We hope this book has offered some food for thought. There is little defense for the overheating of Latvia’s economy, but the way the country navigated and successfully overcame the crisis is where we find lessons for Latvia itself and for the world at large. The big issue was exchange rate policy. We have persistently argued that Latvia was right not to have devalued, and we reiterate this point in the following section. We then distinguish between lessons from the crisis resolution that are unique to Latvia and lessons for the rest of the world. Finally, we consider Latvia’s economic goals, adoption of the euro, and European economic convergence.

Why Latvia Was Right Not to Have Devalued

It is now evident that Latvia is not going to devalue. The lat’s peg to the euro has held, and economic growth returned to Latvia in the third quarter of 2010. All the Jeremiahs whose only question was when Latvia would devalue have been proven wrong. Since most economists were singing this tune, as we discussed in chapter 4, we revisit the arguments with the benefit of hindsight.

In a severe crisis, a successful policy must have simple and clear goals that everyone understands. Therefore nominal anchors, such as exchange rate pegs, budget balances, or monetary targets, are popular remedies. Throughout the crisis, the Latvian government and the Bank of Latvia had two simple and understandable goals: a fixed exchange rate to the euro and a budget deficit of less than 3 percent of GDP by 2012 to render adoption of the euro in 2014 possible. Admittedly, between November 2008 and May 2009, the year of planned accession to the Economic and Monetary Union (EMU) slipped by three years from 2011 to 2014, but that did not blur this target. The peg offered Latvia the desired stable norm for its crisis resolution.
A major positive surprise has been that the public cost of bank losses has been far smaller than anticipated. While the International Monetary Fund (IMF) initially expected bank losses amounting to 15 to 20 percent of GDP, they were limited to some 5 percent in 2008–09, essentially the initial cost for the recapitalization of Parex Bank. Moreover, this is a gross cost, much of which may be recovered when the government eventually sells Parex Bank and its assets. Devaluation would have boosted this cost, as more banks would have collapsed and required recapitalization. The government could have escaped such costs, but since Ireland had failed to do so, how likely was Latvia to succeed? As a result, Latvia’s public debt remains relatively small at 42 percent of GDP at the end of 2010 (figure 7.1), half of the average public debt of the euro area members. No other plausible policy would have kept the public debt this low.

Gross foreign debt has risen with falling GDP, but it has not doubled, as it would have in the case of devaluation, presumably peaking at 165 percent of GDP in the second quarter of 2010, with net foreign debt at only 58 percent of GDP (figure 7.2). The sustainable level of foreign private debt varies greatly by country, but since foreign creditors refinanced Latvia’s debts through this severe crisis, they are likely to continue doing so when economic growth and asset prices recover, and the Latvian government can resume sales of public assets.

Figure 7.1 Public debt, 2008–12e

![Graph showing public debt, 2008–12e.]

Foreign trade has proven the pessimists more wrong than anything else. Exports rose until September 2008, falling sharply for four months, and then lingered at a low level for seven months before starting a brisk surge in September 2009. By September 2010, exports had fully recovered from their nominal level in September 2008. As imports declined much more steeply, Latvia achieved a current account surplus for the first time in many years in January 2009 (figures 6.2 and 6.3). Manufacturing booms when it is no longer crowded out by housing, construction, finance, and consumption.

The fixed exchange rate forced Latvia to undertake many structural reforms, facilitating higher productivity than would otherwise have been the case. This is a strategic achievement.

The absence of devaluation contributed to social equity and social peace, making policy and social processes more controllable. Undoubtedly, income and wealth differentials increased during the boom years, as is usually the case under inflation. The austerity program, by contrast, explicitly aimed at maintaining social assistance to the poor and pensioners, while cutting salaries of well-to-do senior officials. Devaluation, on the contrary, would primarily have benefited wealthy exporters at the expense of everybody else. Not surprisingly, mainly rich businessmen advocated devaluation.

The ultimate argument against devaluation is that inflation has already become the main concern, having risen to 2.5 percent in December 2010 in spite of the horrendous financial crisis. This shows that devaluation was never
justified. Indeed, as advocates of a fixed exchange rate we have argued from the outset that if Latvia had devalued, its adoption of the euro would have stalled for years to come. Latvia’s great opportunity to accede to the EMU is in 2014, and then it will never again have to fear being cut off from international liquidity as it was in late 2008 and 2009.

The proponents of devaluation are left with two possible arguments. One is that GDP could have fallen less. Such a proposition appears doubtful, but it is impossible to establish the relevant counterfactual. The liquidity squeeze and the government crisis would have occurred in any case. Devaluation would have broken the Latvian banking system and caused mass bankruptcies because of currency mismatches. Disorderly devaluation would presumably have spread to Lithuania and Estonia, as well as caused a Swedish banking crisis. All the floating exchange rates in the region—the Swedish krona, Polish zloty, Russian ruble, and Czech koruna—would have depreciated significantly. Regional financial chaos reminiscent of the collapse of the European Monetary System in 1992 with cascading devaluations could have erupted with severe repercussions for all concerned.

Moreover, Latvia’s problem was not primarily exports, but excessive capital inflows, which suddenly stopped. A comparison with Ukraine may be of some relevance. It devalued by 40 percent in 2008 (mainly because of its falling export prices), but even so it experienced a GDP fall of 15 percent in 2009, while Latvia’s decrease was 18 percent. Devaluation would certainly have eased the Latvian GDP decline in the short term, but the risks and social drama would have been far greater. In the long term, however, the structural reforms forced by the stable exchange rate are likely to spur higher growth.

The only strong argument in favor of devaluation is that unemployment might have been lower, because devaluation would have slashed euro wages drastically but thus also the standard of living. Latvia harbors a major concern about emigration, which in all likelihood would have increased after devaluation, because euro wages abroad would have been higher. Emigration did increase in 2009 and more so in 2010, when it reached 0.37 percent, and official statistics may understate emigration, as people do not necessarily register temporary moves. However unfortunate, this is still a limited number but might have been much greater if euro wages had plummeted.

In hindsight, the arguments for the maintenance of the peg appear overwhelming, though not altogether conclusive. In November 2009, one of us (Dombrovskis) summed up his view of devaluation:

Devaluation would be a non-selective reduction of the real income of each resident of the state, which, once again, would hit the most disadvantaged people. Also the savings of the people would suffer from devaluation, including savings of the mandatory funded pension scheme. The problems of borrowers would intensify because 85% of the credits are taken in euros. Latvia is a very small and open economy. It means that the possible benefit of [greater] competitiveness would last for a very short time and be insignificant,
because the prices of imported energy sources and components would automatically increase. Even worse, by devaluing, we would lose the “light at the end of the tunnel.” We would not be able to implement “the exit strategy”—to join the euro zone in 2014.2

Depreciation in any form would have amounted to a big risk. Why take a big risk for no tangible advantage?

**Latvian Peculiarities**

As a small, old, embattled nation, Latvia is rather unique. Few nations have suffered so much and yet survived. Hopefully, suffering engenders some wisdom, and nations do learn from their historical experiences.

Latvia learned many things when it regained its independence from the Soviet Union in August 1991. Like Estonia and Lithuania, Latvia became a nation of rational heroes, people who found through their personal fate that it made sense to be heroic and stand up for their implausible dream. Latvians had gone through fire and water for their nation’s independence, and they were prepared to do so again, fearing the financial crisis could undermine their sovereignty.

In the post-Soviet chaos, Latvians had learned that the best way to build a market economy and stabilize national finances was to do so swiftly and radically. A temporary decline in GDP was not very relevant for future welfare. It was far more important to get the economic system right. Therefore, in the recent crisis, Latvia benefited from an unusually good popular understanding of economics. As the *Financial Times* put it: “The vicious 1990s post-Soviet slump made Latvians hardily resourceful.”3

Since all Latvians had faced the same dilemmas and drawn approximately the same lessons, the country was characterized by an uncommon, broad political consensus. Almost all its many parties could be described as free-market and center-right. The two main political rivals, Ivars Godmanis and I, had very similar thoughts about economic policy. The differences lay in vested interests.

Far too often, people learn only from their own experience, but Latvians benefited from also knowing the situation of their similar neighbors, especially Estonia, the most radical reformer.4 The three Baltic countries studied each other’s experiences, and Latvia’s standard conclusion was to proceed with its reforms. Latvia also learned from the Swedish and Finnish banking and devaluation crises in the early 1990s that banking collapses and devaluation should be avoided if possible.

The dominant cofinancing by the European Commission and the Nordic countries reduced the traditional role of the IMF, which offered Latvian officials unusually open negotiations. As a virtuous member of the European Union, the North Atlantic Treaty Organization (NATO), and the Nordic-Baltic community, Latvia had many friends. Therefore, a huge amount of funding was available at an early stage. This was not unique but unusual.
Unlike most other countries with a fixed exchange rate, Latvia had an obvious and desired exit: adoption of the euro. This mattered to both Latvia’s EU partners and the Latvian population, who favored deeper integration into the European community.

All of Eastern Europe had enjoyed a near decade of high economic growth from 2000 to 2007, but none experienced higher growth than Latvia. Many Latvians thought that they had just been too lucky and that a severe setback was inevitable. In this, they were similar to the South Koreans, who took their hardship in 1997–98 with the same surprising equanimity. After all, the average growth of Latvia even including the crisis was 42 percent for the decade 2000–10, which equaled the average growth for the new eastern EU members.5

Lessons from Latvia for the World

We contend that important lessons can be drawn from the resolution of Latvia’s financial crisis for other countries in crisis. Walter Bagehot, founder of the Economist magazine, reportedly said: “The greatest pleasure in life is doing what people say you cannot do.” We found time and again that in Latvia’s crisis what people said could not be done was done, and it obviously was the best solution. We would like to emphasize nine lessons on the economics of financial crisis and its political economy from Latvia that are relevant for other countries.

First, devaluation was never necessary or inevitable and hardly useful because it would not have solved Latvia’s problems. Latvia suffered from financial overheating, the cure of which was stopping excessive short-term capital inflows, and this did not require devaluation. The financial crisis erupted because of a too sudden stop of international liquidity, requiring mobilization of more liquidity, which was not related to devaluation. The country’s competitiveness needed to improve, which was better done by reducing excessive public expenditures and salaries, and the steady exchange rate parity forced Latvia to undertake long-overdue structural reforms. The alleged risk of a vicious deflationary cycle was never real, because for a small and open economy such as Latvia, prices are largely determined by the surrounding markets. As the pass-through of inflation would have been great, devaluation would not have been effective in restoring competitiveness.

Depreciation is an overadvertised cure in current macroeconomic discourse. A series of recent IMF papers show the new openness—or confusion. One empirical study argues that intermediate exchange rate regimes have generated the best growth performance.6 Another paper shows that exchange rate flexibility helped buffer the impact of the crisis.7 During the boom years, the currency board countries in Eastern Europe had better fiscal balance and higher growth than the countries with floating exchange rates, and the Baltic cases show that internal devaluation is a viable option.8 The pragmatic wisdom from the early 1990s has been restored: There is no universally preferred exchange rate policy. The best choice depends on the concrete circumstances of the country in question.9
Second, the value of euro accession as a goal disciplining policy was considerable and instructive to other countries in similar situations. The Latvian people were motivated by their desire for full European integration with early adoption of the euro. This desire led them to focus on two nominal anchors: a fixed exchange rate and a budget deficit below 3 percent of GDP, so that Latvia could accede to the EMU as early as possible. These two anchors brought stability and clarity to the Latvian economic policy.

Third, Latvia’s experience of fiscal adjustment has convinced us of the universal advantages of carrying out as much of the belt-tightening as possible early on. Hardship is best concentrated in a short period, when people are ready for sacrifice, what Leszek Balcerowicz calls a period of “extraordinary politics.” Latvia succeeded because it concentrated the fiscal adjustments in the first eight months of crisis combat. The latest fourth round of belt-tightening has been limited but politically more cumbersome.

Fourth, the Latvian experience with more than three-quarters of the initial fiscal adjustment from public expenditure cuts shows that they are economically and politically preferable to tax hikes. Most popular budget adjustments were the cuts of salaries and benefits of senior civil servants and state enterprise managers as well as the reduction in public service positions, while the most unpopular measure was the value-added tax (VAT) hike, and popular resistance was fierce against raising income and profit taxes. Latvians have remained strongly committed to their flat income taxes.

Fifth, the large and frontloaded international rescue effort was appropriate and has been successful. An even greater frontloading would have been advantageous, however, as most of the output contraction was caused by a sharp rise in savings, deriving from the dearth of liquidity. Both financing and reforms need to be frontloaded. Today, after the huge rescue packages for Greece, Ireland, and the euro area as a whole, it is difficult to understand that the size of the Latvian package could be controversial. Much larger emergency credits in relation to GDP were needed because of greater globalization, and the scarcity of international liquidity primarily caused the Latvian sudden stop. This crisis resolution helped break prejudices against large financial support packages with fast, early disbursements, which went to budget financing as well, since the budget deficit was primarily caused by a temporary drop in state revenues connected with the drastic output fall.

Sixth, a strange myth has evolved that affluent democracies are politically unable to undertake large cuts in public expenditures. Latvia, as well as its Baltic neighbors, showed that these vibrant democracies were perfectly capable of reducing their public expenditures by about one-tenth of GDP in one year. Social calm prevailed. Most of Latvia’s fiscal adjustment—15 percent of GDP—was concentrated in the first eight months of 2009. Since these large cuts had to be selective, they facilitated structural reforms, not only reducing the capacity but also often improving the quality of public services. The Latvian case shows that macroeconomic crisis accelerated reform.
Seventh, the benefits of stable government have been greatly exaggerated. It is more important that a government be adequate than stable, and a precrisis government is rarely a suitable anticrisis government. Latvia benefited from being able to switch government quickly during the crisis. That was possible because of unstable coalition governments, which are inherent in a parliamentary system with proportional elections. Thus parliamentary systems with many parties, leading to coalition governments and frequent government changes, may be beneficial for the resolution of macroeconomic crises. This observation runs counter to the current literature on political economy, which seems focused on ordinary policymaking that greatly differs from crisis resolution.

Eighth, the bottom line is that populism is not very popular in a serious crisis because the population understands the severity of the crisis and wants a government that can handle the crisis as forcefully as is necessary. Therefore, the Latvian anticrisis government was able to win the parliamentary elections on October 2, 2010. The government benefited from having carefully considered the social aspects of the crisis and having concluded a social partnership agreement on the main austerity policies. The big losers in the 2010 elections were oligarchs who tried to exploit populism.

Finally, the international macroeconomic discussion was not only not useful but even harmful. It indicates an intellectual and moral crisis, well illustrated in Charles Ferguson’s Oscar-winning documentary film Inside Job. Whenever a crisis erupted anywhere, a choir of famous international economists claimed that it was “exactly” like some other recent crisis—the worse the crisis, the more popular the parallel. When the Icelandic economy blew up in early October 2008, a herd of economists claimed that the same would happen to Latvia, although Iceland had a floating exchange rate, a high interest rate, and an overblown domestic banking system. Soon, prominent economists led by New York Times columnist Paul Krugman claimed that “Latvia is the new Argentina.” A fundamental problem is their reliance on a brief list of “stylized facts,” never bothering to find out the facts on the ground.

Foreign-owned banks have been a major bone of contention in Latvia and other crisis countries in Eastern Europe. Foreign investors preferred to buy large banks with significant market power in Eastern Europe, which were on average less profitable but better capitalized than banks that remained domestically owned. With access to cheaper funding at home than local banks, they became more profitable than domestic banks over time, which made them committed to stay. The Swedish banks in Latvia have rightly been blamed for having lent too much in the good times, but they were also the first to sense the impending crisis and reduced their loan expansion in Latvia in mid-2007. In the midst of the crisis, credit shrank considerably throughout the world, as only a few central banks could expand liquidity. The demise of Parex Bank illustrated the danger of a large domestic bank relying on foreign, short-term wholesale finance. The four big foreign banks steeled themselves for the crisis and bore their losses themselves. Today, after the crisis, fully integrated international banks appear advantageous, but effective pan-European bank regulation is needed.
The financial crisis in Latvia has been remarkable for everything that did not happen. There was no significant reaction against globalization, capitalism, the European Union, or the euro. No major strikes or social unrest erupted, while the population rose against populism and unjustified state privileges. Politically and financially, crony businessmen were the biggest losers, whereas the political winners were the moderate but decisive center-right forces. The sensible Latvian public wanted decisive action from their leaders to resolve their problems.

This political economy was reminiscent of the early postcommunist transition, when radical reform and democracy went hand in hand. The ideological wind was clearly liberal and free market but also socially responsible, favoring a somewhat purer market economy and a moderate retrenchment of the social welfare state. Latvians did not object to the welfare state as such, but they wanted social welfare to be trimmed, to become more efficient, and to work for those in need rather than being diverted to the wealthy.

In the first half of 2009, Latvia was often in the news as the country worst affected by the global financial crisis, and speculation reigned that it could be financially hazardous for the whole north European region. By late summer of 2009, the Latvian crisis had abated, and as of spring 2010, Greece, Portugal, Ireland, and Spain were the countries suffering the worst of the crisis.

Today, Latvia stands out as an example of how crises should be resolved: early, fast, and surgically, mobilizing popular understanding and support. This small nation can hopefully offer Greece and other crisis countries in the euro area lessons of radical internal devaluation, because for the EMU members devaluation is not an option.

**Eyes on the Prize: Euro Adoption and European Convergence**

The main goal of Latvia’s economic policy is of course the long-term economic welfare of the Latvian nation, which suffered a serious setback during the crisis. GDP per capita measured in purchasing power parity may recover to 2007 levels only in 2014 (figure 7.3). Only in 2010 did GDP levels return to levels at the beginning of 2005. Three years of boom (2005–07) with a total growth of 33 percent were erased by three years of bust (2008–10), with a decline of 25 percent.

The cost of the economic overheating has been great, and it must not be repeated. Latvia should aim for high but sustainable economic growth, based on improved human capital, increased efficiency, and growing capital investment. But these are not enough. Latvia must also secure macroeconomic stability. Therefore the nation is focused on adopting the euro at the earliest opportunity, which is 2014.

A small open economy that pursues its transactions predominantly in one currency, the euro, needs to have a fixed parity to that exchange rate so that it does not become subject to the vagaries of exchange rate vacillations. Latvia should minimize the currency risks that also exist in the domestic economy.
Figure 7.3  Latvia’s economic convergence with the European Union, 1992–2012e

Source: IMF, World Economic Outlook database, October 2010 (accessed on November 30, 2010).
because of the far-reaching euroization of the credit market. There is no realistic possibility of minimizing the usage of the euro within a free market such as Latvia, and so the only way of eliminating this currency risk is to adopt the euro. As we’ve already mentioned, the main cause of the great Latvian output decline was the sudden stop in international liquidity, which showed how vital liquidity is for Latvia. Adopting the euro would also give Latvia access to the only plausible large source of liquidity, the European Central Bank (ECB), which helped the euro area states with ample credit during the height of the crisis.

Two countries in the euro area, Ireland and Spain, suffered from overheating similar to that in Latvia. They also had overblown banking sectors financed by foreign credit, with too large real estate investments. But it is unrealistic for a very small and open European economy to regulate its banking system much more strictly than its neighbors, because banking can easily migrate abroad. Hopefully, the four new EU bodies for financial supervision among the EU nations will be able to contain asset bubbles, which were previously ignored because nobody had direct responsibility. These four bodies—the European Systemic Risk Board (ESRB), European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA)—all began working on January 1, 2011. The ESRB, which is responsible for establishing a common list of indicators to assess the risks posed by certain financial institutions operating in the European Union, would react to excessive private foreign debt and currency mismatches.18

The gross disregard of the fiscal Maastricht criteria or the Stability and Growth Pact by most euro area countries is not likely to be repeated. The cost of fiscal laxity is probably so evident that most nations will discipline themselves, and if not the other EMU members are likely to impose their will. This crisis has changed the economic policy mindset for a long time. Moreover, when countries with a strong record of fiscal discipline, such as Estonia and Latvia, enter the board of the ECB, monetary discipline will be further reassured.

The key question is whether Latvia—a country that has been most affected by the crisis—will in the foreseeable future become a country with a successful and modern economy, educated society, and highly qualified labor force and where best performing companies of the world are willing to invest. Latvia faces a historical choice: whether to regress to the path of stagnation and backwardness or to identify itself as a strong nation, one of Europe’s success stories, and unite in a common effort to pursue this objective.

Notes


8. Åslund, The Last Shall Be the First, 111–12.


11. This argument has been made well by Vito Tanzi and Ludger Schuknecht, Public Spending in the 20th Century (Cambridge: Cambridge University Press, 2000).


18. The European Banking Authority is based in London, the European Insurance and Occupational Pensions Authority and the European Systemic Risk Board in Frankfurt, and the European Securities and Markets Authority in Paris. The EBA would react if something like the Swedish bank expansion to Latvia of 2005–06 recurred.