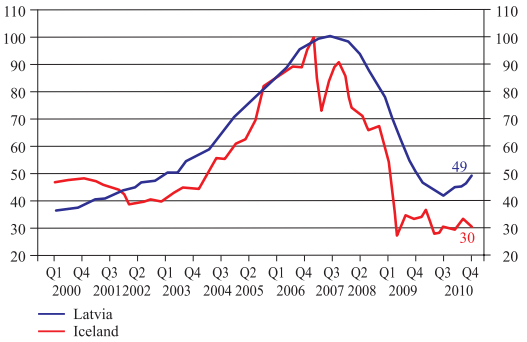
3. In Focus

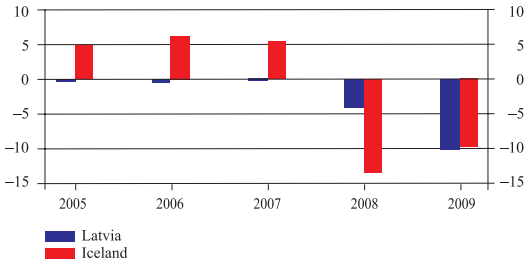
Latvia vs Iceland: some insight into adjustment under different exchange rate regimes

Real gross fixed capital formation
(pre-recession peak = 100)



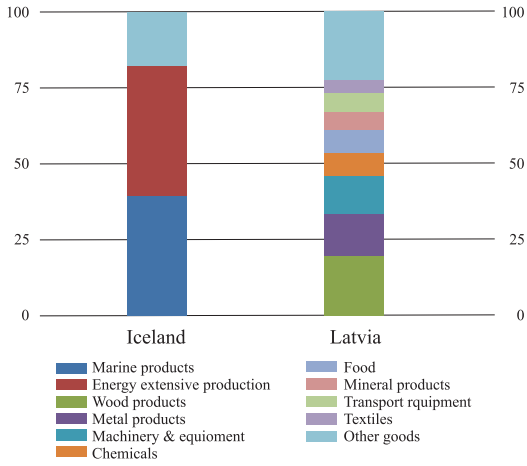
Data source: Eurostat, seasonally adjusted data.

General government budget balance
(% of GDP)



Data source: Eurostat.

Breakdown of merchandise exports
(%)



Data source: CSB Latvia, Statistics Iceland.

Latvia and Iceland occasionally are used as recent examples of economic adjustment under two different exchange rate regimes, namely fixed vs floating. Some economists claim that Iceland, allowing for a nominal depreciation, has fared the recent crisis much better than Latvia, as suggested by a less severe drop in GDP and employment. In this short note, we will try to shed some light on the actual developments to see whether the answer is as simple as that.

First of all, although the overall GDP drop was steeper in Latvia compared to Iceland, this masks diverse developments in its sub-components across both countries. In particular, consumption decline was very similar in both countries. At the beginning of this year, private consumption reached 76% and 74% of the pre-recession peak in Iceland and Latvia respectively. While Latvia experienced a nominal wage decline, in Iceland the real income was compressed by depreciation-related inflation. A similar pattern was observed also in import developments of both countries. Investment, another component of GDP, showed an even stronger decline in Iceland. At the beginning of this year, investment stood at 49% of the pre-recession peak in Latvia, while in Iceland it reached only 30%. However, Iceland performed much better in terms of public consumption and exports resulting in a less severe decline of the Icelandic GDP. While the former was largely related to a much stronger fiscal performance during the run-up to recession (Iceland refrained from building up an unsustainable level of public expenditure during the boom years and ran 5–6% of GDP budget surpluses), the latter, indeed, relied on exchange rate depreciation. However, Iceland was rather an exception to this end, as all other European countries that experienced large depreciations recorded rather strong export declines. For example, real exports of goods and services expanded by nearly 7% in Iceland in 2009, but they contracted by more than 13% in Sweden (on par with Latvia) and by some 10% in the Czech Republic, Hungary and the UK. This could be at least partly explained by the Icelandic export structure that is dominated by natural resources, namely, marine products and energy intensive production building on the use of geothermal energy. For this reason, the Icelandic exports presumably rely more on domestic and less on imported inputs; therefore, depreciation has a much stronger positive effect on exports.

To conclude, both countries have suffered significantly during the recent crisis; however, conclusions regarding the factors affecting performance differences cannot be made based only on aggregate data. The Icelandic GDP (and employment) has dropped less compared to Latvia, but this was due to Iceland-specific factors. Moreover, there are considerable differences looking forward. The Latvian economy and particularly investment have started to recover; our exporters have regained competitiveness in external markets and Latvia currently ranks among top performers in Europe in terms of export and manufacturing expansion. In Iceland, however, investment remains at an extremely low level hinging on future growth prospects, whereas the recent export performance is not encouraging. In addition, Iceland has still to unwind capital controls and restructure its private sector balance sheets (significantly impaired by depreciation), which is associated with capital outflow risks and a potential new wave of bankruptcies.