As the New Year bells rang in 2010, Latvia started rising from the ashes of its deep economic recession. Exports and manufacturing recovered with refreshing vigor, and the ever worse news of the first half of 2009 was replaced with an ever brightening outlook.

For Latvia, it was of great importance that in the spring of 2010 Estonia qualified for the adoption of the euro on January 1, 2011, because this meant that the European Union and the European Central Bank (ECB) accepted to expand the Economic and Monetary Union (EMU) and it signaled the end of the Baltic financial crisis. For Europe as a whole, however, the Greek financial crisis that came to a head in the first days of May 2010 and the broader euro crisis dominated. These crises were followed by eruptions in Ireland, Portugal, and Spain, making Latvia’s economy look calm and well-managed. Suddenly, its internal devaluation stood out as a viable strategy for euro area countries in dire financial straits.

The big Latvian event in 2010 was the parliamentary elections in October, which resulted in the victory of the incumbent government. The People’s Party had defected from the government in March 2010, for which the voters punished it. A month after the elections, I formed government for the second time consisting of only two political blocs with a majority of their own, replacing the four-party minority government.

In the third quarter of 2010, Latvia finally returned to economic growth after nine quarters of declining output. With steadily improving economic forecasts the government could trim the planned austerity measures. The financial crisis was over, but its effects will linger for years.
Estonia Qualifies for the Euro, March–June 2010

In spite of the global financial crisis, Estonia quietly pursued its accession to the EMU. On May 12, 2010, the European Commission published its annual Convergence Report. After noticing that Estonia met the criteria on price stability, budget balance, public debt, and exchange rate stability, the Commission concluded that Estonia had complied with the convergence criteria and “that Estonia fulfils the conditions for the adoption of the euro.”

On July 13, the EU finance ministers made the final decision and decided to keep the existing exchange rate to the euro. On January 1, 2011, Estonia introduced the euro without any problem.

Estonia is a stark example for other countries with currency boards. On the one hand, it had shown that it is possible to comply with the Maastricht criteria in the midst of financial crisis. On the other hand, it had also shown the danger of inflation. Although Estonia did not devalue and went through a severe recession, its inflation year over year had reached 5.1 percent in November 2010, and annualized GDP growth was no less than 5 percent in the third quarter of 2010. Clearly, the main threat was not recession or deflation but inflation. In that case, devaluation made no sense.

The governments of Bulgaria, Lithuania, and Latvia were keenly aware of the Estonian experience and welcomed Estonia’s entry into the eurozone. They are all determined to achieve a budget deficit of no more than 3 percent of GDP in 2012 in order to be allowed to adopt the euro in 2014. Estonia’s entry showed that the door to the eurozone is still open.

Beginning in March 2010, when Estonia’s EMU accession appeared likely, the three big rating agencies started raising first the outlook and eventually the ratings for the three Baltic states “on faster-than-anticipated rebounds.” Moody’s analyst for the Baltic countries commented on Latvia: “The prospect of a disorderly currency devaluation is now highly unlikely.”

The Greek financial crisis in April–May 2010 did not harm Latvia. On the contrary, it offered the country an opportunity to shine as a bold and successful pioneer. The Latvian example showed that devaluation was not necessary. A European democracy and welfare state could carry out an internal devaluation, slashing its budget deficit by more than one-tenth of GDP mainly by cutting public expenditures. “The Greek situation is similar to Latvia’s in that there is no other choice but to downsize expenditures,” Bank of Latvia Governor Ilmārs Rimšēvičs commented to Bloomberg. “We are very pleased that Latvia is more and more mentioned as a template because a year ago people were thinking we [were] going to fail. Today, [Latvia is] more or less out of the woods.”

October 2010 Parliamentary Elections: Popular Approval of Crisis Resolution

On October 2, 2010, Latvia held ordinary parliamentary elections. The dominating theme was crisis resolution after a total output fall of 25 percent and
unemployment of 20 percent. The surprising outcome was an overwhelming victory for the incumbent government.

Positioning itself for the October parliamentary elections, the People’s Party departed from the government coalition in March 2010, distancing itself from the austerity policy. Its leader, Andris Šķēle, had persistently advocated devaluation. With ordinary elections half a year away, it made little sense for the government to resign. It continued ruling with minority support in parliament, but legislation came to a near halt.

In May 2010, the government decided to divide Parex Bank into two banks, a “bad bank” for nonperforming loans and a normal bank. The bad bank was supposed to sell off impaired assets at a deliberate speed to receive decent returns for the state and then be closed down, while the good Parex Bank, renamed Citadele, was to be sold. Sweden had used this technique during its banking crisis in the early 1990s. The plan faced strong objections from the opposition, however, mainly Harmony Center and People’s Party. They tried to halt the plan through legislative proposals, apparently to reward the two former owners of Parex Bank, but they never gathered a majority. In May the opposition tried to oust New Era Minister of Interior Linda Mūrniece in a vote of no confidence and in early June to oust New Era Minister of Economy Artis Kampars in repeated votes of no confidence, but these efforts failed.

The elections were preceded by a consolidation of the political parties. On the center-right, New Era gathered Civic Union and Society for Different Politics, forming a political bloc called Unity. On the oligarchic right, Šķēle and Ainārs Šlesers merged their two parties (Latvia’s First Party/Latvia’s Way and People’s Party) into the new business bloc For a Good Latvia, which opposed the government. On the Russian side, Harmony Center became all dominant, persistently the biggest party in opinion polls. The permanent government party, Union of Greens and Farmers, kept a low profile but maintained its high popularity. Apart from two small Latvian and Russian nationalistic parties, the political stage had consolidated.

The election campaign became a battle between the three leading candidates for prime minister: Jānis Urbanovičs of Harmony Center, Šlesers of For a Good Latvia, and myself. The economic crisis and the International Monetary Fund (IMF)/European Union program dominated the debate. For a Good Latvia and Harmony Center criticized the government’s austerity policy, the IMF, and the Swedish banks in a pretty populist fashion, claiming that the cost had been much higher than necessary and advocating lower public cuts and devaluation. A typical Šlesers statement was: “The government should not have to bow to the IMF….“ They also claimed that a vote for me was really a vote for Lembergs, whose Union of Greens and Farmers would clearly be part of a new government led by New Era.

Unity advocated a clean and small government, fiscal discipline, and export-oriented recovery. Its advocacy can be summarized in one phrase: “We are on the right road.” On August 9, I claimed: “The recession is over and... it can be expected that in the second [half] of the year Latvia’s economy will
regain growth...[of] gross domestic product, tax income, employment....”

Unity insisted that nobody could have taken the country out of the crisis at a smaller cost. It acknowledged the severity of the crisis but blamed its oligarchic predecessors.

On October 2, Latvians offered a resounding vote of confidence in the incumbent center-right minority government. The big winner was Unity, which received 31.2 percent of the votes and 33 seats in parliament. Its main coalition partner, the Union of Greens and Farmers, obtained 19.7 percent of the votes and 22 seats (table 6.1). Together, these two parties held a majority.

Harmony Center increased its votes substantially from 14.4 percent in 2006 to 26.0 percent. Like New Era, Harmony Center had benefited from being in the opposition to the government that had led Latvia into the crisis. But then it criticized the policies of the succeeding, anticrisis government, favoring a much larger budget deficit and toying with devaluation. Its rating slumped during its populist preelection campaign.

Most of all, oligarchic populism suffered a devastating blow. The big loser was For a Good Latvia, with Šlesers and Šķēle. Because of poor poll numbers they had merged their two parties to stay in parliament, but even so their combined votes plunged from 28.2 percent in 2006 to 7.7 percent. Even the superior campaign financing and media access of For a Good Latvia and Harmony Center did not help. One reason may have been that the internet played an increasingly significant role in the Latvian news room.

These elections appear to be a textbook example of how a serious and competent government can win elections even with severe austerity policy, if it convinces the voters. My assessment of the outcome was: “Voters have sent a quite clear message that they prefer stability and continuity.” Populism was no longer very popular in this part of the world, while economic rationality was. Ultimately, the incumbent government appeared more credible as an economic manager. The elections confirmed that Latvia had worked itself out of its severe economic crisis. Its IMF/European Union program had proven not only an economic success but also a political one. Devaluation was neither necessary nor inevitable. Internal devaluation was a viable policy and politically more popular.

For outside observers, the government’s victory was quite a surprise. It was “good news for Latvia and good news for the economy,” Lars Christensen of Danske Bank commented. Yarkin Cebeci of JPMorgan Chase & Co. noted: “Thanks to the rigorous implementation of the economic program Latvia escaped a devaluation whose repercussions could have been much more serious.”

The sitting coalition government increased its majority in parliament from 45 to 63 seats. The natural conclusion was that it would continue to rule, as the Latvian people had clearly approved of its austerity program, the fixed exchange rate, and the IMF/European Union cooperation, but a reconfiguration was considered. For a Good Latvia was out of question, having pursued a populist campaign against the government’s policy and been roundly beaten.
Harmony Center had also pursued a populist campaign, but it had gained greatly. Unity invited Harmony Center to join the government on certain conditions. Harmony Center had to recognize that Latvia had been occupied by the Soviet Union during World War II, that Latvian would stay the single state language, and that the West-oriented foreign policy would be maintained. However, Harmony Center protested against these conditions and was not prepared to recognize that Latvia had been occupied. It also voted against Latvia’s continued military participation in Afghanistan, excluding itself from government once again. The Society for Different Politics, one of the two partners of New Era in the Unity bloc, vetoed the participation of All for Latvia!/For Fatherland and Freedom/Latvian National Independence movement for being too nationalistic.

As a consequence, I continued as prime minister in a two-bloc coalition consisting of Unity and the Union of Greens and Farmers, the eternal government party, with a solid majority of 55 seats. President Valdis Zatlers nominated me as prime minister exactly one month after the elections, and on November 3 the parliament voted 63-35 for the coalition. This was a small government with only 14 ministers, eight from Unity and six from the Union of Greens and Farmers. Unity took care of the economy, foreign affairs, defense, and justice, while all the social portfolios, agriculture, environment, and regional development went to the Greens and Farmers. Finance Minister Einarš Repše had declared early on that he wanted to leave politics. His place was filled by Andris Vilks, who had been the Swedish bank SEB’s chief economist in Latvia.

Table 6.1 Results of the parliamentary elections, 2006 and 2010

<table>
<thead>
<tr>
<th>Party</th>
<th>Percent of votes</th>
<th>Seats</th>
<th>Party</th>
<th>Percent of votes</th>
<th>Seats</th>
</tr>
</thead>
<tbody>
<tr>
<td>People’s Party</td>
<td>19.6</td>
<td>23</td>
<td>For a Good Latviaa</td>
<td>7.7</td>
<td>8</td>
</tr>
<tr>
<td>Latvia’s First Party/Latvia’s Way</td>
<td>8.6</td>
<td>10</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Union of Greens and Farmers</td>
<td>16.7</td>
<td>18</td>
<td>19.7</td>
<td>22</td>
<td></td>
</tr>
<tr>
<td>For Fatherland and Freedom</td>
<td>6.9</td>
<td>8</td>
<td>7.7</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>New Era</td>
<td>16.4</td>
<td>18</td>
<td>Unityb</td>
<td>31.2</td>
<td>33</td>
</tr>
<tr>
<td>Harmony Center</td>
<td>14.4</td>
<td>17</td>
<td>26.0</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>For Human Rights in United Latvia</td>
<td>6.0</td>
<td>6</td>
<td>1.4</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Other parties</td>
<td>10.0</td>
<td>0</td>
<td>6.0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100</td>
<td>100.0</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

n.a. = not applicable

a. In 2010, People’s Party and Latvia’s First Party/Latvia’s Way merged into For a Good Latvia.
b. In 2010, New Era formed a political bloc called Unity with Civic Union and Society for Different Politics.

Source: Central Election Commission of Latvia, www.cvk.lv (accessed on November 30, 2010).
Incidentally, Latvia’s relations with Russia improved following the financial crisis. Bilateral problems have been gradually sorted out or eliminated. The border dispute was settled in March 2007. Moscow impressed Riga by not trying to exploit Latvia’s financial crisis and the January 2009 riots. In December 2010, President Zatlers was invited to Russia for an official presidential visit. Latvia’s relations with Russia had become better than ever since Latvia’s independence.

Budget for 2011

From the outset of 2010, Latvia seemed to have turned its economy around, and all economic statistics were better than anticipated. As a consequence of the faster than expected recovery in 2010, and thus higher tax revenues, the Latvian government argued that it no longer needed as large cuts in 2011 as had previously been planned.

The budget deficit for 2010 had been planned at 8.5 percent of GDP, and preliminarily it ended up just below that number in European System of Accounts of 1995 (ESA95) terms and around 6.4 percent of GDP in cash terms. For 2011, the government adopted a budget with a deficit of 5.4 percent of GDP (ESA95 terms), which was slightly less than the target of 6 percent of GDP agreed with the IMF and the European Union. On December 20 the parliament passed the 2011 budget with a further fiscal tightening of 2.2 percent of GDP.

In the 2011 budget, taxes accounted for two-thirds of the fiscal adjustment, notably a value-added tax (VAT) hike from 21 to 22 percent, and the reduced VAT rate was increased from 10 to 12 percent, while the real estate tax for residential buildings was doubled. Yet, the flat personal income tax was cut from 26 to 25 percent and the personal exemption increased, but the social security contribution rate was increased from 33 to 35 percent of the payroll. The car tax was made more progressive, being reduced for smaller cars and increased for bigger cars. In addition, the minimum wage was raised from 180 lats a month to 200 lats a month, which the government saw as a way of reducing the shadow economy, where higher wages than declared are paid.10

But the IMF and European Commission missions disagreed with the government about how large the fiscal adjustment really was. A joint IMF/European Commission team that visited Riga December 7–14 called for “additional high-quality structural measures of at least LVL 50 million” (0.4 percent of GDP) in 2011 “to bring down the general government deficit below the program’s 2011 ceiling of 6 percent of GDP.” The joint team admonished the Latvian government to keep “the 2012 general government deficit significantly below 3 percent of GDP,” taking a harder stand than previously.11

An outside observer gets the impression that the IMF and the European Commission wanted to overinsure themselves, while the Latvian government saw the strong rebound in the economy and tax revenues and did not want to impose more hardship on already suffering Latvians than really necessary. The
difference was not one of principle but of assessment of economic development and incentives.

In addition, the European Union also requested that the Latvian government prepare a list of state companies slated for privatization. But the government opposed early privatization, seeing it as a firesale. It preferred to wait for better prices as the economy recovered. This was a typical dispute between a creditor desiring early asset sales to secure repayment and a debtor hoping for higher prices in the future. Moreover, privatization was politically sensitive because during the election campaign Šlesers had claimed that the government had concluded a secret agreement with the international donors about large-scale privatization immediately after the elections.12

The Latvian government was in a new and more favorable position, as the financial crisis that had erupted in late 2007 was effectively over. Latvia would not necessarily need more of the committed international financial support. It had received €4.4 billion or 58 percent of the €7.5 billion international credit package. The €2.2 billion from the Nordic countries, Czech Republic, and Poland was left untouched (table 3.2).13

The government started issuing two- to three-year treasury bonds in 2010. Finance Minister Andris Vilks anticipated that the Latvian government might return to the international bond market in the second half of 2011 after it received one more credit rating upgrade. Moody’s maintained Latvia at investment grade, while Standard & Poor’s upgraded it. Both Standard & Poor’s and Fitch Ratings kept Latvia one notch below investment rating. Vilks wanted one of these two agencies to raise the rating to investment grade. On March 15, 2011, Fitch Ratings raised Latvia to investment grade. The yield on Latvia’s 5.5 percent bond due in March 2018 had peaked at 12 percent in March 2008. In late 2010, it traded at a yield of 5.2 to 5.3 percent, which was less than what bilateral government loans would have cost.14 In February 2011, Latvia held an auction for ten-year bonds in lats, and the whole volume on offer of $20 million was sold at an average interest of 6.72 percent.

Still, Latvia’s financial situation remained precarious. The economic branch of the government was in a tight spot. On the one hand, its coalition partner, the Union of Greens and Farmers, opposed all further fiscal adjustment. On the other hand, the European Union and the IMF were as tough as ever. In February 2011, the New Era ministers finally managed to persuade coalition partners to adopt a supplementary budget to satisfy the demands of the European Union and the IMF, reducing the expected budget deficit to 5 percent of GDP. Interestingly, it was more politically difficult to adopt this fiscal adjustment of 0.4 percent of GDP than it had been to promulgate the belt-tightening of 11 percent of GDP in 2009.

In the midst of the crisis, apprehension had arisen on the basis of IMF calculations that Latvia’s public debt would rise to 90 percent of GDP. At the end of 2010, however, it was a moderate 42 percent of GDP, and the somewhat pessimistic IMF forecast was that it would peak at 50 percent of GDP, well below the Maastricht public debt target of 60 percent of GDP. Instead, infla-
tion had become the main Latvian concern as before the crisis. By December 2010, annualized consumer price inflation had already reached 2.5 percent a year, and in January 2011 it surged to 3.7 percent with the VAT hike.  

**Economic Growth Returns**

Latvia went through a dramatic crisis and turnaround in the three years 2008 to 2010. Economic policy during this period was multifaceted. The immediate concern was to restore financial stability. In doing so, the government also aimed at improving economic competitiveness and efficiency of public services. Substantial advances were made, and after two years economic growth returned.

The nation had suffered an abysmal period of nine consecutive quarters of declining GDP in annualized terms from the second quarter of 2008 through the second quarter of 2010. The total fall in GDP was 25 percent. The darkest period was 2009, when GDP plunged by 18 percent. Unemployment peaked at 20.7 percent in early 2010 (figure 5.4). The driving disaster was the real estate crisis, where prices plunged by 70 percent in two years from a sharp peak in early 2007 until early 2009.

The causes of Latvia’s crisis were entirely financial. There was no supply or demand shock or terms-of-trade change. The underlying cause was that Latvia lived on excessive short-term bank borrowing, and the crisis became severe because of a sudden stop of these inflows.

The immediate cause of the economic decline was not lack of external demand but collapse in domestic demand, which could no longer be financed. In 2009 consumption plummeted by 22.4 percent and gross fixed investment by 37.7 percent, driving the decline. Although exports were contracting, net exports surprisingly made a positive contribution to GDP in 2009 because the share of exports in GDP stayed constant, while imports fell by 20 percent more than exports (table 6.2). Gross capital formation or investment halved from 40.4 percent of GDP in 2007 to a still rather high 19 percent of GDP in 2009. The dominant cause of the contraction was that gross national savings skyrocketed from 20 percent of GDP in 2008 to 30.8 percent in 2009. Therefore, the discrepancy between investment and savings became rather extreme at 11.8 percent of GDP (table 6.3).

This increase in savings was not quite voluntary but prompted by the international liquidity cutoff. The Bank of Latvia could not expand the money supply much without risking the country’s financial stability. Latvians blamed the Swedish banks for drastically reducing their lending, but these banks were also squeezed. The financial institution that could have provided liquidity was the ECB, but it did not do anything for Latvia or the other Baltic countries. Only in June 2009 was the Swedish Riksbank allowed to borrow a limited amount of €3 billion from the ECB.

In 2010, however, economic recovery in Latvia gathered steam. The economy performed better than forecast each quarter, as GDP swung from a
The economic recovery was led by a sudden burst of exports, which rose by 29.5 percent in 2010, dismissing the claim that Latvia did not have much to export. From the start of the crisis in 2008, exports had outperformed imports (figure 6.2). As a consequence, Latvia recorded a current account surplus from the beginning of 2009, which it had not experienced since independence. It turned into a substantial surplus of 9.4 percent of GDP in 2009, and it stayed positive in 2010 (figure 6.3).

The small manufacturing sector drove Latvia’s export surge, indicating that the structure of the economy had changed to become more sustainable. Construction, housing, and finance remained depressed, while manufacturing expanded by 14 percent in 2010. Increased export demand for Latvia’s wood and metal products were the engines of recovery, but household consumption
Financial-market conditions have stabilized but are still far from normal. Bank deposits have recovered to precrisis levels, but lending is still falling. Provisioning remains high, and the banks continue to pile up losses. The banks have responded with recapitalization, which has led to continued deleveraging. Latvian banks recorded a total capital-asset ratio of no less than 14 percent, which means that the banks are ready to expand their lending when they find solvent borrowers. The government had to deal with a new banking problem in 2010, when the state-owned, substantially loss-laden Mortgage and Land Bank (MLB) required state recapitalization of 0.6 percent of GDP despite two capital increases in 2009.\(^\text{22}\) As for the foreign banks, none left Latvia. Also reassuring are Latvia’s international reserves, which have been steadily replenished since July 2009, thanks to generous international financial assistance, in particular the large EU disbursements (figure 5.5). The Bank of Latvia has pursued almost no net foreign exchange intervention since the fall of 2009.

Of the €7.5 billion that was mobilized in international credits for Latvia, the country has used only €4.4 billion, that is, €3.1 billion less than the international community feared would be needed. There are three major explanations why larger funds were not needed. The bulk of the savings arose from

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**Figure 6.1** Quarterly change in GDP, 2007–10

![Quarterly change in GDP graph](source: Central Statistical Bureau of Latvia, www.csb.gov.lv (accessed on March 11, 2011).)

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\(^{21}\) See also Contributed.

\(^{22}\) See also Contributed.
Figure 6.2  Monthly export and import dynamics, 2008–10

percent of corresponding period of previous year

the banking crisis being much milder than anticipated, essentially stopping at Parex Bank. The banking crisis required barely 5 percent of the 2008 GDP in the course of 2008–09, while 15 to 20 percent of GDP was feared. The Bank of Latvia hopes that the eventual cost of Parex will be only 2 percent of GDP. The government had set aside €2.7 billion of the international assistance package for bank financing, but only €800 million was needed for Parex Bank, that is, a saving of no less than €1.9 billion, largely due to the absence of currency depreciation. The foreign private banks absorbed substantial losses and recapitalized as necessary at their home bases. The second reason was that the Latvian population refrained from any bank or currency run after 2008. Finally, the early radical crisis resolution helped to avoid unpleasant surprises after June 2009.

Latvia’s fiscal adjustment was unusually large, and assessments of the fiscal consolidation have been quite similar. The World Bank has produced a reasonable estimate of a total of 13.3 percent of GDP from 2008 to 2010, of which 10.4 percent of GDP was expenditure cuts and 2.8 percent of GDP increased revenue (table 6.4). The Latvian Ministry of Finance puts the same number at 14.1 percent of GDP and for 2011 adds an adjustment of 2.2 percent of GDP to a total of 16.3 percent of GDP (figure 6.4).

Latvia produced four packages of fiscal adjustment: December 2008, June 2009, November 2009, and December 2010. Most of the adjustment was concentrated in 2009. Formally, the adjustment was supposed to be 11 percent
Table 6.4  Fiscal adjustment from 2008 to 2010 (percent of GDP)

<table>
<thead>
<tr>
<th>Component</th>
<th>2008</th>
<th>Baseline</th>
<th>Projection</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>35.2</td>
<td>36.8</td>
<td>39.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>38.5</td>
<td>58.2</td>
<td>47.8</td>
<td>10.4</td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>−3.3</td>
<td>−21.4</td>
<td>−8.1</td>
<td>13.3</td>
</tr>
</tbody>
</table>


Figure 6.4  Fiscal consolidation, 2008–11

of GDP in 2009, though the final effect was 9.5 percent of GDP, as many measures were undertaken in the middle of the year (figure 6.4). Ironically, the politically most difficult adjustment package has been the one of December 2010, because then the country was caught in adjustment fatigue. It was much easier to carry out the fiscal tightening early on when the nation faced a clear and real danger.

The fiscal measures carried out in 2009 contained approximately three-quarters expenditure cuts, which was then much easier to implement than revenue measures. Even so, public expenditures rose from 38.5 percent of GDP in 2008 to a forecast 47.8 percent of GDP in 2010 (table 6.4) because of contracting GDP, but this level is likely to fall with economic recovery. Our conclusion is that Latvia was lucky to have pushed so hard for spending reduction in 2009. The Latvian experience illustrates three ideas: that substantial budget deficit cuts are possible in a democracy when necessary, that it is vital to act radically early on, and that it is much easier and more sensible to do the fiscal adjustment through expenditure cuts than through tax increases.

The austerity drive facilitated significant structural reforms that had been desirable for a long time. The most popular was reform of public administration, including the abolition of half of the state agencies and the reduction of civil servants by 30 percent from early 2008 until the third quarter of 2010 (figure 5.2). This downsizing of a state administration must have been one of the biggest during peacetime, and it was accompanied with substantial deregulation. Latvia was already highly ranked on the World Bank Doing Business Index, but it rose from 29th in 2009 to 24th in 2011. The main reason for advancing on the index were improvements in facilitation of closing a business and of registering property.25

The public health care and education systems went through badly needed rationalization. The World Bank passed the judgment: “Latvia has achieved years’ worth of difficult structural reforms in the short space of just a few months.” There was “clear evidence of a shift in health spending, which favors more intensive use of preventive and day-care procedures” and the “heavy burden on the budget of over-capacity of schools and teachers has been lightened significantly.”26

On the one hand, school directors and local authorities were allowed to be flexible in managing education. On the other, they were offered incentives to improve both efficiency and quality through budget financing based on the number of students attending rather than inputs (schools and teachers). As a consequence, the number of schools was reduced from 992 in 2007–08 to 877 in 2009–10, that is, 115 schools or 12 percent of all schools were closed. The total number of school staff declined in one year, from 2008 to 2009, by 4,000 people or 14 percent. Yet, government spending on education rose from 4.4 percent of GDP in 2008 to 5.1 percent of GDP in 2009, and teachers received a large salary hike in early 2010.27

Health care reform was more complex and less radical, but its aim was the same: more efficiency and higher quality. Public employment in health care
fell by 2,700 people, or 8 percent, in 2008–09. These public-sector reforms are almost certain to raise national productivity.

The average public wage fell by 26 percent in nominal terms from November 2008 to November 2009, approximately as legislated, while private wages fell much less (figure 5.3). Unit labor costs in manufacturing declined by 21 percent from mid-2008 until end-2009. As a consequence, private employment fell more steeply by at most 33 percent in annualized terms in 2009.

In this deflationary environment, inflation decreased much faster than had been forecast, whereas the deflationary cycle that pessimists had predicted never materialized. The deepest price fall occurred in the first quarter of 2010, when annualized deflation was 3.7 percent (figure 2.4), but it did not last. By the end of 2010, Latvia had annualized inflation of 2.5 percent, showing that the threat of inflation remains potent, though average deflation in 2010 over 2009 was 1.1 percent.

The government parties’ agreement with its social partners in June 2009, in the midst of the devaluation scare, proved fortuitous. The government has paid great attention to the social welfare of weak social groups. It has emphasized the need for social equity and peace, and the population seems to have taken this message seriously.

However, the biggest shortcoming of the government’s crisis policy has probably been its inability to pursue pension reform. Pension expenditures have been large and retirement age low, with many categories receiving early retirement but low pensions. In the second half of the 1990s, Latvia raised the low Soviet retirement age—60 for men and 55 for women—to an equal 62 years. In 2001, Latvia pioneered a World Bank prototype pension system with three pillars: a public pay-as-you-go minimum pension, a compulsory private saving pension, and private pensions. Gradually, larger pension contributions were supposed to go to compulsory fully funded pensions (the second pillar). By 2008, the share had increased to 8 percent of the income, but it was cut to 2 percent in 2009 to salvage the public pension funding, and it has stayed at that level until 2011. Pension reform has to be restarted in the future.

The government tried to cut pensions by 10 percent in June 2009, but the Constitutional Court reversed that decision and ordered the government to refund withheld pensions in full. Because of the large output contraction and freezing of pensions, the pensions’ share of GDP rose during the crisis. Moreover, from 2005 to 2009, the average pension for new retirees increased by 69 percent. Similarly, pension reform has been stalled because of a conflict between building up private mandatory pension funds based on savings and the financing of public pensions, which have won out in the crisis.

In the second half of 2010, Latvia had returned to sound economic growth, and the crisis had abated. The current account was in surplus, and manufacturing exports were rising. The regrettably high unemployment was falling steadily. The bank system had survived and was well capitalized. Latvia may make use of some more international financial support, but the need is no longer urgent. From the spring of 2009, the government had been deter-
How Latvia Came Through the Financial Crisis

mined to attempt to adopt the euro in 2014, and this determination stays and appears realistic. Ironically, the main concern has once again become inflation, which reached an annualized rate of 3.7 percent in January 2011, showing that a devaluation was never justified.

Notes


9. Ibid.


15. BNS, “Inflation in Latvia to Grow Steeper in H1 Than Expected—Finmin,” February 8, 2011.


17. Ibid., 24.
23. Ibid., 25.
24. Interview with Governor Rimšēvičs on February 4, 2011.
27. Ibid., 156, 159, 167–68.
28. Ibid., 186.