World Bank
Sofja	*Ribkina*	Permanent Representation of Latvia to the EU
Uldis	*Rutkaste*	Bank of Latvia
Andrus	*Säälik*	Ministry of Finance, Estonia
Christoph	*Saurenbach*	European Commission, DG ECFIN
Magnus	*Saxegaard*	International Monetary Fund
Dina	*Silina*	European Commission, DG REGIO
Adja Awa	*Sissoko*	European Commission, DG ECFIN
Sanita	*Skiltere*	Latvian Association of Local and Regional Governments
Peeter	*Soidla*	European Commission, DG ECFIN
Guergana	*Stanoeva*	European Commission, DG ECFIN
Chris	*Thoung*	Cambridge Econometrics
Dace	*Torima*	European Commission, DG ECFIN
Ake	*Tornqvist*	Ministry of Finance, Sweden
Yvonne	*Tsikata*	World Bank
Windy	*Vandevyvere*	European Commission, DG ECFIN
Javier	*Villar Burke*	European Commission, DG ECFIN

Peteris	*Vinkelis*	European Parliament
Kristine	*Vlagsma*	European Commission, DG ECFIN
Christoph	*Wagner*	European Commission, DG ECFIN
Maria	*Wallin Fredholm*	Sveriges Riksbank
Caroline	*Wurtz*	European Commission
Zanda	*Zablovska*	Dienas Bizness
Guna	*Zake - Balta*	European Parliament
Roberts	*Zile*	European Parliament
Edgar	*Ziverts*	European Parliament

Balance-of-payments assistance to Latvia

On 21 December 2011 the fifth and last Supplemental Memorandum of Understanding (SMoU) related to the EU financial assistance to Latvia was signed by the Commission's Vice President Olli Rehn and the Latvian authorities. This followed a positive assessment by the Commission of the implementation of the adjustment programme. The signature of the SMoU was the concluding step under the EU balance-of-payments assistance programme that expired on 19 January 2012. Latvia is now subject to post-programme surveillance until a large part of the EU-funded loans are repaid.

During the programme from 2009 to 2012, Latvia has made remarkable progress in overcoming the worst financial and economic crisis in its recent history. This has required a combination of strong fiscal consolidation and structural adjustment. The country is now in a much sounder position than before the start of the programme. Economic growth has resumed after the unprecedented fall in 2008 and 2009. According to the EU interim forecast presented on 23 February, Latvia's GDP grew by 5.3% in 2011 and is expected to expand by 2.1% in 2012. The renewed stability has been rewarded by the return of Latvia to international financial markets, with two successful issuances since mid-2011. Further reforms will be crucial to secure the important progress already made and address the remaining challenges.

Basic facts about the programme

In light of a rapidly deteriorating economic situation and concerns related to the health of the banking sector, the Latvian authorities applied in late 2008 to the EU, IMF and regional neighbours for financial assistance.

Following multilateral negotiations in December 2008, an agreement was reached to provide multilateral financial assistance to Latvia with an overall amount of €7.5 billion, consisting of the following contributions:

- European Community, €3.1billion under a balance-of-payments assistance programme
- International Monetary Fund, SDR 1.5 billion (around €1.7 billion) under an IMF Stand-by arrangement approved on 23 December 2008, amounting to about 1,200% of Latvia's quota;
- Nordic countries (Sweden, Denmark, Finland, Norway and Estonia), €1.9 billion;
- the World Bank, €0.4 billion;
- the European Bank for Reconstruction and Development, the Czech Republic and Poland, €0.4 billion.

The Community financial assistance was to be made available during a period of three years from the day of the entry into force of the Council decision on providing Community medium-term financial assistance for Latvia, thus the programme expired on 19 January 2012. The EU financial assistance was eventually disbursed in four instalments for a total of €2.9 billion, instead of the six instalments and €3.1 billion initially scheduled:

- €1.0 billion, released 25 February 2009 following signature of the Memorandum of Understanding;
- €1.2 billion, released 27 July 2009;
- €0.5 billion, released 11 March 2010;
- €0.2 billion, released 21 October 2010;

The average interest rate on the amounts disbursed by the European Commission is around 3.2%, with repayments starting in 2014. In total, about €4.5 billion out of the €7.5 billion committed have been paid out. More detailed information about disbursements and applicable conditions, also by other creditors that participated in the programme, is available on the Q&A website of the Ministry of Finance of Latvia.

Key documents

- EC staff report from the 1st Post Program Surveillance mission;
- Fifth supplemental MoU (21.12.2011) and accompanying EC staff report from the 5th review mission;
- Fourth supplemental MoU (07.06.2011) and accompanying EC staff report from the 4th review mission;
- Third supplemental MoU (20.07.2010) and accompanying EC staff report from the 3rd review mission;
- Second supplemental MoU (22.02.2010) ;
- First supplemental MoU (13.07.2009) ;
- Memorandum of Understanding (MoU);
- Council Decision 2009/290/EC providing Community medium-term financial assistance for Latvia (19.01.2009) ;
- Council Decision 2009/592/EC amending Decision 2009/290/EC of 19 January 2009 providing Community medium-term financial assistance for Latvia (13.07.2009);
- Council Decision 2009/289/EC on granting mutual assistance for Latvia (20.01.2009).

Chronology of the balance-of-payments assistance programme in Latvia

2012

1 March: European Commission (DG ECFIN) and the Bank of Latvia Seminar: EU Balance-of-Payments assistance for Latvia: foundations of success.

19 January: Latvia completes the EU balance-of-payments financial assistance programme. The post-programme surveillance will run until a large part of the EU-funded loans will be repaid.

2011

21 December: Signature of the fifth Supplemental Memorandum of Understanding (SMoU) related to the EU financial assistance to Latvia

8 December: Statement by the EC and the IMF on the Review Mission to Latvia

21 November: The Commission has given a positive reply to Latvia's request for the release of EUR 100 million from the subaccount at the Bank of Latvia earmarked for banking sector support to be used for financing general government needs. This follows fulfillment of underlying conditions, as specified in the fourth SMoU.

22 June: The Commission has given a positive reply to Latvia's request for the release of EUR 300 million from the subaccount at the Bank of Latvia earmarked for banking sector support to be used for financing general government needs. This follows fulfillment of underlying conditions, as specified in the fourth SMoU.

8 June: Signature of the fourth Supplemental Memorandum of Understanding (SMoU) related to the EU financial assistance to Latvia

15 April: Statement by the EC and IMF on the Review Mission to Latvia

2010

16 December: Joint statement at the conclusion of a joint IMF and European Commission staff visit to Latvia

21 October: Commission makes a €0.2 billion disbursement as part of the Balance of Payments support to Latvia

20 July: Signing of the Third Supplemental Memorandum of Understanding

25 May – 7 June: Commission and IMF joint review mission to Latvia, see concluding statement

11 March: Disbursement of the third instalment (€ 0.5 billion)

22 February: Signing of the Second Supplemental Memorandum of Understanding

27 January: Statement by Commissioner Almunia on Latvia

2009

27 July: Disbursement of the second instalment (€ 1.2 billion)

13 July: Signing of the First Supplemental Memorandum of Understanding

13 July: Council adopts Decision 2009/592/EC amending Council Decision 2009/290/EC providing Community medium-term financial assistance for Latvia

2 July: Commission decides to release second loan instalment

27 May – 17 June: Commission and IMF joint review mission to Latvia

25 February: Disbursement of the first instalment (€ 1.0 billion)

26-28 January: Signing of the Memorandum of Understanding

20 January: Council adopts Decision 2009/289/EC on granting mutual assistance for Latvia and Council Decision 2009/290/EC providing Community medium-term financial assistance for Latvia

8 January: The European Commission proposes to the Council to provide medium-term financial assistance to Latvia as part of coordinated multilateral and bilateral financial assistance

2008

19 December: Joint statement by the Presidency of the ECOFIN Council and the Commission on providing EU medium-term financial assistance to Latvia

12 December: The Latvian authorities adopt "Economic Stabilisation and Growth Revival Programme", which forms the basis of the programme

Early December: EU financial assistance preparatory mission to Latvia, see statement on progress

22 November: Joint statement by the Presidency of the ECOFIN Council and the Commission on providing EU medium-term financial assistance to Latvia

November: In light of a rapidly deteriorating economic situation and concerns related to the health of the banking sector, Latvia turns to the EU, IMF and regional neighbours for financial assistance

Other sources and information about the balance-of-payments assistance to Latvia

- IMF-Bank of Latvia Conference "Against the Odds: Lessons from the Recovery in The Baltics", held in Riga, 5 June 2012;
- Interview for the Latvian TV Program "Viss Notiek" by Marco Buti and Gabriele Giudice (with subtitles) in the margins of country seminar "EU Balance-of-Payments assistance for Latvia: Foundations of Success", Brussels, 1 March 2012;
- Interview for the Latvian TV Program "De Facto" by Gabriele Giudice, Mission Chief for the EU financial assistance to Latvia, Brussels, 2 December 2011;
- Presentation "The Adjustment in Latvia" by Gabriele Giudice, Mission Chief for the EU financial assistance to Latvia, at the ELIAMEP conference in Poros, Greece, 8 July 2011;
- Interview for the Latvian TV Program "Jauna Nedēļa" by Gabriele Giudice, Mission Chief for the EU financial assistance to Latvia, Brussels, 23 February 2011;
- To join the euro area Latvia needs to stabilise its economy by carrying out structural reforms, by Gabriele Giudice, Mission Chief for the EU financial assistance to Latvia, interview to the Baltic News Service, Riga, 3 December 2010;
- Interview with the Latvian weekly journal "IR" by Gabriele Giudice, Mission Chief for the EU financial assistance to Latvia, Brussels, 24 November 2010;
- An assessment of Latvia's economic policy and needed responses, by Gabriele Giudice, Mission Chief for the EU financial assistance to Latvia, at the Bank of Latvia Conference "Latvia Beyond the Crisis: Towards Sustainable Economic Growth", Riga, 20 October 2010;
- You have too many envelopes, by Gabriele Giudice (Head of Unit, DG ECFIN, European Commission). Interview with the daily newspaper Biznes i Baltija, 22 March;
- On the road to recovery by Iveta Šulca (Head of the Representation of the European Commission in Latvia) and Gabriele Giudice (Head of Unit, DG ECFIN, European Commission). Article in the daily newspaper Diena, 5 March 2010 (translation from Latvian).

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