NEW BOOK DOCUMENTS LATVIA’S SWIFT RECOVERY FROM THE FINANCIAL CRISIS

WASHINGTON—Latvia offers a case study of how rigorous fiscal adjustment combined with structural reforms can restore economic growth and financial stability two years after a devastating financial crisis, according to a new book published by the Peterson Institute for International Economics. The book, *How Latvia Came through the Financial Crisis*, is written by Senior Fellow Anders Åslund and Valdis Dombrovskis, the Prime Minister of Latvia, who offers a first-hand account of how he shepherded Latvia through its recent turmoil. The book also examines the Baltic state’s approach to reform and what lessons the struggling countries of Southern Europe can draw from this drama.

At the beginning of the crisis, Latvia’s economy was the most overheated in the European Union, with a current account deficit of 23 percent of GDP and annualized inflation peaking at 18 percent. As a result, it was one of the hardest hit by the global financial crisis of 2007–08. From 2008 to 2010, GDP plummeted 25 percent and unemployment reached nearly 21 percent. Yet, the country turned its economy around in just two years. Latvia achieved this through an international aid package consisting of contributions from the European Union, International Monetary Fund (IMF), and some of Latvia’s European neighbors. It did so while retaining its peg to the euro, despite a call by many international economists for devaluation.

The authors conclude that, contrary to the widespread view of many economists, a devaluation of Latvia’s currency was not necessary. There is no universally preferred exchange rate regime, but the rate depends on the specific circumstances of the country. Not only was devaluation unnecessary, it would have been harmful. Had the country taken that route few individuals except for rich businessmen would have benefited. Instead, Latvia opted for an “internal devaluation,” which imposed austerity measures distributed equitably, mitigating social hardship. The program concentrated on preserving social services for the poor and pensioners while targeting cuts in public expenditures and salaries, demonstrating that public expenditure cuts were preferable both economically and politically to tax hikes. The authors argue that the value-added tax increase, introduced in 2009, was the least popular fiscal adjustment.

The authors conclude that sufficient fiscal adjustment should be undertaken as early and as swiftly as possible, since people are most open to sacrifice for a short period. Therefore it was fortuitous that Latvia concentrated its fiscal adjustment in the first eight months of its crisis response. Generally, the authors argue, large, frontloaded rescue efforts are the most successful. The support Latvia received from the European Union, IMF, and European neighbors early on was crucial to both its economic and political recovery. Finally, retaining its peg to the euro compelled Latvia to pursue long overdue structural reforms in the public sector, which had been difficult to introduce during the boom years. The goal of euro accession led to a focus on a fixed exchange rate and attaining a budget deficit below 3 percent of GDP.
As a result of its strict austerity policy, Latvia experienced a current account surplus as early as January 2009, and by September 2010 exports had recovered to precrisis levels, without any currency devaluation. By the end of 2010, Latvia emerged from the crisis with a manageable public debt of 42 percent of GDP. It did so, using only 58 percent of the international financing at its disposal.

How Latvia Came through the Financial Crisis
Anders Åslund and Valdis Dombrovskis
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About the Authors

Anders Åslund is a leading specialist on postcommunist economic transformation with more than 30 years of experience in the field. He is the author of 11 books and the editor of 16. Among his recent books are How Ukraine Became a Market Economy and Democracy (2009), Russia's Capitalist Revolution (2007), and How Capitalism Was Built (2007). He has also published widely, including in Foreign Affairs, Foreign Policy, National Interest, New York Times, Washington Post, Financial Times, and Wall Street Journal.

Åslund joined the Peterson Institute for International Economics as senior fellow in 2006. He has worked as an economic adviser to the Russian government (1991–94), to the Ukrainian government (1994–97), and to the president of the Kyrgyz Republic. Before joining the Peterson Institute he was the director of the Russian and Eurasian Program at the Carnegie Endowment for International Peace, and he codirected the Carnegie Moscow Center's project on Post-Soviet Economies.

Previously, he served as a Swedish diplomat in Kuwait, Geneva, Poland, Moscow, and Stockholm. From 1989 until 1994, he was professor and founding director of the Stockholm Institute of Transition Economics at the Stockholm School of Economics. He earned his doctorate from the University of Oxford.

Valdis Dombrovskis has been the Prime Minister of the Republic of Latvia since March 2009. He was also Minister for Regional Development and Local Governments (November–December 2010) and Minister for Children, Family, and Integration Affairs (March–July 2009). From July 2004 to March 2009, he was member of the European Parliament and head of the Latvian delegation in the ETP-ED group. As member of the European Parliament, he was member of the Committee on Budgets and substitute member of Committee on Budgetary Control and Committee on Economic and Monetary matters. He was elected to the Latvian parliament in 2002 and 2010.


Mr. Dombrovskis has earned degrees in economics and physics from the University of Latvia and Riga Technical University. He has also studied at Mainz University (Germany), and the University of Maryland (United States). He is the author of many publications on economics and politics in various periodicals, journals, and electronic media.
About the Peterson Institute

The Peter G. Peterson Institute for International Economics is a private, nonprofit, nonpartisan research institution devoted to the study of international economic policy. Since 1981 the Institute has provided timely and objective analysis of, and concrete solutions to, a wide range of international economic problems. It is one of the very few economics think tanks that are widely regarded as “nonpartisan” by the press and “neutral” by the US Congress, its research staff is cited by the quality media more than that of any other such institution. Support is provided by a wide range of charitable foundations, private corporations and individual donors, and from earnings on the Institute’s publications and capital fund. It moved into its award-winning new building in 2001, and celebrated its 25th anniversary in 2006 and adopted its new name at that time, having previously been the Institute for International Economics.