Latvia’s Post-Soviet Transition

The collapse of the Soviet Union, beginning in the late 1980s, was a dream come true for the Latvian people, who had never voluntarily joined that state. Their great dream—to restore national sovereignty and independence to their country—was fulfilled in August 1991. The next daunting task was to establish a normal, functioning market economy to escape the post-Soviet economic chaos. It needed to be combined with the building of a normal parliamentary democracy as in Western Europe.¹

A Bitter Struggle for Independence

Latvia has had a difficult history, particularly in the last century. Shortly after the end of World War I, in November 1918, the Latvian government declared Latvia an independent state for the first time in history. But within weeks, communists supported by Soviet Russia took control. After brief communist rule and independence battles against both German and Russian troops, Latvia signed the Latvian-Soviet Peace Treaty on August 11, 1920, and Soviet Russia recognized Latvia as an independent and sovereign state. Twenty years of independence followed.

Few countries suffered as much as Latvia during World War II. On August 23, 1939, the Soviet Union and Nazi Germany concluded the Molotov-Ribbentrop Non-Aggression Pact, which divided a number of countries between the two states. The pact awarded the three Baltic states to the Soviet Union, thus sealing Latvia’s fate. On the basis of the Molotov-Ribbentrop Pact, Soviet troops invaded and occupied Latvia in June 1940. The Soviets deported some 35,000 Latvians, mainly members of the Latvian intellectual, political, and business elite, to Siberia, where most of them perished. Nazi Germany
then invaded in June 1941, killing some 70,000 Jews in the Holocaust and some 18,000 Latvians during the occupation. In 1944, the Red Army came back and occupied Latvia, incorporating it into the Soviet Union as one of its 15 union republics. The Soviets deported or executed over 100,000 Latvians, while at least 150,000 fled to the West. Latvia was one of the most divided countries, with one part fighting in the Latvian legion against the communists and another conscripted into the Soviet army—father and son could have been on different sides of the front line.

After World War II, Latvia’s politics and economy were completely soviet-ized, and the nation became subject to intense russification. Latvia’s significant Russian-speaking population expanded rapidly, as Russians, Ukrainians, and Belarusians moved to the comparatively well developed Latvia, while Latvian birth rates were low. According to the Soviet census of 1989, ethnic Latvians made up only 52 percent of the population, and many Latvians feared they would become a minority in their own homeland. Most of the population in Riga spoke Russian as their native tongue. The Latvian nation struggled for its survival.

The Latvians—like the Estonians and the Lithuanians—were never reconciled to their incorporation into the Soviet Union, longing for its demise and for national independence. Historically and geographically, they related to the Scandinavian countries and saw no reason for their occupation by the Soviets. The Balts got their chance with political liberalization under Soviet leader Mikhail Gorbachev in the late 1980s. While Gorbachev considered the Balts the most liberal and enlightened people in the Soviet Union, he did not understand that their goal was not only political and economic liberalization but also national independence.

As soon as Soviet repression began to ease, the Estonians, Latvians, and Lithuanians all started working for their national independence. Their first steps toward independence were disguised as environmental protests, because such causes were permitted by the Soviet power structures. Soon, however, national attention turned to the key issue, condemnation of the Molotov-Ribbentrop Pact and the ensuing Soviet occupation of the Baltics. Developments in the three Baltic countries were largely parallel. Estonia and Lithuania competed for the lead, while Latvia followed suit, held back somewhat since it harbored the largest Soviet military forces.

In each of the three countries, a broad popular front was established in 1988 to restore independence. They were primarily nationalist but also democratic and liberal. The Lithuanian and Estonian Communist Parties tried to keep up with the nationalists, liberalizing their policies and practices, as did the communists in Poland and Hungary, while the Latvian Communist Party split in the middle, with one faction being truly hardline. In the republican elections in February–March 1990, the Baltic popular fronts won more than two-thirds majorities in all three parliaments and assumed executive power in all three republics in the spring of 1990, though Soviet power still controlled
them from Moscow. The Baltic states declared independence from the Soviet Union, which refused to accept it.

Latvia differed from Estonia and Lithuania in several regards. The country harbored larger and more important Soviet military installations than its neighbors. Riga has been the dominant city in the region for centuries, having attracted a large Russian population even before World War II. With its large and good ports, Latvia was the main transit country in the Baltics. Riga’s large industrial enterprises, producing phones and microbuses, overshadowed those in the neighboring countries. Because of its greater strategic significance, Latvia was more tightly controlled by Moscow than its neighbors.

The abortive hardline August 1991 coup in Moscow brought real independence to the Baltic states. Immediately afterward, Russian President Boris Yeltsin recognized their independence. On September 6, the Soviet Union did so as well, and then all other countries followed suit. On September 17, the United Nations welcomed the three Baltic states as members, having ascertained their independence and sovereignty. On August 31, 1994, after lengthy negotiations, the last Russian troops left Latvian territory.

These three nations and their civil societies matured in a comparatively lengthy process of democratization. They were ripe for full democracy with multiparty elections and radical market economic reform. Their national objectives were firmly set: to turn their backs on Russia, to reintegrate with the West, and to establish Western political, economic, and legal systems. As in Central and Southeastern Europe, the slogans were: “We want a normal society” and a “return to Europe.” A normal society was understood as West European democracy with a market economy, private property rights, and the rule of law. A return to Europe meant their integration into West European economic and political organizations, notably membership in the European Union but also in the Council of Europe and the North Atlantic Treaty Organization (NATO).

Radical Transition to a Normal Market Economy

In 1991, when Latvia left the Soviet Union, the Soviet economy was collapsing in every sense: GDP was approaching free fall; the Soviet budget deficit was about 31 percent of GDP; prices were skyrocketing, but even so shortages prevailed as prices were still state controlled; and no foreign currency reserves were on hand, which disrupted most trade. The total official fall in Latvia’s GDP from 1990 to 1993 was no less than 49 percent. Although official statistics exaggerate the decline for various technical reasons, the slump was horrendous.

Establishing a functioning economy was vital for the newly reborn nation. Its reform package contained standard elements of systemic change: liberalization of prices and trade, macroeconomic stabilization, and privatization. All kinds of national institutions and legislation had to be established, often from scratch.
The most critical task after independence was achieving monetary stability. The Baltic nationalists were determined to leave the monetary mess of the ruble zone behind by exiting as soon as possible and establishing their own national currencies, which they saw as the best border against Russia. They disregarded transition costs, because they saw a West-oriented, stable market economy as the best long-term option. The International Monetary Fund (IMF), which Latvia joined in May 1992, was the main international agency involved, but it considered the ruble zone a political issue and preferred to be neutral. Yet it assisted the Baltic states with the launch of their own currencies in mid-1992.5

As so often happened in the Baltic transition, Estonia took the lead and went for a truly radical reform, focusing on its currency and exchange rate policy. In June 1992, it broke out of the ruble zone and established its independent currency in order to distance itself from the Soviet Union and to facilitate financial stabilization. Estonia adopted a currency board, which had several specific properties. First, the exchange rate was permanently fixed, first to the deutsche mark and later to the euro. Second, international reserves covered the whole money supply. Third, the current account balance determined the money supply, which meant not only that domestic authorities could not pursue monetary policy, and interest rates were set by the market, but also that capital inflow would cause inflation. Fourth, the Estonians willingly committed themselves to balance the state budget, disavowing public borrowing and thus government bonds.6

This full-fledged currency board was a robust arrangement, creating credibility both at home and abroad, and the balance of payments would determine inflation. While the IMF did not initiate the currency board, it accepted the idea. Currency boards were considered appropriate for small, open economies that had been subject to high inflation, which suited the Baltic states.7 Estonia introduced the currency board and stabilization policy with a bang in June 1992, combined with an IMF standby program and substantial Western financial support. Since a low exchange rate was chosen, it was easily defended, but the drawback was sizable real appreciation, which kept inflation rather high. The currency board, together with completely free trade, minimized government interference in foreign trade. A concern, however, was the absence of a lender of last resort.

Estonia and Latvia pursued similar free-market radicalism in their macroeconomic policy. Latvia broke out of the ruble zone and launched its currency in July 1992. It undertook an equally impressive stabilization, with an IMF program and large international financial support, but the heart of its stabilization was strict monetary policy, spearheaded by Einars Repše, who was Latvia’s predominant reformer and led Latvian macroeconomic policy for a decade as the chairman of the Bank of Latvia from 1991 to 2001. Latvia was determined to succeed as an independent state regardless of cost. Although it largely followed Estonia, it did not adopt a full-fledged currency board. One reason was that Latvia did not have such large international reserves. Officially, Latvia initially pursued a managed float, which was really an informal peg,
and from February 1994 it pegged to special drawing rights but in practice pursued a quasi currency board. Its inflation plummeted from 959 percent in 1992 to 35 percent in 1993 (figure 1.1), but only in 1997 did it reach the single digits—7 percent, after which inflation hovered around 3 percent a year.

In the early 1990s, Latvia quickly adopted all the many laws required for the construction of a democratic society based on the rule of law. It returned to its Constitution of 1922, which was amended. All the main laws for a normal market economy were revived or adopted anew.

In fiscal policy, Latvia followed Estonia’s radical lead. Unlike other post-communist states, the three Baltic states managed to sharply cut harmful public expenditures, such as enterprise and price subsidies, from the outset. Latvia’s public expenditures stabilized around a moderate 38 percent of GDP. In 1993–95, it introduced a simple and sound tax system with four broad taxes, which were sufficient to balance its expenditures: a flat personal income tax of 25 percent, a value-added tax of 18 percent, and a flat corporate profit tax of 25 percent, which was successively diminished to 15 percent. The old social payroll tax was replaced with social security contributions, which were gradually reduced from 37 to 33 percent. This tax system was simple and efficient and has not gone through any major change since the mid-1990s.8

Privatization was seen as a matter of morals and justice as well as the basis of a market economy. The old property rights of independent Latvia were still remembered and cherished. The fundamental principle of justice was resti-
How Latvia came through the financial crisis

Restitution of farmland and real estate was carried out quickly and with great success but that of medium-sized and large enterprises was not really possible. Small enterprises were easily sold off, and some mass privatization was carried out, with vouchers distributed to all. Privatization proceeded fast and by 1998, two-thirds of GDP originated in the private sector. However, a few large enterprises that were both economically and politically difficult to privatize lingered in state ownership. While economically largely successful, as in most postcommunist countries, privatization was also viewed as an unjust and corrupt process during which much of the public property ended up in the hands of a selected few at ridiculously low prices.

The weakest part of Latvia’s early postcommunist transition was deregulation, which was not quite as radical as in the other Baltic countries. Latvia possesses two of the biggest Baltic ports, Riga and Ventspils, through which considerable transit trade took place. Traders made fortunes in the early transition on arbitrage between free and regulated prices in commodity trade. Such rent-seeking business interests were strong in Latvia and resulted in distortion of the legislative process to the benefit of a few big traders, so-called oligarchs, who also appeared as a result of privatization. They formed strong vested interests that continue to haunt Latvia.

A spectacular achievement of most postcommunist countries was the instant adoption of current account convertibility, which applied to foreign trade and tourist traffic, while capital account convertibility was adopted progressively from 1994, with the Baltic states taking the lead. Estonia was the first postcommunist country to opt for full convertibility in 1994, which greatly facilitated foreign trade liberalization.

Multiple international agreements reinforced trade liberalization. Most important was Latvia’s cooperation with the European Union, based on Latvians’ determination to become an EU member. Its Trade and Cooperation Agreement with the European Community came into force as early as February 1993, and in June 1994 Latvia signed an EU Free Trade Agreement, which came into force in January 1995. In June 1995, Latvia concluded the “Europe Agreement,” an association agreement with the European Union. It aimed at a broad integration of Latvia into the European Union, not only lowering barriers to trade but also establishing a framework for political dialogue and harmonization of legislation. The Europe Agreement provided for free trade in industrial goods within ten years, with the European Union reducing protectionist measures faster than the East-Central European countries. On October 13, 1995, Latvia formally applied for EU membership, and on October 13, 1999, the European Commission recommended that member states open negotiations with Latvia. By 2000, 65 percent of Latvia’s exports went to the then 15 EU members. At that time, 81 percent of its exports was directed to the current 27 EU members. This share moderated to 72 percent by 2009, since traditional trade with Russia somewhat recovered. Estonia and Lithuania are now among Latvia’s foremost trading partners.
As the EU accession process started, Latvia gradually adopted the whole common body of EU law, *acquis communautaire*, currently amounting to some 125,000 pages. Especially during the years 1999–2003, Latvia implemented a far-reaching reform process, adjusting multiple laws, rules, standards, and regulations to EU norms. Consequently, Latvia’s economy became much more efficient and productive. This major transformation is often understated because it consisted of thousands of details rather than major legal codes.

To Latvia, accession to the European Union was central, and its earlier application for membership in the World Trade Organization (WTO) was only a sideshow. It took until February 10, 1999, for Latvia to become a member of the WTO; by then its assumption of EU standards was already well under way.

In the first half of 1995, soon after its vigorous stabilization attempt, Latvia faced a major banking crisis. Banks had been caught off-guard by the sudden macroeconomic stabilization, and Baltija Bank, Latvia’s biggest bank, turned out to be insolvent. It had been betting against the lat, attracting lat deposits offering interest rates of up to 90 percent a year. It had pursued reckless expansion and thought it could overrule the Bank of Latvia. After some hesitation, the Bank of Latvia went for a radical solution. Revealing extensive fraud, it closed and bankrupted 15 commercial banks, accounting for 35 to 40 percent of the banking assets and 53 percent of household deposits. The shareholders lost everything, and the depositors received only partial compensation, since they had taken obvious risks, betting on high interest rates. Banks were forced to accept truly hard budget constraints. The banking crisis impeded Latvia’s economic growth, which had just about turned positive in 1994, and in 1995 its GDP contracted by 2.1 percent, but the harsh resolution cleansed the Latvian banking system.

The Latvian economy was finally taking off, with a GDP growth of 8.3 percent in 1997, when the Russian financial crisis hit in 1998. Latvia escaped with limited damage as it was no longer very dependent on the Russian market, and the growth rate fell only to 3.3 percent in 1999. Latvian enterprises responded with energetic restructuring, initiating a decade of magnificent growth (figure 1.2). Latvia had caught up with the reform leaders in the Baltics and Central Europe and seemed unstoppable.

From 2000, the Latvian market economy was in excellent shape: Inflation was low, government finances close to balance, and a period of extraordinary economic growth started. The nation that had suffered so much in the 20th century appeared to have struck gold in the early 21st century.

A paper from the European Commission characterizes the Baltic transition in rosy but fair terms:

The reform process was highly successful in reducing the role of the state and reorienting the Baltic economies towards a market system, and thus helping these countries meet the Copenhagen criteria and become eligible for EU accession. Overall, institutional convergence was more rapid in the Baltic countries...than on average in other New Member States, as shown by standard indicators of governance and institutional quality.
**Figure 1.2** Annual GDP growth, 1991–2012e

- **Change of economic model**: 1991–93, −56 percent
- **Banking crisis**: 1991–93
- **Russian crisis**: 1998
- **Accession to the European Union**: 2004–07, +33 percent
- **Global crisis + local factors**: 2008–10, −25 percent

Evolution of Latvia’s Democratic Politics

Ever since Latvia became independent, freedom and democracy have prevailed. It has a parliamentary system, with a president with limited powers elected by the parliament. The country held parliamentary elections in 1993, 1995, and then regularly every four years since 1998.

Two dividing lines have characterized Latvian politics since 1991, ethnicity and reform versus vested interests. Since independence, ethnic Latvians have dominated all the ruling parties. Nation building was naturally the main goal of the early post-Soviet period, which involved clarifying the right to Latvian citizenship and the official standing of the Latvian language. Ethnic Russians (and Ukrainians and Belarusians) have tended to gather in a couple of parties. To date, none of them has entered any government, because they have refused to accept the basic principles of Latvia’s statehood and foreign policy.

The center right has dominated Latvian politics, so ideology has not been a dividing line. On September 10, 1991, the parliament banned the Latvian Communist Party as hostile to Latvia’s independence. In 1994, the Socialist Party of Latvia was founded to succeed the Communist Party, but it never gained much popularity, which is also true of social democrats.

Latvia has many political parties, and they are built around personalities rather than ideologies as their political views have been so similar. They have tended to merge into blocs. Usually, six to seven blocs or parties have been represented in parliament, which has meant that three to four parties have been necessary to form a coalition government. As a result of intense jockeying between the parties, each government has lasted for little more than one year on average, but that has not hindered the reform process, since the political views have been so similar. If anything, government instability has promoted reform, because corruption scandals tended to bring down governments.

The other dividing line has been between reform and the vested interests of big businessmen known as oligarchs. Initially, reformers and big businessmen cohabited in the same center-right parties, because the interests of reformers and business coincided to a great extent. Over time, their interests have grown apart, and reformers and businessmen have increasingly separated into different parties.

Corruption, or more politely stated commercial abuse of power, has been a key concern, with some big businessmen having been accused of malfeasance. It has dominated the political debate and brought down the government on several occasions, a healthy sign that the people have not accepted the malfunctioning of the state. A World Bank survey in 1998 showed that the two institutions perceived as most dishonest in Latvia were customs and traffic police, followed by courts, licensing and regulatory agencies, state police, and local municipalities, whereas health care and education involved little corruption. Latvia has carried out a large number of legislative and enforcement measures to reduce corruption, seeking assistance from the World Bank as early as 1996.
The EU and NATO accession processes provided constant pressure to reinforce anticorruption policy.

While many of Latvia’s problems were common to most postcommunist countries, the greatest concern was what the World Bank labels “state capture,” the control by a few powerful individuals of key levers of the state for their own benefit.20 State capture was identified with a few big businessmen, who played a major role in Latvian politics and were suspected of exercising undue influence in major state procurements and privatizations.

To combat corruption, the government set up a Corruption Prevention Council in 1997, and in 2002 it established an independent anticorruption authority, the Corruption Prevention and Combating Bureau (KNAB). It became a hot issue in Latvian politics. Since its establishment, KNAB has been plagued by strife over its powers, its cases, and its appointees, showing that it was a serious effort but that the power of malign forces was substantial.21

Overall, because of the great attention devoted to corruption and the free media, Latvia’s rating on Transparency International’s Corruption Perception Index steadily improved from 2000 until 2008 but declined slightly during the financial crisis (figure 1.3).

By 2004, Latvia appeared to be an astounding success story. In 13 years, it had reestablished itself as an independent and sovereign nation. It had become a full-fledged and well-functioning democracy with a competitive market economy based on predominant private ownership. The rule of law had been
Latvia’s Post-Soviet Transition

secured. Latvia had become a member of both the European Union and NATO. This still poor nation was set for an extraordinary economic expansion. Little did it know that this boom would become far too extraordinary, turning into a bust in the ensuing three years.

Notes

1. Two overall sources for this chapter are Anders Åslund, Building Capitalism: The Transformation of the Former Soviet Bloc (New York: Cambridge University Press, 2002); and Anders Åslund, How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia (New York: Cambridge University Press, 2007).


21. Ibid.