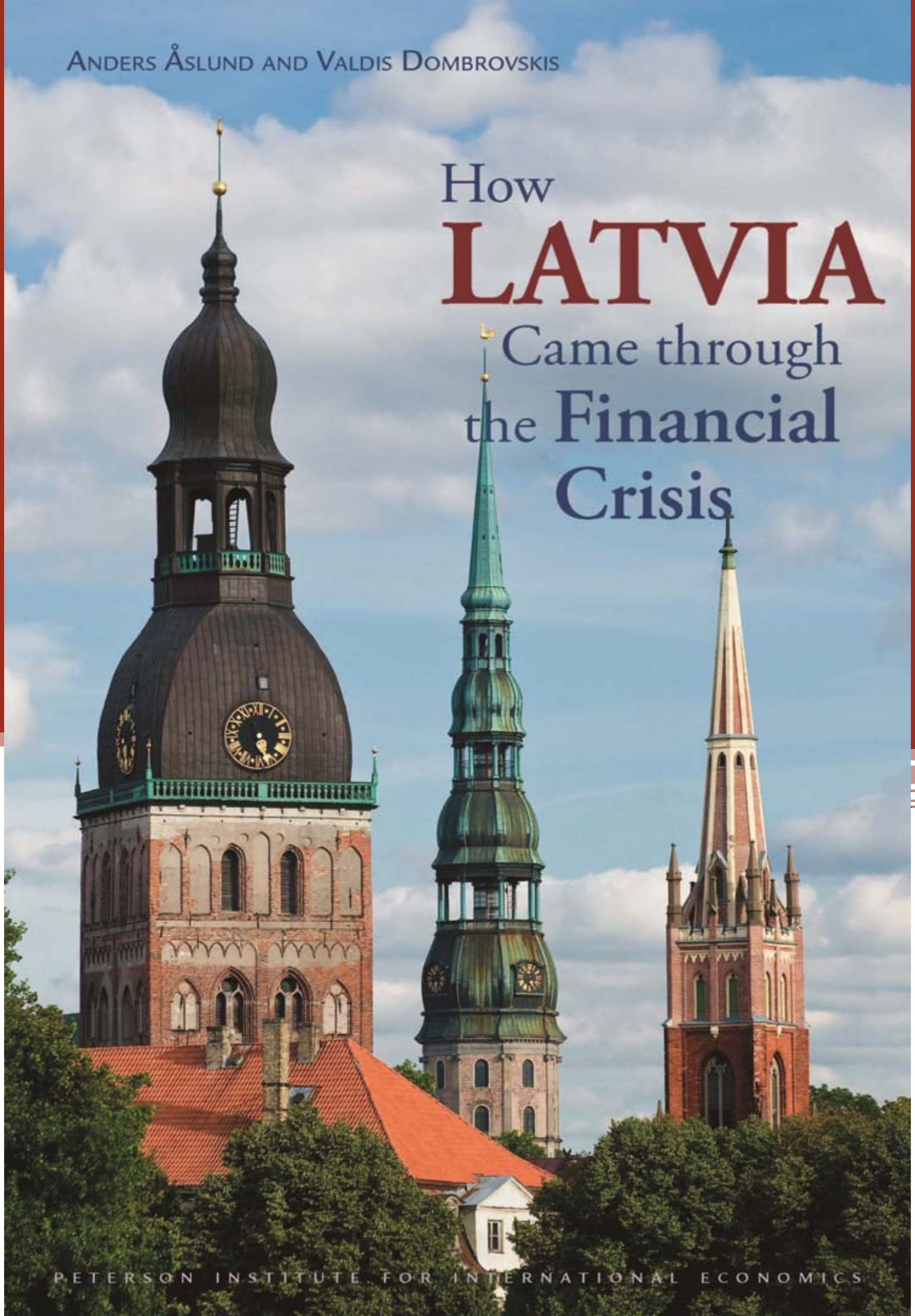

ANDERS ÅSLUND AND VALDIS DOMBROVSKIS
How
LATVIA
Came through
the Financial
Crisis
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Issues

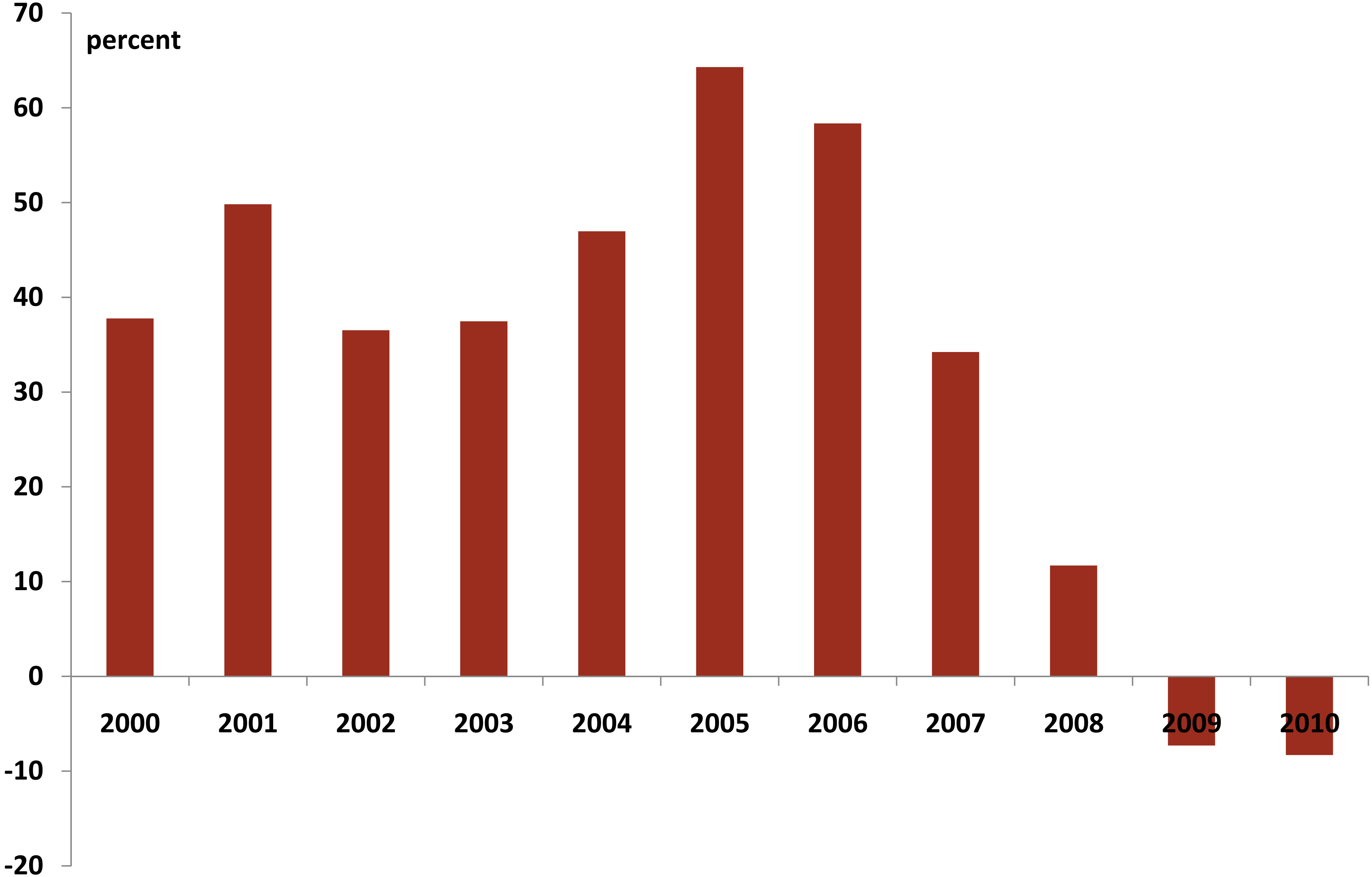
1. Causes of the Financial Crisis
2. To Devalue or Not
3. Essence of the Cure

1. Causes of the Crisis

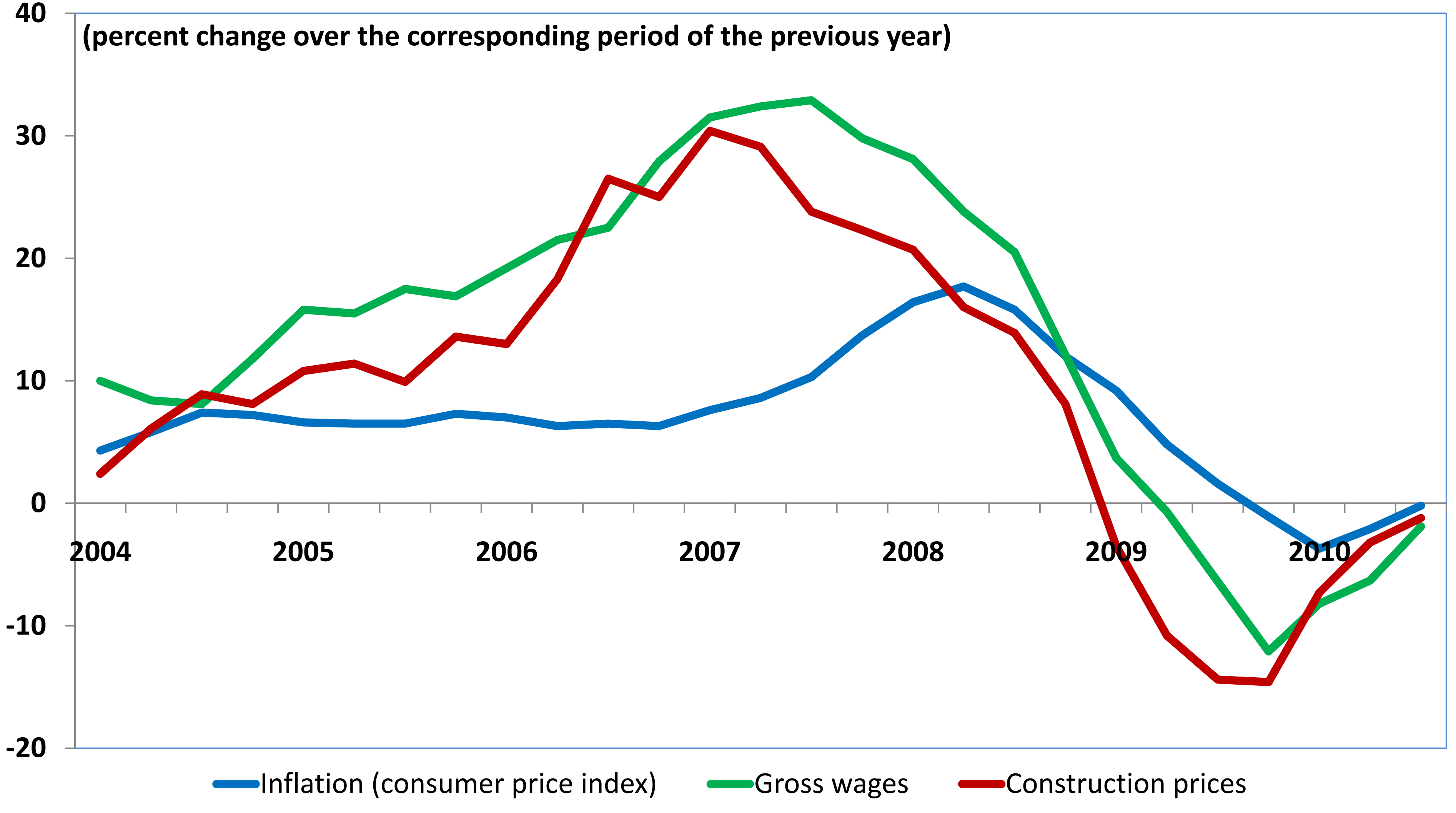
- Loose Monetary policy of the US Fed and ECB
- Excessive capital inflows
- Too large credit expansion
- Real estate bubble
- Rising inflation
- Current account deficit
- No fiscal surplus

But minimal public debt and little leverage

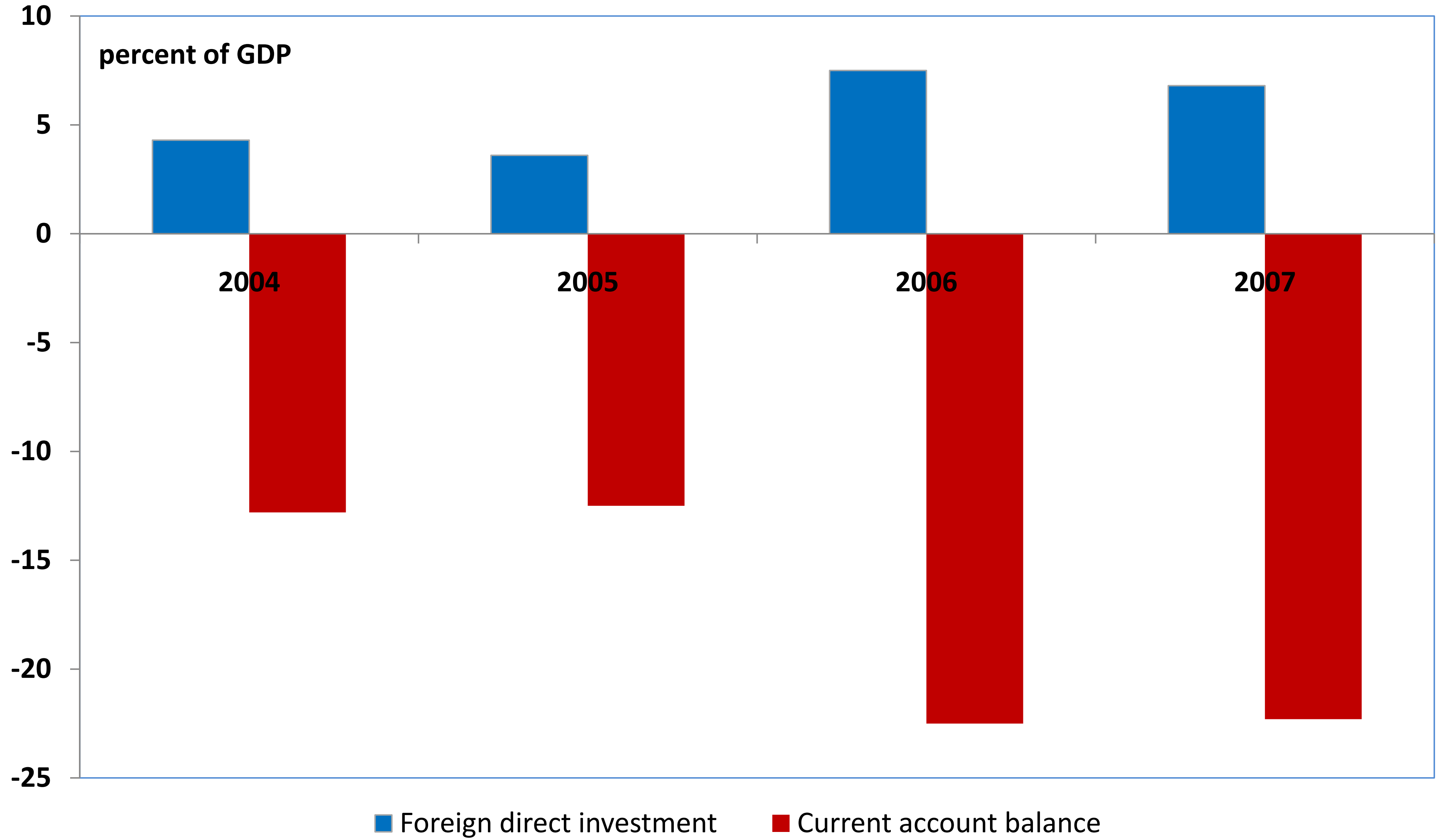
Credit grew 60%/year 2005–6



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

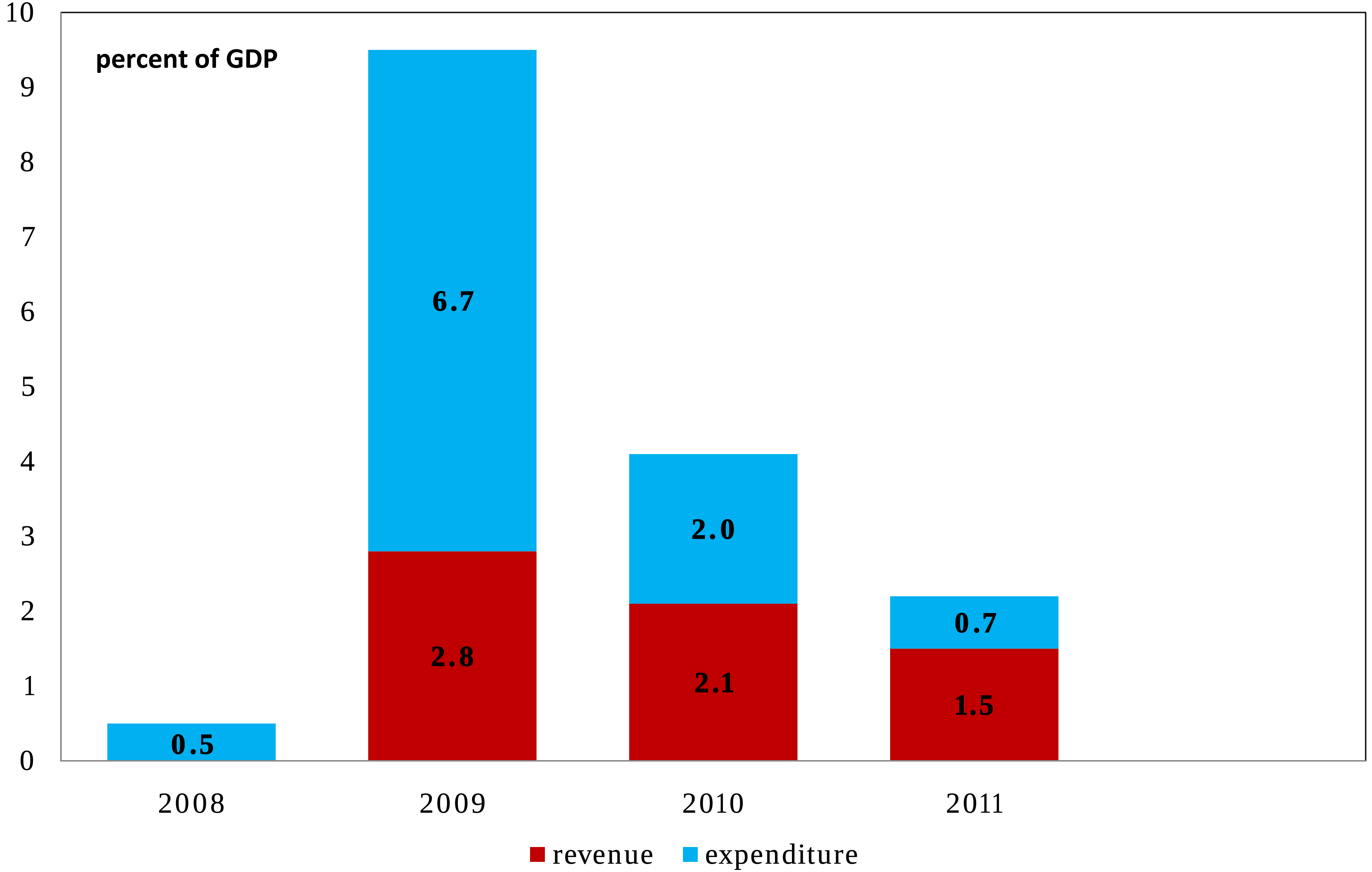
Conclusion on Devaluation

- 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

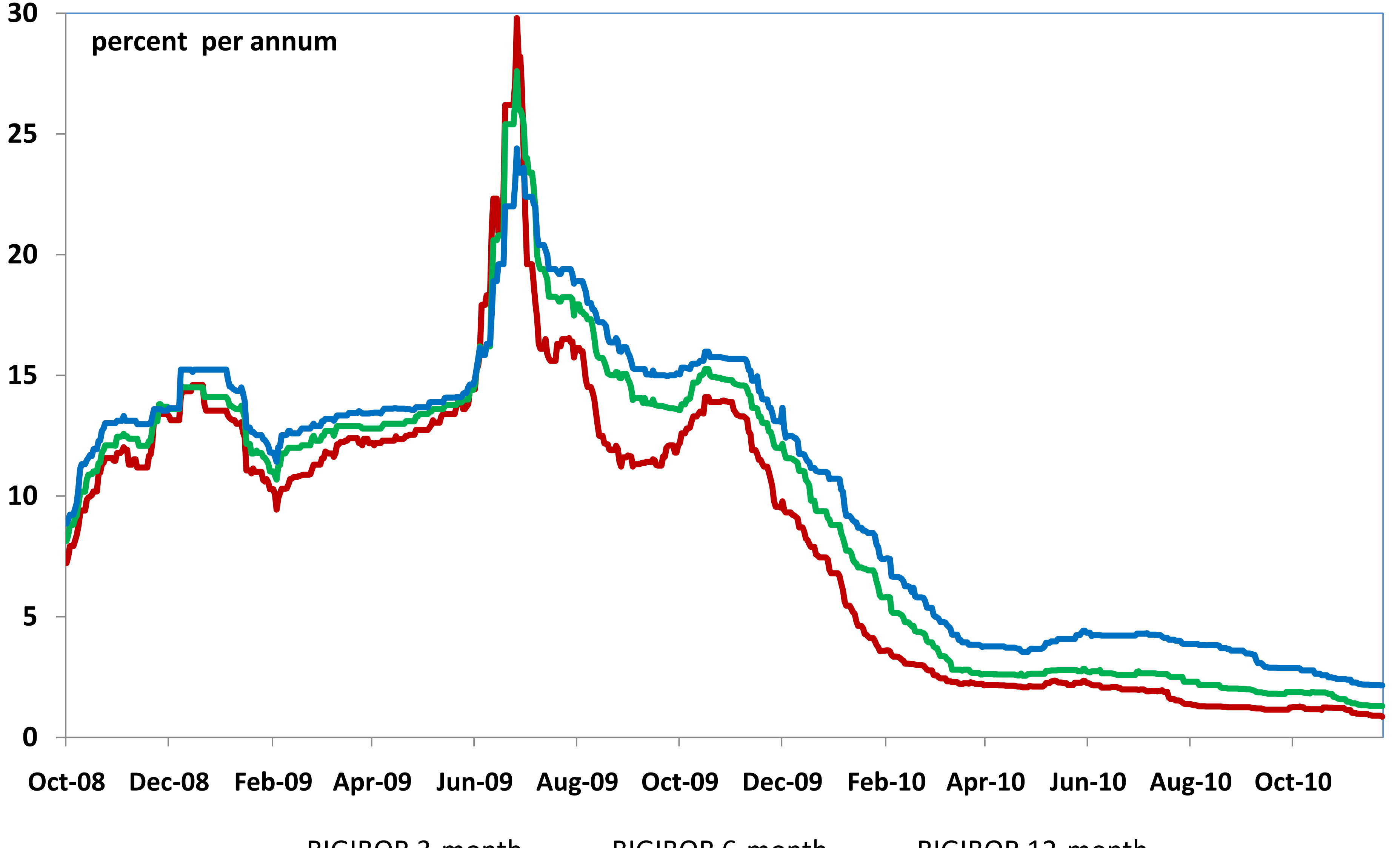
- Early and comprehensive fiscal adjustment
- IMF & EU program
- 7.5 bn euro of financial assistance, 37% of GDP

16% of GDP Fiscal consolidation, 2008-11

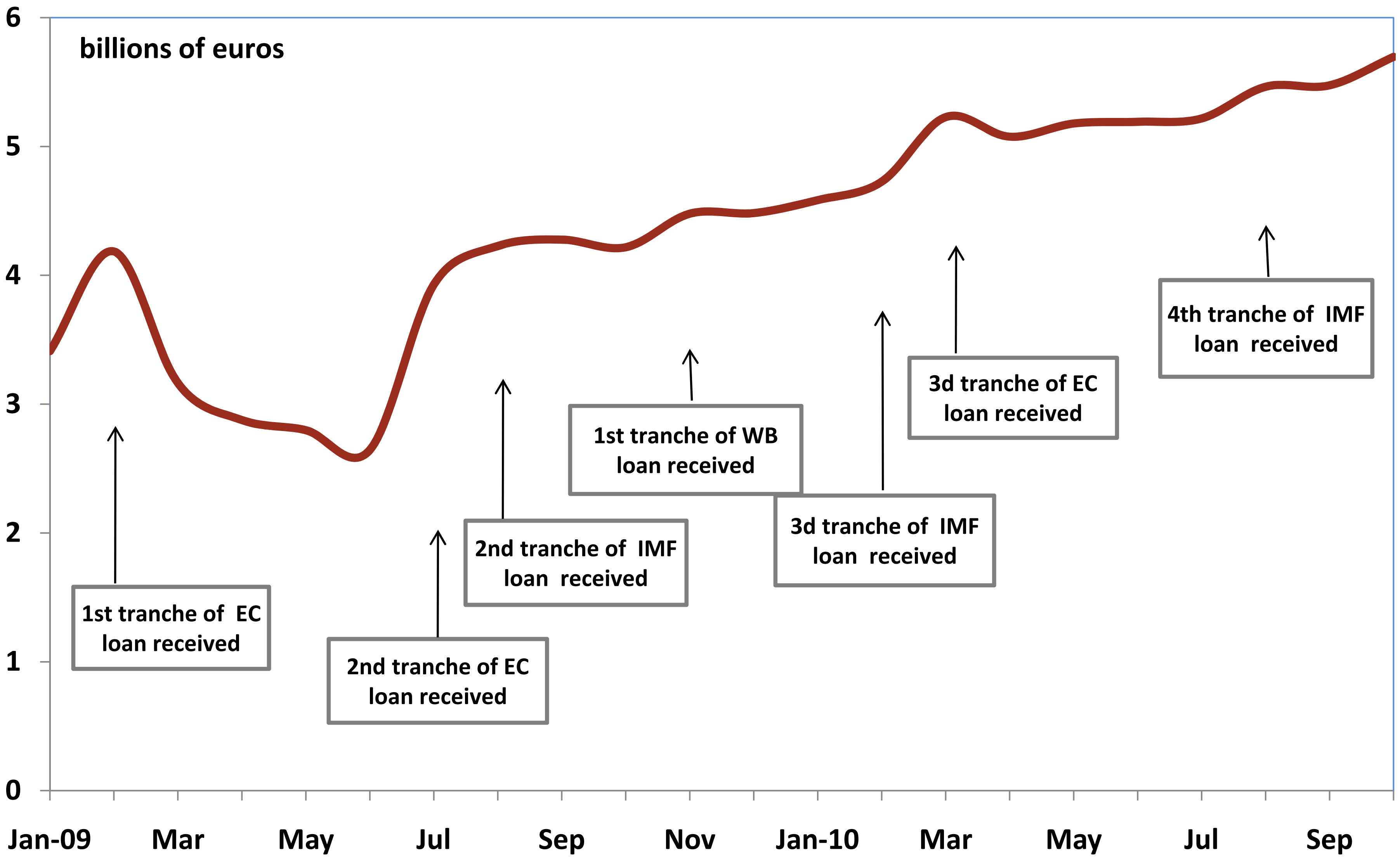


Credit default swap rates peaked in March 2009

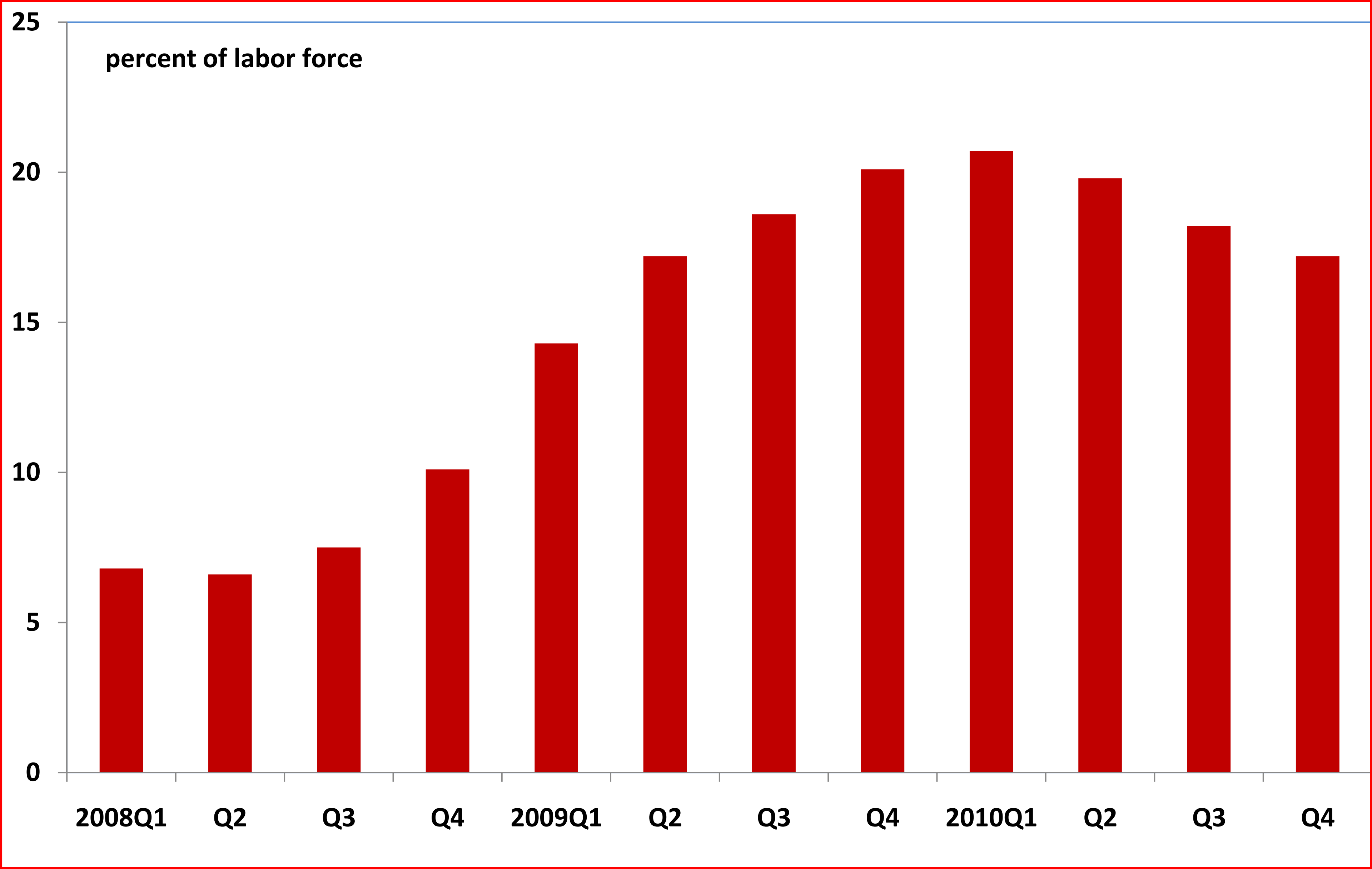
Market interest rates peaked in June 2009



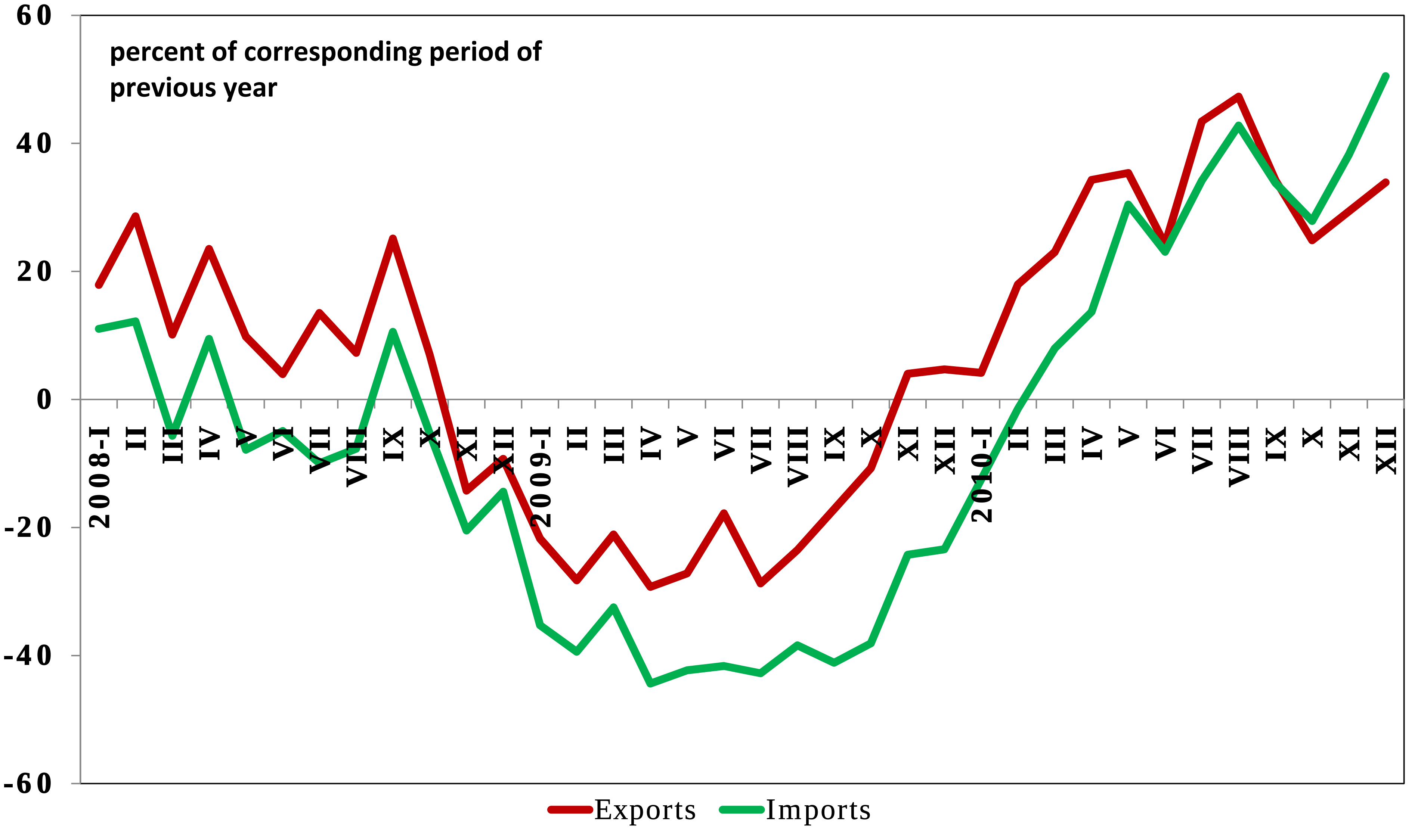
Foreign currency reserves bottomed out late June 2009



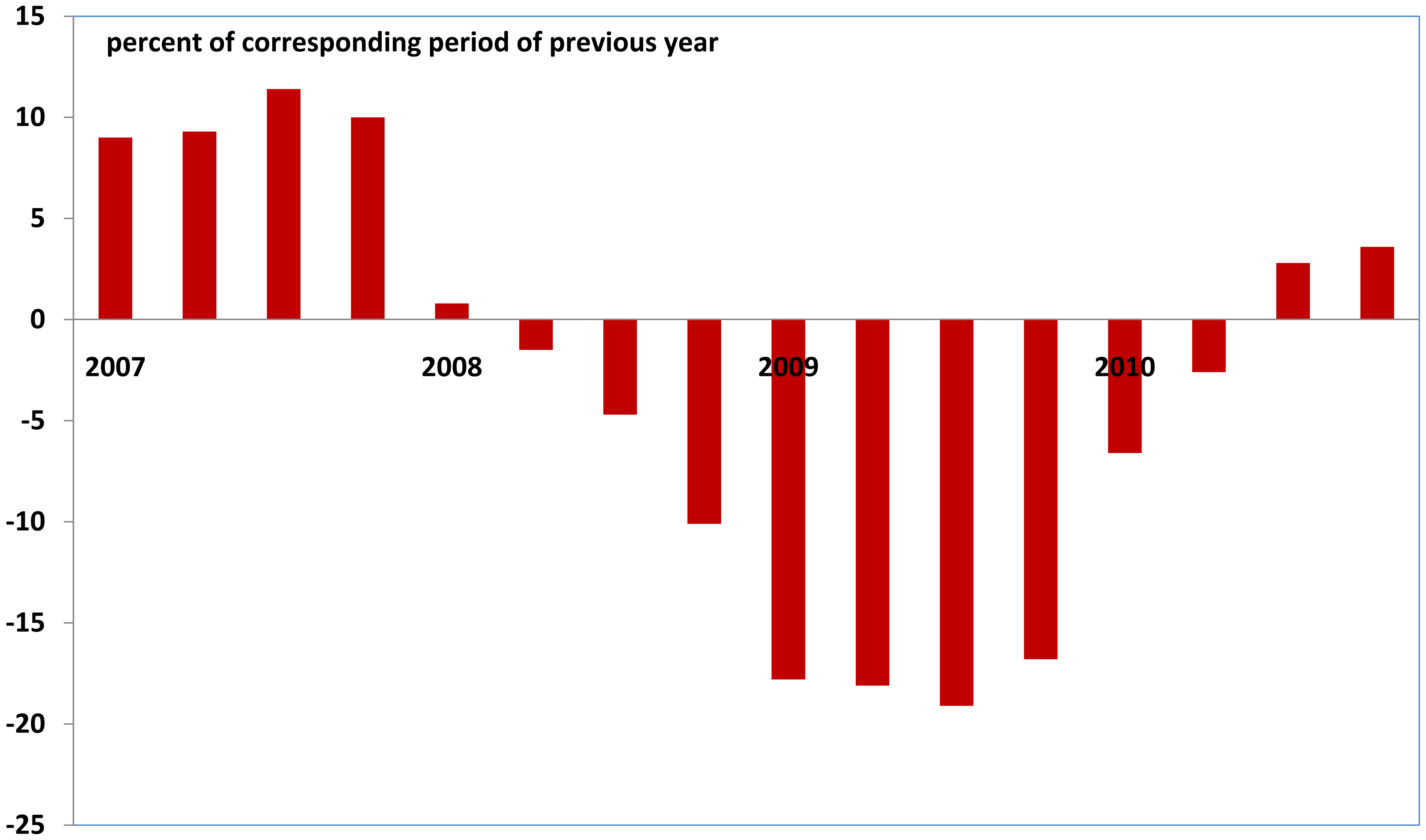
Unemployment peaked in early 2010



Exports Led the Recovery from end 2010



GDP Growth: 3rd Q 2010

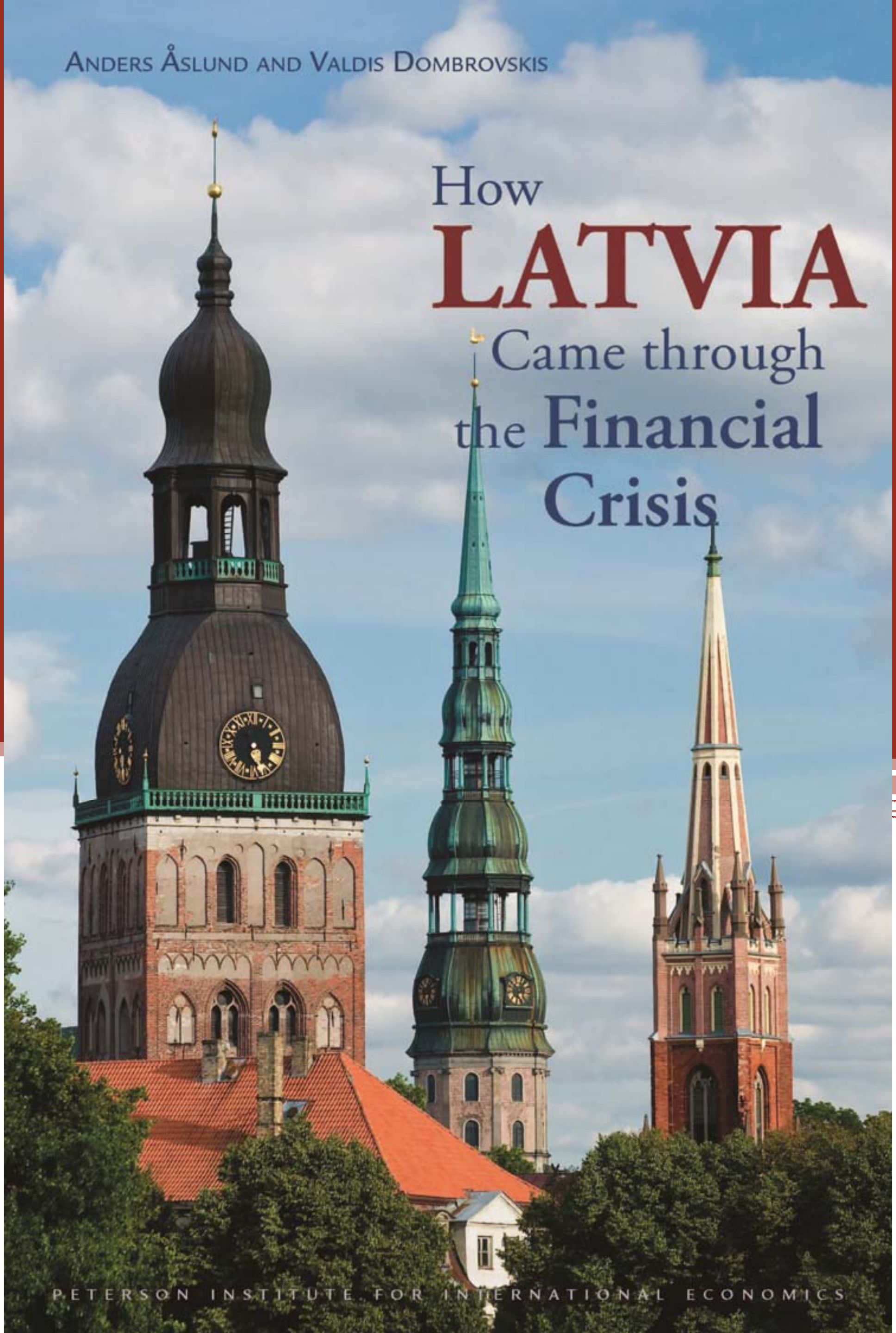


9 Lessons from Latvia for the World

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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