Summary for non-specialists
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EU Balance-of-Payments assistance for Latvia: Foundations of success

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 GDP increase by 34% between 2004 and 2007 and total employment growth by more than 10%. However, the boom was not sustainable and significant imbalances were built 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 between 2004 and 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 on 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 budget deficit widening from 0.3% of GDP in 2007 to 4.2% in 2008; worryingly, in summer 2009 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, the IMF and regional neighbours 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 - there was a high import content of exports; second - the high share of euro-denominated liabilities would have meant immediate insolvency for many corporates and households; third - several domestic banks may have followed Parex Bank; 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 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 the fiscal policy during the boom years, which had been concealed by the 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 the health, education and public administration budgets. The consolidation strategy was also successful in containing the adverse effects on the economy by triggering a positive reaction of the private sector (the so-called non-Keynesian effects), whose confidence was restored resulting in a recovery of private demand and investment when it was most needed. 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 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 the 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 Rimšēvičs, 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's 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 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. 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 boldness of the solutions, possibly providing valuable guidance for future action in difficult times.