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Southern Europe Ignores Lessons from Latvia at Its Peril

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In the current financial crisis plaguing Europe, Latvia stands out for resolving its financial problems quickly and resolutely. After contracting 24 percent in 2008 and 2009, it grew at the rate of 5.5 percent in 2011. The speed and determination with which the government carried out austerity measures in 2009 and restored confidence after suffering the worst output decline is a crucial lesson for the ailing South European countries—Greece, Italy, Portugal, and Spain.[1] Many policy observers and economists have dismissed Latvia's crisis resolution as irrelevant to the situation in Southern Europe. The Latvian orange, they say, cannot be compared with the South European apples. I argue otherwise.

Latvia has proven that internal devaluation—cutting wages and public expenditures—works and that it can turn around an economy quickly. Competitiveness has been considerably improved through structural reforms and sharp reductions in unit labor cost and real effective exchange rate. Latvia has returned to high economic growth thanks to a sharp rise in exports of manufactures. The economy now seems set for steady and high growth for years to come. My point is that democracies can solve big problems.

It is true that Latvia is a small country, with a population that had endured painful post-Soviet transition and was thus prepared to swallow the bitter austerity pill. It is also true that the initial conditions at the onset of the financial crisis in the fall of 2008 were considerably different in Latvia and the South European countries. Before the crisis, Latvia enjoyed a tremendous boom with an average annual growth of 8.8 percent from 2000 until 2007, while Italy and Portugal had low annual growth averaging 1.5 percent, and Greece grew at 4.3 percent. Latvia's contraction of 18 percent in 2009 was, therefore, all the more disastrous; Italy lost 5.5 percent and Portugal and Greece only 2.5 percent of GDP each. Latvia was overheating and its inflation peaked at 17.9 percent in May 2008. Since the South Europeans had no boom or overheating, their inflation was moderate in the band of 2 to 4 percent a year. Latvia's budget deficit was minimal from 2000 until 2007, but it peaked at 10.1 percent of GDP in 2009 due

1. I have made a similar attempt comparing ten Central and East European countries with the GIPS (Greece, Italy, Portugal, and Spain) (Åslund 2012). In this Policy Brief, I limit myself to Greece, Italy, and Portugal so that data in the figures are readable and readily comparable. Otherwise, I would have included Spain as well. My analysis here draws on the epilogue in the Latvian version of Åslund and Dombrovskis (2011).

Box 1 Why Latvia succeeded and the South Europeans are fumbling

Latvia's crisis resolution is a political economy success story. The government managed to carry out its policy in a cohesive fashion and restored confidence at an early stage. Latvia's achievement boils down to five crucial principles, which the South Europeans ignored—and continue to ignore—at their peril.

First, Latvia made full use of the grave sense of crisis in the fall of 2008. The sudden large output shock and liquidity freeze made the unthinkable possible and necessary.

Second, the government implemented a comprehensive anticrisis program that was heavily front-loaded in the first half of 2009, which restored confidence early. The front-loaded Latvian anticrisis programs encountered minimal social resistance.

Third, the program contained more expenditure cuts than revenue measures, which made it more realistic and drove structural reforms. The crisis forced Latvia to trim its public sector, rendering its economic system even more competitive and promoting economic growth.

Fourth, the International Monetary Fund and the European Union provided early and sufficient international financial support, making the crisis resolution financially sustainable.

Finally, the government succeeded in its salesmanship of the adjustment program, by clarifying how severe the crisis was and by making sure that the burden of the crisis was socially equitable.

None of these five crucial conditions have been satisfied by the South Europeans. Their failures are, therefore, not surprising.

to falling output. But it was never as large as in Greece and Portugal. The Latvian crisis had fully developed as early as the summer of 2008, while the Greek crisis became dire only in early 2010.

Latvia suffered primarily from a current account crisis in the private sector and in September 2008 it faced a "sudden stop" of international finance leading to a drastic drop in output, while the South European countries mainly suffer from public finance crises. Some have too much public debt (Italy), some have budget deficits that are too large (Spain), and some have both (Greece and Portugal).

Yet all these crises are financial, and the ultimate aim is to resolve them through a government policy that brings back not only financial stability but also investor confidence, competitiveness, and economic growth. The way Latvia resolved its crisis serves as a near-perfect example of the political economy principles of crisis resolution. These principles apply universally, and therefore I disagree with the refrain that Latvia is irrelevant. If Latvia could dig itself out of one of the worst financial crises through internal devaluation, so can the South Europeans. The comparison between Latvia and the South Europeans ultimately boils down to five principles of political economy applied astutely in the case of Latvia but not by the South Europeans (box 1).

Moreover, the Latvians are not unique in their ability to have endured quick fiscal adjustment. Estonia and Lithuania carried out similar cures in parallel. All the Baltic countries pursued internal devaluation, which rendered their cost levels competitive and allowed them to turn their large current account deficits swiftly into substantial surpluses. Many post-Soviet countries went through even greater adjustments, for example, Russia and Moldova (1997–2000). The combination of severe financial crisis and resolute policymaking led to their policy success.

THE POLITICAL ECONOMY OF LATVIA'S CRISIS RESOLUTION

Various analysts tend to point out one reason or another for Latvia's peculiar success. Inspired by analysis in John Williamson's *The Political Economy of Policy Reform* (1994), I present no less than 20 political economy elements of policymaking during crisis, which come together seamlessly in Latvia's case. These principles are ordered not by importance but by logic and chronology.

1. *A real sense of crisis* prevailed in Latvia in the fall of 2008**.** The more abrupt and deeper the crisis is, the greater the crisis consciousness and the more structural reform is likely. The uncommonly large and sharp fall in GDP shook everybody, facilitating major adjustments. Obviously, nobody argues for decline for the sake of reform, but often crisis brings about beneficial reform (Drazen and Grilli 1993). As Rahm Emanuel said: "A crisis is a terrible thing to waste." The Latvian government exploited it astutely.

2. *The direct cause* of the huge slump *was external*: an international liquidity freeze or a "sudden stop" of international finance, which forced Latvia to sharply increase its national savings and cut both investment and consumption.[2] The underlying cause was overheating with a large current account deficit, but the abrupt crisis could have been overcome if Latvia had enjoyed access to European Central Bank (ECB) liquidity, as the euro area countries did.

3. Size matters. *Small, open countries are more vulnerable* and more dependent on the global economy than bigger or more closed ones. Therefore, the imperative of adjustment is more obvious, and it is easier to persuade the population in a small country that they have to adjust and accept early radical action. It helped that Latvians had the post-Soviet transition in fresh memory. They knew that they could carry out radical reforms and that such reforms could bring about great economic success.

4. *Prior economic success helps*, by generating tolerance for setbacks. Since Latvia had enjoyed eight years of average GDP growth of 9 percent, many Latvians had a strong sense that this luck would eventually run out. People were also aware that a lot of fat had accumulated, and overheating was evident to all through high salary increases, rising housing prices, and inflation. They felt life had been too good and were mentally prepared for a crisis.

5. Crisis resolution calls for *new thinking* with clear and sound economic principles. The Baltic countries were dominated by free market thinking and a broad ideological consensus prevailed. The ideas to trim public expenditures and render the public sector more efficient were well understood, but they ran counter to old vested interests. The Latvian reformers' attack against cronyism within the old elite helped them gain popularity for their reforms. As Williamson (1994, 26) observed, reforms need "the will and ability to appeal directly to the public and bypass vested interests."

6. *Credible culprits are useful*. Latvia has eminent culprits—three oligarchs, who each controlled one parliamentary party. Together these three oligarchic parties had dominated Latvia's politics since independence, typically gaining a slight majority in parliament. Reformers in the government campaigned against corruption and oligarchs, although the oligarchs were part of the ruling coalition. These three parties, which had won 51 percent of the seats in parliament in the 2006 elections, were reduced to one party with only 13 percent of the parliamentary seats in the 2011 elections.

7. Crisis resolution requires *new leaders*. "Successful domestic reform depends on vigorous political leadership" (Sachs 1994, 503). Usually, a government change precedes major reforms, because an anticrisis government has different objectives than a precrisis government. Ordinary politicians are adept at horse-trading and compromises, but crisis resolution requires the opposite—new ideas and determination. Latvia changed government twice during the crisis, in December 2007 and March 2009, with each change bringing about substantial improvement.

8. *Political instability can be beneficial for finding an adequate leader* because the search for a new leader is often an iterative process. The potential ability of a leader is usually evident rather soon. If a new leader fails to gain credibility, he or she should preferably be ejected. This happens easily in a parliamentary system with a coalition government, but it is much more difficult in a presidential system or a parliamentary system ruled by a party with parliamentary majority. Since the old elite and its vested interests are the main problem, democracy is the best means to beat them (Åslund 2007). When reforms were ripe, the Latvian people voted for them in two parliamentary elections in 2010 and 2011, proving incorrect the common presumption that voters will throw out governments that pursue severe austerity programs.

9. *Parliamentary support* is necessary for legislation, but it can be minimal. The Latvian government has persistently been multiparty coalitions. It lost parliamentary majority in the summer of 2010 and was forced to an early election in the fall of 2011, but it was reelected.

10. *Outside expert policymakers* come to the fore during crisis resolution. Policymakers from outside the usual political circles are helpful for effective action because they have different knowledge and another perspective, not being prisoners of the old political game. Latvia's prime example was Finance Minister Andris Vilks, who was chief economist of the Swedish bank SEB in Latvia before joining the government. Prime Minister Valdis Dombrovskis himself benefited from being at a distance in the European Parliament before he took office in March 2009, and he hailed from the central bank with its environment rather isolated from daily politics.

11. *A comprehensive operative program for reform* is usually worked out immediately after a new government has been formed. Radical reform requires simplicity and lucidity rather than nuance. In a crisis, leaders must focus on key concerns

2. This notion was coined by Dornbusch, Goldfajn, and Valdés (1995) and Calvo (1998).

and not get distracted by side issues. They must concentrate on repairing the main pillars of the economy. The Latvian government elaborated its program from March until June 2009. It was reasonable, consistent, credible, simple, and not too large.

12. *The crisis measures should be heavily front-loaded*. The initial sense of crisis needs to be utilized. In 2009, Latvia carried out a fiscal adjustment of 9.5 percent of GDP out of a total adjustment of 17 percent of GDP. The front-loading helped restore confidence early on. Ironically, the Latvian government found the small adjustment in 2011 politically more difficult than the big cuts in 2009 because the popular sense of crisis had faded.

13. *Expenditure cuts are preferable to tax increases.* When the nation is in crisis, people realize that they have to tighten their belts, but they want to see the government tightening its belts as well. People facing falling incomes do not want to pay higher taxes for fewer public services. Moreover, large public expenditures impede growth—since they cannot be distributed evenly—while large cuts tend to drive structural reforms. The Latvian anticrisis measures consisted of large fiscal adjustment, primarily substantial public expenditure cuts and only minor tax increases, as well as substantial wage cuts, foremost in the public sector but also in the private sector.

14. A *social compact* is useful. The Latvian government pursued social dialogue in the spring of 2009. It created a reform management group, together with representatives of employers' organizations, trade unions, and local governments, while preparing proposals for the 2009 budget amendments and the 2010 budget. The painful budget cuts were agreed among all these parties that signed a social accord, which helped to maintain social stability.

15. *Equity* is essential. Latvia designed its adjustment program so that the burden fell disproportionately on the well-to-do, while securing social safety. The government prohibited double incomes for senior civil servants who served on public boards and cut salaries of top officials more than of junior public employees, with 35 percent salary cuts for ministers, while reinforcing unemployment benefits. It tried to cut pensions but far less than wages. Taxes focused on the wealthy, namely property taxes, capital gains taxes, and excise taxes on luxury goods, were introduced or raised.

16. *International support* and *sufficient finance* are vital. The key international institutions were the International Monetary Fund (IMF) and the European Union. They could deliver a large amount of financing fast without any legislative decision and they did. The existence of an IMF standby program was not a convincing argument for structural reforms in itself. It was rather a tool that the government could use for reform because it was interested in doing so, as Latvia did. Latvia received the early international support it needed from the IMF, European Union, and neighboring EU countries. In Lawrence Summers's (2011) words, "Program announcements that are vague and try to purchase stability on the cheap are more likely to exacerbate problems than to resolve them."

17. *Domestic ownership is important.* One of the current IMF ideas is that the government in a crisis country should exercise ownership of its anticrisis program. A contradiction, however, is that the IMF tends to dictate what a government has to do and withhold emergency credits if the country in question does not obey. The Latvian authorities, however, insisted on maintaining the currency peg against the dominant IMF view and won IMF approval even so. Thereby, Latvia assumed ownership of the stabilization program, which, Bank of Latvia Governor Ilmars Rimšēvičs emphasizes, was a major advantage.

18. *Early and decisive implementation of an anticrisis program* is important. Latvia, and the other Baltic states, did exactly that. The Latvian government jumpstarted the reforms, making clear to the population that the paradigm had changed. Since the anticrisis measures were heavily front-loaded, most crisis indicators peaked or bottomed out early (such as market interest rates, consumer confidence, international reserves, industrial production, and credit default swap rates), which bred confidence. It is better to be fast and slightly wrong than perfect and late.

Leszek Balcerowicz (1994) called the short political honeymoon of a new government in the midst of a crisis a period of "extraordinary politics," when the public accepts exceptionally radical reforms. Former Estonian Prime Minister Mart Laar has stated: "To wait is to fail." To quote Lawrence Summers (2011): "Where policy has succeeded…it has been based on clear actions exceeding the minimum necessary to stabilize the situation." Institutional economists claim that everything has to be built slowly and organically, but the opposite is the case in crisis resolution. It is like telling the fire brigade to drive slowly to a fire. The father of the German economic miracle, Ludwig Erhard (1957), carried out currency reform and deregulation in one big package in 1948, which explains its success, regardless of massive resistance.

19. *Salesmanship* and *transparency* are crucial. In the spring of 2009, Prime Minister Dombrovskis told the Latvian people how bad the situation was and offered two alternatives. He stated that one alternative was bad, and the other was worse, and he preferred the bad one. This downbeat determination

helped. Crises breed rumors and suspicion. Therefore, the government program must be public, clear, and readable, which the Latvian one was. The new program should be published in a regular newspaper and new reform ministers need to go out to the public and the media and explain the program over and over again.

20. *Policy review* and *measurement* are essential for policy focus. The regular reviews by the IMF and EU missions were difficult and unpleasant for the Latvian government, but they forced the government to stick to its program. Whatever is measured can be improved. Macroeconomic measurements have been well established for many years, but until the late 1990s business environment and corruption were not measured. Then multiple methods were found to quantify corruption, which have helped numerous countries to combat it, and it has started declining. The ease of doing business index (World Bank and International Finance Corporation 2011) greatly helped Latvia to reduce bureaucratic impediments in the crisis.

Some dogs did not bark. Social stability was maintained. Latvia had one day of riots on January 13, 2009, when about 200 rioters clashed with police in Riga, but no other riots occurred. The trade unions were not very aggressive, and after the crisis erupted no strikes or labor protests worth mentioning occurred. Latvia has a large Russian-speaking minority, but no ethnic tensions emerged.

Ultimately, policy reform is about restoring confidence in the state. The earlier sufficient reform measures are undertaken, the easier it is to establish government credibility. Latvia, like Estonia and Lithuania, managed to do this. Because most reform action was undertaken in the first half year of crisis resolution, no resistance surged and after half a year most crisis indicators had already fallen off their peaks.

DID THE SOUTH EUROPEANS FOLLOW THESE PRINCIPLES?

The quick answer is no. If they had, they would have been far along the crisis resolution path. Those who argue that these principles do not apply to the South Europeans tend to focus on the first five exogenous principles. First, the crisis in the South European countries was not as sudden and stark as it was in the Baltic states. The South Europeans experienced a relatively less dramatic output decline, which made it more difficult to get their policy act together at the early stage (figure 1). Second, the South Europeans did not suffer from a sudden stop causing abrupt output contraction in the fall of 2008 because as members of the Economic and Monetary Union (EMU) they enjoyed ample liquidity from the ECB. Third, the South Europeans are not as small in size as the Baltic states, even if Portugal and Greece are relatively small with a population of 10 million each. Fourth, only Greece had enjoyed significant growth in the decade before the crisis, while Italy and Portugal were close to stagnation. Fifth, the South Europeans are not as pro–free market as the Baltic citizens.

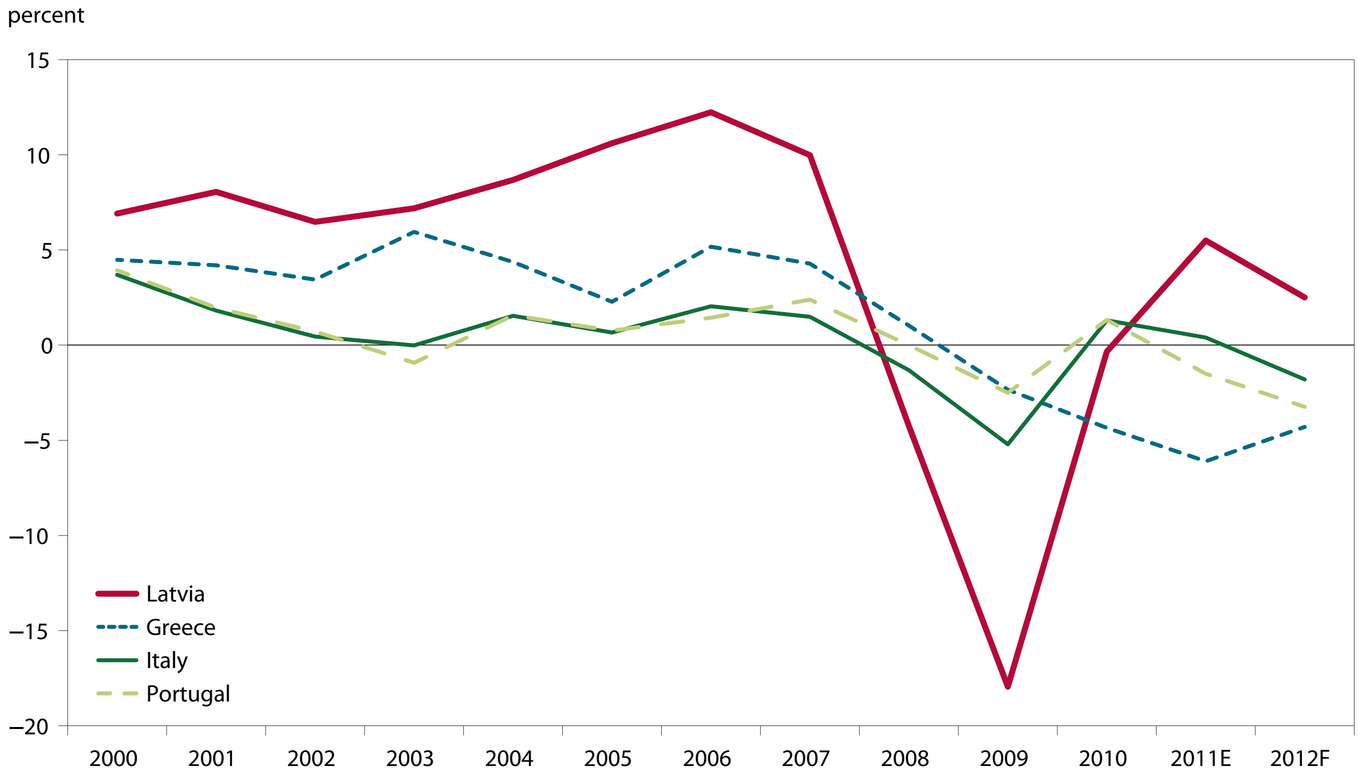
The South Europeans took their time to get a handle on their crises and now are paying the price of their leisurely approach.

It is true that these five exogenous preconditions do not apply to Southern Europe, but they do not tell the whole story. The South Europeans failed with regard to most other principles. This is the point I underscore in this Policy Brief. If they had reacted to the onset of their crises with Latvia's resolve and vigor, they would not be mired in their current deep troubles. They took their time to get a handle on their crises and now are paying the price for their leisurely approach. The slow, delayed, and insufficient Greek measures unleashed massive protests because the government did not convince the people that it was serious through early and firm actions. Greece raised taxes rather than cutting expenditures and even increased public employment from 2010 to 2011. Without serious expenditure cuts or even elementary structural reforms, growth was not likely to recover any time soon. The government ignored equity and did little to sell its program.

The South Europeans' latest programs appear more sensible than the initial programs but time, trust, and patience have been wasted. They are starting in the right direction but belatedly, more slowly, and incompletely. All the South European crisis countries have changed leaders, and their political instability has proven useful. Their new leaders have gained the necessary parliamentary support for new legislation, and especially Italy has appointed a new government of technocrats. With the exception of Greece, the South Europeans seem serious about selling their programs to the public.

Even so, there are substantial shortcomings in the South European anticrisis measures. To begin with, the politicians have been very coy about criticizing the real culprits, reflecting an insufficient break from the old, failed establishment. The South European anticrisis programs have not been very radical or front-loaded; their implementation has not been early or decisive either. While Latvia did 60 percent of its fiscal adjustment in the first year (2009), Greece did only one-quarter (in 2010). Tax increases have dominated over expenditure cuts, and not

Figure 1 GDP growth, 2000–12



E = estimate; F = forecast

Sources: IMF (2011a, 2012a, 2012b); JP Morgan Global Data Watch, March 2, 2012; Greece: Preliminary Debt Sustainablility Analysis, February 15, 2012, http://ftalphaville.ft.com.

surprisingly these additions to already high taxes have turned out to be difficult to collect. The South Europeans have not even tried to compose any social compacts, though that might have been difficult with their militant public sector trade unions. Still, their crisis programs seem nearly devoid of concerns about equity, which is a sure way to failure. Greece and Italy should cut the privileges of parliamentarians and top officials.

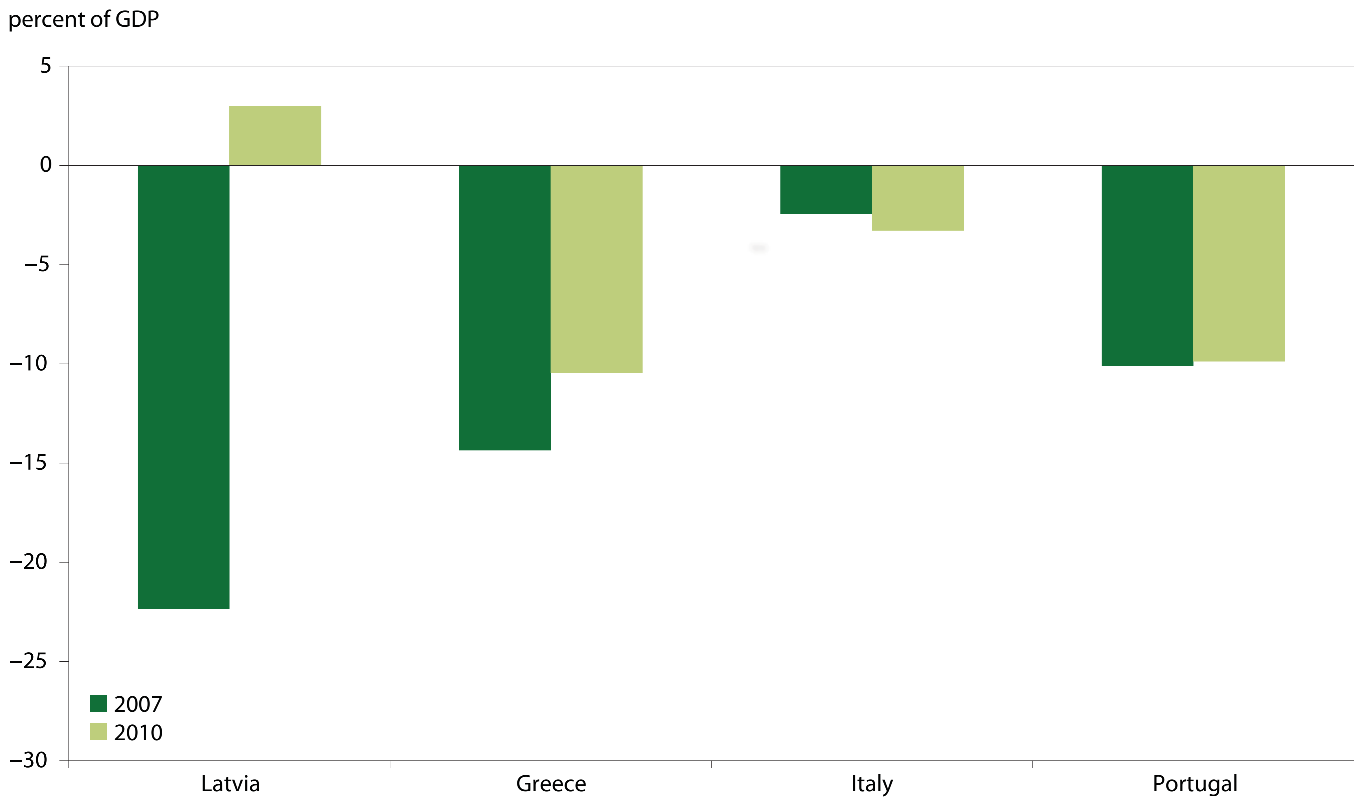
The international support and financing for Southern Europe have not only been sufficient but excessive, which led to the very soft initial anticrisis programs. EU and IMF largesse might be seen as a major cause of failure in the South European crisis resolution. Fortunately, the EU/IMF attitude has grown sterner over time as South European policy failures have become too conspicuous and money is running out. Repeated EU/ECB/IMF policy reviews and more accurate measurement of actual policy measures are driving the South Europeans in the right direction. Yet, as a consequence, the South European anticrisis programs enjoy less domestic ownership than the Latvian program did.

LATVIA OVERCOMES ITS MACROECONOMIC CRISIS

To drive home these points about Latvia's political economy, we also need an overview of the macroeconomic development. The growth pattern in Latvia and the South European countries is telling. While Latvia has not returned to its previous high growth, which was bolstered by excessive credit expansion, it reached 5.5 percent in 2011 and has clearly entered a significantly higher growth trajectory than the South Europeans for years to come (figure 1). In Europe, only the Estonian and Lithuanian economies grew faster that year. Portugal and Italy had slight growth in 2010, while Greece has ended up in a steady and deep recession set to last five years with a cumulative fall in GDP comparable to what Latvia endured. Both Italy and Portugal are mired in steady recession.

Latvia's current account deficit of 13 percent of GDP in 2008 turned into a surplus of 9.4 percent in 2009—an adjustment of no less than 22 percent of GDP in a single year. Admittedly, this improvement was caused by the absence of

Figure 2 Current account balance, 2007 and 2010



Source: IMF (2011a, 2012a).

external finance, but it proved possible. Greece and Portugal, by contrast, still had current account deficits of 10 percent of GDP in 2010, and Portugal showed no improvement at all from 2007 to 2010 (figure 2).

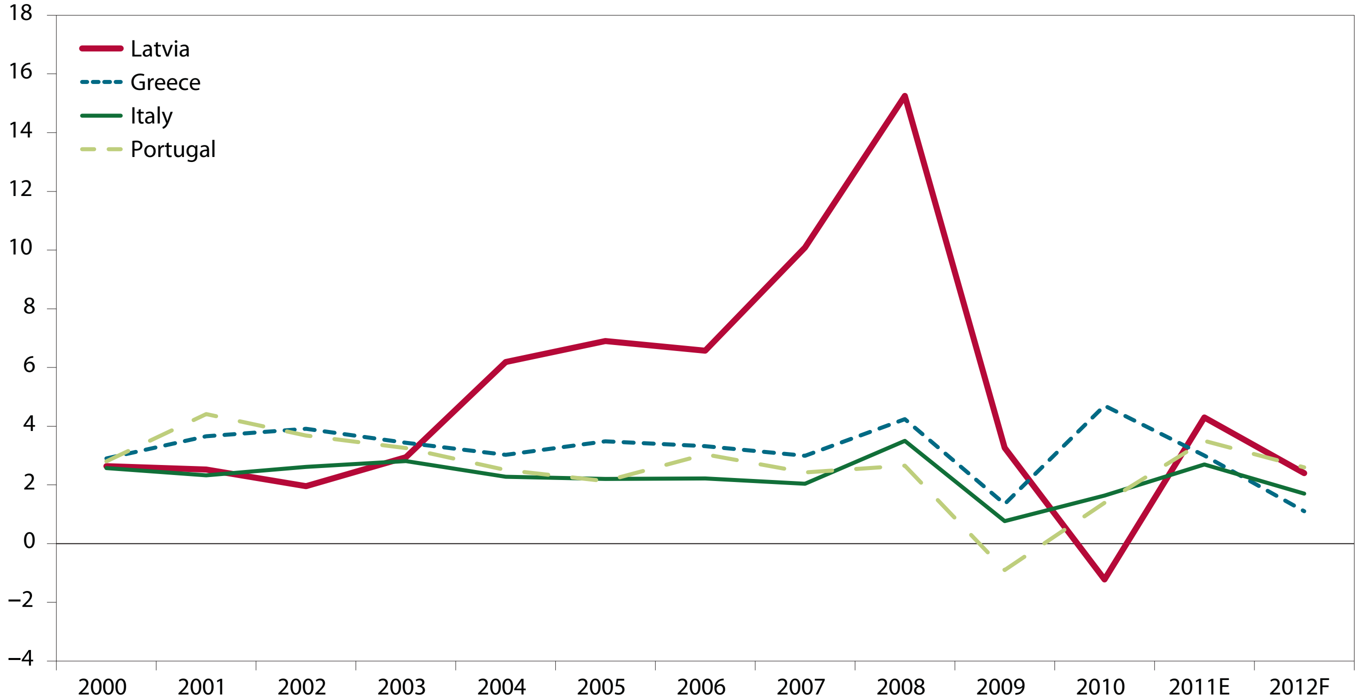
After peaking at 17.9 percent in May 2008, annualized inflation in Latvia fell sharply in the deflationary climate of the global recession because of credit contraction in 2009. Inflation in the South European countries was moderate in the range of 2 to 4 percent a year. In 2011, these countries had moderate inflation of 3 to 4 percent. The dangers of deflation and a deflationary cycle have been much exaggerated. In spite of its severe austerity, Latvia saw minor deflation of only 1 percent in 2009 (end year) because prices held up as most prices are set internationally for such a small and open economy. On the contrary, the real concern was that inflation rose to 4.3 percent in 2011, and it remains the greatest potential obstacle to Latvia's plans to join the EMU in 2014 (figure 3). The government aims to reduce inflation to 2.4 percent in 2012.

Latvia's budget deficit, which was minimal in 2000–2007, increased when the crisis hit because of falling output, but Latvia never had as large a budget deficit as Greece and Portugal. Its deficit peaked at 10.1 percent of GDP in 2009, while Greece had a deficit of 15.8 percent of GDP the same year. Shockingly, Greece had a budget deficit of 9 percent of GDP or more for four years and Portugal for two years. In 2012, Latvia is set to limit its budget deficit to 2 percent of GDP, while Greece plans to maintain a huge deficit of 7 percent of GDP. The actual Greek deficit is even bigger than expected. Greece and Portugal have simply not undertaken any major fiscal adjustment (figure 4). Therefore, it is little surprise that their public debts skyrocket and their output continues to contract.

Public expenditures as a share of GDP rose during the crisis. Before the crisis, the EU-15 had average public expenditures of 46 to 47 percent of GDP. Latvia saw its public expenditures rise as a share of GDP from 36 percent in 2007 to 44 percent in 2009. This expansion was largely caused by contracting GDP, rising pension costs, and other social costs related to increasing unemployment. Still, Latvia largely abstained from enterprise subsidies so common in Western Europe during the crisis, and now it is set to reduce public

Figure 3 Inflation, 2000–12

average consumer prices, percent change



E = estimate; F = forecast

Sources: IMF (2011a, 2012a); OECD *Economic Outlook* Database, December 2011.

Figure 4 Budget deficit, 2005–12

percent of GDP

Source: European Commission, Eurostat Statistics Database, http://epp.eurostat.ec.europa.eu (accessed on March 2, 2012); OECD *Economic Outlook* Database, December 2011; IMF Fiscal Monitor Update, January 2012; IMF (2012a).

Figure 5 Public expenditure as a share of GDP, 2005–12

E = estimate; F = forecast

Sources: IMF (2011a, 2011b, 2011c, 2012a); Ministero dell'Economia e delle Finanze (2011).

expenditures gradually toward their prior level. In Italy, Portugal, and Greece, by contrast, public expenditures were high from the outset and have stayed excessively high around 50 percent of GDP. Unlike Latvia, Southern Europe does not have a clear ambition to reduce public expenditures. For of all the Greek protests against "severe" cuts in public expenditures, they declined by only 3.3 percent of GDP from 2009 to 2011 (figure 5).

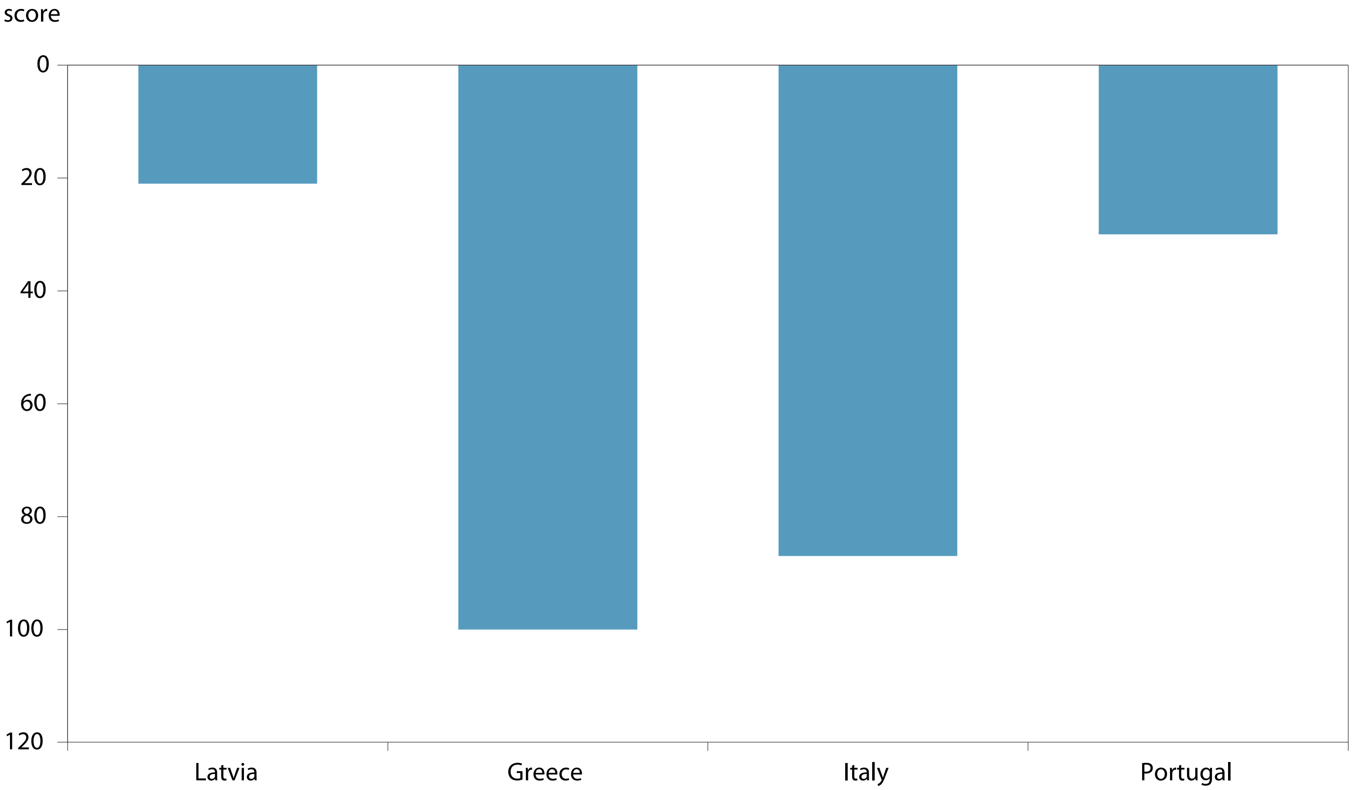
Based on these criteria (GDP growth, current account balance, inflation, budget balance, and public debt), it is evident that Latvia has overcome the macroeconomic crisis. It has returned to sound economic growth, although at a lower rate than before the crisis. The current account is approximately balanced. The budget deficit is moderate and set to fall further. In 2011, Latvia's public debt reached 43 percent of GDP, far below the Maastricht limit of 60 percent of GDP. The South Europeans, by contrast, remain in recession and have much of the crisis ahead of them.

In December 2011, the IMF (2011b) concluded its fifth and final review of its stand-by program with Latvia. Its verdict could not have been more positive:

> The economy is now recovering and growing strongly.... Competitiveness has improved, and the very large pre-crisis current account deficits have been corrected. The authorities maintained their long-standing peg to the euro and continue to pursue their goal of adopting the single currency in 2014. A very large fiscal consolidation effort through the program period—around 15 percentage points of GDP, the bulk implemented in 2009—has corrected a large structural fiscal deficit, and given Latvia strong prospects of meeting the Maastricht fiscal deficit criterion in 2012.

Latvia did not need to draw more than 60 percent of the emergency finance provided by the IMF, the European Union, other international financial institutions, and neighboring countries, abstaining from the last two IMF tranches for 2011. It successfully returned to normal borrowing from financial markets in June 2011, issuing ten-year eurobonds of $500 million at a yield of only 5.25 percent. The IMF assesses that Latvia will reach a budget deficit of 2.1 percent of GDP in 2012.

Figure 6 Ease of doing business ranking, 2012



Note: Lower score indicates greater ease of doing business.

Source: World Bank and International Finance Corporation, *Doing Business 2012* (accessed on March 2, 2012).

On June 5, IMF Managing Director Christine Lagarde (2012) went to Riga to celebrate the Latvian achievements:

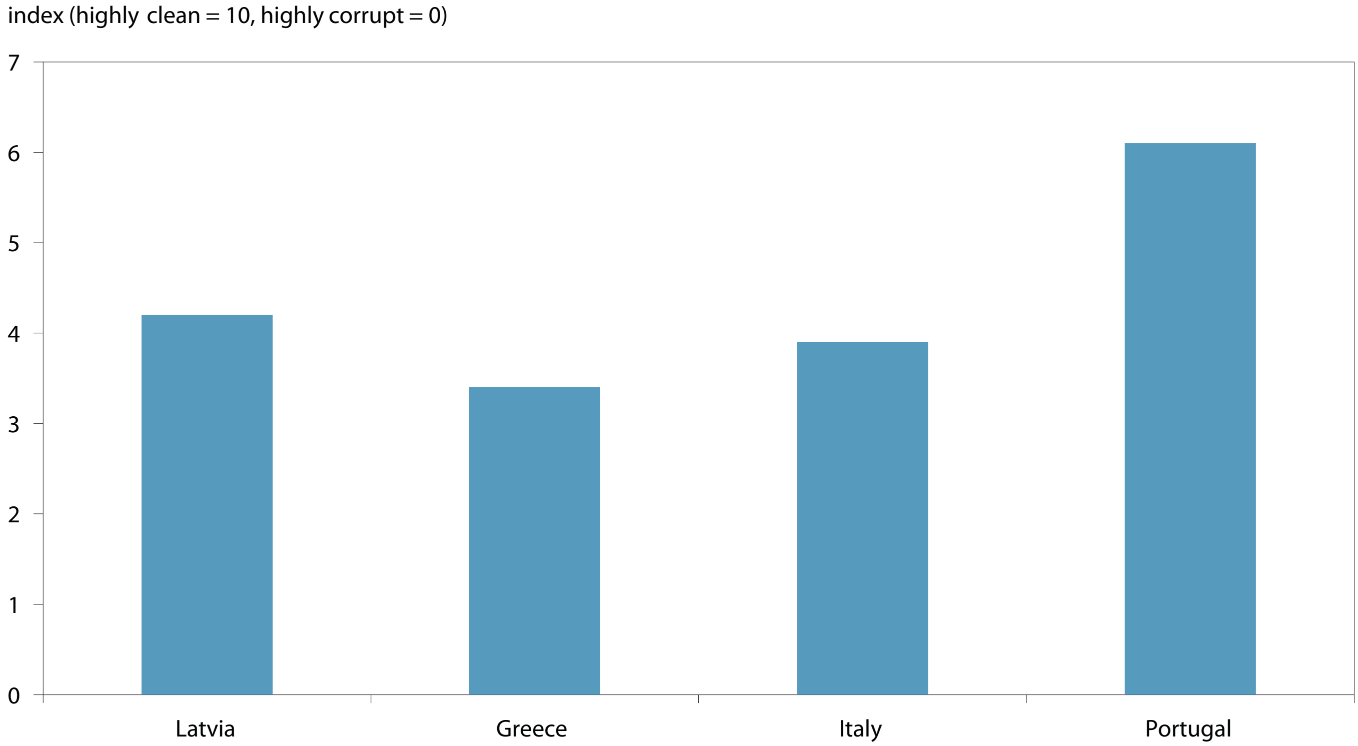
> … you [Latvians] have pulled through. You have returned to strong growth and reduced unemployment, even if it remains far too high at around 16 percent. You have lowered budget deficits and kept government debt ratios to some of the lowest in the European Union. You have become more competitive in world markets through wage and price cuts. You have restored confidence and brought down interest rates through good macroeconomic policies.
>
> We are here today to celebrate your achievements, but also to make sure that you can build on this success as you look to the future.

STRUCTURAL REFORMS IN LATVIA

Other indicators of relevance for Latvia's economic success reflect structural reforms likely to influence future growth. In most regards, Latvia had already advanced further in structural reforms than other countries at its level of economic development, which was one reason for its prior fast economic growth. In comparison with Greece and Italy, Latvia shines, and it has made significant progress during the crisis.

A first measurement of structural reform is ranking on the ease of doing business index (World Bank and International Finance Corporation 2011). Among the Central and East European countries, Latvia has taken the lead, advancing to number 21 among 183 countries. Since Latvia ranks 60 in the world in terms of GDP per capita in purchasing power parity, this indicates substantial capacity for further growth. Italy ranks 87 and Greece 100 (figure 6). In Latvia, recent reform measures have made it simpler to register property, resolve insolvency, pay taxes, start a business, and enforce a contract. A welcome result was that in 2011 the number of newly registered firms in Latvia increased by 18,041, or more than 10 percent, to 184,459. This was the highest number of new firms since 1994, reflecting a revival of entrepreneurship in Latvia.

Figure 7 Corruption Perception Index, 2011



Source: Transparency International, Corruption Perception Index , 2011 (accessed on March 2, 2012).

As a consequence of improved business conditions, corruption is abating. On Transparency International's Corruption Perception Index, Latvia ranks somewhat better than Greece and Italy, while Portugal is doing quite well. Combating corruption is more inert than deregulation (figure 7).

The large structural adjustments in Latvia have had considerable impact on real unit labor cost, which has been brought down by both nominal wage cuts and various forms of rationalization. In the whole of Europe, real unit labor cost has fallen most of all in Latvia by 16.4 percent from 2008 to 2011, while it has barely changed in Italy, Portugal, and Greece (figure 8). Naturally, this means greatly improved competitiveness for Latvia, while the South Europeans need to become more serious about reforms.

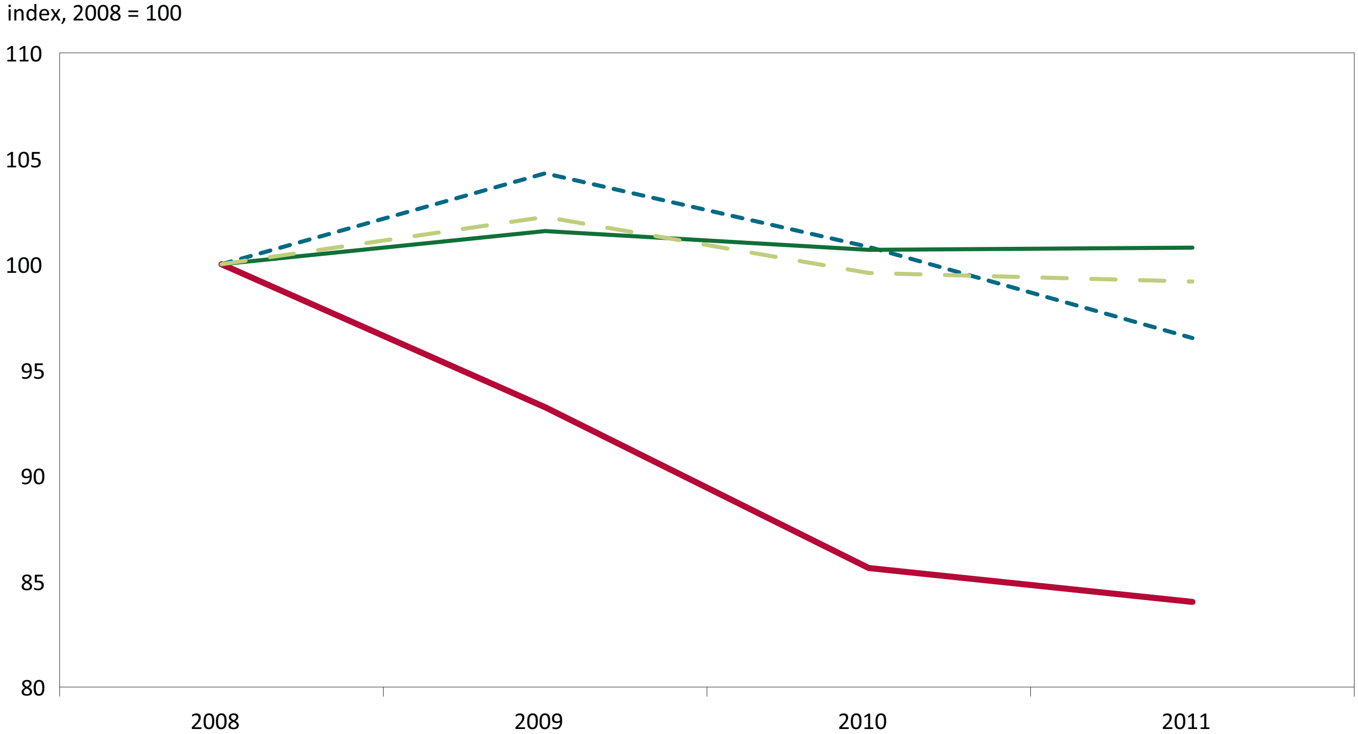
The real effective exchange rate (REER, based on unit labor cost) offers a similarly revealing picture. The differences from 2008 to 2010 are amazingly large. Again, Latvia stands out in the whole of Europe. Its REER fell by 17 percent, while the South Europeans actually registered a slight increase (figure 9). The variations over only two years are great, showing how much Latvia has increased its competitiveness through internal devaluation, which has incorporated both increased efficiency and reduced wages.

The most impressive effects of Latvia's crisis resolution are the most surprising. Exports have taken off: From the second quarter of 2010 until the third quarter of 2011, exports increased by 18 to 32 percent each quarter over the same quarter in the previous year. Meanwhile, Portugal and Italy saw their exports grow at a rate of 15 percent, and Greece not surprisingly lagged behind (figure 10). Export expansion led the recovery of output in all countries and it was driven by a similarly rapid increase in manufacturing.

The strong performance of Latvia's exports is surprising and leads to one major conclusion: Nominal depreciation is neither necessary nor beneficial for kickstarting exports, contrary to conventional wisdom. The actual choice was not between nominal depreciation and a stable real exchange rate but between nominal or internal devaluation. In 2008 and 2009, several economists and observers argued that Latvia had to devalue or that it would have been better for Latvia to have devalued (Hugh 2008; Krugman 2008a, 2008b; Roubini 2009). Fortunately, devaluation did not turn out to be necessary.

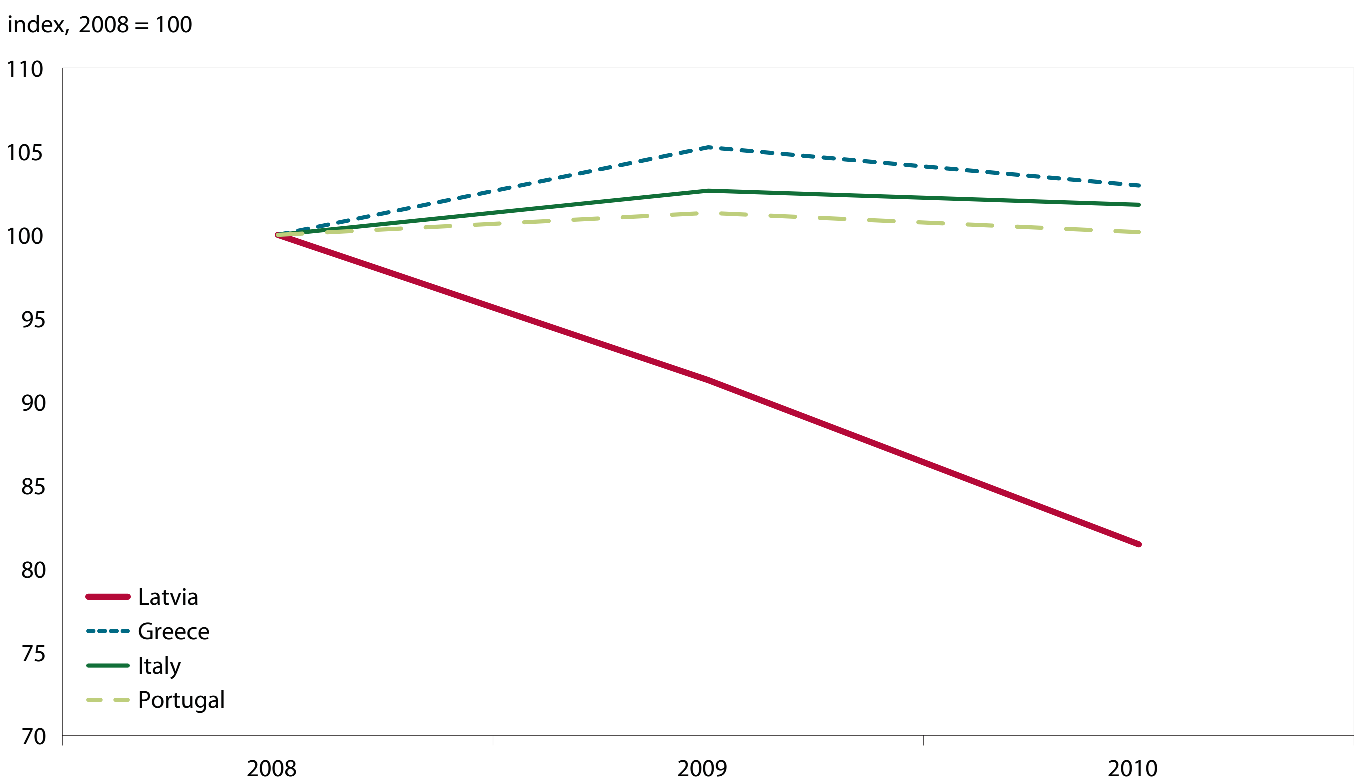
Zsolt Darvas (2011) compares the resolution of the banking crises in Iceland, Ireland, and Latvia and argues that

Figure 8 Real unit labor cost, 2008–11



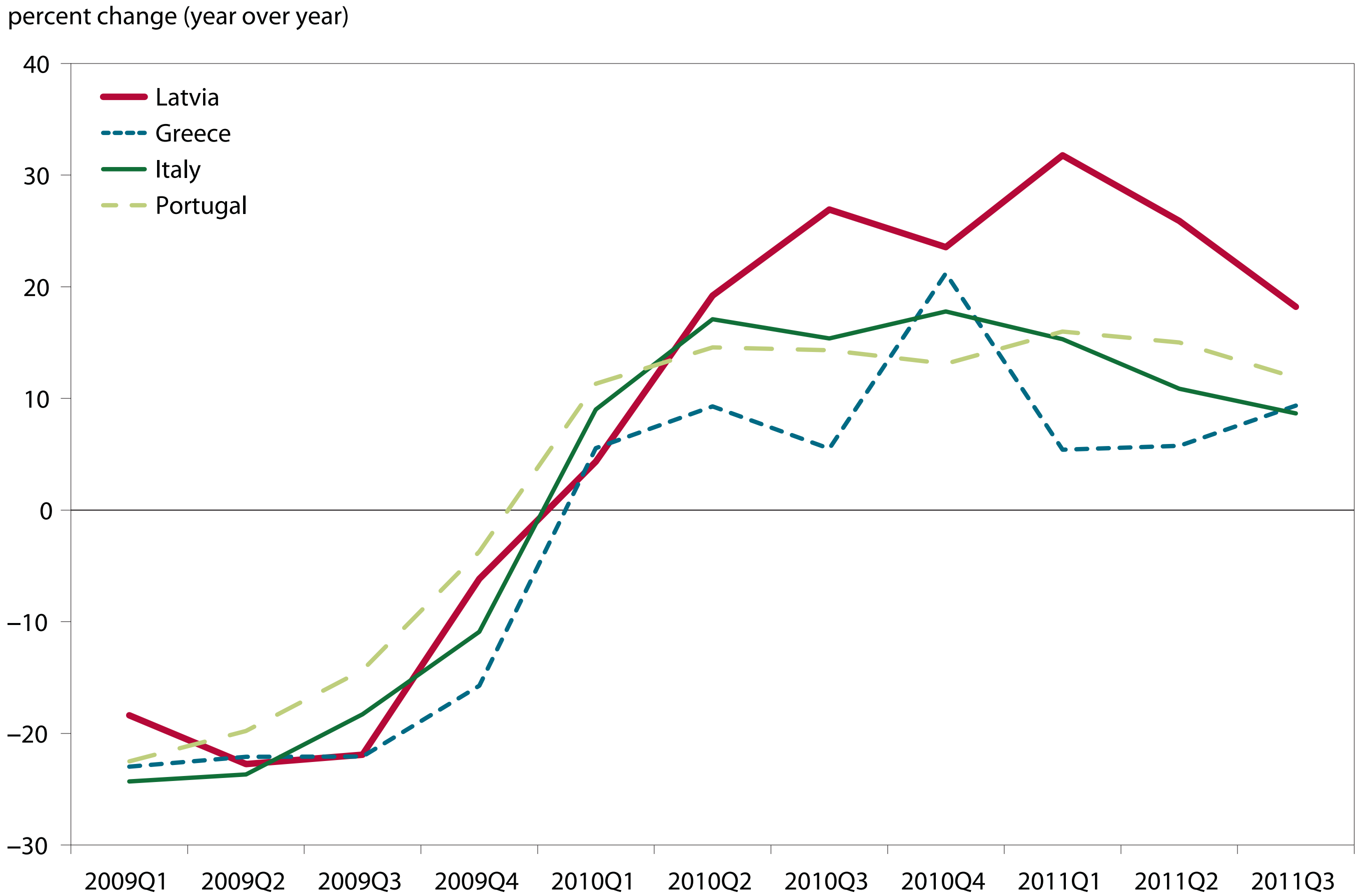
Source: European Commission, Eurostat Statistics Database, http://epp.eurostat.ec.europa.eu (accessed on February 28, 2012).

Figure 9 Real effective exchange rate, 2008–10



Source: European Commission, Eurostat Statistics Database, http://epp.eurostat.ec.europa.eu (accessed on March 2, 2012).

Figure 10 Total exports, quarterly data, 2009Q1–2011Q3



Source: European Commission, Eurostat Statistics Database, http://epp.eurostat.ec.europa.eu (accessed on March 8, 2012).

Iceland did better than Latvia because of a floating exchange rate and bankrupting of its banks. The preconditions and crises of these three countries, however, were so different that no such comparison offers any clear conclusion. For example, at the onset of crisis in Latvia, the IMF (2009, 5) assessed that Latvian output exceeded potential by no less than 9 percent in 2007, so output had to contract. Thus, for a fair comparison, we should deduct 9 percentage points from the Latvian output decline, which would reduce its cumulative output fall from 24 to 15 percent. The most important outcome is the long-term growth trajectory, which will not be known for many years.

Latvia's fixed exchange rates did not impede but facilitated radical adjustment. It forced Latvia to undertake more structural reform, proving that internal devaluation was a viable option and probably even advantageous. These observations offer considerable hope for the countries in the euro area in need of structural improvements, although they need to liberalize their labor markets to fully benefit. Maurice Obstfeld and Kenneth Rogoff (2001, 373) pointed out "the exceedingly weak relationship between the exchange rate and virtually any macroeconomic aggregates." The claim that devaluation is necessary for increased competitiveness is simply not true; other policies are more important. A corollary is that the need for major cost adjustment is not a reason to leave the euro area.

For future growth, investment in human and physical capital is vital. Given the level of development, an investment ratio of 25 percent of GDP or slightly more would appear appropriate for the region as a whole. During the boom, the investment ratio in Latvia was too high, peaking at 40 percent of GDP in 2006 and 2007. It plummeted, but not below 20 percent of GDP in 2009, since EU structural funding bolstered investment. Latvia's investment ratio already surged to 23 percent of GDP in 2011, and it seems likely to continue rising. By contrast, Southern Europe has far too low an investment ratio, and this is what Greece and Portugal have really cut (figure 11). Their investment needs to recover if they are to attain significant growth.

Figure 11 Investment as a share of GDP, 2005–11

E = estimate

Source: IMF (2011a).

As discussed above, all European countries need to trim their public expenditure to 35 to 40 percent of GDP to allow for sound economic growth (Sachs and Warner 1996, Tanzi and Schuknecht 2000). Fortunately, Latvia is on the way to doing just that, and conditions for future high economic growth have been recreated, but Southern Europe remains in a deep hole in most regards.

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