In 2008, Latvia entered the bust of a classical boom-bust cycle. Latvia had already begun to feel the heat from the global financial crisis in early 2007 through the restriction of credit. With less credit, housing prices started falling and with them both consumer demand and investment. Output contracted so sharply by the second quarter of 2008 that it threatened the banks. With the bankruptcy of Lehman Brothers in September 2008, liquidity froze throughout the world, and Latvia, which heavily depended on foreign finance, faced a “sudden stop.”

In the absence of international liquidity, Parex Bank—Latvia’s second largest bank and largest independent commercial bank—collapsed in November 2008. It had run into problems due to the global financial crisis and mismanagement by its former owners. The government had to nationalize and recapitalize it. The costs were so sizable that the government was compelled to call in the International Monetary Fund (IMF) and the European Commission for emergency financing. The government concluded a Stand-By Arrangement with the IMF, which was reinforced with even more financing from the European Commission and Nordic countries.

The financial crisis was already evident in late 2007, although its severity was not. During that period Latvia was forced to change governments because Prime Minister Aigar Kalvītis was embroiled in a scandal for attempting to fire the head of the Corruption Prevention and Combating Bureau (KNAB), which prompted the “umbrella revolution” against him. After negotiations, the same parties agreed to form a “crisis” government in December 2007 but with Ivars Godmanis as prime minister. Having been Latvia’s first prime minister after the country regained independence, Godmanis was, on the one hand, generally respected both in Latvia and abroad. He was a big man with a white...
beard, exuding natural authority. On the other hand, he was also controversial because many people associated his government with the lawlessness, corruption, messy privatization, and economic hardship of the immediate post-Soviet period, and he represented the oligarchic Latvia’s First Party/Latvia’s Way.³

In the fall of 2008, four officials dominated the Latvian political scene. One was Godmanis, and the others were Minister of Finance Atis Slakteris, Governor of the Bank of Latvia Ilmārs Rimšēvičs, and President Valdis Zatlers. In almost every regard, Slakteris seemed the opposite of Godmanis. He was seen as the ultimate party politician, with little apparent understanding of economics or finance. He was usually the last to suggest austerity measures.

Rimšēvičs has been governor of the Bank of Latvia since December 2001, when Einars Repše quit to return to politics. He was Repše’s deputy at the Bank of Latvia but acted strictly as the bank’s governor. He stood for three firm ideas: fixed exchange rate, early entry of Latvia into the Economic and Monetary Union, and therefore a tight budget to fulfill the Maastricht criteria.

Zatlers became president in July 2007, elected by the parliament. He was in most regards a political outsider, not belonging to any party, though he had been a member of the board of the Latvian Popular Front in 1988–89, and he enjoyed high professional status as the country’s star surgeon. Since Latvia is a parliamentary republic, presidential powers are limited. The president appoints the prime minister to be confirmed by a parliamentary majority and has the right to call a referendum on the dissolution of the parliament, but if the people say no, he is forced to resign. Zatlers played an active role in the financial crisis. He complained about the failure of the government, reflecting public discontent, and toyed with the idea of early elections, but he also tried to mobilize support for the policy of the government of which he was often critical.

Fall 2008: The Bubble Pops

The global financial crisis started when US real estate prices began declining in the second half of 2006. In 2007, Latvia, one of the most overheated economies in the world by then, was among the first countries to be stung by the crisis. Initially, few understood the severity of the crisis, and strong business interests held their own within the government. Yet, one of the most insightful and critical economic observers, Lars Christensen of Danske Bank, warned in July 2008: “There is a risk that the unwinding of imbalances can lead to an ‘output loss’ of 10-15% of GDP in the Baltic states, Bulgaria and Romania.”⁴ The blows were several and hard but spread over two years. Five big, distinct blows set off the crisis, and they were all financial.

First, the Latvian authorities initiated an anti-inflation plan in early 2007. The Bank of Latvia continued tightening its regulatory policies, primarily by restricting mortgage lending and increasing reserve ratios. Unlike previous minor reserve tightening, this policy had some impact, and lending started decelerating in mid-2007.
Second, more or less simultaneously, in the summer of 2007, SEB began tightening its credit policies toward Latvia and a few months later so did Swedbank. The peak of the credit boom thus ended, initially hitting the housing and construction sectors. Housing prices fell at a rate of 35 percent a year from the second quarter of 2007, becoming the driver of the downturn. Latvia faced a full-blown credit crunch from the beginning of 2008. Economic growth slowed, as consumption and investment fell. Growth was negligible in the first quarter of 2008, and output declined in the second quarter. Even so, inflation peaked at 17.9 percent in May 2008. Wage growth decelerated and employment declined in the early fall of 2008. By the third quarter, Latvia’s GDP approached free fall.

The third blow was the Lehman Brothers bankruptcy on September 15, 2008, when Latvia was already deep into a financial crisis. Even so, it hit Latvia with a “sudden stop.” Global liquidity froze, shutting off the country’s access to international financial markets over night. An already severe recession became a rampant financial crisis.

Fourth, the prime victim of the sudden stop was Parex Bank, the biggest domestically owned Latvian bank, with one-fifth of all bank assets in the country. It could no longer finance itself on the European wholesale market, and it had syndicated loans falling due. A run on its deposits started, and it lost one-quarter of its deposits from the end of August through November. The government had no choice but to take over. On November 8, 2008, the Latvian government announced it was buying 51 percent of Parex Bank from its owners Viktors Krasovickis and Valerijs Kargins for the symbolic amount of 2 lats. Yet, the outflow of deposits did not stop. On December 1, the authorities imposed a partial freeze on deposit withdrawals to conserve liquidity. The government had to recapitalize Parex at a total of 4.9 percent of GDP, and 2.6 percent of GDP was needed in additional guarantees.

Fifth, Latvia had no access to international or European liquidity, although it was a member of the European Union and as such a shareholder of the European Central Bank (ECB). It had little choice but to go to the IMF. As Jean Pisani-Ferry and Adam S. Posen write: “The euro did little to improve the crisis response of neighboring countries in Central and Eastern Europe…. Even if the formal mandates of the [ECB] and the Eurogroup…do not formally include it, broader stability in the region should be a major economic and political objective as well.” The little liquidity that was made available stemmed from the Swedish banks, and the Swedish Riksbank and the Danish central bank offered a bridge loan to keep Latvia going until the IMF-EU-Nordic package was concluded. Another source of finance was the European Investment Bank (EIB), an EU institution, which concluded an agreement with Latvia on a credit of €750 million on October 30, 2008, for EU funds cofinancing, in the early stages of the crisis.

To understand the political economy of the Latvian financial crisis, it is crucial to closely follow the events that unfolded. It is always striking how unaware most actors seem in a financial crisis until it is a reality. Late Professor
Rudiger Dornbusch used to say that a financial crisis usually happens much later than anybody expected, but when it starts everything goes much faster than anybody could have imagined.

Although financial experts, bankers, and Prime Minister Godmanis were aware of the impending crisis in the first half of 2008, little worth mentioning happened in economic policy. The first scare of financial crisis occurred in February 2008 when the exchange rate suffered a speculative attack. It was instigated at the street level with runs on the foreign exchange kiosks. This attempt failed, and that’s possibly why Latvians were not so worried about devaluation later on. As late as March 2008, Latvia managed to sell €400 million of Eurobonds due in 2018 at a decent yield of 5.5 percent.9 In the summer of 2008, rumors circulated about possible bank failures, pinpointing the big Swedish banks.

Absurdly, in August 2008 Latvia held two referendums on unrelated issues—one on early parliamentary elections and another on raising minimal pensions to the existential minimum. Both failed, but even so pensions were raised through indexation and supplementary pensions. Following several scandals, confidence in the government was low, and opinion polls from October 2008 indicated that none of the four government parties would have passed the 5 percent threshold to be represented in parliament. The beneficiaries were the two big opposition parties, Harmony Center and New Era.

The first serious calls for austerity emerged at the end of September 2008. Godmanis led the charge and ordered state agencies to prepare for a cut in their staff of 10 percent and warned that the salaries of state employees would not be raised in 2009. Trade unions refused to accept any freezing of state salaries, and an opinion poll in early October claimed that 63 percent of the population concurred. The union turned to the parliament after failing to persuade the government. The police threatened to strike, and farmers were upset over the government wanting to cut agricultural subsidies. In late October, more than 1,000 medical staff went on strike demanding higher salaries.10 Austerity was still a distant goal.

The initial budget proposal of October 6, 2008, forecast a budget deficit of 1.85 percent of GDP, on the basis of expected GDP growth of 2 percent in 2009, inflation of 7.6 percent, and unemployment of 8.1 percent. Bank of Latvia Governor Rimšēvičs protested that the real deficit would be 4 to 5.5 percent of GDP, as GDP was not likely to grow. In fact the IMF warned in October that GDP in 2009 would fall by 2.2 percent. Finance Minister Slakteris did not participate in the discussion of the budget because he was abroad on holiday.11

The public discussion, however, soon turned, when in October and early November 2008 negative statistics started dripping in. On October 14, 2008, Eurostat announced that Latvia’s industrial production in August had plummeted by 11.1 percent.12 In October, retail sales plummeted by 14.4 percent, showing that domestic demand was plunging because of lack of liquidity.13
The number of enterprises going bankrupt surged. Unemployment rose fast and reached 7.2 percent in November.14 These statistics aggravated the public’s perception of the economy, reinforcing the crisis mood. Latvians no longer opposed cuts but called for more radical austerity measures. Public demands for benefits gave way to political and social groups demanding that fat cats be punished—the president’s chancery, state officials, the parliament, state corporations, and local governments. Prime Minister Godmanis (not the minister of finance) had already started cutting state wages from early October. One “sacred cow” after the other was slaughtered with great speed, and after every slaughter the public cried for more. The austerity campaign acquired an almost revolutionary zeal. Most controversial was eliminating the substantial fees that many senior officials received for being members of boards of state corporations, which made up about half their income, and the parliament’s decision to abolish all these fees barely scraped through.15 Since becoming a member of the North Atlantic Treaty Organization (NATO) in 2004, Latvia had firmly endeavored to spend 2 percent of GDP on its defense. Now, for the first time, the government was determined to cut military expenditures.16 Eventually, they were trimmed to 1 percent of GDP.

On November 7, 2008, ironically the anniversary of Russia’s October revolution, Latvia suffered a big blow. Initial statistics indicated that GDP in the third quarter of 2008 had fallen by 4.2 percent (later revised to 4.7 percent). It dawned on the Latvian elite that their economy was near free fall. The tone of the public discourse changed further. GDP forecasts for 2009 were revised nearly daily. On November 3, the European Commission predicted a fall of 2.7 percent. In late November, Swedbank foresaw a contraction of 4 percent, followed by SEB predicting a decline of 5 percent, which was also the IMF’s revised December forecast and became the basis for its financing program. Sensibly, Minister of Economy Kaspars Gerhards observed that the GDP for the next year could not possibly be forecast.17

The public urged the government to act to escape the crisis, complaining that it took baby steps and shielded vested interests. The chairman of the Association of Realtors demanded that the government aim for a budget surplus of 5 percent of GDP. One liberal opposition politician, Aigars Štockenbergs, called the budget “turbid and helpless.” A survey of businessmen showed that 54 percent wanted a balanced or surplus budget. The Free Trade Union Confederation of Latvia joined this choir, complaining that the government’s budget was overoptimistic and did not consider the social partners’ proposals on expenditure cuts.18

On November 14, the parliament adopted a budget for 2009, with a slight majority of 53 to 43. New Era and Harmony Center opposed it as insufficient and unrealistic, but this budget was perceived as temporary.19 All knew that its assumptions were excessively optimistic, and Godmanis declared that he would cut public expenditures ad hoc. On November 24, all state bonuses and other additional expenditures for 2009 were eliminated.
Besides negative statistics, false analogies were also in the news. From mid-October, various international analysts claimed that Latvia was becoming another Iceland, where three big banks had been just nationalized, and that the same economic problems were likely to emerge in Latvia. Godmanis responded that an Icelandic scenario was impossible in Latvia. In particular, Iceland’s ratio of banking assets to GDP was several times larger than that in Latvia. He should also have added that Iceland had a floating exchange rate and very high interest rates and was not a member of the European Union.

The crisis also subjected the Latvian government to sniping from within. A typical news report read: “In the corridors of the parliament the question is intensely discussed when the Godmanis government will fall.” It was predicted to fall in the spring before the local elections. And sure enough, the government fell in February 2009. Representatives of the coalition party, the People’s Party, suggested repeatedly that their leader Andris Ščēkše should become prime minister once again. Ščēkše exploited the drama of crisis but fudged his response, claiming that the three tasks of the Latvian economy were: “Productivity, productivity and once again productivity.” He thus paraphrased one of Vladimir Lenin’s most famous statements but said nothing about how to take Latvia out of the crisis. On another occasion, he complained that the budget for 2009 was too optimistic, requiring sharp correction, but abstained from revealing the change he had in mind. Clearly, Ščēkše sought the moment to become prime minister again.

President Zatlers also kept criticizing the Godmanis government. He said that he was ready for the possible resignation of the government but added that a change of government in the midst of such a difficult economic situation would be undesirable. Soon afterward, he proposed a referendum on the dissolution of the parliament but complained that a change of government would take too long—five months—and desired a better constitutional order. The president even blamed one specific party, People’s Party, for Latvia’s poor preparation for the financial crisis. Speaking about Slakteris, Zatlers said: “It would be good if we could raise the prestige of the minister of finance.” His frequent public criticism undermined the government. Evidently, he reckoned that Latvia needed firmer hands at the rudder, though his criticism was directed against the ministers of finance and economy rather than the prime minister.

Most clouds have a silver lining, and even Latvia’s dark clouds in the last quarter of 2008 showed flickers of hope. After peaking in May 2008, annualized inflation fell like a stone by about one percentage point a month, and foreign trade was turning around. As domestic demand contracted, exports increased, rising by no less than 14 percent during the first nine months of 2008, while imports declined by 1.6 percent. The large current account deficit shrank in no time. An early structural reform was per-student financing of education, providing state financing in relation to the number of students, which the trade unions accepted as a means of redirecting funding to teachers.
Run on Parex Bank: Latvia Calls in the IMF

Rather than calming the public mood, the adoption of the 2009 budget was seen by the public as a declaration of the government’s impotence. On November 15, the deposit run on Parex Bank turned into a run to exchange lats for euros and other foreign currencies. Rumors were rife that devaluation of the lat was imminent. Slakteris hardly helped by declaring that the lat was stable: “Even if the whole world economy collapses, the lat will be the last to fall.”

The Bank of Latvia reacted to the deposit withdrawals by increasing liquidity, extending domestic credit, and easing reserve ratios, which reduced its foreign exchange reserves by one-quarter during the three months from September to November 2008. Like other new EU members, Latvia had relatively small reserves compared with its short-term external debt.

Therefore, it could not take the easing of its monetary policy far. Yet, contrary to widespread fears, Latvia did not experience any financial meltdown or another severe bank run. During the height of the liquidity crisis, from the end of August until the end of November 2008, total bank deposits declined by 10 percent excluding valuation effects. The payments system continued to function. As usual late in their assessments, the three rating agencies downgraded Latvia in the fourth quarter of 2008.

The Latvian government was understandably at a loss facing the Parex Bank crisis, so it called in a technical IMF mission in mid-November. Soon the depth of the crisis became evident, and the Latvian authorities requested an IMF Stand-By Arrangement. The first round of the IMF negotiations took place on November 17–23, with Christoph Rosenberg as mission chief.

On November 20, the Latvian security police arrested a Latvian newspaper journalist and a musician for spreading destabilization rumors about the devaluation of the lat. At the same time the security police appealed to the media to not create panic and to publish only properly checked data. These actions stopped short of censorship but violated normal democratic standards.

In early December, all realized how serious the crisis was. Godmanis no longer minced his words but reminded the population that the Latvian GDP had slumped by 37 percent after the collapse of the Soviet Union. He complained that it was difficult to make any plans when the GDP forecasts changed virtually every day. Presciently, the Latvian employment authority warned that unemployment could rise to 15 to 20 percent in 2009. Godmanis declared that international financing was needed for three reasons: to manage Parex Bank, to finance the budget deficit, and to stabilize the financial market.

The IMF mission returned to Latvia for negotiations from December 5 to 18. On December 5, Prime Minister Godmanis presented the IMF program to the parliament. A week of intense political negotiations ensued.

At the center of the crisis lay the collapse of Parex Bank. The two owners—Krasovickis and Kargins—were known and well-connected Latvian citizens, who had won the first private license in the Soviet Union to trade in hard currency in
1990. It was one of the early, highly entrepreneurial post-Soviet banks, complete with all the baggage. In 1992, Parex advertised: “We exchange all currencies and ask no questions.” In 2005, it announced that Riga was closer to Moscow than Switzerland was and that everyone at Parex spoke Russian. In a last daring blitz, its billboards in Stockholm offered 6.5 percent a year deposit rates in Swedish kronor. Latvia was divided in their views of the two former owners, long the richest men in Latvia. While some were proud of these self-made Latvians who could compete with big foreign banks, others were not. Parex Bank eventually sued the two men in 2010 for “violation of the bank’s interests.”

Latvia’s starting point was that devaluation was unthinkable. The only Latvian official who wavered was Slakteris, stating: “I talked with the executive director of the IMF and he assumed that for the stabilization of the economy the Bank of Latvia has to reduce the exchange rate of the lat. Then we could exit the crisis according to the Argentine scenario: this is already widely discussed by Fund experts. Such a plunge as now, Latvia can never survive.” Godmanis instantly rebuked Slakteris and clarified that devaluation was out of the question.

Godmanis contemplated large cuts in public expenditures, slashing state salaries by 40 to 45 percent and reducing staff by 20 percent in certain state institutions. He ordered the state secretaries to assess the possibility of cutting salaries in the state administration by 10 to 30 percent as well as wages in state-owned enterprises by 15 percent. Virtually all public expenditures apart from pensions and social support for the poorest were to be cut.

Yet the government insisted on reducing the flat personal income tax from 25 to 23 percent, while it accepted the IMF demand to raise both the value-added tax (VAT) from 18 to 21 percent and some excise taxes. The corporate profit tax remained at 15 percent.

On December 10, Godmanis gathered social partners to consult about the anticrisis program. The Latvian Confederation of Employers opposed the increased VAT and demanded lower personal income taxes as in Estonia and Lithuania. The Free Trade Union Confederation of Latvia was still more critical: “The draconian tax reform and wage cuts lead to an even more profound crisis and undermine the basis of the state—the economy and enterprise. They lead also to increased unemployment and reduced demand.” They threatened to contest the new laws in the Constitutional Court. Thus both employers and trade unions refused to accept the government’s austerity plan, but Godmanis did not compromise.

 Needless to say, the opposition had no reason to go soft on the government, demanding a more radical austerity program. Their anger was directed against the old elite of top officials living in symbiosis with wealthy businessmen while claiming to defend the poor and pensioners. On December 10, the two main opposition parties, New Era and Harmony Center, demanded the resignation of the Godmanis government. Harmony Center’s parliamentary leader Jānis Urbanovics complained that there “exists a non-competitive political system with an unchanging political top. All our parties for the last
15 years...are only different pieces of one political ‘sausage,’ and they differ only by weight and label."

Harmony Center called for a coalition of national unity or national salvation, trying to exploit the situation to become a legitimate government partner. To that effect, it actually signed an agreement in support of the stabilization plan. Characteristic of the public mood, Harmony Center approved of the public salary cuts but complained that the government had not utilized all options to cut the expenditures of the state apparatus.

New Era had called for austerity and anticorruption measures for years. It had no reason to approve of this belated stabilization program, which was softer than New Era desired and contained tax increases. It demanded more professionalism, determination, and transparency, also calling for a government of national unity comprising all the parliamentary parties. It voted against the stabilization program. Representing the hardest liberal opposition to the government’s stabilization program, Aigars Štockenbergs criticized it for being too soft on the elite: “Godmanis found tens of reasons not to end tax holidays for dividends, not to introduce capital gains tax and not to tax magnificent villas,..., where those ‘spoilt by the fat years’ built their castles. This government defends only the rich, who need endless tax holidays.”

In the midst of this sensitive situation, Minister of Finance Slakteris gave a long interview to Bloomberg television on December 8, 2008, attracting immense public attention. Not exactly fluent in English, Slakteris missed the meaning of many questions and had little to say. The final nail in his political coffin came when he was asked what had led Latvia into such a terrible crisis. He responded with a smile: “Nothing special.” This became the slogan of a burgeoning protest movement against the government with posters and t-shirts saying “nothing special.” This interview seriously undermined public confidence in the government. The opposition called a vote of no confidence in the minister of finance, which took place on December 11. New Era, Harmony Center, and various independents voted for his ouster with 41 votes, while the government mobilized 53 votes in his defense. But the Godmanis government was doomed.

The public sense of crisis had become profound and all embracing. The ultimate issue was Latvia’s national survival. Harmony Center’s Urbanovičs exclaimed: “Is there any alternative today to our proposals? Unfortunately, there is one and that is a catastrophic alternative, namely Latvia’s ultimate loss of economic independence, its depopulation and the marginalization of the remaining population. People will simply spread out over the world...”

On December 11, the parliament adopted the controversial package of tax changes demanded by the IMF, and the Ministry of Finance published “Latvia’s Economic Stabilization and Growth Revival Program.” The brief stabilization program set out the basic policies agreed with the IMF and the European Commission. The budget deficit would be 5 percent of GDP in 2009. The total fiscal tightening was assessed at 1 billion lats or 7 percent of GDP in 2009. The public expenditure cuts were draconian: reducing public employees
by 15 percent, public nominal wages by 15 percent, and state procurement of goods and services by 25 percent. VAT was to rise by 3 percentage points, and excise duties were to be raised for fuel, coffee, alcohol, and other beverages. At the same time, structural reforms were to be promoted to make the labor market more elastic and facilitate investment.

The International Assistance Package

In December 2008, the IMF, the European Commission, and several European—mainly Nordic—countries prepared and financed an international loan package for Latvia. The stabilization program was concluded as a traditional IMF Stand-By Arrangement on December 18, 2008. It was supposed to last 27 months, and the IMF offered an exceptionally large credit of €1.7 billion or $2.35 billion. The credit was heavily frontloaded with one-third being issued in the first of ten tranches. The IMF Executive Board adopted this program on December 23, only four days after it was concluded. Thus, the first tranche could be disbursed as a Christmas present to badly suffering Latvia.

The IMF led the negotiations, with staff from the European Commission, the European Central Bank (ECB), the World Bank, the European Bank for Reconstruction and Development (EBRD), the Swedish Ministry of Finance, the Riksbank, and other Nordic governments participating. Rarely has an IMF negotiation involved so many participants, and seldom have the views expressed at the table been so varied on the key issue of principle, namely the exchange rate policy. The IMF mission itself had 11 people. It was led by Christoph Rosenberg, who accepted the Latvian argument for maintaining the peg to the euro, but most of his mission was skeptical. The Latvian team was led by Prime Minister Godmanis, Minister of Finance Slakteris, and Bank of Latvia Governor Rimšēvičs. It represented the strong Latvian consensus: maintain the peg at the price that is necessary.

The negotiations took uncommonly long, November 17–23 and again December 5–18, partly due to disagreements in particular between most of the IMF staff and all the other participants and partly because of the very uncertainty of the economic situation and complications involving Parex Bank. The sharp differences among these participants resulted in an unusually well written and analytical IMF staff report.

The main objectives of the program were clearly stated: “to arrest the immediate liquidity crisis and to ensure long-term external stability, while maintaining the exchange rate peg.” This was to be done through measures to stabilize the financial sector and substantial fiscal policy tightening combined with structural reforms and income policies to improve competitiveness.

Until the end of 2008, Latvia’s public finances appeared to be in good shape. The immediate reason for Latvia having to call in the IMF was the collapse of Parex Bank, and the broader concern was the country’s liquidity crisis. In addition, the country needed to become more competitive. Either prices had to be brought down or production rendered more efficient. The financial crisis
would undermine government finances. Five big issues dominated the negotiations: exchange rate policy, Parex Bank, economic outlook, fiscal adjustment, and the mobilization of international financing.

First, the Latvian authorities stated in no uncertain terms that the fixed exchange rate was not an issue for discussion. The IMF put it: “A change in the peg is strongly opposed by the Latvian authorities and by the EU institutions, and thus would undermine program ownership.” It went further: “Any change in regime would cause significant economic, social and political disruption.” The IMF accepted the Latvian position: “The program’s aim is to meet the Maastricht criteria to facilitate adoption of the euro.” The internal IMF discussion about devaluation continued in the staff report. The supporters of Latvia’s peg included a box with 13 cases in nine countries from the last three decades of “important real exchange depreciation under currency pegs.” The opponents of the peg included a final caveat: “Risks to the program are nevertheless considerable.”

Second, the most difficult issue was rather technical: What could and should be done with Parex Bank? The IMF staff report stated: “The authorities’ first priority is to arrest the deteriorating condition in Parex Bank, as the rest of the banking system so far has been able to meet increased demands for liquidity.” A second and decisive step taken on December 5 was a precondition of the IMF program: The government raised its share of Parex Bank from 51 to 85 percent of the shares and appointed new professional management to run the bank. Parex Bank had €975 million in syndicated loans, which could fall due in the first half of 2009, amounting to 4.6 percent of GDP. Another concern was that the former owners would tap the bank for money. Therefore, it was necessary to “ringfence” Parex Bank. The IMF estimated that the total fiscal costs for bank restructuring could be 15 to 20 percent of GDP through 2010.

Third, economic forecasts were all a big unknown. At the time, the global economy seemed to have entered a sinkhole and nobody could predict how deep the economy would fall, but a government budget or an IMF program always needs forecasts regardless of how little basis they may have. The IMF and the Latvian government made similar predictions, but they were regularly revised downward, and the prognosis in the IMF program was way off the actual outcome. These numbers show how great the uncertainty was and how impossible it is to accurately forecast in the midst of a severe financial crisis.

While the IMF foresaw in December 2008 a 5 percent slump in 2009 GDP, the actual fall was 18 percent, as the recession was far greater than anticipated. Correspondingly, the predicted current account deficit of 7.3 percent of GDP in 2009 swung around to become a surplus of 8.6 percent of GDP. Similarly, average inflation predicted to be 5.9 percent in 2009 stopped at 3.3 percent and fell into minor deflation in 2010 (table 3.1). These numbers show a scared population that more than tightened its belt. As a result, GDP fell much more than expected, whereas the current account deficit was eliminated in no time.
Prices developed close to ideal, eliminating inflation but not turning into a deflationary cycle.

Fourth, major fiscal adjustments were required, but given the strong and broad Latvian commitment to the peg this was not as controversial as might be assumed. One of the first and important preconditions of the “It’s Mostly Fiscal” IMF was that Latvia address its budget deficit. The parliament had passed a budget in November 2008 aiming at a budget deficit of 1 percent of GDP in 2009, but its assumptions were overoptimistic, and one month later the IMF assessed the likely budget deficit in 2009 at 12 percent of GDP, as growth forecasts fell and tax revenues, as is usual, contracted more than output.

The IMF demanded a reduction of the budget deficit by 7.1 percent of GDP, allowing for a budget deficit of 4.9 percent of GDP in 2009. Roughly two-thirds of the fiscal consolidation, or 4.6 percent of GDP, was supposed to come from cuts in public expenditure and one-third or 2.5 percent of GDP from increased taxation.

The cuts in public expenditures were enormous: a real cut of 25 percent of most current spending. All public wages were to be slashed by 25 percent in nominal terms. In addition, on December 10, the government signed a protocol with local governments compelling them to undertake the same nominal wage cuts as the central administration. The focus lay on comprehensive reforms of the state and local administration, the education system, and civil service, which had been prepared for years. Yet, both the Latvian government and the IMF were anxious to maintain social expenditures. Pensions were frozen in nominal terms in 2009, and social spending was supposed to increase from 21 to 25 percent of the budget.

The Latvian government opposed abandonment of the flat income tax and the low corporate profit taxes, but it accepted with regret an increase in the value-added tax (VAT) from 18 to 21 percent, and various excise taxes were also hiked. As a result, state revenues worth about 4 percent of GDP were to be

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<td>Inflation (percent; period average)</td>
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Table 3.1 IMF forecasts and outcomes, 2008–10

shifted from direct to indirect taxes, with the intention of enhancing economic efficiency. The IMF also favored broader capital gains taxes and real estate taxes, but nothing was decided in December 2008.

Finally, substantial financing would be required for Latvia’s stabilization. How much financing would be necessary, and who could mobilize it? The IMF assessed Latvia’s gross external financing requirements at close to €7.5 billion through early 2011, that is, 37 percent of Latvia’s actual 2008 GDP—an unprecedented amount.51

International capital flows were also difficult to predict. For example, one important source of international financing was capital injections by foreign shareholders in their Latvian bank subsidiaries, which the IMF estimated would amount to as much as 9.7 percent of GDP in 2009–10 or €2.0 billion. Much depended on whether these capital injections would be provided or not.

Traditionally, the IMF had limited its lending to three times the quota a country held with the Fund. However, the IMF had already participated in the exceptionally large stabilization programs notably for South Korea and Turkey, so the ice was already broken. After Hungary had got 12 times its quota, Latvia could hardly be given less. Yet, non-European IMF members were not prepared to accept more, so Latvia obtained an IMF commitment of credits of €1.7 billion, which was only 22 percent of the financing cap of €7.5 billion.

Usually, the World Bank had also made substantial contributions to IMF financing, but during the European financial crisis the Bank decided to limit its contribution mostly to social safety networks to the tune of €400 million. The EBRD contributed €100 million. In effect, this financing was for recapitalization of Parex Bank.

The European Commission had played a pioneering role in the stabilization program for Hungary in October 2008. To the IMF’s commitment of €12.3 billion, the Commission added a substantial €6.5 billion. It was drawn from the European Stabilization Fund, a balance-of-payments support facility of €12 billion that had been set up in the early 1990s to support countries in crisis in Southern Europe. The fund was meant for EU countries outside the euro area. On December 2, 2008, the European Council doubled the fund to €25 billion, so the European Union had ample funds to support Latvia.52

Latvia benefited from the Hungarian precedent and the reinforced EU funding. In addition, it enjoyed solid support from its Baltic and Nordic neighbors, who formed one region on the IMF board and had cut their teeth on the Icelandic crisis. Because of all these positive forces, Latvia managed to get a commitment of credits of no less than €3.1 billion from the European Commission, almost twice as much as from the IMF, and it was heavily front-loaded. No less than €2.2 billion was supposed to be disbursed over the next six months.

The total from these international organizations amounted to €5.3 billion, which still left a substantial financing gap of €2.2 billion. As the situation became clear, Swedish Minister of Finance Anders Borg called the closest friends of
Latvia to an emergency meeting at Arlanda airport in Stockholm on December 10. In a kind of auction, Borg allotted the remaining financing gap to Latvia’s friends. Sweden, Denmark, Norway, and Finland together committed to total credits of €1.8 billion. Impressively, three new EU members outside of the euro area made their own commitments: the Czech Republic, €200 million, Poland, €100 million, and even small Estonia, €100 million. The whole financing gap was then covered, and the IMF agreement could be concluded (table 3.2).

This bilateral funding was always perceived as a backstop. It required special parliamentary decisions in each country, which were forthcoming without problem. However, unlike the frontloaded IMF and EU funding, it was backloaded and not supposed to be disbursed until 2010 or 2011. Moreover, while the multilateral credits would cost 3 to 3.5 percent a year in interest, the bilateral funds would cost about 6 percent a year. Therefore, the Latvian government saw the bilateral funds as a reserve that it would hopefully not need, and it did not. Yet, these commitments were critical for the approval of the IMF agreement.

A peculiarity in the Latvian stabilization efforts was that the Swedish Riksbank and the Danish central bank opened a swap line of €500 million to bridge the IMF stand-by loan, showing the great commitment of the Nordic countries to Latvia’s stabilization. In 2007, the US Federal Reserve started offering large swap lines to the world’s foremost central banks—ECB, Bank of Japan, Bank of England, and Swiss National Bank—and then extended them to nearly every advanced economy. In October 2008, the US Federal Reserve provided four emerging economies with large credit swaps: Brazil, Mexico, Singapore, and South Korea each received $30 billion. This was not the

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**Table 3.2 International financial support: Commitments and disbursements, 2008–11 (millions of euros)**

<table>
<thead>
<tr>
<th>Lender</th>
<th>Disbursements</th>
<th>Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>European Union</td>
<td>—</td>
<td>2,200</td>
</tr>
<tr>
<td>International Monetary Fund</td>
<td>591</td>
<td>194</td>
</tr>
<tr>
<td>World Bank</td>
<td>—</td>
<td>200</td>
</tr>
<tr>
<td>European Bank for Reconstruction and Development</td>
<td>—</td>
<td>80</td>
</tr>
<tr>
<td>Nordics (Denmark, Estonia, Finland, Norway, and Sweden)</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Poland</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>591</td>
<td>2,674</td>
</tr>
</tbody>
</table>

Federal Reserve’s duty, but it did so because of its sense of responsibility for global financial stability.

The ECB did not have any obligation to issue swap credit lines either, but in stark contrast to the US Federal Reserve, it was indifferent to liquidity scarcity in surrounding economies, even non–euro area EU countries. The ECB offered two euro swap lines, to the Swedish Riksbank and the Danish National Bank, but it did so late. Hungary and Poland were offered repo loans, which were of no significance as they required liquid euro assets as collateral. Instead, Poland had to go to the IMF for a Flexible Credit Line, which fulfilled the same function as a swap line. If the ECB had acted as the US Federal Reserve, it would have offered swap lines to all solvent non–euro area EU countries, but it did not. Neither before, during, nor after the crisis did the ECB lift a finger for Latvia, although it is one of the shareholders of the ECB. As Adam S. Posen has argued: “A successful regional currency role for the euro would entail fulfilling responsibilities toward countries in the region that have adopted the euro as a monetary anchor or whose financial systems are partially euroized.”56 If the ECB had provided swap lines to the Baltic states, Poland, and the Czech Republic, by accepting government bonds denominated in local currencies of non–euro area EU countries as collateral, as Zsolt Darvas and Jean Pisani-Ferry advocated,57 the output collapse in the Baltic region would in all probability have been contained.

On December 23, 2008, the IMF Executive Board speedily approved a $2.35 billion 27-month Stand-By Arrangement for Latvia and disbursed a first installment of €586 million or $860 million. The European Union also fulfilled its commitments from December but at a somewhat more leisurely pace. On January 20, 2009, the European Council decided to make up to €3.1 billion available to Latvia as medium-term financial assistance with a maximum maturity of seven years, demanding a long list of structural reforms. On February 25, it disbursed its first installment of €1 billion, securing three months of international reserves for Latvia.

Notes


43. Urbanovičs, “Kas vainīgs un ko darīt?” [“Who Is to Blame and What Should Be Done?”]


46. Ibid.

47. Ibid.


49. Ibid., 6–7, 12, 17.

50. Ibid., 14–17, 30.

51. Ibid., 18–20.


