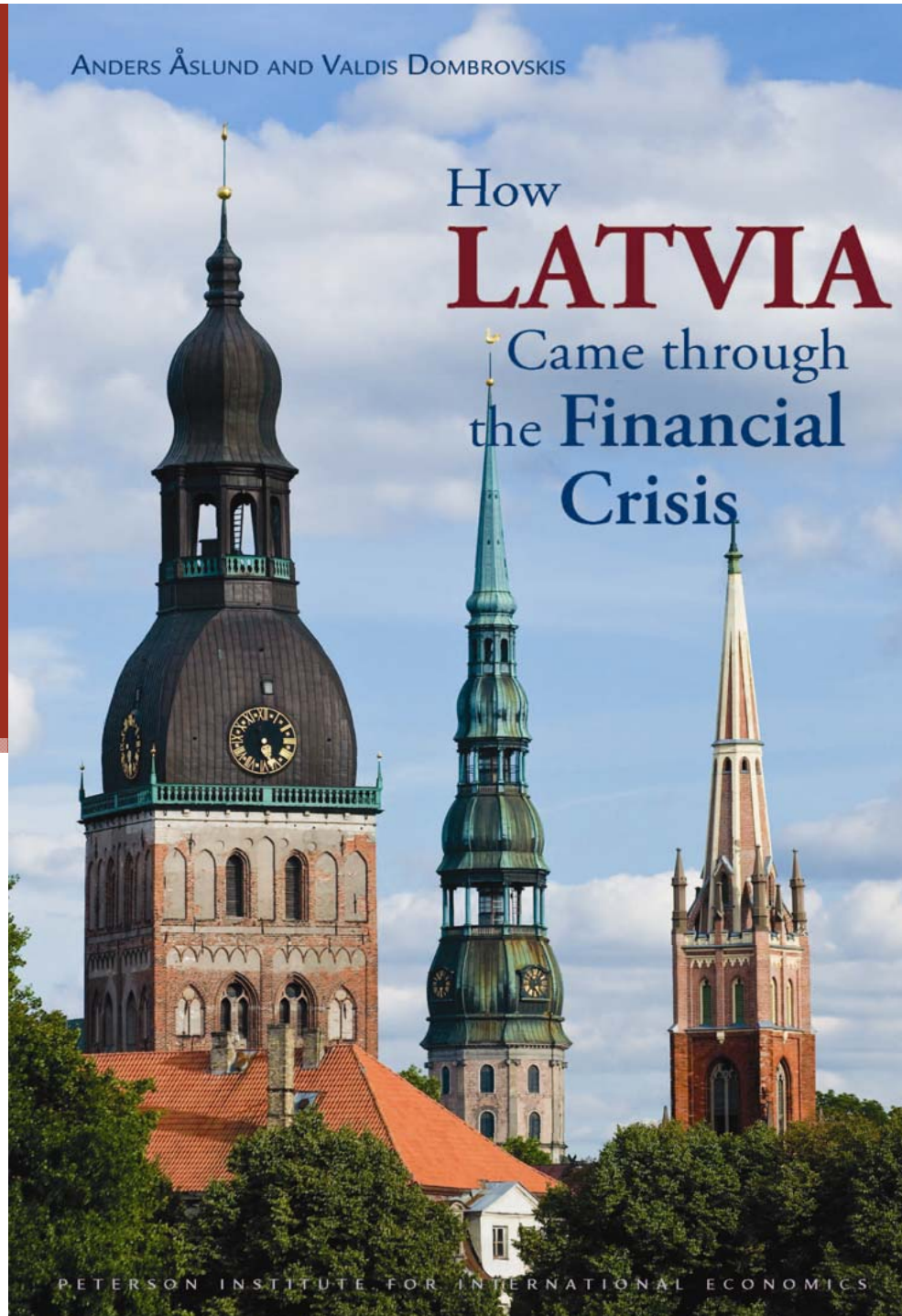


ANDERS ÅSLUND AND VALDIS DOMBROVSKIS

How  
**LATVIA**  
Came through  
the **Financial  
Crisis**



PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

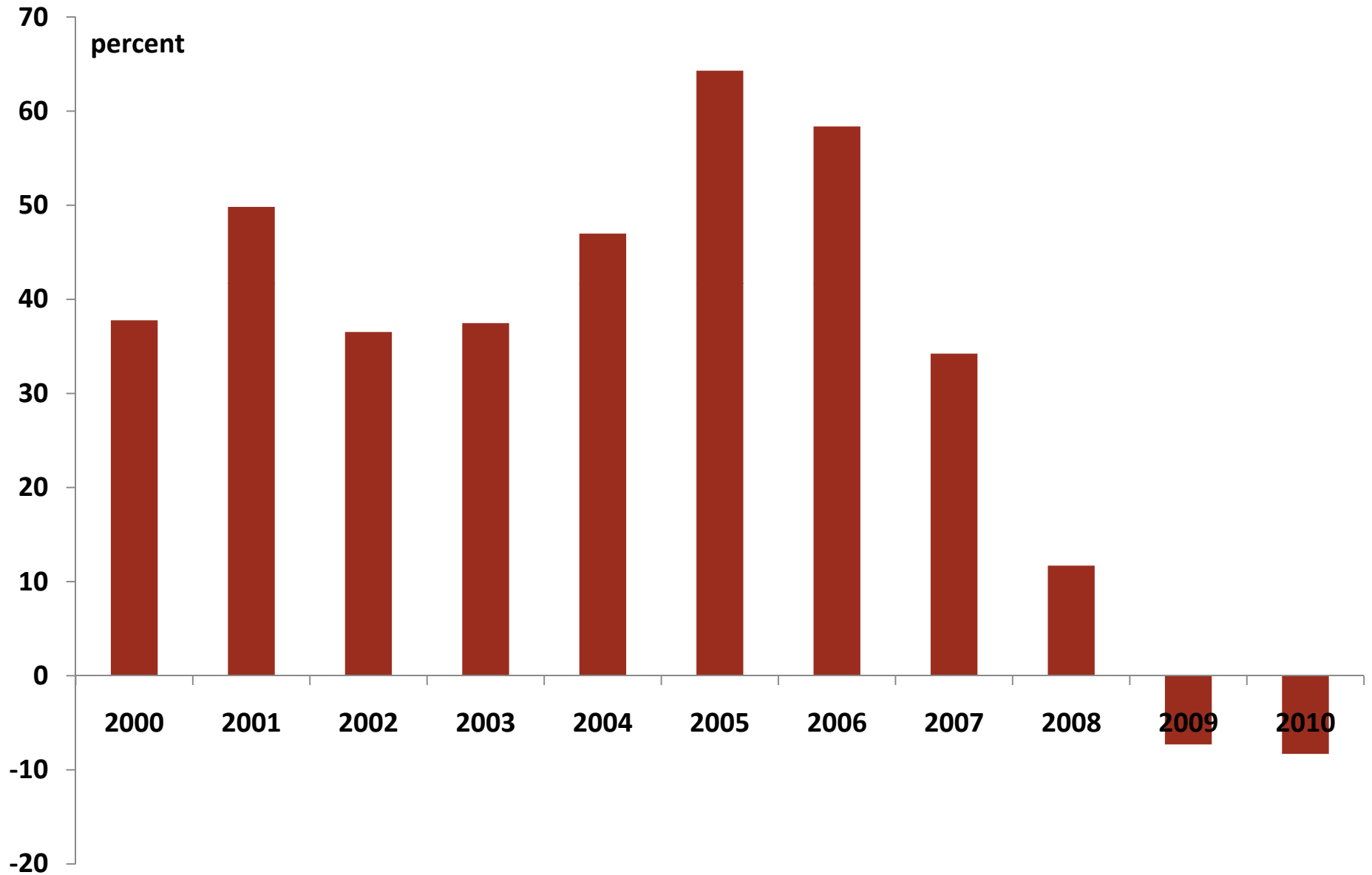
# Issues

- 1. Causes of the Financial Crisis**
- 2. To Devalue or Not**
- 3. Essence of the Cure**

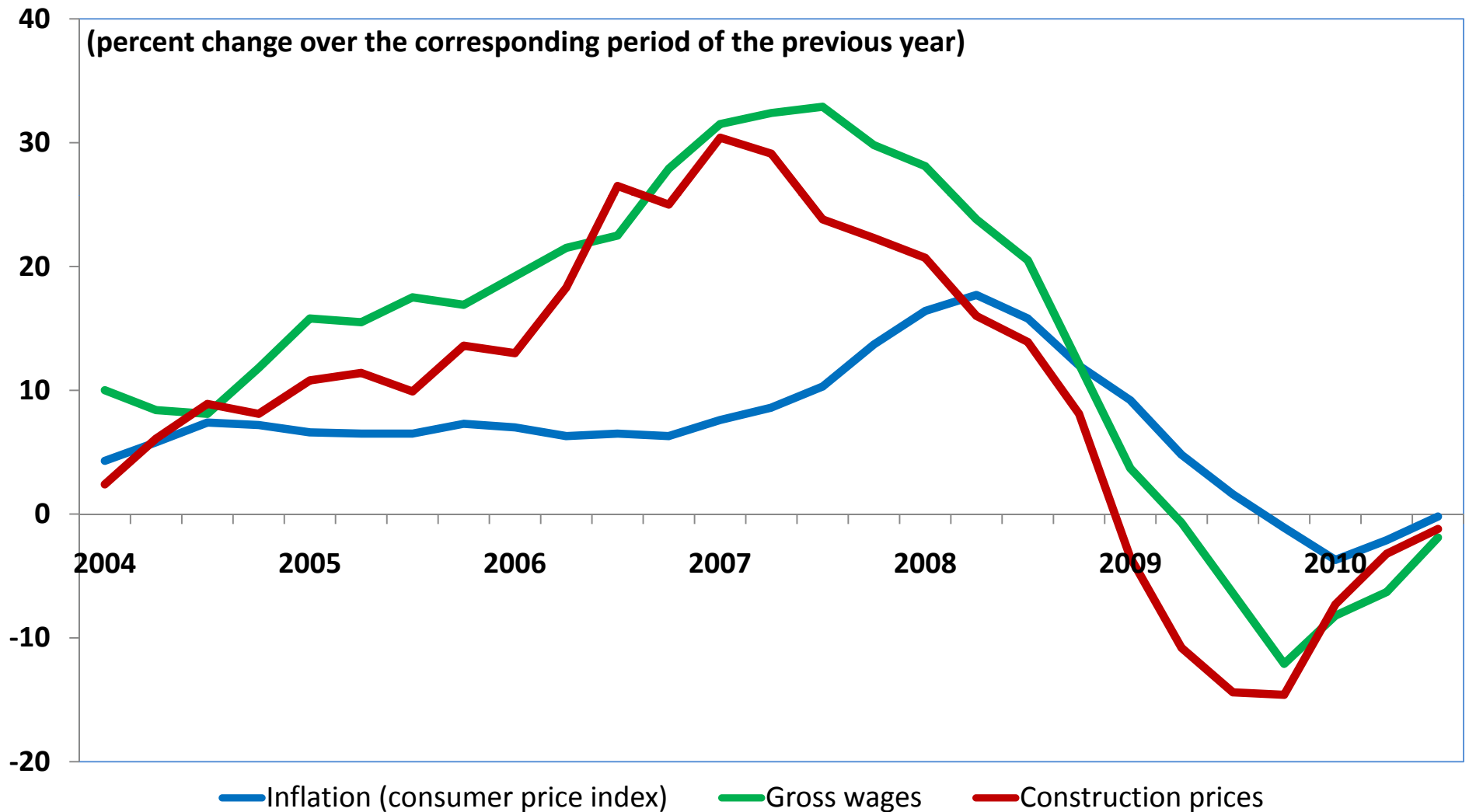
# 1. Causes of the Crisis

- **Loose Monetary policy of the US Fed and ECB**
  - **Excessive capital inflows**
  - **Too large credit expansion**
  - **Real estate bubble**
  - **Rising inflation**
  - **Current account deficit**
  - **No fiscal surplus**
- But minimal public debt and little leverage**

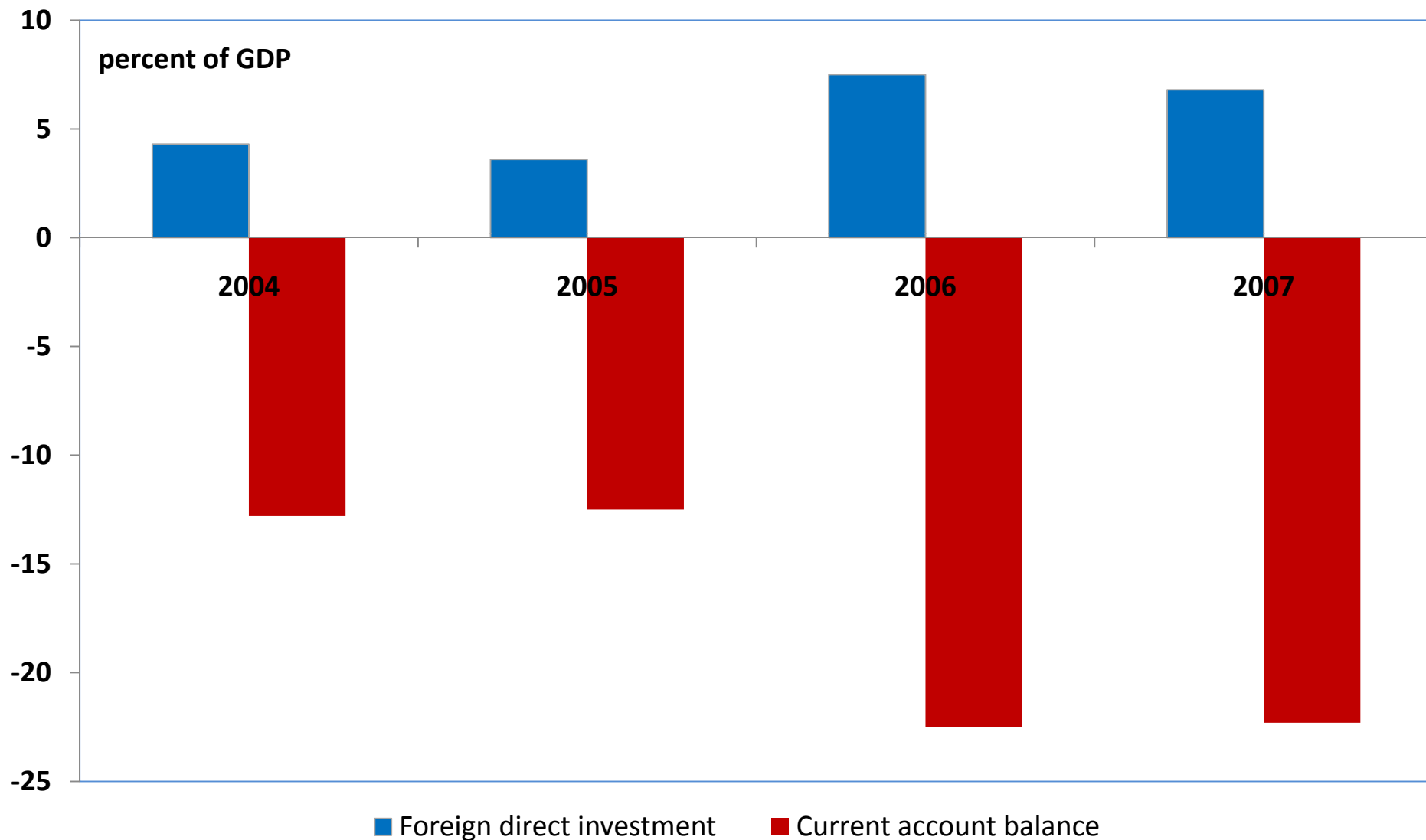
# Credit grew 60%/year 2005–6



# Inflation 18%, gross wages +33% construction prices +30% at peak



# Current account for larger than foreign direct investment, 2004–7: 22.5% of GDP



# Key Problems

1. Overheating followed by “sudden stop”
  2. Big falls in GDP: Latvia 25%
  3. Caused large budget deficits
- Needed: Liquidity, budget cuts & wage cuts

## 2. Why Devalue?

Paul Krugman: “Latvia is the new Argentina.”

- Latvia’s competitiveness had fallen too sharply
- Internal devaluation was politically impossible
- Latvia needed stimulus



# Why Devalue? (2)

- Danger of deflationary cycle
- Latvia did not deserve help
- “Latvia doesn’t produce much to export”
- Roubini: “devaluation seems unavoidable”

# But devaluation is risky

- Devaluation could have been uncontrollably large (Belarus)
- Lead to wild inflation (Belarus)
- Less reforms
- Bank system could have collapse (Ukraine)
- Mass bankruptcies
- Real foreign debt would have doubled

# Instead: Internal Devaluation

- Fiscal adjustment 9.5% of GDP in 2009 & total 16%
  - Reduced public salaries by 26% & private salaries by 10%
  - Closed half state agencies
  - Dismissed 29% of civil servants
- Lean & efficient public sector

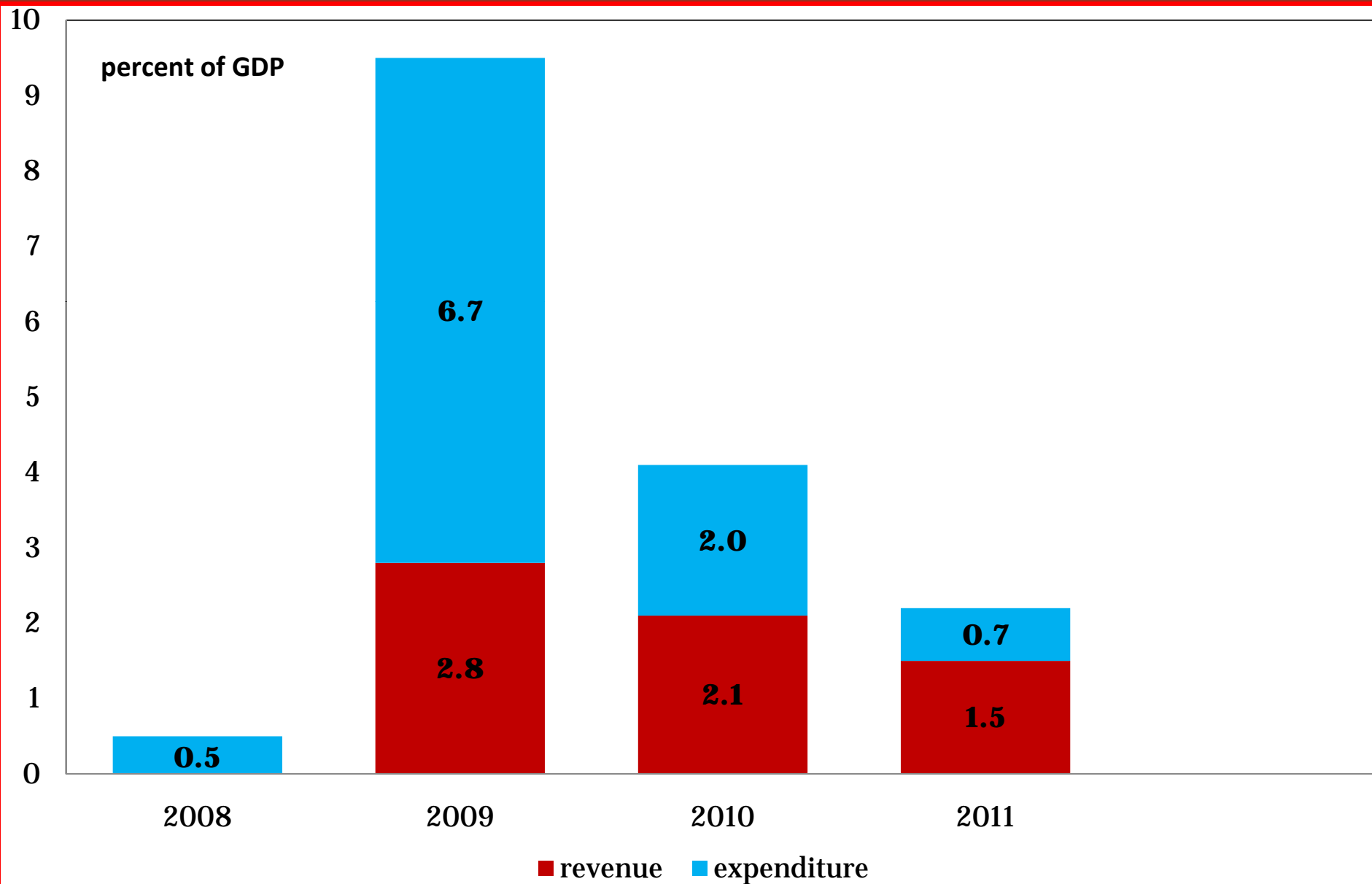
# Conclusion on Devaluation

- No exchange rate regime could have salvaged the open Latvian economy
- Fixed exchange rate saved Latvia from collapse of bank system, mass bankruptcies and doubling of foreign debt
- It facilitated vital structural reforms
- Latvia is ready for adoption of euro in 2014
- Economists need to go beyond stylized facts to real facts.

# 3. Crisis Resolution

- **Early and comprehensive fiscal adjustment**
- **IMF & EU program**
- **7.5 bn euro of financial assistance, 37% of GDP**

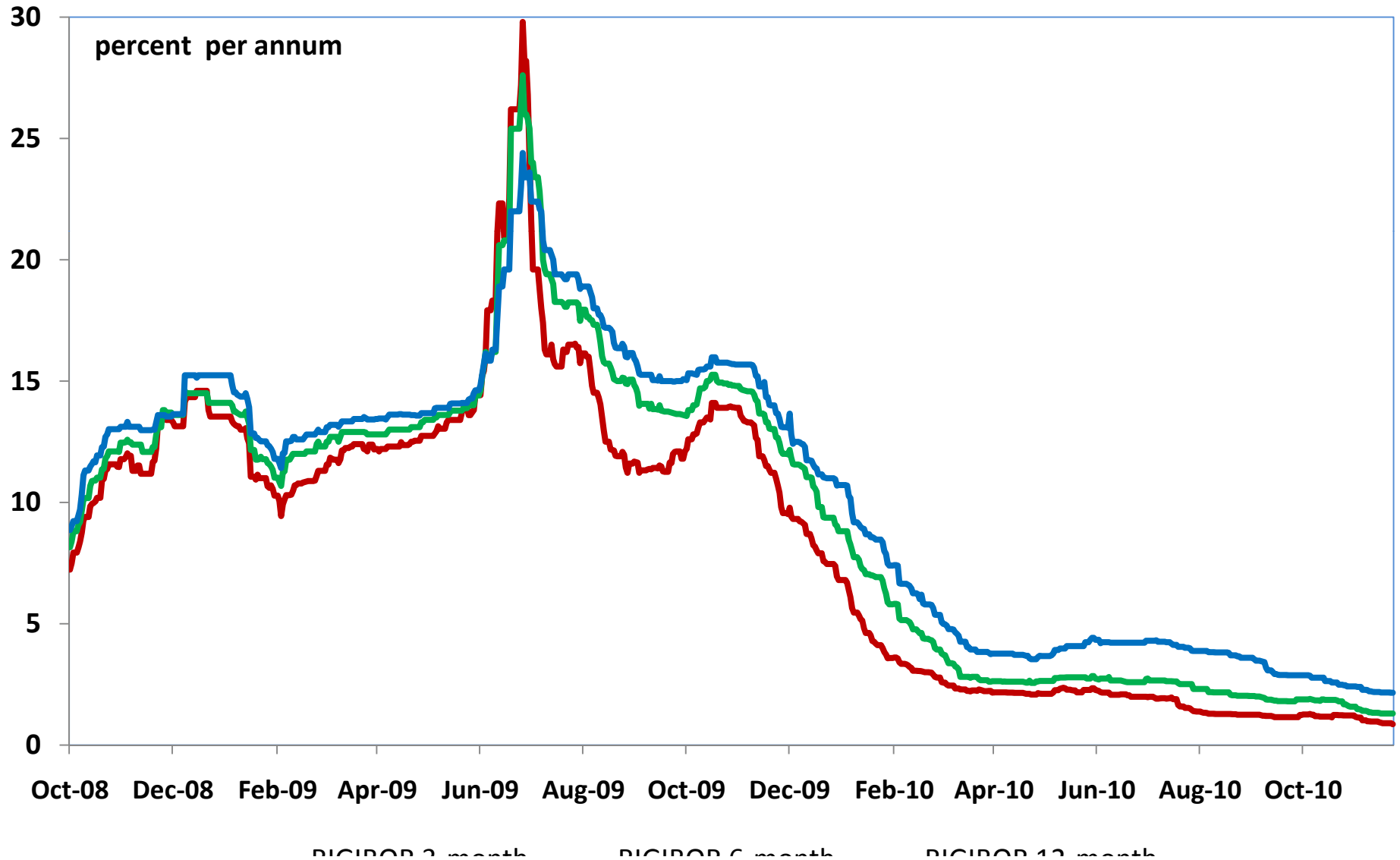
# 16% of GDP Fiscal consolidation, 2008-11



# Credit default swap rates peaked in March 2009

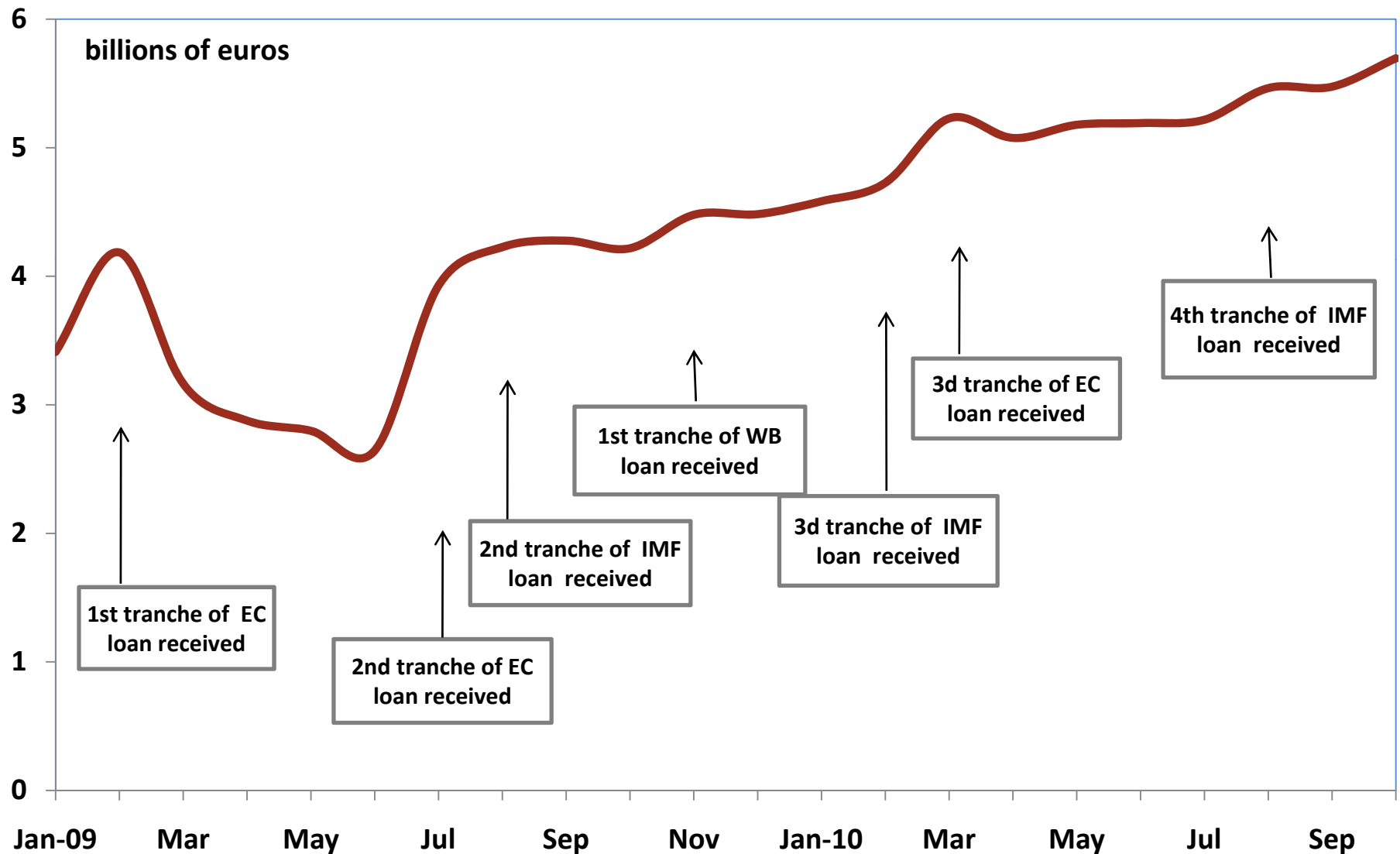


# Market interest rates peaked in June 2009

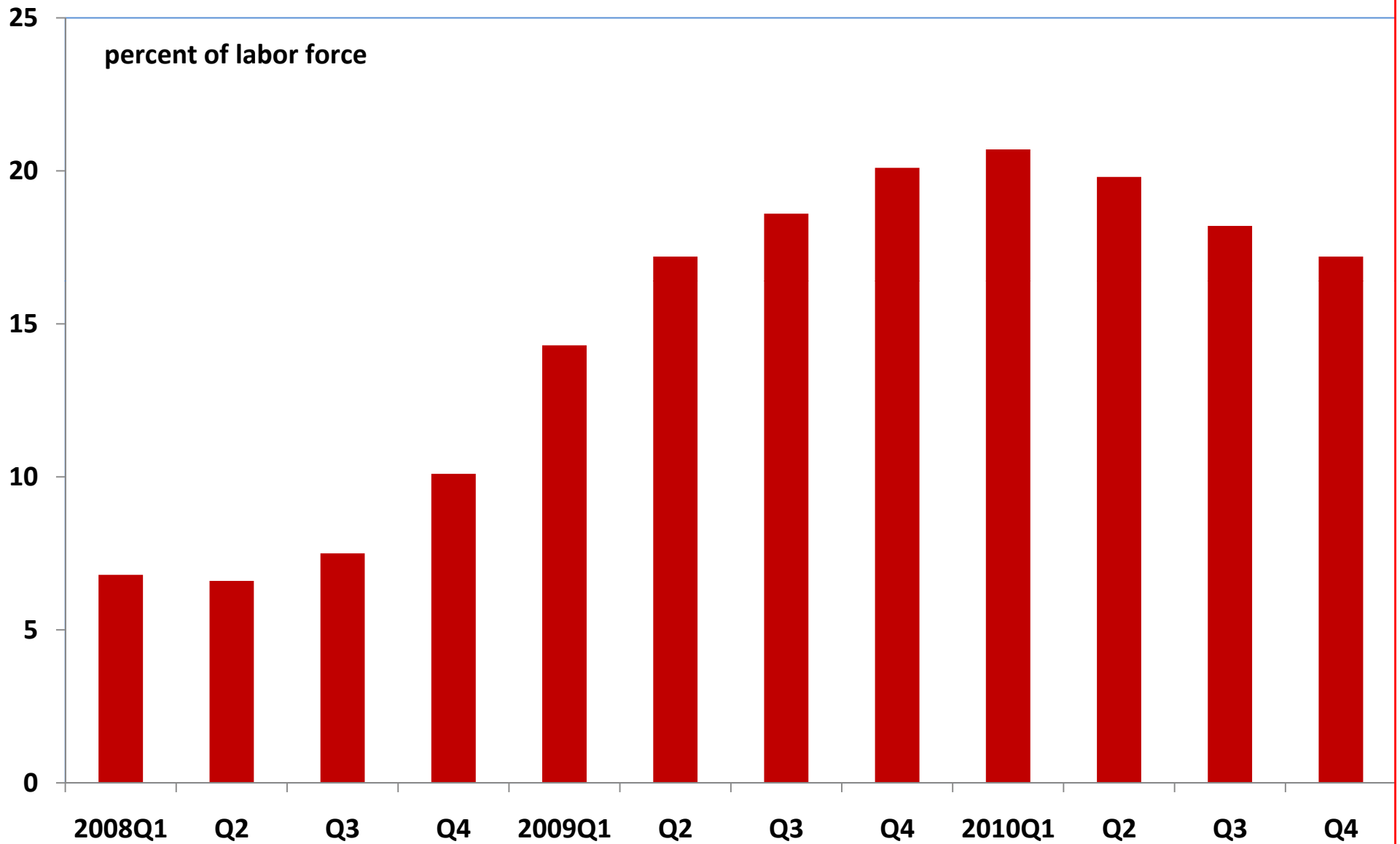




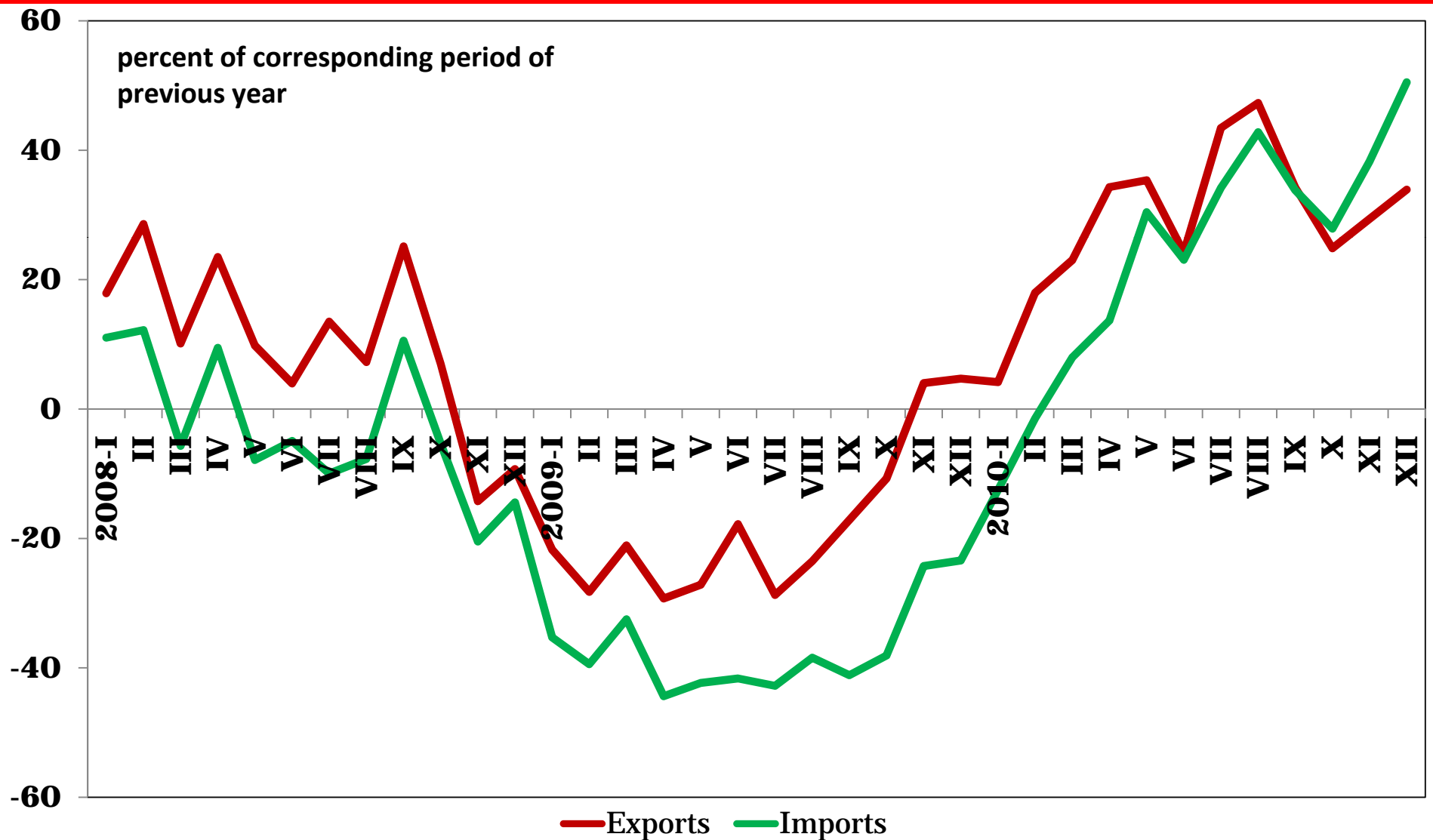
# Foreign currency reserves bottomed out late June 2009



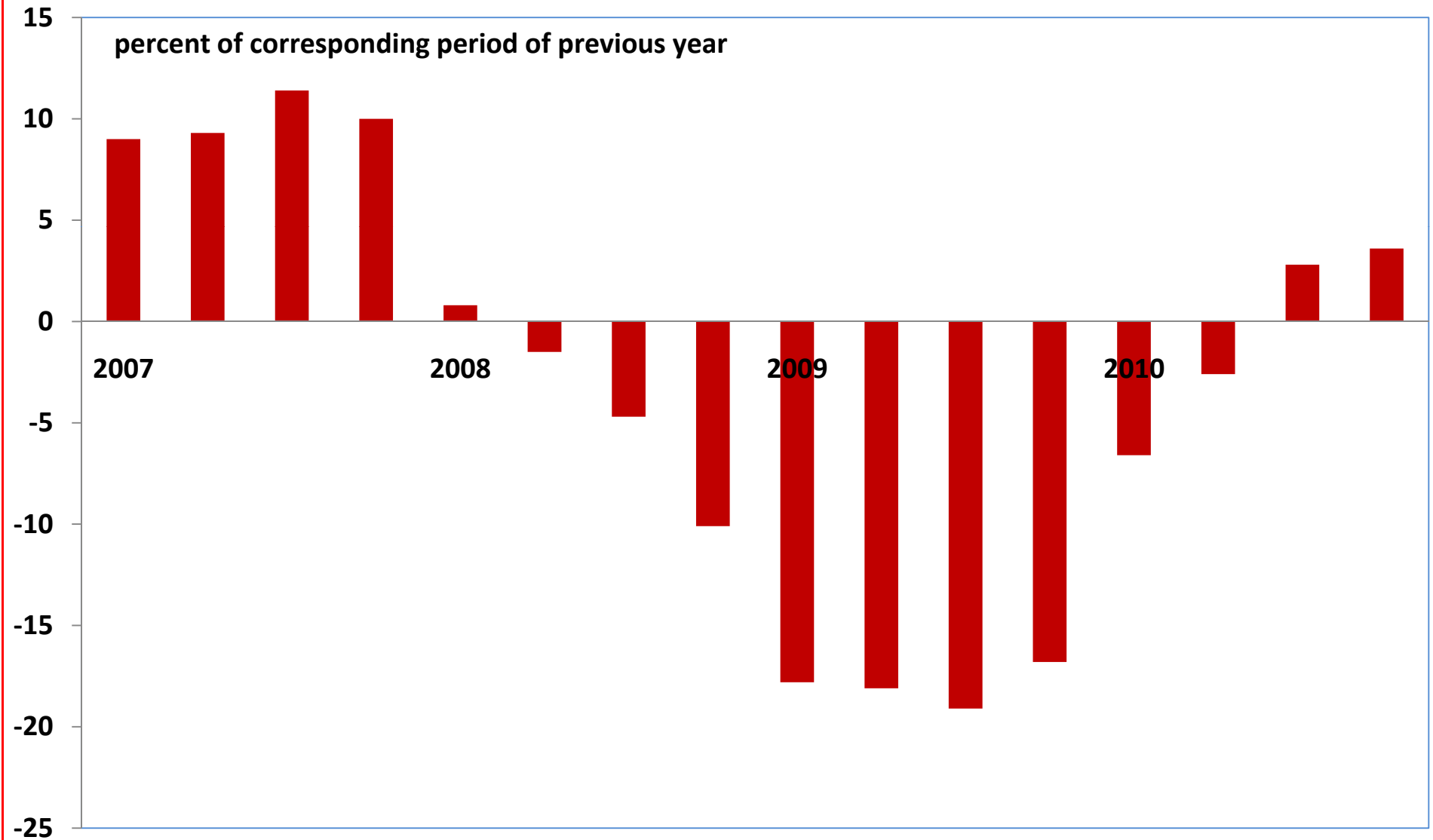
# Unemployment peaked in early 2010



# Exports Led the Recovery from end 2010



# GDP Growth: 3<sup>rd</sup> Q 2010



# 9 Lessons from Latvia for the World

1. Devaluation was neither necessary nor inevitable
2. Goal of euro accession is valuable
3. Early fiscal adjustment preferable
4. Better to cut public expenditures than to raise taxes
5. International rescue should be large and front-loaded

# 9 Lessons from Latvia for the World

6. Strange myth that democracies cannot cut public expenditures

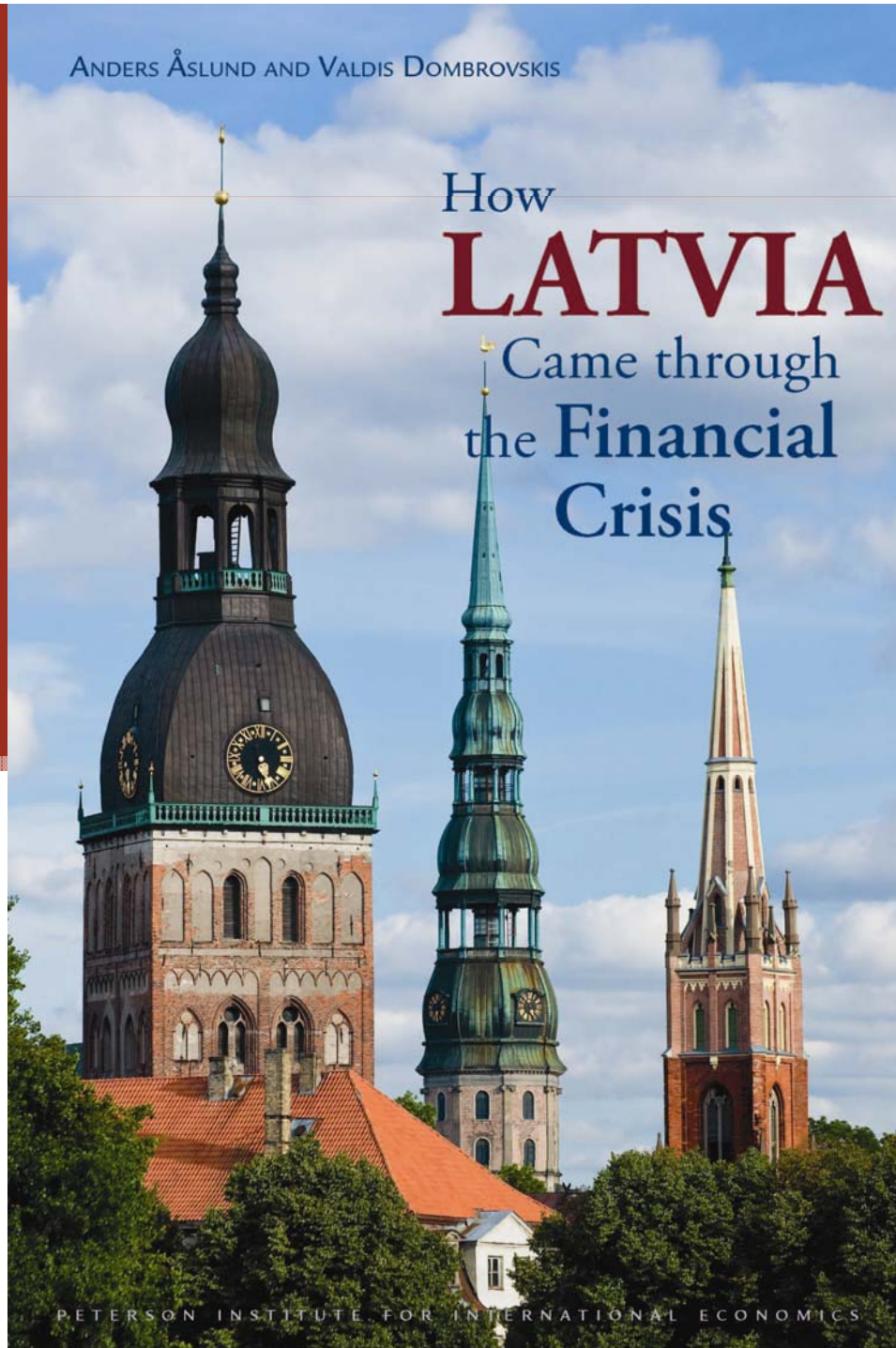
7. Unstable coalition government good for crisis resolution

8. Populism is not very popular in a serious crisis

9. International macroeconomics more harmful than useful

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