

How Latvia Can Escape from the Financial Crisis

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The three Baltic countries—Estonia, Latvia, and Lithuania—have long been among the leaders in postcommunist reform.¹ In my 2007 book, *How Capitalism Was Built*, I concluded without hesitation:

The Baltic states...are the star performers [among postcommunist countries]. They are full democracies with normal market economies and predominant private ownership. They have a steady, high growth rate of around 8 percent a year. Their corruption is low, and their budgets are close to balance. The Baltic governments are small and well run.²

The Baltic economies undertook the three essential steps early on. They liberalized prices and trade. They broke out of the inflationary ruble zone in 1992 and swiftly stabilized their newly minted currencies with a fixed exchange rate as an anchor, strict fiscal and monetary policies. They also carried out fast privatization.

Therefore, the current crisis is all the more shocking. All the three Baltic economies are in deep economic crisis. Latvia experienced a decline in GDP of 4.6 percent in 2008, and Estonia 3.6 percent, and this year all the three Baltic economies are expected to contract by 12 to 18 percent.³ No other economies are facing such declines apart from Ukraine and Armenia, which are not directly related to the Baltic hardship.

The Problem

These economies have suffered from one key problem: excessive current account deficits. Latvia took the prize with a deficit of 23 percent of GDP in both 2006 and 2007, but Estonia and Lithuania were also above 10 percent of GDP, while a current account deficit exceeding 5 percent of GDP is considered unhealthy. But much of the deficit, 8 to 9 percent of GDP, was financed healthily with long-term foreign direct investment.

The concern has been short-term capital inflows, largely from foreign (mainly Swedish) banks, which have led to overheating of the Baltic economies. Latvia had an average GDP growth of 11 percent in 2005–07. Because all three countries maintain fixed exchange rates to the euro, the inflows boosted the money supply and drove up inflation, which reached 15 percent in Latvia last year. High inflation combined with fixed exchange rate raised the production costs, pricing the Baltic countries out of the market, especially as neighboring Russia, Sweden, and Poland let their currencies depreciate. The expansionary bank lending stimulated housing purchases for mortgages, which grossly inflated real estate prices. The currency inflow

¹ I first visited Latvia in 1974. In July 1992, Swedish Prime Minister Carl Bildt asked me to go to Latvia and assess the currency reform. From 1991 to 1993, I was a member of the non-governmental International Baltic Economic Commission. I have visited the Baltic countries frequently for the last three decades and been a strong supporter of their reforms policies, although not an official government adviser. I last visited Riga in early June 2009.

² Anders Åslund, *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia*, Cambridge University Press, New York, 2007, p. 306.

³ *East European Consensus Forecasts*, June 15, 2009.

resulted in excessive imports and a large trade deficit. Finally, all this private borrowing left Latvia with a foreign debt of 137 percent of GDP at the end of 2008.

The single cause of their hardship was that their exchange rates were fixed to the euro, as requested by the European Union's ERM2 (the European Exchange Rate Mechanism 2), which attracted the excessive capital inflows that caused the overheating. They were caught in the "impossible trinity" of fixed exchange rates, free capital movements, and independent monetary policy. Because of the fixed exchange rate and free capital movement, the Baltic countries could not pursue an independent monetary policy. Instead their interest rates were determined by the eurozone, which meant that their real interest rates were negative. Even if these countries could have hiked their interest rates, the effect would not have been monetary contraction but further attraction of short-term foreign capital given the fixed exchange rate. Bulgaria is in a similar bind, as were Ukraine and Russia until their recent devaluations.

Their fiscal policy, by contrast, has been quite prudent. Until 2008, Latvia and Lithuania had almost balanced budgets, while Estonia was very conservative with a budget surplus of almost 3 percent of GDP in 2006 and 2007. They have hardly any public debt, and Estonia has even accumulated a reserve fund from its budget surpluses.

As long as Latvia did not abandon its peg, it could undertake only two measures. It could have run a large budget surplus as Estonia did, but when the crisis hit, Estonia was not spared, only somewhat less hit. Another possible measure was stricter bank regulation, but almost the whole world was failing in this regard.

The bubble started bursting in 2007, when foreign banks belatedly slowed their lending. Housing prices started declining, and with them investment and private consumption, reducing GDP and boosting unemployment. On the positive side, inflation decelerated from a peak in the spring of 2008, and imports slowed down, which reduced the current account deficits.

In hindsight, it is easy to say that the Baltic states should have abandoned their currency boards with fixed exchange rates four to five years ago to preempt overheating, but politically that was impossible. The populations embraced their stable exchange rates with enthusiasm. When they joined the European Union in May 2004, they wanted to adopt the euro as soon as possible. The European Central Bank (ECB) demands two years of fixed exchange rate to the euro in ERM2 plus meeting a number of Maastricht criteria before a country can be accepted into the Economic and Monetary Union.

Latvia had hoped to adopt the euro in 2008. It fulfilled the Maastricht criteria on a budget deficit of less than 3 percent of GDP. Its public debt is minimal, far below the ceiling of 60 percent of GDP, and it has fixed its exchange rate to the euro. But since 2004, when Latvia entered the European Union, its inflation has persistently exceeded 6 percent a year.

Lithuania was very close to be accepted into the eurozone in 2006. It complied with all the other Maastricht criteria, while numerous eurozone countries have repeatedly violated the budget deficit target of 3 percent of GDP. Yet it was disqualified because the ECB inflation ceiling was 1.5 percentage points over the average of the three EU countries that had the lowest inflation, two of which were Poland and Sweden that did not belong to the eurozone. The ECB could and should have accepted Lithuania in 2006, which could have averted the current crisis.

The fact remains that the Baltic countries have pursued more virtuous economic policy than virtually any other European country, and few countries committed fewer policy mistakes. In a time of hardship, the Baltics can and should be helped, as the international community sensibly has concluded.

Crisis Solution

In October 2008 Latvia needed emergency loans to manage its foreign debt, and it turned to the IMF, the fire brigade of international finance. The big policy question was whether Latvia should devalue. Theoretically,

three options existed. One was to maintain the fixed exchange rate; another was a freely floating exchange rate; the third possibility was certain devaluation and unilateral introduction of the euro.

The third option was purely theoretical, and a limited devaluation of 20 percent, but that was precluded as the ECB strongly opposed Latvia's unilateral adoption of the euro. The Latvian government has accepted its verdict, because it does not want to forego full membership of the eurozone. Two European but non-EU countries, Kosovo and Montenegro, have unilaterally adopted the euro, but without representation or influence on the ECB. As an EU member, Latvia has the disadvantage of having to obey the EU authorities. The unilateral adoption of the euro was precluded.

Usually, a country escapes a cost crisis and external imbalance by letting its exchange rate float, which mostly leads to a substantial depreciation. This would have been very costly, and the question is whether it was necessary. Christoph Rosenberg, who led the December IMF mission to Latvia, has laid out the arguments against devaluation.⁴

Both the Latvian government and population strongly opposed devaluation. As late as August 2009, an opinion poll reported that almost two-thirds of the Latvians wanted the lat peg to the euro to remain unchanged.⁵ They seemed prepared to take substantial social costs, including large wage cuts, and the Latvian labor market is very flexible. An early euro adoption remains their goal, with the government committed to reaching the Maastricht criteria and adopting the euro by 2014.

A devaluation would probably be sharp if it occurred, because so few payments are made in lats, which are used for little but tax payments, public expenditures, and wage payments. An uncontrolled devaluation on a very thin market could easily be 50 percent, devastating Latvia's public finances, as the country's foreign debt would double to some 270 percent of GDP. With mortgages predominantly in euro, depreciation would lead to an avalanche of bad debt and mortgage defaults, which would aggravate inflation and the output contraction. Given that Latvia is a small, open economy, the positive effect would be comparatively limited, which would aggravate the depreciation.

During a few days of Latvian devaluation scare in early June 2009, all floating Eastern European currencies fell a few percent. A minister of finance in the region told me that in case of a Latvian devaluation, he thought the currency boards of Estonia, Lithuania, and Bulgaria would collapse because of contagion in financial markets. IMF programs with cofinancing would be necessary for these countries as well. The floating currencies would fall 15 to 20 percent. Quite possibly, half a dozen major European banks would go under and Europe would face a spectacular banking crisis not hitherto seen. The danger of severe exchange rate instability and competitive devaluations, leading to severe banking crisis, was evident. A Latvian devaluation could have become as harmful for Europe as the bankruptcy of Austria's Kreditanstalt in 1931 or Lehman Brothers' collapse last September.

The alternative to devaluation was to adopt a standard IMF stand-by program with three key elements. First, as the recession brought about substantial declines in state revenue, public expenditures had to be slashed. Second, Latvia had priced itself out of the market and prices and wages had to be reduced. Third, the sudden stop of market financing required substantial international government financing.

The IMF provided more financing than usual, but it amounted to only about one-third of the whole package. As a member of the European Union, Latvia could count on European support. The European Union itself and the Nordic countries, as well as Estonia, Poland, and the Czech Republic, contributed with substantial co-financing to the IMF package, which amounted to some \$10 billion. For a country with a

⁴ Christoph Rosenberg, "Why the IMF Supports the Latvian Currency Peg," *RGE Monitor*, January 6, 2009.

⁵ IMF External Relations Department, *Morning Press*, August 4, 2009.

GDP in 2008 of only \$28 billion, this was more than one-third of GDP. Latvia's very smallness made this massive support possible.

Overall, the positive assessment of the Baltic political and economic reforms holds true. Free-market policies are not in danger. Nor is democracy or social peace. After a decade of very high economic growth, these countries encounter their first serious recession. The big question is whether the Baltic economies will be able to pull through by cutting costs or whether devaluation will be necessary.

Why the Lat Holds

For nearly a year, prominent American economists—such as Paul Krugman, Nouriel Roubini, and Kenneth Rogoff—have maintained that Latvia is just another Argentina and that it is was only a matter of when, not if, Latvia would be forced to devalue its currency.⁶ Despite all these warnings, devaluation seems increasingly unlikely.

True, the lat had become overvalued, and Latvia's current account deficit was huge and led to the accumulation of an excessive private debt. The conventional wisdom argues that such large foreign imbalances can be corrected only through devaluation. Recent examples of such failed pegged exchange rates are Thailand, Indonesia, Malaysia, and South Korea in 1997–98, Russia in 1998, and Argentina in 2001.

Yet many pegged exchange rates have survived severe crises. That is especially true of small, open economies with limited financial sectors. Stanford economists Peter Blair Henry and Conrad Miller argue that Barbados has been economically more successful than Jamaica because Barbados pegged its exchange rate to the US dollar in 1975 and stuck to it. In 1991 Barbados experienced a serious current account crisis, and “the IMF recommended devaluation,” but “the Barbadians resisted the recommendation.” “Instead of devaluing, the government began a set of negotiations with employers, unions, and workers that culminated with a tripartite protocol on wages and prices in 1993,” in which “workers and unions assented to a one-time cut in real wages of about 9 percent.... The fall in real wages helped restore external competitiveness and profitability.... The economy recovered quickly.”⁷ Unlike Barbados, Jamaica devalued repeatedly and ignored structural reforms.

There are many other examples. Slovakia has outperformed Hungary in the last decade, and their main difference is that Slovakia had a pegged exchange rate for long periods, while Hungary has had a floating rate. In 1982 Denmark pegged its krone to the deutsch mark. This peg that still holds helped Denmark start radical liberalizing reforms a decade before Sweden, which persistently devalued.

The conventional wisdom that devaluation is inevitable in a severe current account crisis is simply not correct. Barbados, Slovakia, and Denmark have shown that a peg can enforce economic discipline and facilitate structural reforms. A devaluation brings fast cost relief, but many countries have ended up in a vicious inflation-and-devaluation circle. Finland and Sweden in the 1970s and 1980s come to mind. The maintenance of a peg may offer a safer exit out of crisis by forcing reforms.

The goal of any country in this kind of economic distress is to reduce costs, which is best done directly by cutting salaries, prices, and public expenditures. By standing firm, the Latvian government can

⁶ Paul Krugman, “Latvia is the New Argentina,” *The New York Times* blog, December 23, 2008; Nouriel Roubini, “Latvia’s Currency Crisis Is a Rerun of Argentina’s,” *Financial Times*, June 11, 2009; Edward Hugh, “Why the IMF’s Decision to Agree a Latvian Bailout Programme Without Devaluation Is a Mistake,” *RGE Monitor*, December 22, 2008, “Rogoff Says Latvia Should Devalue Its Currency,” Bloomberg, June 29, 2009.

⁷ Peter Blair Henry and Conrad Miller, “Institutions versus Policies: A Tale of Two Islands,” *American Economic Review* 99, no. 2: 261–67.

force necessary structural reforms of its post-Soviet public sector with far too many teachers (one teacher for every six students), hospital beds, and underutilized real estate. Devaluation is only a second best solution if the government lacks the political strength to undertake direct cuts, because devaluation boosts the foreign debt burden of the country in crisis.

The Latvian policymakers are determined to resolve the crisis and to restart stalled structural reforms. Impressively, the government has cut public salaries in two rounds by 35 percent, and pensions by 10 percent. This is more than Barbados did. The wage cuts have been approved by the trade unions and the parliament.

Thanks to cost cuts and reduced demand for imports, the current account turned positive as early as January 2009, and prices are falling. JP Morgan forecasts a current account surplus of 4.4 percent of GDP in 2009.⁸ At present, reserves correspond to about seven months of imports. Since July, the Bank of Latvia has had little need to intervene on the currency market to defend the lat.

The Latvians are a serious nation committed to their independence and economic success. After eight years of an average GDP growth of 9 percent, they appear prepared to endure quite a bit of suffering, though there are always limits. But the nation saw only one significant social protest last January. Since minor violence erupted, the organizers called off further demonstrations. The recent budget and salary cuts were adopted by a majority of 63 percent of the parliament. Primarily a few big businessmen favor devaluation. Their reasons are natural. Their export revenues would be maintained, while their wage costs would decline sharply. Conversely, that is a reason for trade unions to accept orderly nominal wage cuts rather than much larger real wage cuts through a devaluation.

Technically, it is very difficult to speculate against the lat because the Latvian economy is so small, its financial sector so tiny, and lats are rarely used. Of all loans in the Latvian economy, 87 percent are made in euros. Currently, Latvia's international reserves are about \$5.5 billion, almost equaling both the \$1.65 billion of lats in circulation and total bank deposits in lat of \$4.2 billion, which should be enough to guarantee stability.⁹ Few other financial assets denominated in lat can be sold short. Total outstanding government bonds in lat are only \$1.9 billion. The stock market is minuscule, with a daily turnover of a mere \$200,000. In early June, bankers in Riga told me that speculators offered 10 percent a month to speculate against the lat, but nobody wanted to lend to them because all the holders of lat are interested in its sustenance.

A senior investment banker said that their customers only speculate through credit default swaps (CDS) to avoid counterparty risk. Even so the CDS rate has fallen from a high of 1,100 basis points last March to a moderate level of 400 basis points in late September, compared with 5,000 basis points for Ukraine last February, which did not result in default either.

The crisis has caused a new financial problem: a large budget deficit, as the crisis has undermined state revenues and boosted social expenditures. Even after truly Herculean budget cuts, the Latvian government assesses its budget deficit at 9 percent of GDP, and the European Commission concurs, while the IMF believes that it might be as large as 15.5 percent of GDP, based on its prediction of a GDP slump of 18 percent. Yet, Latvia has a strong tradition of nearly balanced budgets and minimal public debt and it should be able to restore its sound public finances.

Many European policymakers understood the danger to the European banking system and trusted the Latvian fiscal standards, so they were ready to bail out Latvia. Moreover, both the risk of Latvian devaluation and its potential consequences have quickly declined over time.

⁸ Michael Marrese, "The Convergence of the CEEMEA Countries as the Global Recession Ends," JP Morgan, July 29, 2009.

⁹ Information from the Bank of Latvia website.

The IMF, on the contrary, seemed confused in the turmoil in the spring and summer of 2009. After having concluded a stand-by agreement with Latvia last December, it refused to issue a second, supposedly quarterly, tranche of some \$300 million and maintained a deafening public silence. On July 2, the European Union went ahead on its own, giving Latvia a second tranche of \$1.7 billion. The Europeans started wondering what the IMF was doing with its money. Any failure of the IMF program for Latvia would weigh heavily on the IMF, but since it was already so deeply engaged in the country, it had better make the program a success. Finally, on July 27, a very hesitant IMF concluded its first review of the stand-by agreement with Latvia and decided to disburse a second tranche of \$278 million.¹⁰

Presumably, this delayed IMF decision marked the end of the acute Latvian financial crisis. Global economic growth has returned. The Bank of Latvia has not been forced to intervene any longer. CDS rates and interest rates have continued to fall. In August, annualized inflation had dropped to 1.8 percent from 15 percent a year earlier, as prices are falling from month to month. The real exchange rate is rising.

How Latvia Differs from Argentina

Amazingly, American economists have been caught in the slapstick platitude that “Latvia is the new Argentina” to quote Nobel Prize winner Paul Krugman.¹¹ In reality, the only similarities between the two countries are that they have had fixed exchange rates and ended up in severe financial difficulties. For the rest, everything in politics, economics, and geopolitics is as different as the Argentines dance tango and the Latvians sing.

Latvia is a newly reborn state anxious to preserve its independence, as it lost one quarter of its population in World War II through death and deportation, while Argentina faces no foreign threat worth mentioning.

Latvia is a very small economy, while Argentina is much larger. As *Financial Times* observed: “...in small countries such as Latvia, unlike Argentina, relatively limited multilateral aid can go a long way.”¹² Latvia is a very open economy, but Argentina is rather closed. Latvia has a highly flexible economy and labor market allowing wage and price cuts, while Argentina had strong entrenched interests breeding inertia.

Latvia has persistently been near budget balance and has a minimal public debt, whereas Argentina had a lasting large budget deficit and accumulated a excessive public debt.

Latvia is a unitary state, but Argentina is a federation with complex regional interests. Politics are quite easy in the small Latvian world of economic virtue. After minor social unrest in January, calm reigns, and few but big businessmen advocate devaluation, while Argentina’s politics have been populist and difficult.

Argentina had a long-lasting record of high inflation, failed reforms, stabilization programs, and even currencies, whereas Latvia undertook reforms once and stuck successfully to them until the current crisis.

Latvia had a tiny public debt, while Argentina’s public debt has been patently large. Argentina has experienced a large number of external defaults, while Latvia had never done so. Latvia is a member of the European Union with the other Baltic and Scandinavian countries as supportive peer countries, while Argentina has been on its own. As a member of the European Union, Latvia benefits from ample financial support. Latvia has a natural exit from its euro peg, namely the adoption of the euro, while Argentina had no sensible exit.

¹⁰ International Monetary Fund, “IMF Reaches Staff-level Agreement with the Latvian authorities on first Review under Stand-by Arrangement,” Press Release no. 09/269.

¹¹ Paul Krugman, “Latvia is the New Argentina,” *New York Times* blog, December 23, 2008.

¹² “Riga Mortis,” *Financial Times*, May 14, 2009.

This list could be extended, but it is already overwhelming. It is difficult to imagine two countries more different than Latvia and Argentina. Therefore, it would be rather surprising if any analogy between them could be relevant, and they should probably seek different solutions.

Future: Revival and Euro Adoption

The old saying goes: it is always darkest just before dawn. Macroeconomic forecasts are helpful in ordinary circumstances when developments are driven by minor changes in standard variables, but they are useless in crises, when usually irrelevant parameters become all important. Therefore, macroeconomic forecasters hardly ever predict when a crisis will hit, how long it will last, or how deep it will be. Invariably, predictions turn worse all the time until the recovery is a fact. We have arrived at that point. Forecasts turned more pessimistic until July, when the global economy was already recovering.

The case I remember most starkly is Russia in 1999. In December 1998, the IMF expected Russia's GDP to fall by 8.9 percent in 1999, and the renowned Institute of International Finance predicted a slump of no less than 15 percent. But the Russian GDP surged by an astounding 6.4 percent.

Given the size of the Latvian cost adjustment, a more rapid than expected economic recovery is all too likely, especially as it is a small and open economy, whose recovery will be governed by exports and not by domestic demand. The sharper the fall in GDP is, the more dramatic the recovery tends to be, as free capacity is ample.

The current Eastern European financial crisis is reminiscent of the East Asian crisis in 1997–98. Both are pure current account crises pertaining to the private sector. In East Asia, the shock was massive and GDP falls drastic, but the crisis was brief and the recovery fast and sharp, driven by exports. Latvia and the other Baltic states are likely to see similar surges. There is nothing fundamentally wrong with the Baltic economic systems, and they will come out of this crisis even better.

A major goal of the Latvian nation remains the adoption of the euro. The only hurdle has been too high inflation, which has now disappeared. A big devaluation would have boosted inflation and thus made the euro unattainable. That was not Latvia's choice. The current problem is instead an excessive budget deficit, but that can and will be controlled. As soon as that has been accomplished, Latvia will be ready to adopt the euro in 2014 or even earlier.

The European Union and neighboring EU countries have offered impressive support, but the ECB has only been notable for its absence. One would hope that the ECB learns from this crisis that the enlargement and reinforcement of the eurozone should be facilitated rather than impeded for the financial security of both the eurozone and the European Union as a whole.