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Analysis of Economic Adjustments as a Result of a Deep Crisis – the Case of Latvia

Key words: *economic adjustments, economic policy, economic growth, economic crisis*

Abstract: The Latvian economy has been the most crisis affected economy so far in the whole territory of the EU. The expected GDP fall during the year 2009 is close to 20%, the unemployment rate is approaching 20%, and prices have already started to fall. There are major fiscal problems in the economy. For the second year Latvian society has lived under the threat of devaluation of the national currency. The country has applied for serious external financial assistance from the IMF and the European Commission. The sharp decrease in the economic activity is strongly related to the high current account deficit in the balance of payments which developed during the previous years of a high growth thus making the Latvian economy extremely vulnerable. As a financial inflow has strongly decreased, there is a rapid decline in both private and government consumption and investment. This paper is aimed at analysing and explaining the roots of the drastic changes in almost all macroeconomic indicators that have led to serious economic adjustments and strict changes in the economic policy. The paper will assess the outcomes of the economic adjustments as well as extract the most important lessons that have to be taken from what has happened in the crisis most affected economy of the EU. Both a quantitative analysis of indicators and a qualitative analysis of economic policy decisions are analysed within this paper.

INTRODUCTION

Latvia is an example of how careless attitude towards economic processes and a wrong economic policy can change a country from being the fastest growing economy in the EU to the most crisis affected economy in the EU.

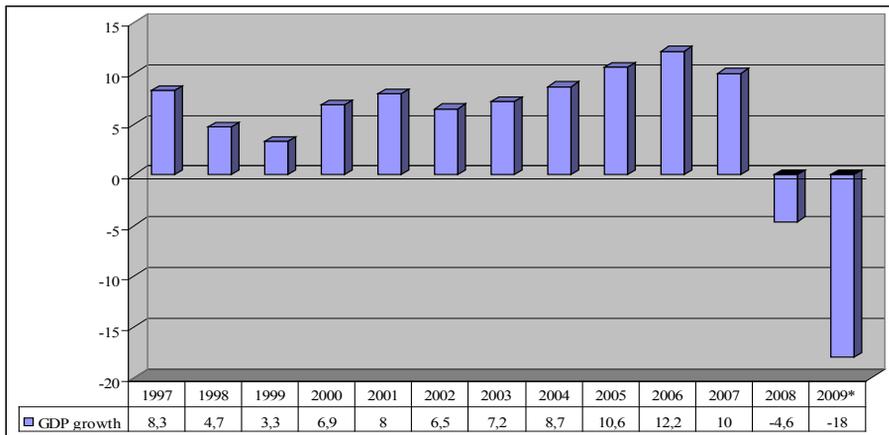
The aim of the paper is to analyse and explain the roots for drastic changes in almost all macroeconomic indicators that have led to serious economic adjustments and strict changes in the economic policy. The research results could be considered as topical since the Latvian case is absolutely unique, as changes in practically all the most important macroeconomic indicators have been the

most dramatic in the whole of the European Union. The present paper will assess the outcomes of the economic adjustments as well as extract the most important lessons that have to be taken from what has happened in the crisis most affected economy of the EU.

FROM FLYING HIGH TO DUST AND ASHES

Latvia was economically ‘flying high’ for about 10 years. To be precise, there was a feeling of flying high which was supported by several important macroeconomic indicators and permanent inspiring voices of politicians asserting that Latvia is rapidly catching-up with the EU developed economies in living standards of society and, in particular, economic development level. Especially this euphoria took over the bigger part of Latvian society in the years following its accession to the EU, when Latvia became a leading country inside the whole EU in GDP growth for couple of years (see Figure 1) and when its unemployment rate was permanently decreasing (see Figure2) and wages were increasing (see Figure 3).

Figure 1. GDP annual growth in Latvia in the years 1997–2009, %



* estimated by the Ministry of Economics of the Republic of Latvia (in June, 2009).

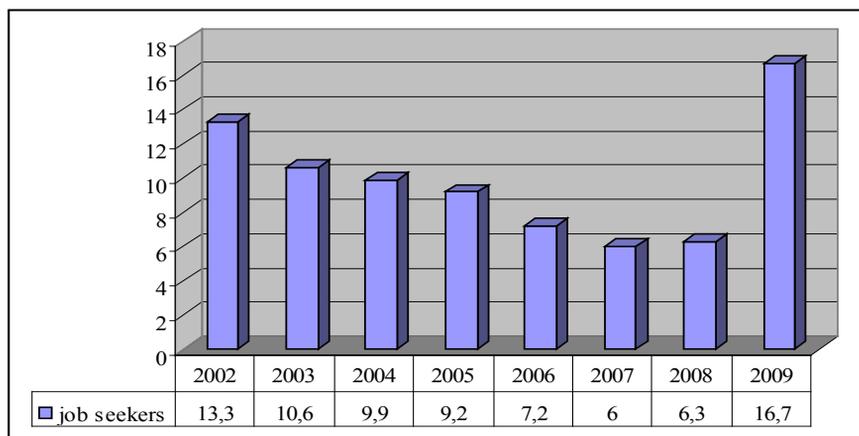
Source: LR Ekonomikas ministrijas Ziņojums par Latvijas tautsaimniecības attīstību (2009. gada jūnijs), pg.10: <http://www.em.gov.lv/em/2nd/?cat=30353> – viewed on 17.11.2009.

Source: Compiled by author, using the estimation of the Ministry of Economics and data from the Central Statistical Bureau of Latvia:

<http://data.csb.gov.lv/DATABASEEN/ekfin/Short%20term%20statistical%20data/02.%20Gross%20domestic%20product/02.%20Gross%20domestic%20product.asp> – viewed on 17.11.2009.

As one can see, a fast growth could be observed especially in the period of 2005–2007 when GDP grew on average by 11% per year. It should be stressed that this high growth was achieved mainly due to an extremely high and even excessive domestic demand largely based on an intensive inflow of foreign capital. Private investment and consumption increased significantly during these years. As recognized by the Ministry of Economics and proven by data, the increase of exports played a less significant role in the growth (The Ministry of Economics of the Republic of Latvia, June, 2009, p. 9). Few people, including politicians and other economic policy makers, realized on time the risks associated with a growth that is mainly based on the inflow of foreign capital raising both the domestic debt to the level of the rest of the world and the dependence on a foreign capital in the form of foreign direct investment. Especially when heavy drivers of the growth were located within speculative (and not productive) sectors of the economy associated with the real estate market and retailing. Therefore, the growth was accompanied at the same time with the highest inflation in the EU–CPI reached 10.1% and 15.4% in the years 2007 and 2008 respectively. This phenomenon could be classified as, so called, ‘galloping inflation’ - the syndrome from which developing countries suffer from time to time (Samuelson, Nordhaus, 2001, p.687).

Figure 2. Unemployment rate was calculated on the basis of the number of job seekers (aged 15–74) in the 2nd quarter in Latvia, in the years 2002–2009, %

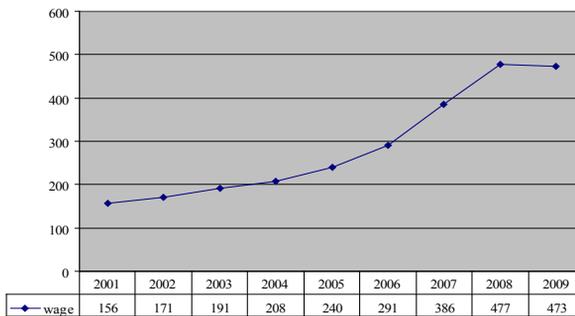


Source: data of Central Statistical Bureau of Latvia

<http://data.csb.gov.lv/DATABASEEN/Iedzsoc/Annual%20statistical%20data/05.%20Employment%20and%20unemployment/05.%20Employment%20and%20unemployment.asp> – viewed on 16.11.2009.

Within the same period of time a decrease in the number of unemployed persons and of the unemployment rate was observed. Mostly because of the increase in the economic activity, still partially because of the labour emigration following the opening of labour markets in several EU countries for the Central and Eastern European countries. Wage convergence followed, as several labour markets opened immediately, and was supported by a heavy increase in labour demand on the domestic market. An average monthly salary reached 500 lats (711 euros) in the 4th quarter of 2008 that hardly corresponds to the labour productivity in the country at that time.

Figure 3. Average monthly salary (pre-tax) in the 2nd quarter in Latvia, in the years 2001–2009, %



Source: data of Central Statistical Bureau of Latvia

<http://data.csb.gov.lv/DATABASEEN/iedzoc/Annual%20statistical%20data/Wages%20and%20salaries/Wages%20and%20salaries.asp> – viewed on 16.11.2009.

It should be noted that, to a very large extent, the responsibility for inadequate salary increases in the economy lies on the shoulders of the Latvian fiscal policy makers who, in the period of excessive growth and the threat of overheating, continued to increase government spending sharply by increasing salaries in the public sector. It is expected that there is going to be a correction of the level of salaries in the oncoming periods as the government has been, and will be, forced to cut sharply government expenditures, including salaries of the public sector. A decreasing demand on the external market will affect the same tendency in a private sector as well.

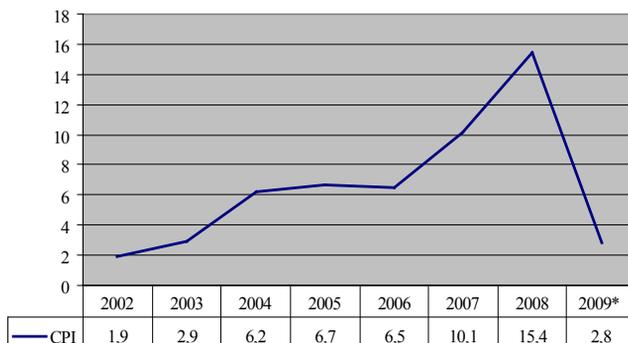
As one can see, all the figures above, as well as Figure 4 below, demonstrate serious changes in the economic situation when we look at the data for the years 2008 and 2009. The GDP decrease started already in 2008 (-4.6% against the previous year) and is expected to fall by about 18% in 2009 (the current data indicate 18.4% decrease in first half of the year and 18.4% decline in the 3rd quarter, if compared with the same periods of the previous year). In 2008 and in the first three quarters of 2009, Latvia had the largest decrease in the whole EU.

Unemployment is soaring up very rapidly and it is just a question of time when the rate will reach the level of 20%. At the same time wages are going to decrease and emigration of labour is going to continue but probably with a higher intensity than previously.

The soaring trend in prices of the years 2007 and 2008 is now depressed and even though the average yearly inflation is going to be maintained (see Figure 4, the estimation of the Bank of Latvia is that the average yearly inflation will be 3.0–3.5%) in 2009, the 12-month period consumer price index is already negative at the end of 2009 – there is already actual deflation in Latvia.

The prices increase in the years 2007 and 2008 could have been much lower if the fiscal policy of the government would have been adequate. Typically, to prevent the occurrence of a fundamental disequilibrium in the economy, a deflationary fiscal policy could be used to prevent excessive inflation, such as that experienced in many countries in the early 1970s (Sloman, Hinde, 2007, p.684). The Latvian government continued its expansionary fiscal policy by increasing salaries in the public sector and raising other type of public expenditures.

Figure 4. Inflation in Latvia (measured by a consumer price index) in the years 2002–2009, %



* estimated by the Ministry of Economics of the Republic of Latvia (in June, 2009).

Source: LR Ekonomikas ministrijas Ziņojums par Latvijas tautsaimniecības attīstību (2009. gada jūnijs), pg.10: <http://www.em.gov.lv/em/2nd/?cat=30353> - viewed on 17.11.2009.

Source: Compiled by author, using estimation of Ministry of Economics and data of Central Statistical Bureau of Latvia: <http://data.csb.gov.lv/DATABASEEN/ekfin/Annual%20statistical%20data/Consumer%20prices/Consumer%20prices.asp> – viewed on 17.11.2009.

How does it come that a country experiencing several ‘fat years’ (the expression of the former Latvian President of the Cabinet of Ministers - Mr.Aigars Kalvitis) suddenly turns to dust and ashes and has to undertake and live with serious economic adjustments and apply for external financial assistance from the EU and International Monetary Fund? How is it that the fastest growing economy in the whole EU becomes the most crisis affected economy in this region?

ANALYSIS OF THE CRISES CAUSES

There is a huge number of causes and reasons why a developing economy that has recently re-established its independency, changed its economic system, gone through different controversial economic reforms in a relatively short period of time may suddenly fall into recession and even in a deep crisis. The reasons might be found in the wrongly conducted privatization process, wrong tax reforms, unstable bank system, wrong exchange-rate regime, wrong fiscal and monetary policies, bad entrepreneurial environment and weak support for enterprises, too heavy or too hesitated liberalization processes towards external sector, etc. Without doubts, many mistakes, just as in other transition economies, were made in the aforementioned mentioned fields of the country's policy.

But what made a huge difference, if compared with other transition economies which were also crisis affected, is what we could find in the country's balance of payments. In this paper the author does not have a sufficient space for a detailed study of the whole of Latvia's balance of payments structural analysis, but the most important indicators concerning the balance are summarized in an analytic way and are shown in Table 1. It should be noted that the overall current account position is for many purposes the most important figure in the balance of payments (Copeland, 2005, p.20).

After a careful look at the figures for the years 2003–2007 shown in the table above (for the period from before the implementation of the economic adjustments) it would be justified to say that the Latvian economy 'was sitting on a powder keg waiting for a burner to come'. Even more, this indicates who actually was responsible for that rapid growth in the quoted period and what price will have to be paid by Latvians in the oncoming years, or even decades.

The balance of payments provides a clear answer to the question why the Latvian economy was booming for several years – the inflow of foreign capital in the form of both direct investment, portfolio investment and especially other investment related with the accumulation of debt was the main source for maintaining a high domestic demand which was accompanied also by the expansionary fiscal policy on the expenditure side in Latvia. The Ministry of Economics in its regular half year report on the state of the development of the Latvian economy (June 2009) said that: 'At present, due to the decrease in capital inflow, there is a rapid decline of private consumption and investment, as well as substantial economic adjustments are being implemented, which will result in the improvement of the trade balance of goods and services along with a decline of economic activities upon decreasing domestic demand. This is well reflected in the dynamics of the domestic demand, which continues to decrease rapidly: domestic demand in the 1st quarter of 2009 was 19.7% lower than in the respective quarter of 2008' (The Ministry of Economics of the Republic of Latvia, June, 2009, p. 9).

Table 1. Balance of payments in Latvia (analytical indicators) before and after the economic adjustments

Components	Before adjustments						After adjustments	
	2003	2004	2005	2006	2007	2008	2009 I q	2009 II q
Formas sākums Current account (% of GDP)	Formas sākums -8.2	-12.8	-12.5	-22.5	-22.3	-13	1.3	14.2
Formas sākums Current account (excl. reinvested earnings) and capital account (% of GDP)	-6.7	-9.6	-9.2	-17.7	-18.2	-11.7	-1	15.7
Formas sākums Foreign trade balance, goods (% of GDP)	-20.9	-22.3	-21.8	-27.6	-25.3	-19.1	-11.9	-7.3
Formas sākums External debt (gross; % of GDP)	79.5	93.3	99.4	114	127.6	128.8	129	132.2
Formas sākums External debt (net; % of GDP)	24.1	29.9	35.6	44	49.5	56.5	56.6	56.7
Formas sākums Foreign direct investment in Latvia (net flows; % of GDP)	2.7	4.6	4.4	8.3	8.1	3.7	0.5	-3.8

Source: Compiled by the author with the data from the Bank of Latvia http://www.bank.lv/LMB/LMB_en.php – viewed on 12.11.2009.

It turns out that actually foreign capital has maintained the domestic demand and the growth processes and the external demand did not contribute so much to the overall growth, as it was mentioned above. Was it not too risky? It was clear that the inflow of foreign investment would continue only as long as there is a favourable climate in the global economy and good opportunities for speculative deals with real estate. In the same report of the Ministry of Economics they say: 'Even more rapidly, in the first quarter of 2009, investments in fixed assets continued to go down (decline of 34.1%), which is still to a large extent related to the substantial decrease of activities in the real estate market' (The Ministry of Economics of the Republic of Latvia, June, 2009, p. 9).

As soon as global financial crisis came, the inflow of foreign capital decreased sharply. Moreover, the outflow of foreign capital could be observed (for example, Table 1 shows that net foreign direct investment became negative in the 2nd quarter of 2009 – which has never happened before).

The price for 'the fat years' turned out to be very high – the hard landing (as witnessed by the activity indicators for 2008 and 2009) which has been psychologically painful for the majority of Latvian society as well as the inherited debt that will lie on the shoulders of the Latvian people now and in the future – especially given that hard landing has called for necessity to borrow money from international institutions to stabilize the financial sector and to cover the budget deficit. These loans will make the country's debt burden heavier and extend the time of possible solution of it.

POLICY MISTAKES AND LESSONS TO BE LEARNED

Latvian policy makers may use an opportunity (which is often a case) to hide behind the global crisis and to lay the blame for all local economic problems on it. There is no judgment for doing so. No other economies with similar preconditions (Lithuania, Estonia, Poland, the Czech Republic, Slovakia, Slovenia and others) have been hurt so strongly. There are grounds for criticism and serious lessons to be learned for future needs.

In general, Latvian economic policy makers violated basic principles that are taught in every macroeconomics course – the government should use contractionary fiscal policy when there is too fast pace of strong economic growth and soaring prices that may lead to overheating. Budget surpluses could have not only slowed down excessive and dangerous growth but also would have generated some resources that might be used during the crisis that has arrived. Instead of that over the period of a strong growth Latvia continued to live with budget deficits, increasing government expenditures and lowering some taxes (for example, personal income tax). As for today, economic logics would require expansionary policies in order to heat up the economy. Unfortunately, this is almost impossible

under the current economic situation which requires balancing of government revenues and expenditures. International creditors of Latvia strongly insist on extremely tight fiscal policies reducing the budget deficit as much as possible.

Another policy mistake was long lasting hesitation to set up stronger control instruments over credit availability – for several years there was too liberal credit availability to households and the corporate sector that allowed for speculative activities and real estate bubble. As a result of that, many Latvian households and companies have become and will become insolvent. They may partially blame themselves for being irresponsible and short-sighted. Still, there is also an obvious state's role to control these processes. The government started to put constraint measures just in the middle of 2007 when it was too late.

Closely related to previous problem is another lesson to be learned. An economy may easily run into a trap, if it is not controlling the amounts of inflowing foreign capital, especially in the form of borrowed capital. Latvia has experienced how it is to become a hostage to the rest of the world. Nowadays, the national economic policy has become not only Latvia's problem – several international institutions and foreign governments have interests here and are strongly impacting policy makers in different ways.

Monetary policy possibilities are very limited in a country like Latvia which is a small and very open economy. The central bank has acted very tightly over the years ensuring a fixed exchange-rate (initially against SDR, from 2005 against euro), thus anchoring also price fluctuations in the domestic market and has tried to adjust interest rates to the needs of the economy. There has been pressure from several politicians and economists to devalue the national currency – the lat. The Bank of Latvia has maintained a very strong position about this issue – the lat should not be devalued and the corridor for fluctuations (+/-1%) may not be widened.

Possible devaluation of the national currency has been a very hot topic over the last couple of years in Latvia. Some political powers and also independent economists have insisted on devaluation or widening of fluctuations' corridor.

As the most important aspect favouring devaluation in Latvia has been a possibility to improve foreign trade balance which has been permanently negative in Latvia. Still, it should be taken into account that in different countries the effects of devaluation on trade balance are different. The more capital goods in the structure of imports, the less significant and long-lasting these effects may turn out. As concerns the Latvian case, there is a significant proportion of capital goods imported.

A very important question concerning the issue of devaluation should be asked about price elasticity of imported and exported goods. In the theory of economics, Marshall–Lerner condition says that, for a currency devaluation to have a positive impact on trade balance, the sum of price elasticity of exports and imports must be greater than 1 or, in simple words, there must be

a significant increase in demand for exported goods after exporters lower prices for these goods, and there must be a significant decrease in demand for imported goods after importers increase prices for their goods. So, this condition implies that there is a technical reason why a reduction in value of a nation's currency does not need to improve immediately its balance of payments (Davidson, 2009, p.125). If we look at the import structure in Latvia, there are a lot of economically very important goods that cannot be substituted by local suppliers. Typical examples would be practically all the energy resources, transport vehicles, industrial equipment. Import price elasticity in the case of Latvia can be estimated as very low.

In Latvia devaluation would lead to a rapid and strong price increase effect as the proportion of imported goods and services to GDP in 2007 was 61.8%, in 2008 – 55.3% which is rather high. This inflation would be supply side inflation.

There is an argument that devaluation would favour also other income receivers from the rest of the world – residents working abroad, Latvian investors outside Latvia, current transfer receivers. The counter argument is that absolute amounts of these financial flows are not significant enough to sacrifice the stability of the national currency.

Beneficiaries would also include some local companies that have to compete with importers on the domestic market. However, there is no precise information how many companies belong to this group and how important they are. Besides, it should be taken into account that these benefits will not be long-lasting due to the inflation effect.

The strongest argument against devaluation in Latvia is the fact that 88.2% of all resident credits (in the 3rd quarter of 2009) are in foreign currencies (mostly in euro). Devaluation would mean respective increase in credit payments denominated in lats.

An average household in Latvia, which is typically living on income expressed in lats, would also suffer from devaluation as their real purchasing power would decrease.

Another argument for would be competitive devaluation as the value of several trading partners' currencies has decreased over the last years - Poland, Sweden, United Kingdom, Russia are examples of these countries. At the same time Latvia's neighbours and the most important trade partners - Lithuania and Estonia have maintained fixed exchange rates against euro. Several euro area countries (especially Germany) are also very important trading partners.

The author believes that positive effects of devaluation in Latvia will not compensate the negative ones.

CONCLUSIONS

The most important conclusions of the paper are as follows:

1. After 10 years of a strong growth, the Latvian economy experienced very hard landing - from the fastest growing economy to the most crisis affected economy in the EU. After a few years of rapid GDP increase, wage increases, decrease in unemployment, suddenly Latvia experienced a dramatic fall of economic performance reversing the mentioned indicators.

2. After the analysis of the Latvian balance of payments stated for the last 7 years, it becomes clear that for years the Latvian economy was sitting on a powder keg just waiting for a burner to come. The permanently negative current account up to the level of 20–25% of GDP for several years made the Latvian economy extremely vulnerable and dependent on foreign financial inflows.

3. The burner came in the form of the global financial crisis. But it should not be blamed for what has happened in the Latvian economy. If it had not been for this global financial crisis, some other burner would come sooner or later.

4. Being in a hostage position to some international financial institutions and governments is purely the fault of Latvian policy makers who were not able to diagnose the problems in adequate time. They lived in the state of euphoria, ignored basic economic policy rules, especially those of fiscal policy, credit control, financial flow control and others.

5. The current debate about possible devaluation of the national currency as a remedy for the economic problems of Latvia is weakly grounded and it seems that devaluation would bring more problems than solutions to the Latvian economy as it is very small and open, heavily dependent on non-replaceable energy resources and other important capital goods which are rather price inelastic.

6. The Latvian case brings forward lessons on how economic policy makers should not act over the years of a strong economic growth. Perhaps, the most important lesson is the understanding that too heavy reliance on foreign investment may lead into trap (foreign debt) from which the whole society will not be able to get out for decades.

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ANALIZA DOSTOSOWAŃ GOSPODARCZYCH W WYNIKU GŁĘBOKIEGO KRYZYSU: PRZYPADEK ŁOTWY

Słowa kluczowe: kryzys, ekonomiczne dostosowanie

Abstrakt: Gospodarka łotewska jest najbardziej dotkniętą kryzysem gospodarką spośród całego terytorium UE. Oczekiwany spadek PKB w 2009 r. jest bliski 20%, stopa bezrobocia osiąga 20%, ceny już zaczęły się obniżać. Istnieją poważne problemy fiskalne w gospodarce. Od dwóch lat społeczeństwo żyje pod groźbą dewaluacji waluty krajowej. Kraj wnioskował o udzielenie poważnej pomocy finansowej z MFW i Komisji Europejskiej. Gwałtowny spadek aktywności gospodarczej jest silnie związana z wysokim deficytem na rachunku bieżącym bilansu płatniczego w poprzednich latach, gdy występował wysoki wzrost gospodarczy, co stawia gospodarkę Łotwy w niezwykle trudnej sytuacji. Ponieważ napływ środków finansowych znacznie zmalał, nastąpił gwałtowny spadek zarówno konsumpcji prywatnej, wydatków rządowych, jak i inwestycji. Artykuł ma na celu analizę i wyjaśnienie przyczyn drastycznych zmian prawie wszystkich wskaźników ekonomicznych, które doprowadziły do poważnych dostosowań gospodarczych i surowych zmian w polityce gospodarczej. W artykule oceniono rezultaty zmian gospodarczych, jak również zawarto wnioski z doświadczeń krajów UE najbardziej dotkniętych kryzysem. Przeanalizowano zarówno ilościową analizę wskaźników, jak i jakościową analizę decyzji w zakresie polityki gospodarczej.