3. In Focus

"Country workshop: EU Balance-of-Payments assistance for Latvia: Foundations of Success" 01.03.2012

Last month a workshop in Brussels was taking stock of the last three years of EU/IMF supported stabilisation in Latvia and the policy path taken. Workshop materials are now available at http://www.macroeconomics.lv/summary-and-presentations and http://www.macroeconomics.lv/video-1

The overall conclusion was that in the Latvian case the internal adjustment worked well: the country has regained competitiveness, its fiscal house has been put in order, and – alongside with the other Baltic countries which have undergone similar adjustment processes – Latvia is among the leaders in Europe in terms of growth and job creation. Latvia is now preparing for the adoption of the euro, targeting the year 2014. Ilmars Rimsevics, the Governor of the Bank of Latvia, said that the book on Latvian crisis resolution will be completed when the country introduces the single currency.

"Mission impossible" turned out to be possible thanks to speed, ownership, commitment, and solidarity. Fiscal contraction can be expansionary in a small and open economy if you do it resolutely and early in the crisis, focusing on expenditure cuts rather than tax increases and if it is supported by the pull of external demand.

But a snapshot of recent developments also included a look at **the origins of the recent crisis**. The pre-crisis growth in Latvia was fuelled by massive capital inflows, building up excessive demand and a real estate bubble (GDP grew by 34% during 2004-2007 and contracted by 21% during the recent crisis).

Why was devaluation not a solution for Latvia as many suggested at the outset of the recent crisis, at the end of 2008? High import content in exports and domestic production, any competitive gains largely outweighed by a surge in input costs; lack of domestic substitutes for a large part of consumer goods. No immediate improvement in the current account as the Marshall-Lerner condition is not met. High share of FX liabilities: many corporates would face negative equity immediately. Inefficient insolvency procedure and a court system incapable to cope with a sharp increase in insolvency cases. Hence, the result of devaluation would have been: much larger costs to the economy, loss of credibility and a likely run on banks, resulting in a collapse of the domestic banking system.

Internal adjustment was the only path to follow. Time bought for structural reforms that make adjustment smoother; improved public sector efficiency. Less corporate bankruptcies reduce costs for the economy and the more gradual adjustment motivates businesses for productive improvements. Latvia's economy is reasonably flexible and capable to adjust; by and large the society understands the root causes of the crisis and supports the necessary austerity measures and reforms.

Results. The Latvian economy has been steered back to growth in a "V" shaped recovery: benefiting from the internal adjustment and fiscal consolidation started at an early stage and underpinned by structural reforms that supported competitiveness. A protracted recession, predicted by many, has been avoided.

GDP growth reached 5.3% in 2011 and was among the fastest in Europe. More importantly and in contrast to countries that devalued and imposed capital controls, Latvia experienced a strong recovery in investments that make its future outlook much brighter. The current forecast scenario has Latvia complying with the Maastricht criteria as of the beginning of 2013; **the aim of introducing the euro in 2014 is thus well within reach**.