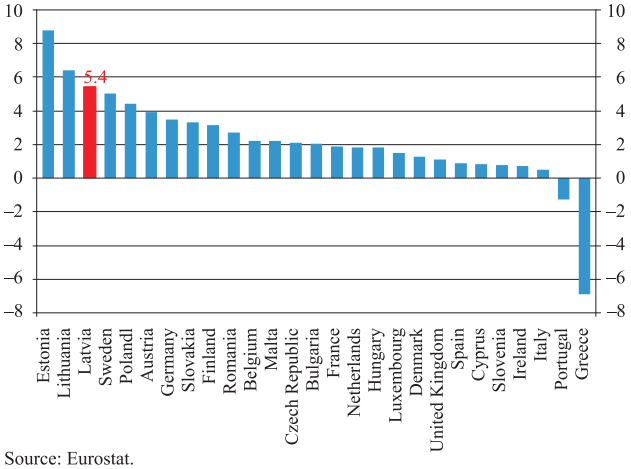
3. In Focus

Internal adjustment strategy proved to be successful

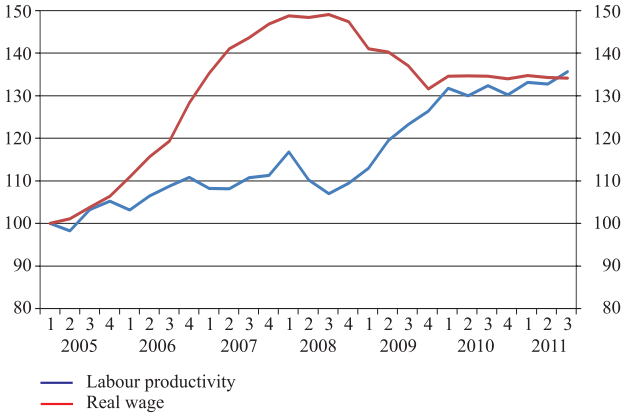
Over the recent years, Latvia experienced a severe recession; the recovery, however, proved to be fast and strong, quite in contrast to the expectations of a long and painful adjustment initially voiced by many economists. The internal adjustment strategy chosen by the Latvian authorities has proved successful. The EU/IMF-lead international financial assistance programme has helped to restore confidence and get the economy back on track. In 2008, only a few believed that the internal adjustment strategy would succeed and the adjustment mechanism under the fixed exchange rate regime was not understood by many; therefore, a long-lasting output decline was predicted. Although the implementation of budget austerity measures and structural reforms required an enormous effort on the part of the nation (fiscal retrenchment in the amount of 17.6% of GDP over the period of 2009–2011), the economy turned out to be sufficiently flexible to regain competitiveness through internal adjustment. With the improved cost competitiveness, the Latvian economy is expanding at a solid pace now; the GDP growth rate of 5.4% y-o-y achieved in the first three quarters of 2011 ranks Latvia among Europe's top performers.

Real GDP growth in the first three quarters of 2011
(%; y-o-y)



Source: Eurostat.

Real hourly wage and labour productivity per hour
(2005 Q1 = 100; seasonally adjusted)



Source: Central Statistical Bureau of Latvia.

Many imbalances were corrected in a timely manner and the economy re-adjusted towards a more export-oriented model. Owing to the high degree of labour market flexibility nominal wages have declined significantly and, in combination with productivity improvements, have ensured gains in price competitiveness. Cost optimisation and enhanced productivity contributed to the closing of the wage-productivity gap. External imbalances have been corrected rapidly. Latvia's market shares in major trading partner countries have increased over the last two years owing to competitiveness gains boosting the exports since 2009.

The international financial assistance programme was successfully completed at the end of 2011, with the IMF acknowledging that Latvia has achieved better shock resistance for the economy as compared to the period before the 2008 global economic crisis. Latvia did not draw on the residual funds in 2011 and overall has used only about 60% of the allocated programme funding. Instead, Latvia has re-established its name in capital markets by releasing already two successful and oversubscribed bond issues on the international capital markets.

As a sign of returning confidence, Latvia was able to tap the international financial markets in June 2011 with a 500 million USD worth 10-year bond issue and just recently with a one billion USD worth 5-year bond issue. The former was Latvia's first international bond issue since early 2008 with investors' aggregate bids exceeding the supply sevenfold, whereas the bid-cover ratio stayed close to 6 for the most recent issue. These deals were important milestones for Latvia. Taking into account the breadth and depth of investor interest, it could be interpreted as a sign of recognition of Latvia's accomplishments in stabilising its economy.