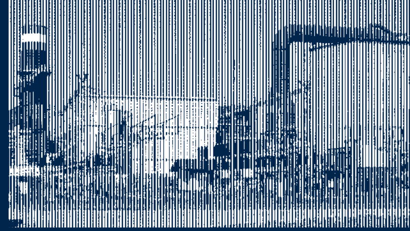
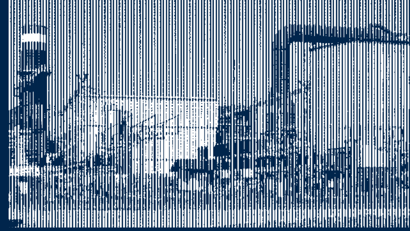
INDEX



Mārtiņš Bitāns

LATVIA'S ECONOMIC DEVELOPMENT FOLLOWING THE ACCESSION TO THE EUROPEAN UNION: A CLASSIC BOOM-BUST CYCLE



Mārtiņš Bitāns

LATVIA'S ECONOMIC DEVELOPMENT FOLLOWING THE ACCESSION TO THE EUROPEAN UNION: A CLASSIC BOOM-BUST CYCLE

OFFICIAL BACKGROUND

Following a positive popular vote at the 2003 referendum, Latvia along with both other Baltic States became a fully-fledged EU Member State on 1 May 2004. This date became a significant milestone also with regard to further economic development, as upon the EU accession Latvia also started to enjoy fully all the fundamental economic freedoms of the EU (free movement of goods, capital and people)[1]. Work on harmonisation of legislation began already long before the EU accession, yet significant economic shifts occurred in Latvia only after 1 May 2004.

Latvia's joining the EU did not cause any major changes in the daily routine of the Bank of Latvia. The main legal provisions within the competence of the Bank of Latvia that had to be harmonised concerned the identification and elimination of restrictions on cross-border capital flows as well as the strengthening of the central bank independence and price stability as the main objective of the central bank. Nevertheless, as the provisions of Latvian legislation had already been largely tuned to the letter and spirit of the EU at the moment of their implementation, no significant changes were required. At the referendum, the population of Latvia also voted on Latvia's accession to the euro area (conditional upon meeting certain eligibility criteria). One of the criteria is the requirement that prior to joining the euro area any EU Member State has to participate in the exchange rate mechanism (ERM II) for at least two years.[2]

The main changes to the policy implemented by the Bank of Latvia were related to the re-pegging of the lats from the SDR basket of currencies to the euro. Key questions to be dealt with concerned the establishing of the peg rate and selecting the maximum fluctuation band (although the ERM II provides a standard fluctuation band of ±15%, Member States may unilaterally commit themselves to a narrower fluctuation band).

Having considered several options, the Council of the Bank of Latvia resolved to prevent any manipulations with the exchange rate. Latvia joined the ERM II based on the market rate of that specific time (the rate of the euro vis-á-vis the respective currencies of the SDR currency basket) and maintaining the existing fluctuation band of ±1%. The main argument in favour of this decision was the conviction that the fixed exchange rate regime had proven successful in Latvia and was beneficial to small and open economies, such as Latvia. Moreover, in the process of preparing for participation in the ERM II a decision was taken well in advance that the Bank of Latvia would not engage in any speculations and would not attempt to guess the universally "optimal" exchange rate. The Bank of Latvia rather believed that it was more important to provide as detailed as possible information about the envisaged changes in the exchange rate regime and allow for a sufficiently generous time period during which all the necessary preparations and adjustments by the population and businesses could be made.[3]

Latvia joined the ERM II on 2 May 2005 with the central rate vis-á-vis the euro set at 0.702804. The Bank of Latvia made a unilateral commitment to intervene in the foreign exchange market should the exchange rate of the lats against the euro deviate from that official exchange rate by more than 1% on either side. Formally, this agreement on Latvia's participation in the ERM II also provided for potential ECB interventions should the lats exchange rate vis-á-vis the euro deviate from the official rate by more than 15%, yet, considering the strategy pursued by the Bank of Latvia, no interventions by the ECB were required.

When joining the ERM II, Latvia's economic policy makers additionally made several additional commitments that, strictly speaking, did not entail any legal implications, yet provided a good measuring stick of the country's economical and political maturity. The main commitment was to contain and limit any inflation pressures in Latvia. After pegging the lats to the euro, the monetary policy instruments continued to lose their effectiveness; therefore, the government of Latvia pledged to implement counter-cyclical fiscal policies in combating inflationary risks. When joining the ERM II, Latvia committed itself to limiting any excessively rapid lending expansion and to preventing any wage rises that substantially exceed productivity improvements.[4]

It has to be stressed that these were not just another set of requirements imposed by the EU and almost forced on the Latvian authorities. This was the commitment of Latvia's government to implement policies tailored to the particular economic situation in Latvia. Yet in the course of time many of those initial promises started to lose importance in the eyes of the economic policy-makers as other priorities came to the forefront. At the beginning, the economic policy-makers themselves as well as several experts believed that this carefree attitude would do no serious harm. Ignoring the basic rules of economics turned out to be a grave mistake, however, and the price to pay for this mistake was rather high.

WHAT HAPPENED IN THE ECONOMY?

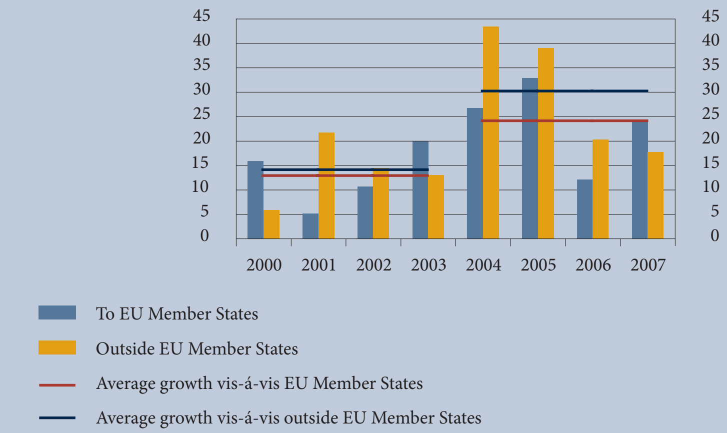
One of the principal economic freedoms in the EU is the free movement of goods. Thus one of the most important effects caused by Latvia's accession to the EU was a significant increase in foreign trade. Although the trade in goods in Latvia became rather liberal already following the restoration of independence and the approximation of Latvia's legislation with the EU *acquis communautaire* began already long before the EU accession and, therefore, the positive trade integration effect was felt already in the previous years, a steep rise in the foreign trade turnover was observed specifically from 2004 when Latvia joined the EU.

In 2000–2003, Latvia's exports to the EU Member States increased by an average of approximately 13% per year, with the overall rise in the period of four years exceeding 60%, whereas within the next four years after the accession Latvia's export growth to the EU Member States almost doubled, on average reaching 24% per year (see Chart 1). It is important to note that the export expansion towards the EU Member States did not happen at the expense of the rest of the world. Latvia's exports to third countries grew even more rapidly than those to the EU Member States. Before Latvia's accession to the EU, exports to third countries evolved similarly to exports to the EU Member States (an average annual increase of 13%), whereas after Latvia joined the EU the average rise in exports outside the EU exceeded 30%. Consequently, the EU accession not only simplified significantly the trading with other EU Member States, but also provided Latvia with an opportunity to negotiate better terms of trade also in business with third countries, particularly with the CIS countries.

In Latvia's case, another economic freedom (free movement of workers within the EU) manifested itself primarily as emigration of working-age population to those countries which were the first to open their borders to labour flows and where the average wage was considerably higher than in Latvia. According to the official statistics, approximately 15 thousand people left Latvia for abroad within the period of 2004–2007 (which is not much more than during similar periods before), yet several estimates suggest that the real number of emigrants could be considerably higher.[5]

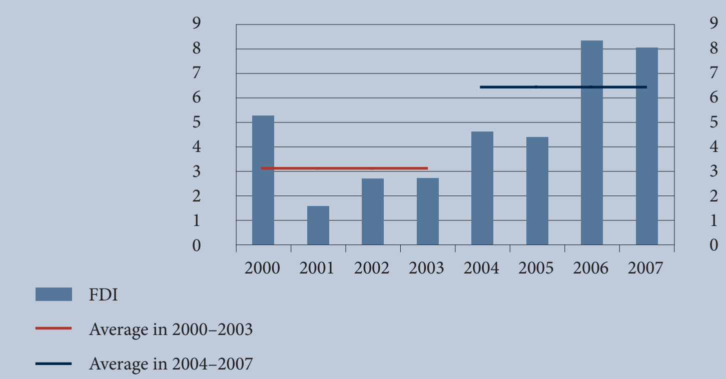
This is implicitly confirmed also by the balance-of-payments data on cross-border money transfers by population. With the working-age population leaving the country to work abroad after the EU accession and repatriating part of their earnings, the average value of international transfers grew from about 5% of GDP to 7% of GDP. That boosted the cash inflows into Latvia and supported subsequent economic overheating. A decline in the free labour force in Latvia was an additional consequence of the emigration of population. This effect was less

Chart 1. ANNUAL GROWTH OF LATVIA'S EXPORTS OF GOODS (2000–2007; %)



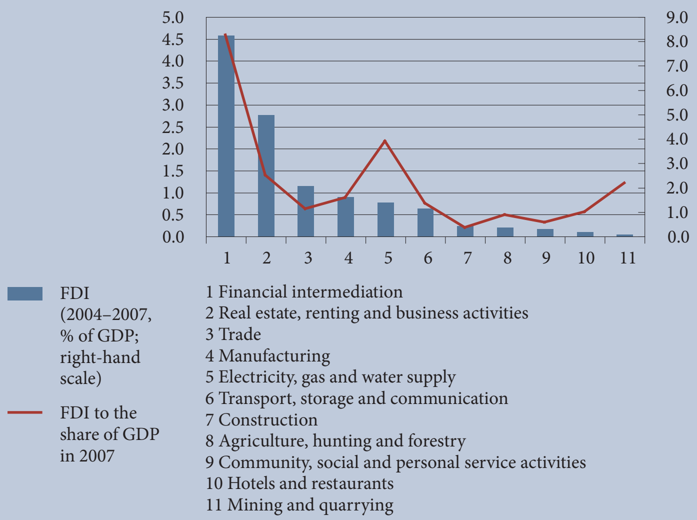
Source: CSB.

Chart 2. FDI INFLOWS IN LATVIA (2000–2007; % of GDP)



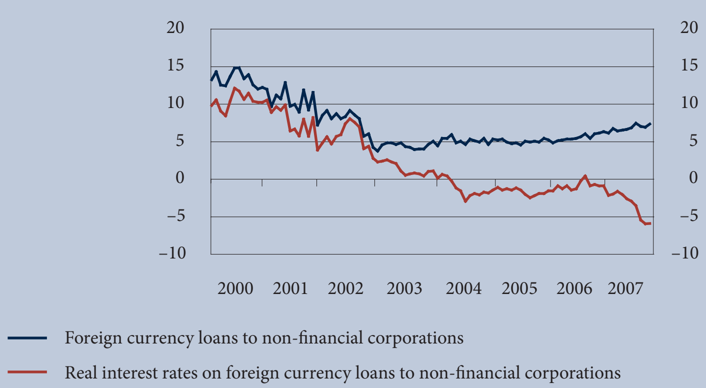
Source: Bank of Latvia.

Chart 3. FDI IN LATVIA BY SECTOR (2004–2007)



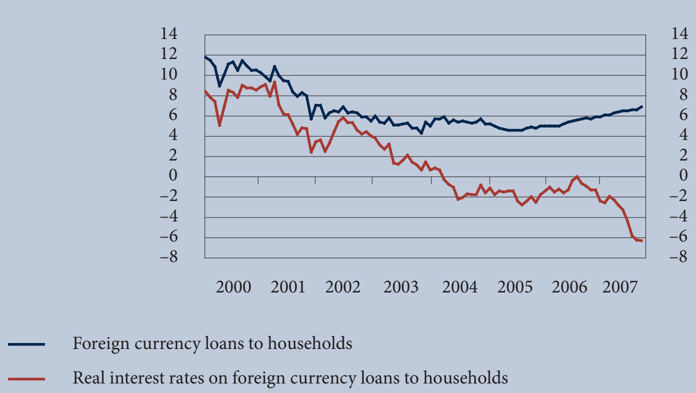
Sources: Bank of Latvia and CSB.

Chart 4. WEIGHTED AVERAGE INTEREST RATE ON LOANS TO RESIDENT NON-FINANCIAL CORPORATIONS (2000–2007; %)



Sources: Bank of Latvia and CSB.

Chart 5. WEIGHTED AVERAGE INTEREST RATE ON LOANS TO RESIDENT HOUSEHOLDS (2000–2007; %)



Sources: Bank of Latvia and CSB.

obvious, yet its impact on the build-up of economic instability was probably much stronger than that of the increase in cross-border transfers.

Moreover, with the EU accession Latvia convincingly and irrevocably left the grey geopolitical area it had lingered in since the collapse of the USSR and the restoration of the national independence and joined an economic area with clearly-defined and generally known operational principles. Also the lifting of the remaining restrictions on capital movement vis-á-vis other EU Member States created friendly environment for long-term investment in Latvia; therefore, the amount of foreign direct investment increased significantly from an average of 3% of GDP within the period up to 2003 to more than 6% of GDP on average in 2004–2007; see Chart 2).

Foreign direct investment inflows went mainly to the financial sector, real estate activities and trade (see Chart 3).

Latvia's accession to the EU had a significant effect also on the perceived risk premiums in the financial markets. With the uncertainty subsiding and confidence in the economy and the profitability of investments on the rise, the lending rates available to Latvia's population and corporates declined considerably. The decision of several Scandinavian banks to buy majority stock at almost all Latvia's biggest banks also was of great importance, thereby significantly increasing the amount of available resources in Latvia. Although the major Latvian banks became the property of foreign investors already prior to Latvia's accession to the EU, lending started to explode only after Latvia's official EU accession.

Even though the nominal interest rates available to the average borrower in Latvia were still slightly higher than those offered to a similar borrower in, for example, Germany, considering the fact that the inflation in Latvia was higher than in Germany, the interest rates available in Latvia were actually among the lowest in the EU in real terms (taking into account both the nominal interest rates and the expected inflation). The attractive rates encouraged borrowing, thereby increasing inflation, pushing the real lending rates even lower and fuelling even higher appetite for borrowing (see Charts 4 and 5). All this set the merry-go-round of credit boom spinning fast and it was additionally stimulated also by several other factors: mass privatisation of apartments, the establishment of the Land Register etc.

To finance the credit expansion, Latvian banks increased their leverage significantly. Considering the relatively limited domestic borrowing options (domestic savings rate was traditionally low; moreover, the falling interest rates also did not support the growth of deposits), the banks financed their lending activities mainly through their foreign affiliates (parent banks) as well as using syndicated loans from the foreign banks. Within the period of 2004–2007, the average annual foreign borrowing of Latvian banks exceeded 17% of GDP. Moreover, at that time several Latvian companies borrowed in foreign financial markets without the intermediation of banks (an average annual amount of over 4% of GDP; see Chart 6).

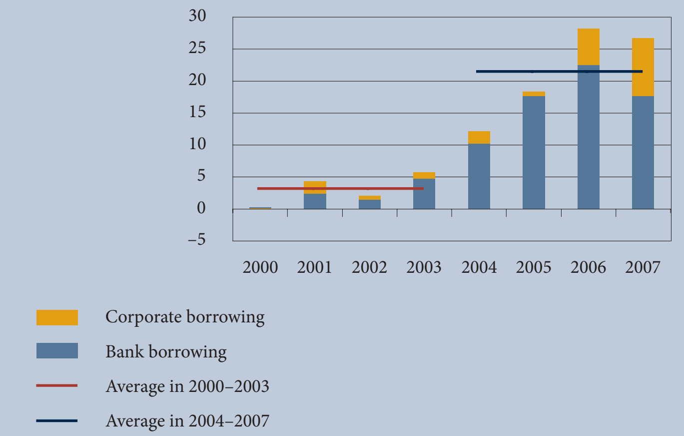
Overall, after the EU accession the financial inflows into Latvia through those various channels (international borrowing by banks and companies, foreign direct investment, private cross-border payments) reached exceptionally high levels. Financial inflows of such a magnitude affected Latvia's overall development because it is a small economy. Starting from 2005, the GDP growth accelerated considerably against the background of the rapidly growing domestic consumption and reached double-digit figures (see Chart 7).

Overall, in the period 2004–2007 Latvia's economic growth was the fastest in the EU and one of the fastest in the world (see Chart 8). Other Baltic States also reported high growth rates within that period. Against this background, the success story of the "Baltic tiger" became increasingly more popular among politicians and economic experts, with the central question being the number of years it would take for Latvia and other Baltic States to catch up with the living standards of the developed EU countries. A period of 10 years was most often quoted as the average required time-span to reach this objective. Analysts from international organisations, so cautious on other occasions, also gave in to the general euphoria and came to believe that this episode of rapid economic growth was a long-term phenomenon.[6]

This optimism is understandable and can be explained: in the context of free liquidity and a shrinking pool of free labour force (inter alia supported by labour emigration), wages increased significantly, often exceeding the productivity growth as the businesses struggled to retain their staff (see Chart 9). At the beginning, however, the steeply rising wages did not cause any significant complications to the businesses as the peaking domestic demand fuelled by higher wages more than offset the increasing labour costs, pushing up the output prices. As a result, many sectors even saw an improvement in profitability in 2005–2007.

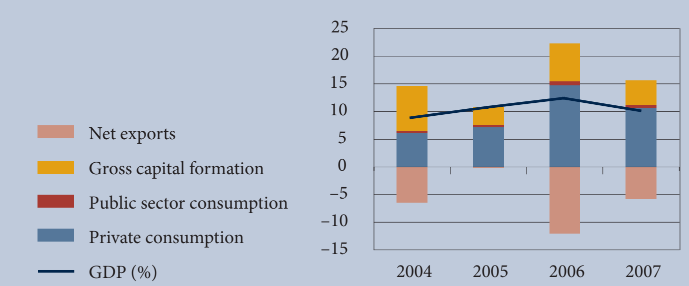
The probability that the economy could continue to develop this way in the long-term seemed realistic. However, on the back of the vigorous growth, the first tentative signs appeared and became stronger year-by-year that in the absence of any preventive measures this particular growth model, based on domestic demand and sustained by lending expansion, would create serious problems to each and every inhabitant of Latvia already in a not-so-distant future.

Chart 6. FOREIGN BORROWING BY BANKS AND CORPORATES (2000–2007; % of GDP)



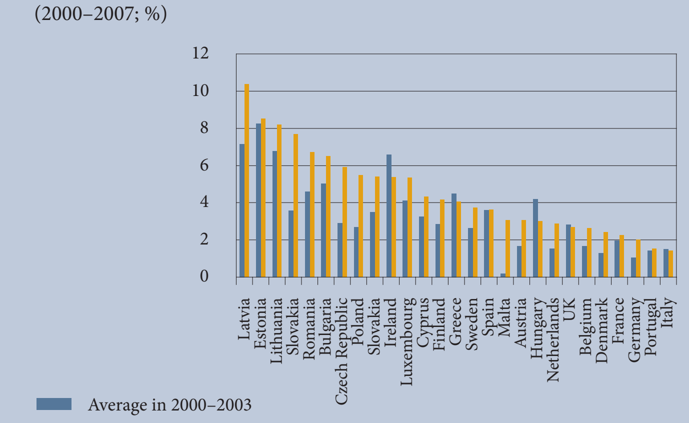
Sources: Bank of Latvia and CSB.

Chart 7. CHANGES IN LATVIA'S GDP BY MAIN DEMAND COMPONENTS (2004–2007; percentage points)



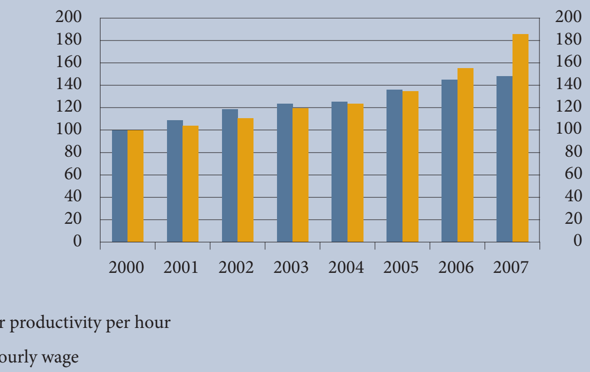
Source: CSB.

Chart 8. AVERAGE GDP GROWTH RATES IN EU MEMBER STATES (2000–2007; %)



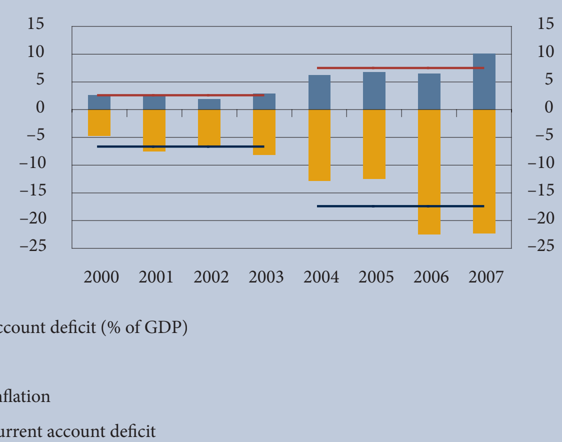
Source: Eurostat.

Chart 9. LABOUR PRODUCTIVITY AND WAGES DEVELOPMENT IN LATVIA (2000–2007; 2000 = 100)



Source: CSB.

Chart 10. DEVELOPMENT OF THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS AND INFLATION IN LATVIA (2000–2007; %)



Sources: Bank of Latvia and CSB.

With currency in circulation growing faster than the economy's capacity to absorb it, money depreciated inevitably, i.e. inflation increased. This was even further exacerbated by the price/wage spiral (in the circumstances of growing wages, production costs increase and that, in turn, makes businesses raise the prices on their outputs, thereby causing demand for higher wages etc.). The average annual inflation grew from 2.9% in 2003 to over 6% in 2004–2006 and exceeded 10% in 2007.

This price hike did not hit the population too hard, because wages also rose accordingly; nevertheless, selling the goods and services outside Latvia became increasingly more difficult, as the price increase in export markets was lower than in Latvia. The high inflation and rising labour costs had a negative effect on the competitiveness of Latvian exporters. Increasingly accelerating domestic demand also meant a rise in the demand for imports. With the export and import gap widening, the current account deficit of Latvia's balance of payments also increased. In 2003, it was slightly over 8% of GDP (a level that is generally considered quite a serious warning of economic overheating), whereas in 2006 and 2007 it already exceeded 20% of GDP (see Chart 10).

A current account deficit is the measure of the exports and imports gap, yet it also points to the need for external financing which in Latvia's case was mainly external borrowing of the banks. This financing source is considerably less stable than, for example, the foreign direct investment inflows. Therefore, with the above-mentioned growth model and its financing sources remaining unchanged, it became increasingly clearer that the economic growth in Latvia lacked sustainability.

Firstly, the private sector debt also expanded alongside with the loans granted. The ratio of debt to income for resident loans increased from 40% of GDP in 2003 to nearly 90% of GDP in 2007 (see Chart 11). One of the fundamental rules of economics is that a country's debt cannot rise infinitely. Sooner or later the national debt reaches the critical threshold where further financing of the debt becomes impossible due to an excessively high risk premium requested by investors. As a result of the strong lending growth, Latvia was rapidly approaching this debt threshold.

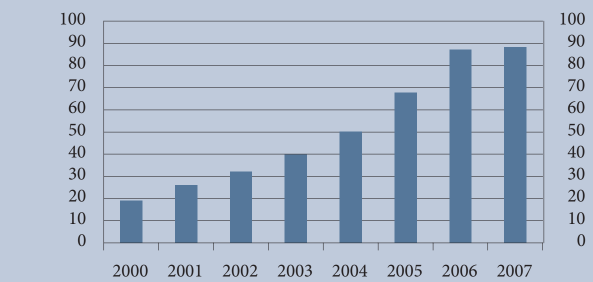
Secondly, with time, the banks themselves found it increasingly more difficult and complicated to maintain a constantly high rate of lending expansion. Contrary to the first years following the EU accession when the market was still under-developed and the demand for improvement of the living standards was high and the banks could handle the increase of their loan portfolios quite easily (there were rather many customers who could afford to undertake sizeable long-term commitments), with the time passing, the number of such potential bank customers started to decrease. In order to attract new customers and thus ensure stable lending growth, the banks had to ease their credit standards and in some cases the amount of the loan offered even exceeded the value of the collateral. Such practice also has its limits, as excessive easing of the credit standards leads to growing risks of potential future losses, something that even the most optimistic bank managers and shareholders cannot ignore.

Thirdly, the buoyant lending expansion also caused higher demand for real estate followed by quite a logical and equally steep rise in real estate prices. As a result of the strong demand and limited new offer, the real estate prices grew much faster than the average income of the population. Therefore, even though the lending expansion created an illusion that any resident of Latvia could afford to buy real estate easier than before, the reality, in fact, was quite the opposite: considering the ratio of their income to real estate prices, the number of people who really could afford those properties was constantly shrinking (see Chart 12). Thus initially the strong expansion of credit fuelled the rising demand for real estate. With time, however, the rising demand caused an even faster increase in real estate prices, which ultimately cooled off the demand.

The selected national growth strategy also entailed significant changes in the structure of the Latvian economy which had a negative effect on the long-term economic development. For example, the bulk of the loans granted and the foreign investment inflows were channelled to areas relating to trade, construction as well as real estate development and management rather than to the production sector. Thus the economic sectors that were dependent on domestic consumption grew more rapidly than the exporting sectors. The average annual growth of manufacturing output decreased from about 8% in the period 2000–2003 to 4.8% in 2004–2007, whereas that of the three domestic consumption oriented sectors (construction, trade and real estate activities) increased from 10% in 2000–2003 to 14.5% in 2004–2007 (see Chart 13 for the developments in the above sectors). The overall economic development was increasingly relying on the real estate sector development and the related sectors, whereas the export development potential decreased. In the circumstances of buoyant growth (and the respective rise in wages), the structure of the labour market also changed. Employment in construction, trade and real estate management sectors increased, whereas that in industry declined (see Chart 14).

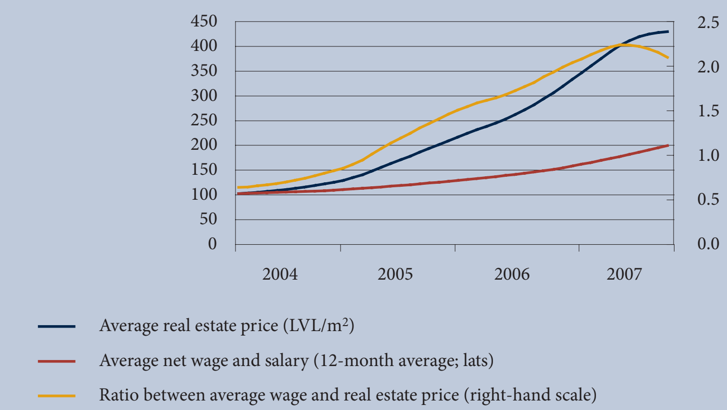
At the same time, the rise in predominantly foreign-currency-denominated debt supported by the active lending policies resulted in a need for unwinding: in order to be able to repay this debt in time and without any difficulty in the future, an increasingly larger part of the economy had to work for external

Chart 11. RATIO OF LOANS TO GDP (2000–2007; %)



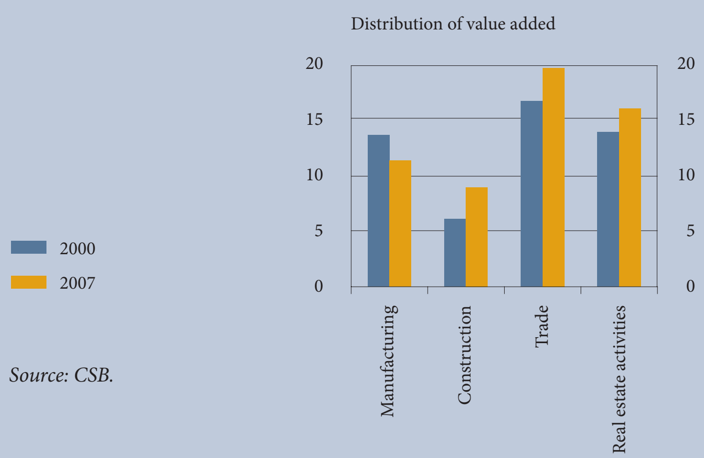
Sources: Bank of Latvia and CSB.

Chart 12. DEVELOPMENT OF REAL ESTATE PRICES AND AVERAGE WAGE IN LATVIA (2004–2007)



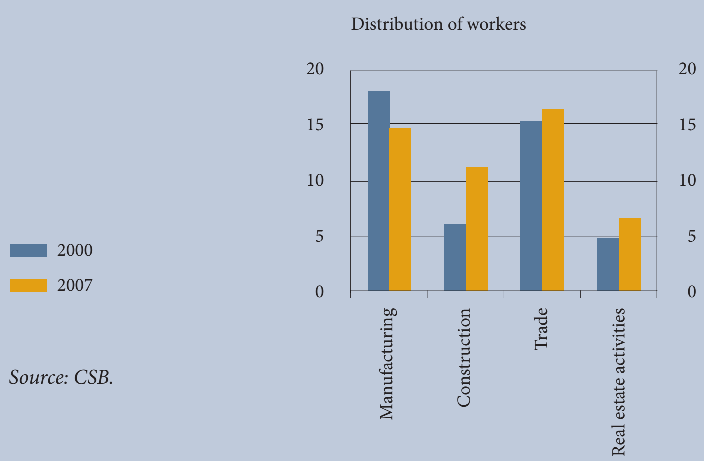
Sources: CSB, Latio Ltd. and Bank of Latvia.

Chart 13. CHANGES IN VALUE ADDED IN LATVIA (2000 and 2007)



Source: CSB.

Chart 14. CHANGES IN EMPLOYMENT STRUCTURE IN LATVIA (2000 and 2007)



Source: CSB.

trade to generate additional foreign currency income. This mismatch between the actual and the economically justified growth model gradually increased and the situation became similar to a time-ticking bomb: there was no longer any doubt whether it would go off, the only question was when it would happen.

The central bank has often been blamed that the fixed exchange rate of the lats vis-á-vis the euro stimulated capital inflows and the additional borrowing, further supported by the excessively low interest rates. Nevertheless, a deeper analysis suggests that Latvia's main problem was not the capital inflows in the economy *per se*. The stage of economic development in Latvia and the low level of domestic savings were the objective reasons that determined the dominance of foreign capital as the main source of investment in Latvia. In this regard, the EU accession opened up new opportunities for Latvia. The problems were caused by the fact that the investment was used for consumption and short-term gains instead of increasing the national production and export capacity, strengthening competitiveness and productivity gains. The fact that borrowed money was used to finance consumption boom both led to skyrocketing debt levels and at the same time worsened the economy's capacity to generate a sufficient stream of foreign exchange to repay those (ever growing) debts. So the opportunities provided by the EU accession were not explored properly (one can even almost say they were wasted).

ECONOMIC POLICY RESPONSE TO THE RISING RISKS OF OVERHEATING

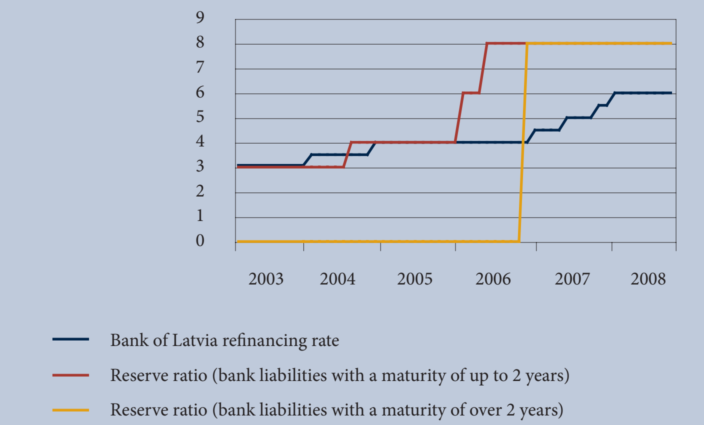
With the first signs that the Latvian economy had started to deviate from the sustainable development path and with the rising awareness that timely policy response was needed to prevent macroeconomic imbalances from growing further, the Bank of Latvia resorted to the monetary policy instruments at its disposal. It was possible to use two of them: the refinancing rate (the interest rate at which the Bank of Latvia grants loans to banks in exchange for an adequate collateral, usually government securities) and the reserve ratio (percentage of the minimum reserves used to calculate the average monthly amount of money that the banks are obliged to hold on their accounts with the Bank of Latvia and that they cannot use for further lending expansion).

Against the background of rising risks stemming from the rapid economic growth, the Bank of Latvia raised the refinancing rate for the first time already in 2004 (up to then the refinancing rate had only been reduced). Soon the reserve ratio was also increased. Overall, within a two-year period the reserve ratio was raised from 3% at the beginning of 2004 to 8% at the end of 2005. That was followed by expanding the reserve base at the beginning of 2006 to include also bank liabilities with a maturity over 2 years (before that, no reserve ratio was applied to longer-term liabilities in order to stimulate long-term financing inflows). In the next two years, the refinancing rate was further increased on several occasions until reaching 6% in mid-2007, a level twice as high as at the beginning of 2004 (see Chart 15 and Box 1).

These measures implemented by the Bank of Latvia, no doubt, had a certain role to play as they effectively dampened some lending activities by making them more expensive. These activities also signalled the growing risks to the macroeconomic stability and probably made some market participants to reconsider their choices. Nevertheless, it could not fully prevent the economic overheating and the soaring inflation in Latvia due to several reasons.

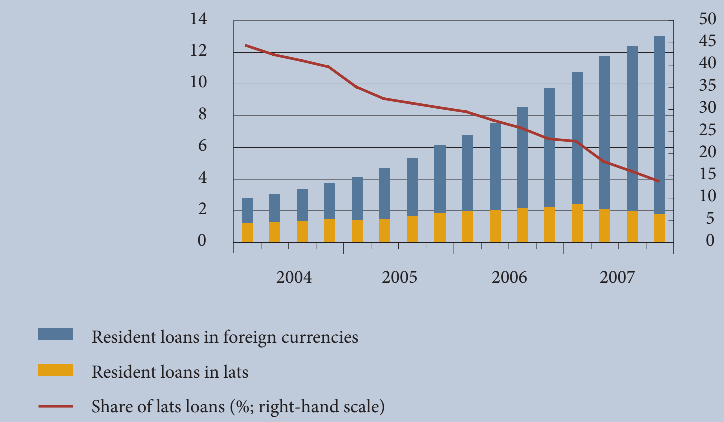
Firstly, in light of the free movement of capital across the borders of the EU Member States, the role and effectiveness of the traditional monetary instruments at the disposal of the national central banks of small and open economies decreased significantly. Higher refinancing rates imposed by the Bank of Latvia made borrowing in lats more expensive; therefore, the banks increased their supply of foreign currency (primarily euro) denominated loans and their customers' demand for them also expanded accordingly. Thus the share of the lats-denominated loans shrank from almost 50% to slightly over 10% in a couple of years (see Chart 16). Therefore, the effect of the interest rates set by the Bank of Latvia on the overall economic development became increasingly weaker, whereas the importance of the key ECB interest rates, on which the Bank of Latvia had no effect, grew.

Chart 15. BANK OF LATVIA REFINANCING RATE AND RESERVE RATIO (2004–2007; %)



Source: Bank of Latvia.

Chart 16. CHANGES IN THE CURRENCY STRUCTURE OF BANK LOANS (2004–2007; billions of lats; %)



Source: Bank of Latvia.

Box 1

INTEREST RATES AND RESERVE RATIOS SET BY THE BANK OF LATVIA

(annual; %)

Effective from (dd.mm.yyyy)	Bank of Latvia's refinancing rate	Interest rates on Lombard loans			Interest rates on time deposits		Reserve ratio (%)	
		Up to 10th day	11th–20th day	Over 20 days	7 days	14 days		
Status as at 01.01.2004	3.0	5.0	6.0	7.0	2.0	2.25		3.0
11.03.2004	3.5	–	–	–	–	–		–
24.07.2004	–	–	–	–	–	–		4.0
12.11.2004	4.0	–	–	–	–	–		–
24.08.2005	–	–	–	–	–	–		6.0
24.12.2005	–	–	–	–	–	–		8.0
							Liabilities with a maturity of over 2 years	Other liabilities included in the reserve base
24.05.2006[1)]	–	–	–	–	–	–	8.0	8.0
15.07.2006	4.5	5.5	6.5	7.5	–	–	–	–
17.11.2006	5.0	6.0	7.0	8.0	–	–	–	–
		Interest rates on the Bank of Latvia's marginal lending facility			Interest rates on the Bank of Latvia's overnight deposit facility			
24.03.2007	5.5			6.5		2.0	–	–
18.05.2007	6.0			7.5		–	–	
24.02.2008	–			–		3.0	7.0	–
		If the lending facility has been used no more than 5 working days within the previous 30 day period	If the lending facility has been used 6–10 working days within the previous 30 day period	If the lending facility has been used more than 10 working days within the previous 30 day period				
24.04.2008	–	–	–	–		–	6.0	–
24.10.2008	–	–	–	–		–	5.0	7.0
24.11.2008		–	–	–		–	4.0	6.0
09.12.2008	–	7.5	15.0	30.0		–	–	–
24.12.2008		–	–	–		–	3.0	5.0
24.01.2009	–	–	–	–		2.0	–	–
24.03.2009	5.0	–	–	–		1.0	–	–
24.05.2009	4.0	–	–	–		–	–	–
					Interest rates on the Bank of Latvia's deposit facility			
					Overnight	7 days		
24.03.2010	3.5	–	–	–	0.5	1.0	–	–
24.07.2010	–	–	–	–	0.375	0.5	–	–
24.11.2010	–	–	–	–	0.25	0.375	–	–
24.01.2012	–	–	–	–	–	–	2.0	4.0
24.03.2012	–	5.0	10.0	15.0	–	–	–	–
24.07.2012	3.0	4.0	7.0	10.0	0.1	0.125	–	–
24.09.2012	2.5	3.0	6.0	9.0	0.05	0.075	–	–

[1)] As of 24.05.2006, the reserve ratio is also applied to the bank liabilities with an agreed maturity of over 2 years.

Secondly, it has to be kept in mind that the instruments at the disposal of a central bank are meant for adjusting small outbursts of inflation rather than for putting a stop to a major inflation rise.

Thirdly, even if the central bank had possessed a theoretical ability of fully discontinuing any lending (for example, by setting a reserve ratio in the amount of 100%), it would hardly have been a correct decision as such a step would have caused significant adverse consequences, such as a complete credit crunch, even for exporting companies. Latvia's main problem was the concentration of resources in some sectors of the economy that stimulated short-term consumption and did not improve the long-term development potential of the economy. Raising of the reserve ratio to a level that would discourage lending would have also made businesses fully unable to draw new investment (due to the low level of development, the capital market could not serve as a serious alternative to the bank loan channel) and thus it would have nipped any further growth opportunities.

Fourthly, considering the limited opportunities of applying the monetary policy instruments, the Bank of Latvia implemented the above measures hoping that other economic policy makers would also see the risks to macroeconomic stability and would act accordingly within the scope of their competence in order to stabilise the economy by implementing coordinated macroeconomic policies. That, however, did not happen (see Box 2). The banks focussed on conquering new markets, expanding the existing market shares and ensuring short-term profitability. The relatively low depth of the financial sector (in comparison with the developed EU Member States) was perceived as an indication of unused opportunities and high future growth, while disregarding the relationship between the depth of the financial sector and the income level (which in Latvia was also considerably lower than the EU average). As it turned out, the underestimation of risks dealt a painful blow to the banks, as they had to write down to losses amounts equalling the sizeable profits earned in the previous boom years.

The attitude of the government representatives and the Members of the Parliament towards the risks to the macroeconomic stability, at least initially, was not unanimous. On the one hand, there was a popular belief that the economic growth was more important than stability and high inflation was the price to be paid for the vigorous growth. On the other hand, the government members realised very clearly that the high inflation acted as an income diminishing factor and thereby as an obstacle also to attaining the government's goal of welfare improvement. In the circumstances of general uncertainty, the government formulated a significant dilemma for itself at the turn of 2004: to tackle the problem of the inflation hike immediately (yet risking to lose its popularity) or to postpone the addressing of the problem for as long as possible and meanwhile enjoy the short-term benefits of the economic boom (hoping that maybe with time the inflation problem will somehow sort itself out).

Shortly afterwards, at the beginning of 2005, it became obvious from the announcements made by the government members that the government had opted for the second option (the so-called "getting over the inflation"; see Box 2). This decision largely determined the future of Latvia's economy. It became clear that coordinated economic policy action to mitigate the risks associated with the economic overheating was something impossible to achieve, at least not while the government views on this issue remained unchanged. Therefore, in the years to follow the Bank of Latvia continued to pursue a tighter monetary policy where possible, while at the same time it continued to bring the issue of the growing risks to the government's attention and encouraged other economic policy makers also take preventive steps within their competence.

One of those attempts was related to the development of an anti-inflation plan. Initially, this plan which was developed with the participation of the Bank of Latvia experts included measures to limit mortgage lending, particularly with respect to cases when more than one real estate mortgage was registered in the name of a single person. The plan also provided that mortgage loans would only be granted to physical persons on the basis of their provable (legal) income. The Bank of Latvia advocated an immediate implementation of this plan, yet this view did not gain the support of other economic policy makers (see Box 3). Thus the implementation of the anti-inflation plan was delayed for far too long. Up until the beginning of 2007, the economic policy makers predominantly believed that the focus of attention and effort should be on achieving a maximum growth rate. The soaring inflation was accepted as an inevitable side-effect and the price to be paid for the rapid growth. The Bank of Latvia's remark that such a trade-off – higher inflation in exchange for more robust growth – was an illusion was disregarded.

The main reason why the government chose not to pay sufficient attention to macroeconomic stability issues was the fact that the impressive economic growth figures played to the government's advantage. Both the rising economic activity as well as the high inflation brought additional tax revenue to the government budget. The government could spend those windfall revenues on reaching various popular short-term objectives. In 2003–2007, the budgetary revenue regularly outperformed the targets planned at the start of the year and the government was equally regular in introducing amendments to the law on budget

Box 2

THE VIEWS OF ECONOMIC POLICY MAKERS AND EXPERTS ON LATVIA'S DEVELOPMENT (2004–2007)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2004 (inflation at the beginning and the end of the year: 3.9% and 7.3% respectively)	
It is clear that the 2004 budgetary deficit exceeding 2% of gross domestic product is inappropriately high and measures to reduce this budgetary deficit should be implemented within the nearest months. With the current development rate holding, the government must focus on further stability in the public finances system and the budgetary deficit for 2005 which should not exceed 1% of gross domestic product. The monetary policy instruments at the Bank of Latvia's disposal are insufficient to reduce the domestic demand: close cooperation between the Bank of Latvia and the Latvian government in the field of the national fiscal policy is also required. (11.03. 2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) The Bank of Latvia believes that although the current rise in inflation is primarily driven by several external supply factors, it is justified to conclude that the persistently high and even growing domestic demand has also started to have at least a partial effect on inflation. (An article by R. Pētersons in the newspaper *Neatkarīgā Rīta Avīze,* 12.03.2004) (..) the potential risks of overheating and a widening external current account deficit represent a challenge to Latvia's economy in the medium term. (..) Given the 2003 outturn and the potential risks of overheating, we urge the authorities to explore the possibilities for fiscal tightening in 2004, and, at a minimum, use any additional revenues to lower the deficit. (Latvia – 2004 Article IV Consultation Concluding Statement of the IMF Mission, 29 April 2004) In the circumstances when the domestic demand in the economy is already high (..), it is particularly alarming to see that Latvia's fiscal position has deteriorated in May and June. Concerned about the sustainability of the so-far buoyant growth of Latvia's economy and wanting to prevent serious deterioration of Latvia's international prestige, the Council of the Bank of Latvia again urges the government not to allow the budgetary deficit of this year to exceed 1.5% of GDP. (15.07.2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Attempts to secure sustainable national growth on account of raising the budgetary deficit would be clearly contrary to the fundamental laws of economics. So far, no country has managed to achieve significant improvement in its welfare by increasing the budgetary deficit. (09.09.2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) It has to be noted that the current lending development is primarily based on loans designated for consumption. Mortgage loans are predominant instead of loans for expansion and modernisation of production which could increase Latvia's production potential in the future. (11.11.2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Aigars Kalvītis, the newly-appointed Prime Minister, points out that the government will have to decide between either letting the state get over the inflation or implementing unpopular restrictive measures. (An article by I. Šķepaste and I. Mārtiņa in the newspaper *Dienas Bizness*, 06.12.2004)	The Prime Minister Indulis Emsis (Union of Greens and Farmers) has no intention of listening in to the Bank of Latvia's appeal to reduce the budgetary deficit..."We would love to have a balanced budget, but not at any price. We have to look at what is happening in the streets, in real life. We cannot be sterile figure admirers. And we won't be!" says the head of the government. (An article in the newspaper *Latvijas Avīze*, 27.04.2004) Inflation is no threat to the macroeconomic stability. This is the opinion of the Ministry of Economics. Namely, although inflation was higher at the beginning of this year than the one observed previously, it is not as high as to threaten the macroeconomic stability in Latvia and to require new and crucial measures. (An article in the newspaper *Latvijas Vēstnesis*, 13.05.2004) A balanced budget is not an end in itself. A budget should serve the national development. We are not afraid to undertake risks saying that there is no need to warn about any overheating in Latvia's situation, we have to "go full throttle". (A. Šlesers, Deputy Prime Minister, in an article in the newspaper *Diena*, 09.08.2004) Gundars Bērziņš (Popular Party), Head of the Saeima Budget and Finance Commission: I think that the Bank of Latvia exaggerates the inflation threats and the government's responsibility. The Bank of Latvia speaks of the truths that are suitable for countries with 50–100 years of a market economy, while the Latvian economy is a fast growing economy and it has to be approached creatively. The Bank of Latvia bases its opinion on clever books, but the ideas expressed therein cannot be applied to Latvia directly as they are. Maybe after some years new laws will be written in economics textbooks based on the example made by Latvia and other growing economies. (An article by J. Sizova in the newspaper *Diena*, 15.09.2004) Teodors Tverijons, the President of the Association of Commercial Banks of Latvia, believes that the totally ungrounded discussions about Latvia's economic overheating benefit various political speculations. "A 40% credit growth maybe would be something fantastic in Germany or Sweden, but it is a normal rate in Latvia. What is abnormal for others, can be normal for us", says Mr Tverijons (An article by B. Latkovskis in the newspaper *Neatkarīgā Rīta Avīze*, 15.10.2004) O. Spurdziņš: Some negative trends have also appeared: for example, the relatively high inflation "eating away" the income of both the population and the country overall. It seems, however, that we have reached a certain turning point in October and the inflation could go down. (Oskars Spurdziņš, the Minister of Finance, with the end of Indulis Emsis' government and the year 2008 approaching, is discussing the European Union, customs, taxes and inflation issues, *Latvijas Ekonomists*, No. 12, 2004) "This is my belief and not a forecast: the Latvian economy has no reason to overheat!" said Juris Lujāns, the Minister of Economy (An article by A. Vaivars in the newspaper *Dienas Bizness*, 02.11.2004)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2005 (inflation at the beginning and the end of the year: 6.6% and 7.0% respectively)	
We believe that the persistently high lending growth confirms the need for the government to consider seriously measures to decelerate this process, particularly in the area of real estate lending. It has to be noted that these measures should reduce the attractiveness of profiteering, whereas no loan tax or duty should be applied to, for instance, a new family taking their first loan for the purchase or repairs of a house or an apartment. (21.03.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) It is wrong to wait until we just "get over" the inflation rise. Sooner or later, high inflation dampens the economic growth. Attempts to address the inflation problem with wrong instruments can only make it bigger and the future consequences even more serious. (19.05.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) As the inflation in Latvia remains higher than previously forecast, Ilmārs Rimšēvičs, the Governor of the Bank of Latvia, believes that specific measures to push it down should be implemented, otherwise our economy may not witness growth rates equal to the steep ones experienced last year. The Governor of the Bank of Latvia stresses that under such circumstances the government has to increase its focus on ensuring further decline in the budgetary deficit. (An article by G. Kronberga in the newspaper *Latvijas Vēstnesis*, 20.05.2005) At present, however, the pace of economic expansion is creating challenges for macroeconomic stability. With output slightly above potential, the mission stressed the need for a firmer fiscal stance than planned. (2005 Article IV Consultation – Staff Report, 14.07.2005) At the moment, there are already the first signs of a price spiral in Latvia, i.e. an increase of prices in one sector of goods or services is mentioned as the reason for raising prices in other sectors. One of the main factors sustaining the domestic demand at a high level remains the active lending policies pursued by the banking sector. Namely, there are already some indications that could suggest that, with the number of debtors increasing, the quality of the banks' loan portfolio could be deteriorating. This will make the banks review and change their lending policies sooner or later. Therefore, the currently observed lending development rates should be considered excessively elevated and lacking long-term sustainability. (22.09.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) In the current conditions of rapid growth and high inflation, the fiscal policy should be aimed at reaching a completely balanced budget, using the windfall tax revenue to contain the budgetary deficit rather than to finance additional expenditure. (17.11.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia)	The government has no intention to combat the inflation growth by imposing restrictions and the country will be allowed "to get over this disease", said the Prime Minister Aigars Kalvītis in his interview with Latvijas Radio. (An article by V. Dzene in the newspaper *Dienas Bizness*, 03.01.2005) Although the issue of whether we should or we should not take over Ireland's experience with taxing mortgage loans is currently being considered, the Minister of Finance Oskars Spurdziņš believes that it is unlikely that it will be done. (An article by E. Lidere in the newspaper *Neatkarīgā Rīta Avīze*, 26.01.2005) "Latvia's economy is healthy", says the Prime Minister Aigars Kalvītis. He stresses that nothing will be done to reduce the inflation also in the future, because the situation will stabilise on its own by the end of the year. (An article by I. Veģe in the newspaper *Dienas Bizness*, 11.03.2005) O. Spurdziņš: Considering Latvia's high economic development rates, the current inflation is at an acceptable level. It would be tragic if the inflation reached double-digit figures. It is not time for strict measures as we have not yet approached the critical border. (An article by G. Kronberga in the newspaper *Latvijas Vēstnesis*, 07.07.2005)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2006 (inflation at the beginning and the end of the year: 7.5% and 6.8% respectively)	
At the same time, what we could expect from the government is solutions to push down the inflation. (..) Two serious problems have emerged. First: money has started to lose its function as a store of value. (..) Second: once the wage spiral has started, one sector will face problems sooner, another maybe later, but we are all losing competitiveness anyway. (O. Kehris, President of the Economists Association 2010, to the newspaper *Lauku Avīze*, 10.03.2006) One of the biggest problems related to the strong domestic demand which prevents the inflation and the current account deficit from declining substantially is the incommensurate development of lending. The annual increase in resident loans (over 60%) observed during the last months is too steep from the point of view of both the macroeconomic risk as well as the stability of public finances. Moreover, the tendency for lending to develop vigorously on account of expanding foreign debt instead of domestic deposits is also becoming increasingly more pronounced. Thus the economy receives inflows of financial resources via loans which, considering the currently strong domestic demand, acts as an additional upward factor to the inflation. (14.03.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Inflation, above 6% for the third consecutive year, has started to erode the competitiveness of Latvian exporters on foreign markets which with some time may result in deceleration of the overall economic growth as well. (11.05.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Unfortunately, several signs have appeared in the economy signalling that the current rate of development cannot be sustained in a longer term and the hiking inflation has already started to threaten further growth of the national economy. (M. Bitāns, Advisor to the Governor of the Bank of Latvia, in an article in the newspaper *Dienas Bizness*, 19.05.2006) We can see from the latest statements by our politicians and some economists that the experience of other countries in addressing similar problems is not being taken on board. Firstly, under these circumstances of high inflation the government should restrict any further stimulation of demand and avoid increasing the budgetary deficit. On the contrary, as a minimum, it should form a balanced budget, if not a surplus budget. Secondly, politicians should return to the development of a real inflation rate reduction plan. (I. Rimšēvičs in an article by the newspaper *Diena*, 09.06.2006) The Governor of the Bank of Latvia stresses: if we fail to rein in inflation, it will cost us dearly! (An article by G. Grūbe in the newspaper *Latvijas Vēstnesis*, 16.–22.06.2006) I. Rimšēvičs: The Bank of Latvia certainly does not wish to court disaster, yet an inflation rate rising over 6% in one and a half year is a dangerous tendency. (An article by A. Dunda in the newspaper *Bizness & Baltija*, 19.06.2006) An upfront policy tightening is needed to contain near-term overheating and secure a soft landing. A sizable front-loaded fiscal adjustment, combined with more subdued wage and credit growth, would help unwind the output gap, slow inflation, narrow the current account deficit, and stabilize external liabilities. (IMF Staff Report for the 2005 Article IV Consultation, 13.09.2006) This is the right moment to make savings in the budget for the time when the growth decelerates. (07.09.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Inflation expectations become an increasingly more important factor is sustaining a high inflation rate: under the circumstances of persistently high inflation they become increasingly stronger and cause an increasingly tighter "vicious" spiral of wages and prices interaction. At the moment, it seems that the inflation expectations are underestimated in Latvia and not considered a sufficiently serious inflationary factor. This is confirmed by the wide-spread belief that high inflation is inevitable at times of rapid growth. (..) Unfortunately, we have to conclude that, so far, we have not used the unusually favourable and stimulating economic conditions determined primarily by the comparatively low interest rates and the favourable exchange rate in order to significantly strengthen the production capacity in Latvia and improve the competitiveness of Latvian producers. Instead, domestic-consumption-based sectors have been developed, thereby supporting higher growth only in the short-term! (16.11.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia)	"A balanced budget is an ideal model for any Minister of Finance, and maybe we would have had it this year at some point; however, there has never been a balanced budget in the year preceding the elections, as the society has many wishes", says Oskars Spurdziņš. (An article by Z. Dūmiņa in the newspaper *Diena*, 15.02.2006) T. Tverijons: It is not that important what we call a particular stage of the economic development; nevertheless, it has to be mentioned that overheating also is no tragedy, no catastrophe: it is a very beautiful name for an economic development stage, which does not carry any clearly negative connotation. Considering the growth of the gross domestic product, average wage and salary increase achieved last year, 7.5% inflation yields a wonderful result and there is no reason for grief. (An article by A. Vaivars in the newspaper *Dienas Bizness*, 05.06.2006) O. Spurdziņš stressed: "A balanced budget would be my dream in the capacity of the Minister of Finance, yet I cannot promise to achieve it." (An article by B. Rulle in the newspaper *Diena*, 11.10.2006) T. Tverijons: Firstly, the talks about the excessively high inflation in our country are way too much exaggerated. At the moment, it is consistent with the rapid economic development of our country and it is not something to be worried about. (An article in *Neatkarīgā Rīta Avīze*, 19.12.2006) O. Spurdziņš: The expected inflation is not high. I really have to agree with the Prime Minister A. Kalvītis on this: he said that inflation is a popular subject today. (An article by A. Vaivars in the newspaper *Dienas Bizness*, 19.12.2006)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2007 (inflation at the beginning and the end of the year: 7.1% and 14.1% respectively)	
At the moment, when we have already had three years of an exceptional price rise, it is clear that we shall not be able to do completely without involving the heavy artillery in the national macroeconomic policy. The government together with the Bank of Latvia is ready to implement a set of measures to curb inflation. It is possible that some steps will be unpopular, but we should not hesitate with their implementation. (O. Spurdziņš in an article by the newspaper *Diena*, 07.03.2007) The population of Latvia should choose less to live in debt and, prior to taking loans, assess their financial capability more carefully, [..] said Aigars Kalvītis, the Prime Minister (Popular Party), when explaining the government's ideas for fighting inflation. Mr. Kalvītis believes that the scale of lending in Latvia has exceeded "all ceilings". (An article in LETA, 07.03.2007) All major macroeconomic performance indicators indicate that Latvia has continued steering towards overheating during the last quarters. Therefore, the action plan for stabilisation of the national macroeconomic situation approved by the government is highly appreciated. [..] those who have already come to a conclusion that such an economic stabilisation plan and the measures contained therein would have been more effective if launched a year or two ago are partly right. (15.03.2007 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) There is an urgent need for decisive action to unwind overheating pressures and narrow external imbalances by sharply curtailing domestic demand. A comprehensive strategy is therefore needed to curb domestic spending and wage growth, and moderate real estate prices to rebalance incentives for investing in tradables sectors. (Statement by IMF Mission to Latvia on 2007 Article IV Consultation Discussions, 04.05.2007) "Inflation was expected to rise in the first four months of this year; nevertheless, it becomes increasingly clearer that measures to decelerate the inflation rise are required", BNS news agency was told by Oskars Spurdziņš, Minister of Finance. The Prime Minister Aigars Kalvītis, in turn, told the BNS agency that the inflation rise was "serious". (An article by M. Cerava featured by the BNS, 10.05.2007) When adopting amendments to the 2007 law on the state budget, it is intended to target a balanced budget. (An article by M. Fridrihsone in the newspaper *Dienas Bizness*, 22.08.2007)	Arno Pjatkins, the Advisor to the Prime Minister Aigars Kalvītis (Popular Party), also said that there were objective reasons for the high inflation rate. At the same time, he highlighted Latvia's buoyant economic development. (An article by J. Bagātais, LETA, 08.02.2007) T. Tverijons: At the Association, we believe that the existing level of inflation is the objectively necessary level resulting from the national economic development. (An article by V. Stepanovich in the newspaper *Час*, 01.08.2007)

Box 3
THE VIEWS OF POLICY MAKERS ABOUT THE NEED FOR AN ANTI-INFLATION PLAN

As the Prime Minister explained, at the moment the inflation plan cannot be made public because it may contain ideas which, even though just rumours, could cause turbulence in the business environment. (Kalvītis to the BNS, 27.07.2005)

T. Tverijons: "These restrictions on mortgage lending or restrictions on lending – to hope that this will curb the inflation – we are saying – it is bluff. It will not." (A feature by I. Elksne on LNT news, TVNET, 25.07.2005)

After several months of working on the confidential anti-inflation plan, the government, however, agreed on Tuesday not to implement any consumer price restricting measures in Latvia at the moment. Oskars Spurdziņš, the Minister of Finance, explained to the journalists that the government has taken stock of its "arsenal of weapons" but it not going to use it at the moment as currently the inflation is not rising rapidly. Some of the measures included in the plan for reducing the price rises could have an adverse effect on Latvia's economic development.
Teodors Tverijons, the President of the Association of Latvian Commercial Banks, admitted to the BNS agency that the decision not to implement the anti-inflation plan was a "very wise decision". (An article by A. Brasliņa, A. Skurbe featured by the BNS, 16.08.2005)

"We hope that the government understands the gravity of the situation, that it will not be too late with launching the plan and that it will act consistently at a crucial moment", BNS agency was told by Ilmārs Rimšēvičs, the Governor of the Bank of Latvia. (An article by A. Brasliņa, A. Skurbe featured by the BNS, 16.08.2005)

The Bank of Latvia indicated to the BNS agency that the government should immediately launch the anti-inflation plan, in order to ensure buoyant long-term development of Latvia's economy. (An article by R. Zemdega in the newspaper *Diena*, 11.10.2005)

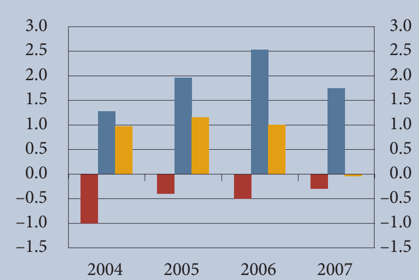
A. Štokenbergs (Economic Advisor to the Prime Minister): the government decided not to implement any measures that would reduce consumption. It was decided to analyse the situation every month. (..) Some measures featured in the confidential plan were adopted and they reduced the inflation by 0.1%–0.2%. At the moment, the inflation has been reined in. (An article by A. Elkin in the newspaper *Вести сегодня*, 07.10.2005)

Table 1. ORIGINAL AND AMENDED BUDGET EXPENDITURE OF THE CENTRAL GOVERNMENT

	Original budget expenditure (thousands of lats)	Date of amendments to the budget law	Amended budget expenditure (thousands of lats)	Expenditure increase (% of the original)
2004	2 079.7	26.08.2004	2 199.6	5.8
		16.12.2004	2 226.1	7.0
2005	2 709.9	30.08.2005	2 851.0	5.2
2006	3 362.7	19.10.2006	3 530.6	5.0
2007	4 396.4	20.09.2007	4 434.7	0.9

Source: Saeima of the Republic of Latvia.

Chart 17. ACTUAL AND THEORETICALLY PROBABLE LEVEL OF BUDGETARY DEFICIT (2004–2007; % of GDP)



Sources: Eurostat and author's estimates.

in the second half of the year which reviewed and increased the expenditure part. In 2004, the government even managed to amend the law and increase the spending twice (see Table 1).

This ensured certain popularity for the government; nevertheless, it did nothing to help reduce the budgetary deficit and ran contrary to economic sense. Figuratively speaking, it was like pouring oil into an already burning inflation fire: not only did it fail to put out the flames, but made them more powerful. Starting from 2004, the gap between the actual budgetary deficit and the deficit that would be considered adequate in light of the economic situation of that time regularly reached several percentage points of GDP (see Chart 17). In the perception of the politicians, a balanced budget was a huge accomplishment and a goal to be kept in mind, while the economic developments in Latvia required a government budget that was in considerable surplus (see Box 2).

Moreover, this overly loose fiscal policy not only stimulated the inflation rise, but also made it impossible for the government to build contingency reserves or safety buffers to be used in periods when the economic growth would decelerate. Implementation of anti-cyclical fiscal policies would have helped accumulate over 1 billion lats in the general government budget by the end 2007 (this amount would have been useful in the years to follow).

Even if the politicians had decided to do nothing in the fiscal front during that time it would have been a rather good policy. If the government had abstained from introducing any budgetary amendments boosting the spending in the second half of each year, it is most likely that the government budget would have run a considerable surplus in the period 2004–2006. Consequently, it would have been much closer to the economically adequate level. Moreover, at the end of 2007 the government budget would have accumulated an almost 500 million lats large reserve which could have been potentially used by the government in the years to follow.

Unfortunately, the budget was all spent and no savings were made as the predominant view was that Latvia would remain amidst this cycle of extremely fast growth for a long time. Only at the beginning of 2007 when the annual inflation in Latvia jumped from 7.3% to 8.5% in a month and it became clear that it would climb even higher in the near-term and reach a double-digit figure, the government's mood changed.

In February, the government representatives still believed that there was an objective reason for the high inflation, while already in March their announcements carried a message that it would be impossible to solve the inflation problem without the government intervening. Finally, the anti-inflation plan was adopted and the government was committed to end the year with a balanced budget.

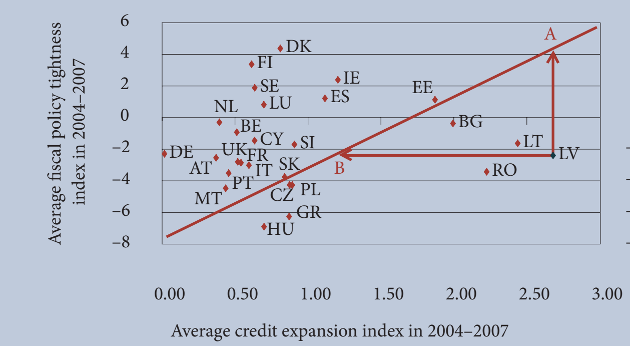
Alas, a lot of precious time had already been wasted. Moreover, some of the decisions taken were insufficiently firm, as the current economic situation warranted a budget with a considerable surplus and not just a balanced budget (and even that, by the way, was not achieved in 2007 anyway, if calculated according to the generally accepted EU methodology). Despite the clearly rising inflation and the deepening risks of economic overheating, the banking sector also stubbornly held to the belief that the economic development in Latvia did not require any adjustment.

Thus the overall economic policy in Latvia within the period of 2004–2007 lacked any coordination. The central bank was well-aware of the risks potentially stemming from the overly rapid economic development and tried to change the situation as much as it could, but it did not have any sufficiently strong instruments at its disposal to change the course of the economy. Banks focussed on conquering new markets and in the middle of this fight underestimated the risks to stability associated with the economic growth. Government was preoccupied with allocation of the windfall budgetary revenue to gain short-term popularity and did not make any savings.

Thus at the end of 2007 the accumulated fiscal and financial imbalances in Latvia started to threaten its further economic development. Latvia was not the only country facing such fiscal and financial imbalances. At that time, problems emerged in many EU Member States either in the fiscal area (Hungary and Greece; see Chart 18) or in terms of an excessively rapid credit expansion (Lithuania, Romania and Bulgaria). Nevertheless, Latvia was a unique case as it had obvious and significant problems in both areas. As can be seen in the following Chart, other countries where the lending boom developed similarly to that in Latvia implemented much tighter fiscal policies (Bulgaria and Estonia), whereas the countries pursuing even more expansionary fiscal policies in comparison with Latvia (Poland and the Czech Republic) had much lower lending growth.

Seeing this incongruity, the Bank of Latvia tried to convince the government of the need to tighten the fiscal policy (dot A in Chart 18). Considering the reserved attitude of the government, an alternative option would be to limit the lending expansion (dot B in Chart 18), yet the banking sector representatives were also not particularly happy with this idea. Consequently, the probability that significant and unpleasant adjustments in the Latvian economy were inevitable became stronger and stronger already at the end of 2007 and the beginning of 2008. Some hope remained that these would be gradual and it would be possible to avoid major turbulances. Alas, the hopes were crashed.

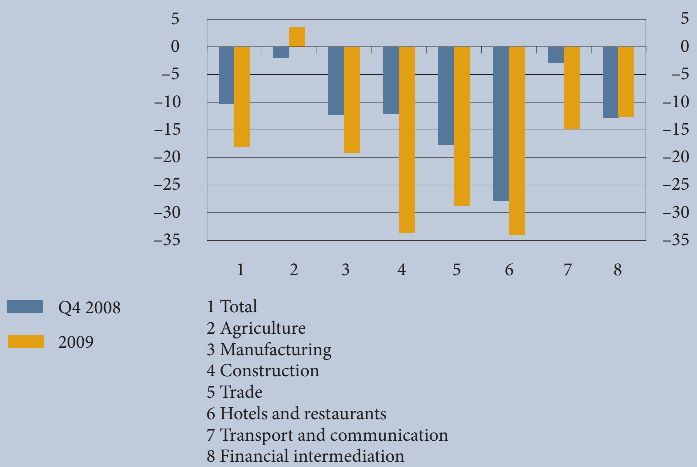
Chart 18. MACROECONOMIC STABILITY ENVIRONMENT IN EU MEMBER STATES (2004–2007)



Sources: Eurostat and the author's estimates.

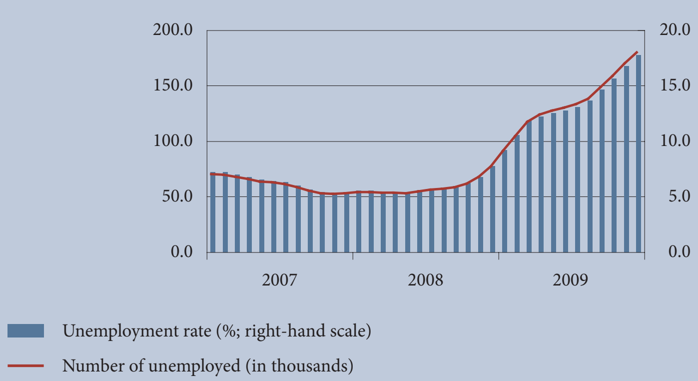
CRISIS AND THE POLICY RESPONSE

Chart 19. CHANGES IN GDP BY TYPE OF ACTIVITY
(Q4 2008 and 2009; year-on-year; %)



Source: CSB.

Chart 20. UNEMPLOYMENT RATE IN LATVIA (2007–2009)



Source: CSB.

It is commonly believed that the latest global crisis was triggered by the default of *Lehman Brothers*, a US investment bank, in September 2008 which caused panic waves and dealt a serious blow to the overall stability of the global financial sector. However, in reality, the macroeconomic imbalances had increased steadily in several countries in the period leading to 2008 and in the absence of sufficiently active government measures to restore the stability the crisis was an inevitable result of the long-lasting build-up of these imbalances. The bankruptcy of the above-mentioned investment bank merely accelerated the process. The fact that the main reasons for the economic instability stemmed from the domestic environment is confirmed by the huge differences in the impact of the global crisis on various countries. The countries having accumulated significant macroeconomic imbalances in the pre-crisis years are currently facing the steepest economic downslide (Greece), whereas the countries having paid more attention to the macroeconomic stability issues are less affected by the economic crisis or do not feel it at all (Germany, Sweden and the Netherlands).

As already mentioned before, Latvia also managed to build up one of the heaviest burdens of macroeconomic imbalances in the EU during the years of its booming growth. Therefore, it was logical that the subsequent fall was also one of the deepest. The international and inter-bank credit crunch observed at the turn of 2008 was close to fatal for Latvia's economic development model which was based on free access to loans.[7]

With the financing conditions of Latvian banks and their foreign parent banks deteriorating as well as the management of the banks refocusing from conquering new markets to more adequate risk assessment, loans available to Latvian businesses and households contracted sharply. While at the beginning of 2008 an average amount of 200 million lats was granted in resident loans every month, at the end of the year the amount of new bank loans was smaller than the received interest and principal repayments of the previously granted loans; as a result, the loan portfolio of banks in Latvia started to shrink. These changes had a significant effect also on other sectors of the Latvian economy, particularly those where the growth was directly dependent on lending developments (see Chart 19).

Mirroring the general decline in the economic activity, unemployment rose considerably in Latvia, additionally supported by the fact that the sectors where the decline was the steepest were the ones registering the largest inflows of labour in the previous years (see Chart 20).

The primary operational principle of economic policy makers in an economic downturn is anti-cyclical fiscal and monetary policies. Therefore, considering the adverse economic development trends and their negative effect on the price stability (manifesting itself as deflation), the Bank of Latvia reduced the reserve base on several occasions in 2008, in order to increase the free liquidity of the banks and thereby try to encourage lending. Nevertheless, as the time went by, it became apparent that the banks chose to continue holding their free liquidity on their accounts with the Bank of Latvia instead of investing in the economy. Thus in the circumstances when the lending growth is negative and the banks generally do not need to resort to the central bank financing, the refinancing rate of the central bank also loses its practical importance and the interest rates on the central bank's deposit facilities offered to the banks become the main monetary policy instrument. Therefore, in order to discourage the banks from keeping their money with the central bank, the Bank of Latvia topped the reductions of the refinancing rate since the beginning of 2010 with several reductions of the Bank of Latvia deposit facility rates, approaching zero at the end of 2010 (see Box 1). However, with each occasion of reducing the interest rates, the effectiveness of the monetary policy and its power to continue stimulating the economy decreased (as the possibility to introduce further interest rate cuts also declined).

In such circumstances, the fiscal policy implemented in Latvia and its course was of an utmost importance. Once the economic growth starts to decelerate, the fiscal policy automatically becomes counter-cyclical: tax revenue shrinks, whereas the government spending increases as a result of growing unemployment and hence also the number of people receiving unemployment benefits, thereby pushing up the budgetary deficit as well. The growing deficit, on the one hand, helps to soften the fall in the economic growth, whereas, on the other hand, it is an additional source of macroeconomic instability, particularly in circumstances when this deficit has to be financed by foreign borrowing and the concerns of the financial market participants and potential lenders about the ability of the state to repay the already received loans have deepened. Unable to convince the investors of the sustainability of the country's fiscal position and find financing to cover the planned budgetary deficit, the government would either have to go bankrupt (i.e. go in default, including discontinue the payments of pensions, benefits and salaries from the budget) or balance the budget expenditure with the actual revenue immediately, thereby accelerating the economic downturn.

Therefore, the most effective fiscal policy in a period of an economic downturn can be implemented if the government has been able to hoard liquidity in the previous years by formulating surplus budgets during the years of booming growth, as it was done by Estonia. Latvia failed to do the same; therefore, at the end of 2008 the government had to choose between trying to convince foreign investors that Latvia's fiscal position was sustainable (but that would mean government spending cuts and thereby reduce the anti-cyclical effect of the fiscal policy) or abstaining from doing it and hoping that it would be possible to find all the required financing in the international financial markets dominated by uncertainty and intensifying tensions (yet realising that should it turn out to be impossible to find the financing, the sovereign default probability would come to the forefront). The fact that even in November 2008 the government planned the next year's budget with expenditure exceeding the 2008 spending by roughly 500 million lats despite the clearly downward trend observed for tax revenue suggests that it preferred the second option.

The potential consequences of this decision are unknown as the government had to adjust its plans significantly as a result of the financial problems associated with the JSC *Parex banka*. Contrary to other major Latvian banks (which drew financing from their parent banks in the Scandinavian countries), this bank primarily tapped the financial markets (*inter alia* taking syndicated foreign bank loans and issuing Eurobonds) to raise the foreign financing required to fund the lending expansion. Against the background of sharply contracting liquidity and growing tensions in the global financial markets, it became impossible to refinance those loans, while the bank's assets were seriously impaired. As a result, the bank was facing serious liquidity and solvency problems further exacerbated by the deposit run. It became obvious that the bank required financial assistance from the government to continue its business. Taking into account the systemic nature of the bank and the huge direct and indirect losses caused by the potential closure of the JSC *Parex banka*[8], the government decided to bail out the bank by taking over the bank's assets and undertaking also the outstanding liabilities of the bank. This step, no doubt, shielded Latvia's economy from unpredictable shocks and, possibly, from an economic catastrophe. At the same time, it deepened the concerns of foreign investors about the fiscal position of the government and its sustainability, as the government did not have the money required to meet the bank's liabilities and inject capital at that moment. Budgetary reserves accumulated in the previous years would have come in handy. Unfortunately, there were no such reserves and that meant that a failure to receive financial assistance from international donors would have seriously undermined further legal capacity of Latvia's government.

In order to prevent the looming sovereign default, Latvian government struck an agreement with the IMF, EC and several other countries on granting financial assistance in the amount of 7.5 billion euro conditional on implementation of an economic stabilisation programme aimed at ensuring Latvia's fiscal sustainability and the stability of the financial sector as well as restoring its competitiveness.[9] One of the main elements of the programme was gradual reducing of the budgetary deficit from almost 10% of GDP to a level consistent with the Maastricht criterion in four years. Overall, the government expenditure was cut by more than 11%: the 2011 general budget expenditure was approximately at the level of 2007. Nevertheless, considering that the expenditure cuts practically did not affect the social area, the decline in other areas was even more impressive: the central government basic budget spending was reduced by more than 17% in four years and the general expenditure as at the end of 2011 stood at the same level as in 2006–2007.

This impressive fiscal consolidation resulted in significant easing of the concerns about Latvia's fiscal stability as well as supported the restoration of competitiveness and re-focussing of the economy on a growth model based on exports instead of domestic consumption. At the same time, this decrease in the government spending caused a fall in domestic consumption. It has to be realised that fiscal consolidation is not an ideal economic policy in the circumstances of a shrinking gross domestic product. Nevertheless, it is significantly better than the alternative lying ahead for Latvia if the international financial assistance had not been granted: immediate balancing of the budgetary revenue and expenditure, followed by an even deeper economic downslide.

The second key element of the programme was the preserving of the existing fixed exchange rate. Initially, at the end of 2008, the IMF analysed also alternative exchange rate strategies, for example, broadening of the exchange rate fluctuation band to ±15% or unilateral euro implementation. Nevertheless, at the discussions with the IMF representatives, the Bank of Latvia secured an agreement that preserving an unchanged fixed exchange rate was the safest and optimum way of overcoming the crisis in Latvia's circumstances. The main arguments in favour of keeping an unchanged exchange rate were as follows. Firstly, an exchange rate adjustment would not improve the situation significantly given the notable increase in both the government debt as well as the private sector debt as a result of the intensive lending. Considering that the debt was mostly denominated in foreign currencies, devaluation would (on the contrary) result in even higher government debt and also the interest payable.

Secondly, a side effect to devaluation would be higher costs of raw materials, fuel and other imported commodities which would also have a negative impact on the prices of outputs produced in Latvia. Given the fact that due to the weak domestic demand the rising costs could not be offset by raising the output prices, the solvency of Latvian businesses would deteriorate and they would face bankruptcy, thereby increasing unemployment.

Thirdly, the quality of the banks' assets would also be significantly impaired and thus the opportunities to raise the financing required for new investment as well. In its report, the IMF also recognised that with devaluation the initial contraction of the GDP would be approximately one third larger than in a no-devaluation scenario (in Latvia's case it would have meant a decline by more than 23% in the economic activity in 2009), whereas the hypothetical subsequent even more buoyant growth phase could remain hypothetical mainly due to the negative effects caused by devaluation in the financial sector (definitely exacerbated by the extreme sensitivity to adverse banking developments characteristic of the Latvian market and depositor panic waves).

Moreover, currently the IMF also admits that liberating the exchange rate would not have ensured more rapid and successful overcoming of the crisis: analysis of economic development trends in various countries of the world in the context of the global financial crisis leads to a conclusion that countries with a fixed exchange rate are overall doing neither better, nor worse than countries with a floating exchange rate in this crisis.[10] In small countries, exchange rate fluctuations quickly pass through to the domestic market prices, thus the impact on the real sector is minimal. Moreover, a floating exchange rate does not free a country from the necessity to align its expenses with its income. In its latest reports on Latvia, the IMF also admits that despite the initial concerns the implementation of the existing programme (including the preservation of a fixed exchange rate) has ensured economic recovery.[11]

THE CONSEQUENCES OF THE CRISIS

Although the financial assistance received from the international institutions enabled Latvia to implement the set of measures required to stabilise the fiscal situation in a longer time-span and thereby considerably mitigate the adverse economic and social consequences of the financial crisis, none of the options available would have managed to protect the society completely from taking painful decisions and from their consequences. Return from an illusionary euphoria created by the financial bubble to economically justified reality always involves socially unpleasant measures. In Latvia's case, this bubble of macroeconomic imbalances was particularly big; therefore, the return to the economically justified level was complicated. With easy and almost unlimited financing flows drying out, the time of debt-based consumption and growth was over and it was the time to reduce the accumulated debt burden. This process was particularly painful because of understanding that the level of income achieved in Latvia in 2005–2007 could not be sustained by Latvia's current structure of the economy and the economically justified income level was about one fourth lower than the one achieved in the years of the buoyant growth.

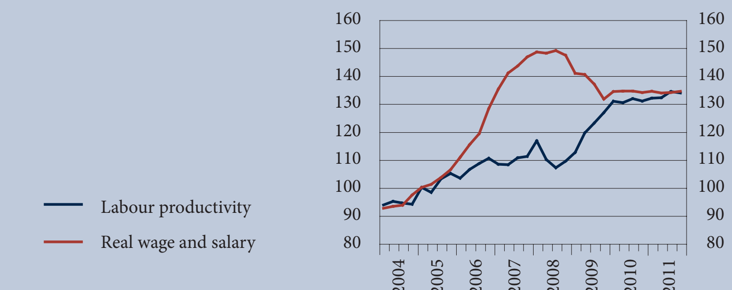
Despite their socially complicated nature, the implemented measures have yielded tangible results, particularly in the area of the macroeconomic stability where the previously dominant risks have been prevented or substantially reduced. For example, unit labour costs have improved significantly as a result of shrinking wages and increased productivity, and the wage-productivity gap observed in 2005–2007 has fully closed (see Chart 21).

Thus the Latvian producers have regained their competitiveness on the external markets. It is confirmed also by the export growth. In absolute terms, the exports of Latvian goods have exceeded the pre-crisis level (see Chart 22).

This, in turn, has resulted in a significant improvement of the current account of Latvia's balance of payments which has become positive for the first time since 1994 (see Chart 23). Even assuming that, with the economic growth picking up again and banks gaining profit, the current account will return to a negative territory (as it usually happens in countries where the growth rate exceeds those of its trade partners, i.e. in developing countries, including Latvia), it is justified to believe that a current account deficit exceeding 20% will no longer be observed in Latvia in a foreseeable future.

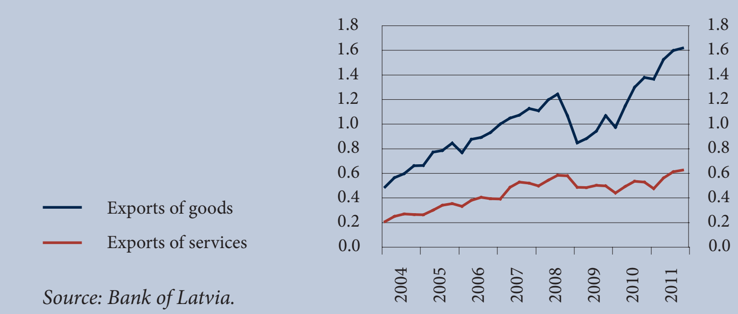
In terms of inflation, the situation has also improved considerably. Following a short period of deflation, inflation has returned, albeit remaining relatively low. Inflation growth was supported by a combination of various external factors (rising oil and food prices), as currently there is no domestic pressure on the prices caused by the wage-productivity gap (see Chart 24).

Chart 21. DEVELOPMENT OF LABOUR PRODUCTIVITY AND REAL WAGE AND SALARY (2004–2011; Q1 2005 = 100)



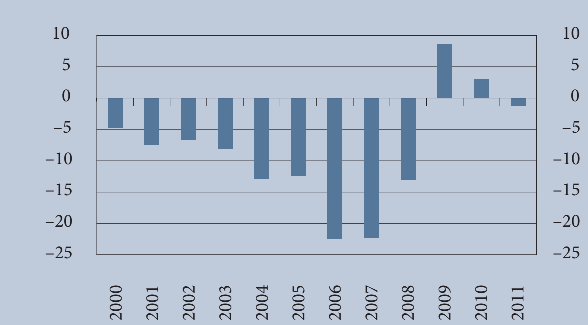
Source: CSB.

Chart 22. LATVIA'S EXPORT DYNAMICS (2004–2011; billions of lats)



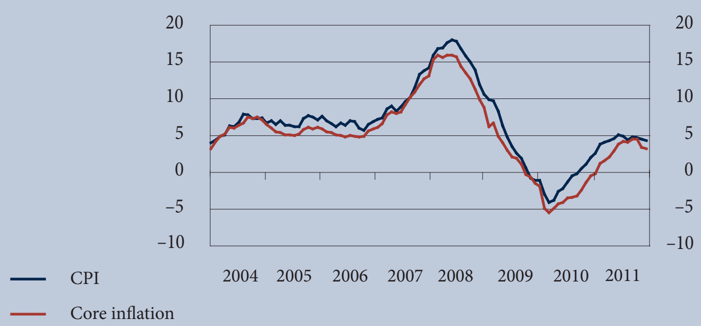
Source: Bank of Latvia.

Chart 23. BALANCE OF THE CURRENT ACCOUNT OF LATVIA'S BALANCE OF PAYMENTS (2000–2011; % of GDP)



Sources: Bank of Latvia and CSB.

Chart 24. ANNUAL CHANGES IN CPI IN LATVIA
(2004–2011; year-on-year; %)

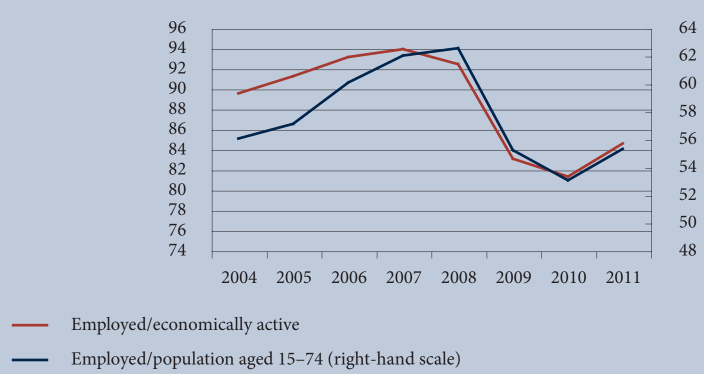


Sources: CSB and Bank of Latvia estimates.

Chart 25. LATVIA'S GOVERNMENT DEBT (2005–2011; % of GDP)

Sources: The Treasury and CSB.

Chart 26. EMPLOYMENT DYNAMICS IN LATVIA (2004–2011; %)



Source: CSB.

The situation in the financial sector has also improved notably. With the quality of their loan portfolios deteriorating and the share of non-performing loans growing, the banks were forced to build additional provisions. In order to offset the incurred losses and meet the regulatory requirements, the banks raised additional capital. Currently, the banks have resumed earning profit, their liquidity remains ample and, with the improvement of the government's fiscal situation, stability has returned to the money market and interest rates have retreated considerably below the pre-crisis levels.

Nevertheless, although there are significant improvements in the area of the macroeconomic stability, several serious structural problems still persist in Latvia's economy which have emerged or aggravated as a result of the crisis and which require more time to address and fully eliminate.

Firstly, the high budgetary deficit observed since 2009 caused a sharp increase in the government debt. The government debt grew from the level of below 10% of GDP to 45% of GDP at the end of 2010 based on ESA 95 methodology (see Chart 25). Thus the government debt which was insignificant prior to the crisis has expanded to a substantial level and its servicing requires significant budgetary contribution, thereby compressing the financing available to other areas funded from the budget. The growing debt service costs and budgetary spending on the debt service are the price Latvia's government has to pay for the opportunity not to implement an outright fiscal consolidation and expenditure cuts at the end of 2008.

Secondly, the years of buoyant growth have brought about some adverse changes in the structure of Latvia's economy. Considering that the share of sectors relying on domestic demand expanded significantly in Latvia's economy prior to the crisis, in the circumstances of a sharp dive in the growth of those sectors, the capacity of other sectors was no longer sufficient to offset the considerable growth deceleration. Therefore, the overall employment in Latvia decreased notably. With turnover on a downward path, employment in construction and trade sectors declined and at the same time, jobs were cut in the public sector, while the sectors that performed comparatively better were unable to generate new jobs equally quickly (see Chart 26).

Construction and public administration are the areas where the employees were the most heavily affected by the changes in the economic environment. Nevertheless, in some sectors (e.g. in transport and communication), employment is even higher than before the crisis (see Chart 27).

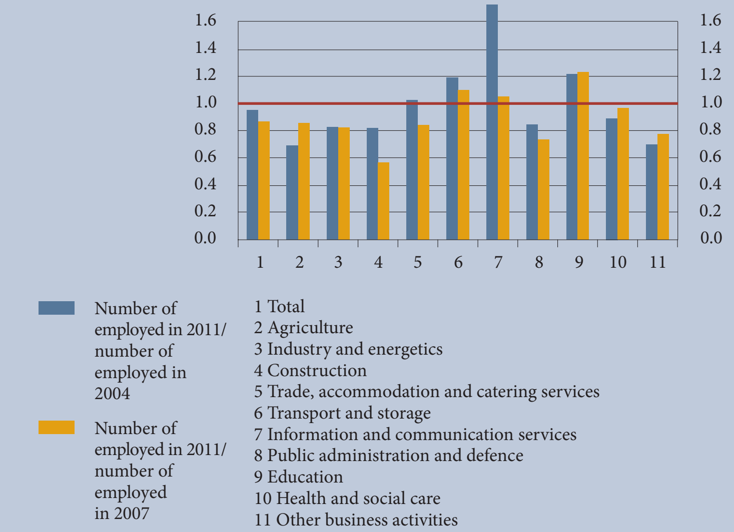
This is a clear indication of the structural nature of unemployment. One of the reasons for the high unemployment is not insufficient demand, but rather the need for the labour force to upgrade and change the set of skills as it moves over time from sectors relying on domestic demand to those servicing the external sector. Yet this does not mean that the level of unemployment that has risen considerably under the impact of the crisis will decline automatically once the economy recovers. Workers who have been long absent from the active labour market face a significantly growing skills mismatch risk and the level of long-term unemployment could thereby also increase notably. To reduce it, active labour market support measures are required, as the high structural unemployment may act to seriously hinder further economic development.

Thirdly, despite significant stabilisation signs evident in the country's financial sector, the loan portfolio of banks continues to shrink. This can be only partly explained by the falling demand. During the years of booming growth, the rise in resident deposits could not fully finance the loans granted; therefore, the ratio between the bank loans granted and deposits received grew significantly. Affected by the crisis, banks have started to pay much more attention to financial stability issues, thus they are concentrating more on attracting additional deposits and restructuring the existing loans than on granting new loans (see Chart 28). Lower level of income also means that amount of liabilities that can be safely undertaken by households and businesses is smaller than before; moreover, banks can no longer rely on a constant increase in the value of collateral in the future.

Such lending development has had a negative impact on the overall investment level in Latvia. Prior to the crisis, the overall investment in fixed capital formation exceeded 30% of GDP, whereas the crisis caused the investment shrink more than twofold. Although the level of investment has slightly increased (currently about 20% of GDP), it is too low for successful long-term development of the economy (see Chart 29).

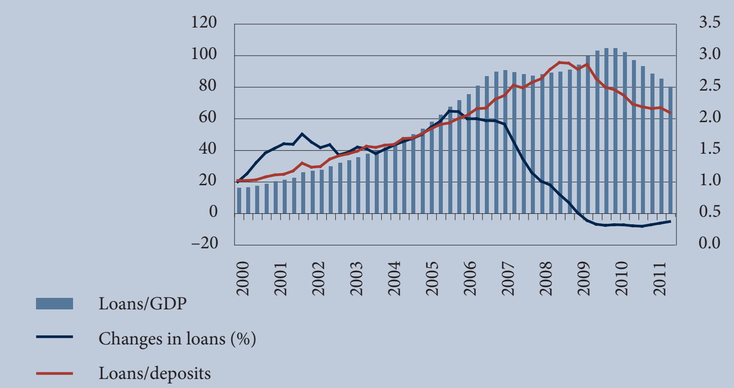
If the lending does not recover significantly, the growth rate can be expected to remain low, as confirmed also by international research.[12] The good news for Latvia is that despite the losses incurred due to the crisis the biggest and most significant banks have not left Latvia and are ready to continue their business also within foreseeable future. Nevertheless, it would be wrong to rely fully on the bank lending channel as the main driver of the economy. Latvia's experience shows that more loans do not automatically guarantee a higher living standard. Therefore, alternative sources have to be found at the same time, using foreign direct investment as well as tapping capital markets. Maintaining an investment-friendly environment and developing the export potential should thus become one of the main national priorities. Accession to the euro area is only one of many measures to be implemented within this context.

Chart 27. UNEMPLOYMENT RATE CHANGES IN LATVIA BY ECONOMIC SECTOR



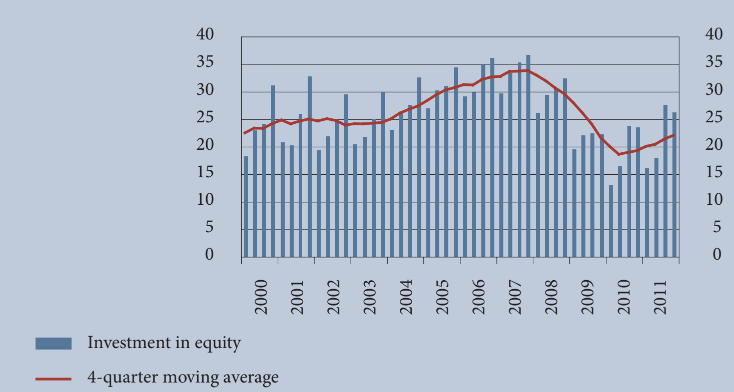
Source: CSB.

Chart 28. CHANGES IN RESIDENT LOANS AND RESIDENT DEPOSITS IN LATVIA (2000–2011)



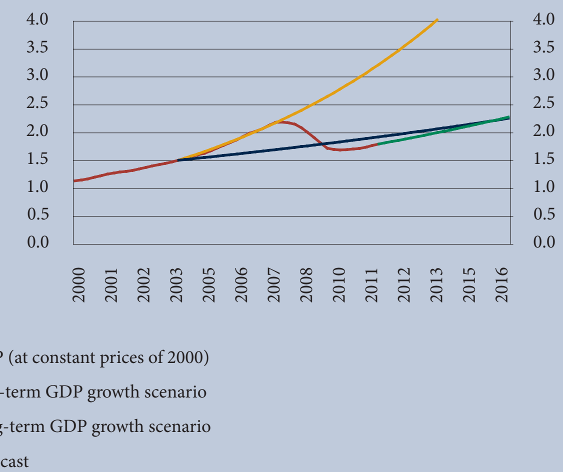
Source: Bank of Latvia.

Chart 29. INVESTMENT IN LATVIA (2000–2011; % of GDP)



Source: CSB.

Chart 30. LATVIA'S ECONOMIC GROWTH AND ITS SCENARIOS
(billions of lats)



Sources: Eurostat and the author's estimates.

CONCLUSIONS

The economic developments observed during the last 10 years have proved that a small and open economy cannot achieve sustainable economic development and improve its welfare based on rising domestic consumption alone. The attempts to sustain high domestic consumption without the support of export growth result in a loss of competitiveness and build-up of macroeconomic imbalances, thereby accelerating the set-in of a crisis. Conversely, with national exports developing successfully and export revenue increasing, the amount of money in the economy also grows. This creates a basis for sustainable development of domestic-market-oriented sectors. Latvia's only option is an export-based growth model.

Maintaining a fixed and unchanged national exchange rate has been and remains a vital component of this model. Ability to prevent any attempts to manipulate with the exchange rate has enabled Latvia to overcome the financial crisis successfully and ensure the restoration of the macroeconomic stability. At the same time, it has to be remembered that the exchange rate is only one, albeit important, instrument of the overall economic policy and it cannot help solving all economic problems in Latvia. For example, no manipulation with the exchange rate would help reducing the high unemployment rate. As the reasons behind it are mainly structural, structural solutions are required.

The developments observed in the recent years have clearly proved the importance of an anti-cyclical fiscal policy as well as the substantial risks to the economy and, in fact, to every individual if such a policy is not implemented. Moreover, it is important to remember that the need for fiscal stimulus in periods of an economic downslide is only one part of such an anti-cyclical policy. In order for such a policy to be effective, it is also necessary to build sufficiently large reserves during the years of booming growth. Ignoring this important rule may involve serious consequences. The price of a single mistake, an excessively loose fiscal policy in Latvia during the years of buoyant growth, is a much higher debt level which, in turn, means that significant budgetary funding will be channelled to debt repayments in the near future instead of spending it on benefits, pensions and infrastructural investment. Failing to implement measures to reduce the debt and making a similar mistake in the future could push the government debt to a level posing a threat of sovereign default or even endangering the country's existence. Hopefully, the future policy makers will be wiser and will not repeat the mistakes of their predecessors.

Thirdly, the EU accession was not and still is not a remedy to all economic and financial problems. Yet the participation in this union provides a country with opportunities that would otherwise be out of reach. Each country uses those opportunities as allowed by its administrative capacity. Therefore, the EU participation can turn out to be a story of success and can also be considered a failure. The story is similar with participation in the euro area and the euro implementation. The euro is used in Germany, the Netherlands and Estonia as well as in Greece and Portugal, yet the economic development in each particular country is determined by the ability of the economic policy makers of each country to use the benefits provided by the euro rather than the euro itself. Even in the history of a single country one can find both periods of successful growth as well as periods when governments have chosen to take the easiest path associated with the participation in a monetary union and allowed the build-up of an asset price bubble creating a short-lived economic growth illusion, inevitably followed by economic stagnation (Ireland). This proves that success at one stage does not guarantee success at the following stages. On the other hand, if a country has had bad luck with the economic development, this does not mean that it is doomed forever. Latvia made its mistake while being outside the euro area and thus, possibly, managed to escape the build-up of even larger macroeconomic imbalances followed by an even more painful fall. Being in the euro area will require more careful thinking behind the economic policy decisions than before, so that fully-fledged participation in the EMU can make a positive contribution to the Latvian economy.

The most recent history of economics in Latvia clearly proved that the conviction of being able to catch up with the living standards of the most developed European countries quickly was delusional. During the years of the booming growth, the prevalent belief was that Latvia could manage to do so in as little as 10 years and it was based on the assumptions that the Latvian economy would continue to grow and its growth would continue to be measured in double-digit figures. It turned out, however, that it was impossible without taking measures to improve Latvia's external competitiveness and ensure sustainable development. The average growth rate of the last 10 years, despite being high in some particular years, overall fluctuated around 4% (see Chart 30).

If Latvia's economy continues to develop at the same rate, even if all the best circumstances combine, catching up with the average EU income level would require 40–50 years. In the worst case scenario, this level of welfare may turn out a dream never to be fulfilled. Hopefully, these conclusions with be an additional incentive to carry out the required economic and structural reforms to avoid this adverse development scenario and to ensure that further development of the economy finds a positive reflection in improved welfare of each resident of Latvia.

ENDNOTES

[1] Free movement of workers initially worked only partly, as several of the old EU Member States (e.g. Germany) had set a transition period for opening their labour markets to the new Member States.

[2] Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union (2006/C 73/08), *Official Journal of the European Union*, C 73, 25.03.2006, pp. 21–27.

[3] See more details at *http://www.bank.lv/publikacijas/averss-un-reverss/2004-4/latvijas-bankas-eiro-ieviesanas-strategija-un-tas-ekonomiskais-pamatojums/4502*.

[4] *http://www.ecb.int/press/pr/date/2005/html/pr050429.en.html*.

[5] *http://ftp.iza.org/dp5878.pdf.*

[6] See, for example, Schadler, S., Mody, A., Abiad, A. et. al. *Growth in the Central and Eastern European Countries of the European Union*. IMF Occasional Paper, No. 252, Washington DC, January 2007; *World Bank EU8 Quarterly Economic Report*. World Bank, July 2005.

[7] Another characteristic trait of Latvia's economic development of that time was the rapidly growing public sector debt. Consequently, Latvia would have inevitably reached a level of debt where refinancing is practically impossible even without the global financial crisis which started at the turn of 2008 and the economic consequences would have been identical to the ones actually observed.

[8] According to the Bank of Latvia's estimates, the overall loss to Latvia brought about by winding up the business of the JSC *Parex banka* would have amounted to approximately 3 billion lats (see *http://www.bank.lv/presei/parex-bankas-parnemsana/parex-bankas-slegsana-butu-katastrofa-latvijas-tautsaimniecibai*).

[9] See *http://www.imf.org/external/pubs/ft/scr/2009/cr0903.pdf.*

[10] *http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/c1.pdf.*

[11] See *http://www.imf.org/external/pubs/ft/scr/2011/cr11126.pdf.*

[12] See, for example, *http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/c4.pdf.*

SOURCES AND LITERATURE

Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union (2006/C 73/08). *Official Journal of the European Union*, C 73, 25.03.2006, pp. 21–27. Available: *http://www.ecb.int/ecb/legal/pdf/c_07320060325en00210027.pdf*.

Bank of Latvia Annual Reports for 2005–2011. Available: *http://www.bank.lv/en/publications/annual-report/2782*.

Bank of Latvia's statistical data room. Available: *http://www.bank.lv/en/statistics/data-room/main-indicators*.

Eurostat database. Available: *http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database*.

Hazans, Mihails, Kaia, Philips. *The Post-Enlargement Migration Experience in the Baltic Labor Markets*. IZA DP, No. 5878, July 2011. Available: *http://ftp.iza.org/dp5878.pdf*.

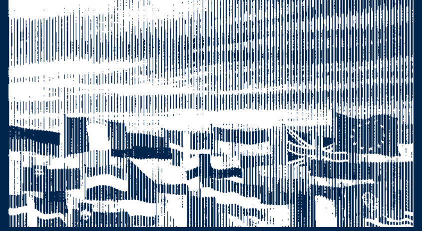
IMF reports on the latest economic development trends in Latvia. Available: *http://www.imf.org/external/country/LVA/index.htm*.

Schadler, Susan, Mody, Ashoka, Abiad, Abdul et. al. *Growth in the Central and Eastern European Countries of the European Union*. IMF Occasional Paper, No. 252, Washington DC, January 2007, 64 p.

Statistical data by the Finance and Capital Market Commission. Available: *http://www.fktk.lv/en/statistics/latest/*.

Statistical database of Central Statistical Bureau of Latvia. Available: *http://www.csb.gov.lv/en/dati/statistics-database-30501.html*.

World Bank EU8 Quarterly Economic Report. World Bank, July 2005, 20 p.



Dr. oec. Vita Pilsuma

THE ROLE AND ACTIVITIES OF THE BANK OF LATVIA IN EUROPEAN MONETARY INTEGRATION (2004–2012)

OFFICIAL BACKGROUND

Following a positive popular vote at the 2003 referendum, Latvia along with both other Baltic States became a fully-fledged EU Member State on 1 May 2004. This date became a significant milestone also with regard to further economic development, as upon the EU accession Latvia also started to enjoy fully all the fundamental economic freedoms of the EU (free movement of goods, capital and people)[1]. Work on harmonisation of legislation began already long before the EU accession, yet significant economic shifts occurred in Latvia only after 1 May 2004.

Latvia's joining the EU did not cause any major changes in the daily routine of the Bank of Latvia. The main legal provisions within the competence of the Bank of Latvia that had to be harmonised concerned the identification and elimination of restrictions on cross-border capital flows as well as the strengthening of the central bank independence and price stability as the main objective of the central bank. Nevertheless, as the provisions of Latvian legislation had already been largely tuned to the letter and spirit of the EU at the moment of their implementation, no significant changes were required. At the referendum, the population of Latvia also voted on Latvia's accession to the euro area (conditional upon meeting certain eligibility criteria). One of the criteria is the requirement that prior to joining the euro area any EU Member State has to participate in the exchange rate mechanism (ERM II) for at least two years.[2]

The main changes to the policy implemented by the Bank of Latvia were related to the re-pegging of the lats from the SDR basket of currencies to the euro. Key questions to be dealt with concerned the establishing of the peg rate and selecting the maximum fluctuation band (although the ERM II provides a standard fluctuation band of ±15%, Member States may unilaterally commit themselves to a narrower fluctuation band).

Having considered several options, the Council of the Bank of Latvia resolved to prevent any manipulations with the exchange rate. Latvia joined the ERM II based on the market rate of that specific time (the rate of the euro vis-á-vis the respective currencies of the SDR currency basket) and maintaining the existing fluctuation band of ±1%. The main argument in favour of this decision was the conviction that the fixed exchange rate regime had proven successful in Latvia and was beneficial to small and open economies, such as Latvia. Moreover, in the process of preparing for participation in the ERM II a decision was taken well in advance that the Bank of Latvia would not engage in any speculations and would not attempt to guess the universally "optimal" exchange rate. The Bank of Latvia rather believed that it was more important to provide as detailed as possible information about the envisaged changes in the exchange rate regime and allow for a sufficiently generous time period during which all the necessary preparations and adjustments by the population and businesses could be made.[3]

Latvia joined the ERM II on 2 May 2005 with the central rate vis-á-vis the euro set at 0.702804. The Bank of Latvia made a unilateral commitment to intervene in the foreign exchange market should the exchange rate of the lats against the euro deviate from that official exchange rate by more than 1% on either side. Formally, this agreement on Latvia's participation in the ERM II also provided for potential ECB interventions should the lats exchange rate vis-á-vis the euro deviate from the official rate by more than 15%, yet, considering the strategy pursued by the Bank of Latvia, no interventions by the ECB were required.

When joining the ERM II, Latvia's economic policy makers additionally made several additional commitments that, strictly speaking, did not entail any legal implications, yet provided a good measuring stick of the country's economical and political maturity. The main commitment was to contain and limit any inflation pressures in Latvia. After pegging the lats to the euro, the monetary policy instruments continued to lose their effectiveness; therefore, the government of Latvia pledged to implement counter-cyclical fiscal policies in combating inflationary risks. When joining the ERM II, Latvia committed itself to limiting any excessively rapid lending expansion and to preventing any wage rises that substantially exceed productivity improvements.[4]

It has to be stressed that these were not just another set of requirements imposed by the EU and almost forced on the Latvian authorities. This was the commitment of Latvia's government to implement policies tailored to the particular economic situation in Latvia. Yet in the course of time many of those initial promises started to lose importance in the eyes of the economic policy-makers as other priorities came to the forefront. At the beginning, the economic policy-makers themselves as well as several experts believed that this carefree attitude would do no serious harm. Ignoring the basic rules of economics turned out to be a grave mistake, however, and the price to pay for this mistake was rather high.

WHAT HAPPENED IN THE ECONOMY?

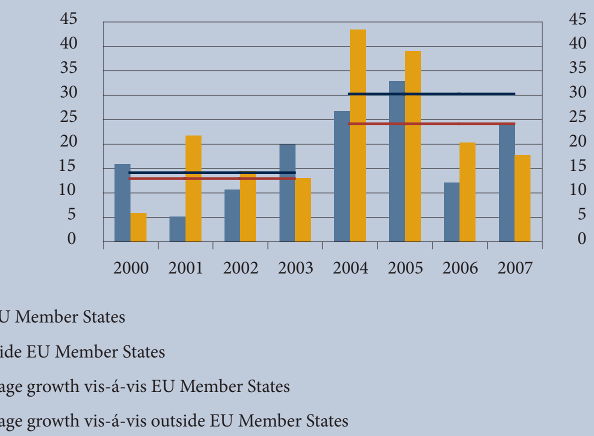
One of the principal economic freedoms in the EU is the free movement of goods. Thus one of the most important effects caused by Latvia's accession to the EU was a significant increase in foreign trade. Although the trade in goods in Latvia became rather liberal already following the restoration of independence and the approximation of Latvia's legislation with the EU *acquis communautaire* began already long before the EU accession and, therefore, the positive trade integration effect was felt already in the previous years, a steep rise in the foreign trade turnover was observed specifically from 2004 when Latvia joined the EU.

In 2000–2003, Latvia's exports to the EU Member States increased by an average of approximately 13% per year, with the overall rise in the period of four years exceeding 60%, whereas within the next four years after the accession Latvia's export growth to the EU Member States almost doubled, on average reaching 24% per year (see Chart 1). It is important to note that the export expansion towards the EU Member States did not happen at the expense of the rest of the world. Latvia's exports to third countries grew even more rapidly than those to the EU Member States. Before Latvia's accession to the EU, exports to third countries evolved similarly to exports to the EU Member States (an average annual increase of 13%), whereas after Latvia joined the EU the average rise in exports outside the EU exceeded 30%. Consequently, the EU accession not only simplified significantly the trading with other EU Member States, but also provided Latvia with an opportunity to negotiate better terms of trade also in business with third countries, particularly with the CIS countries.

In Latvia's case, another economic freedom (free movement of workers within the EU) manifested itself primarily as emigration of working-age population to those countries which were the first to open their borders to labour flows and where the average wage was considerably higher than in Latvia. According to the official statistics, approximately 15 thousand people left Latvia for abroad within the period of 2004–2007 (which is not much more than during similar periods before), yet several estimates suggest that the real number of emigrants could be considerably higher.[5]

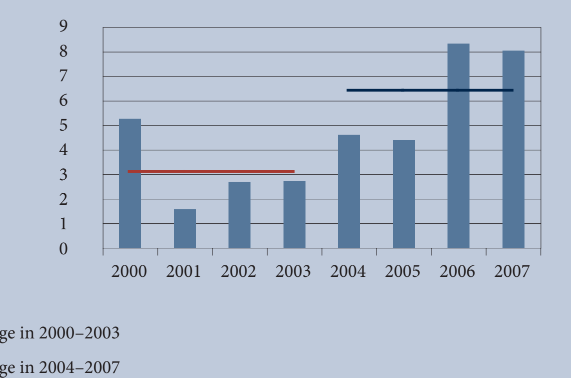
This is implicitly confirmed also by the balance-of-payments data on cross-border money transfers by population. With the working-age population leaving the country to work abroad after the EU accession and repatriating part of their earnings, the average value of international transfers grew from about 5% of GDP to 7% of GDP. That boosted the cash inflows into Latvia and supported subsequent economic overheating. A decline in the free labour force in Latvia was an additional consequence of the emigration of population. This effect was less

Chart 1. ANNUAL GROWTH OF LATVIA'S EXPORTS OF GOODS (2000–2007; %)



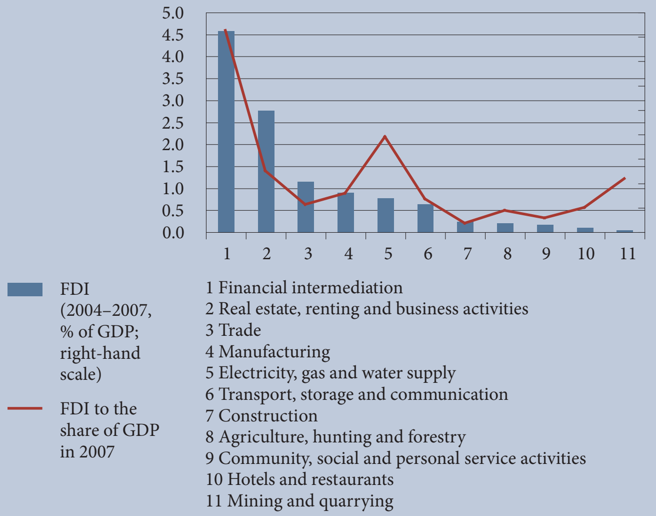
Source: CSB.

Chart 2. FDI INFLOWS IN LATVIA (2000–2007; % of GDP)



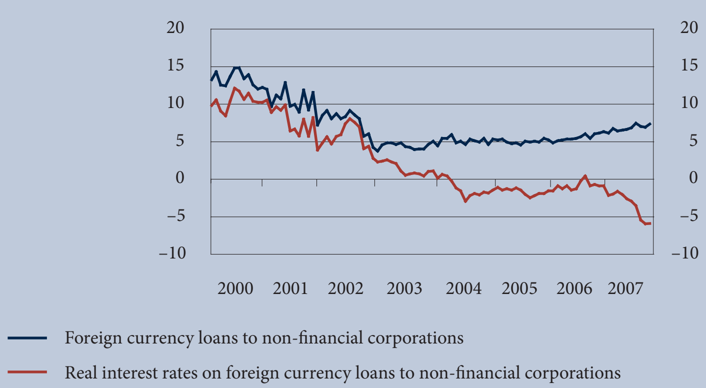
Source: Bank of Latvia.

Chart 3. FDI IN LATVIA BY SECTOR (2004–2007)



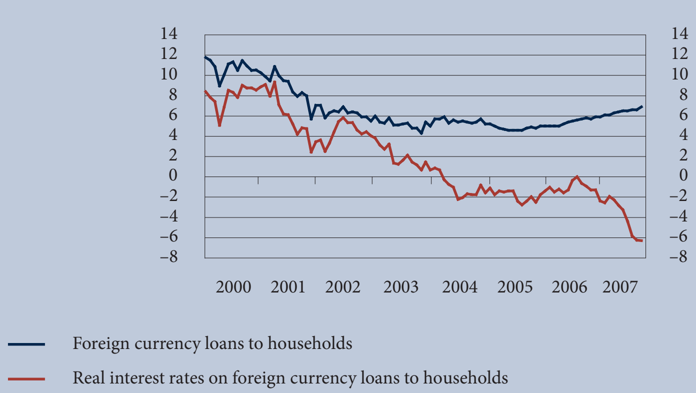
Sources: Bank of Latvia and CSB.

Chart 4. WEIGHTED AVERAGE INTEREST RATE ON LOANS TO RESIDENT NON-FINANCIAL CORPORATIONS (2000–2007; %)



Sources: Bank of Latvia and CSB.

Chart 5. WEIGHTED AVERAGE INTEREST RATE ON LOANS TO RESIDENT HOUSEHOLDS (2000–2007; %)



Sources: Bank of Latvia and CSB.

obvious, yet its impact on the build-up of economic instability was probably much stronger than that of the increase in cross-border transfers.

Moreover, with the EU accession Latvia convincingly and irrevocably left the grey geopolitical area it had lingered in since the collapse of the USSR and the restoration of the national independence and joined an economic area with clearly-defined and generally known operational principles. Also the lifting of the remaining restrictions on capital movement vis-á-vis other EU Member States created friendly environment for long-term investment in Latvia; therefore, the amount of foreign direct investment increased significantly from an average of 3% of GDP within the period up to 2003 to more than 6% of GDP on average in 2004–2007; see Chart 2).

Foreign direct investment inflows went mainly to the financial sector, real estate activities and trade (see Chart 3).

Latvia's accession to the EU had a significant effect also on the perceived risk premiums in the financial markets. With the uncertainty subsiding and confidence in the economy and the profitability of investments on the rise, the lending rates available to Latvia's population and corporates declined considerably. The decision of several Scandinavian banks to buy majority stock at almost all Latvia's biggest banks also was of great importance, thereby significantly increasing the amount of available resources in Latvia. Although the major Latvian banks became the property of foreign investors already prior to Latvia's accession to the EU, lending started to explode only after Latvia's official EU accession.

Even though the nominal interest rates available to the average borrower in Latvia were still slightly higher than those offered to a similar borrower in, for example, Germany, considering the fact that the inflation in Latvia was higher than in Germany, the interest rates available in Latvia were actually among the lowest in the EU in real terms (taking into account both the nominal interest rates and the expected inflation). The attractive rates encouraged borrowing, thereby increasing inflation, pushing the real lending rates even lower and fuelling even higher appetite for borrowing (see Charts 4 and 5). All this set the merry-go-round of credit boom spinning fast and it was additionally stimulated also by several other factors: mass privatisation of apartments, the establishment of the Land Register etc.

To finance the credit expansion, Latvian banks increased their leverage significantly. Considering the relatively limited domestic borrowing options (domestic savings rate was traditionally low; moreover, the falling interest rates also did not support the growth of deposits), the banks financed their lending activities mainly through their foreign affiliates (parent banks) as well as using syndicated loans from the foreign banks. Within the period of 2004–2007, the average annual foreign borrowing of Latvian banks exceeded 17% of GDP. Moreover, at that time several Latvian companies borrowed in foreign financial markets without the intermediation of banks (an average annual amount of over 4% of GDP; see Chart 6).

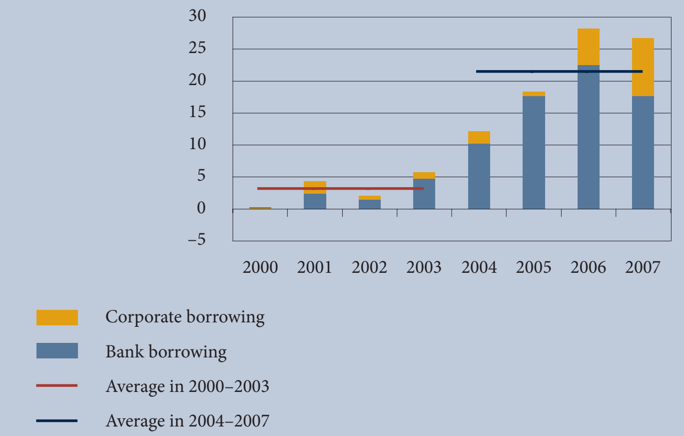
Overall, after the EU accession the financial inflows into Latvia through those various channels (international borrowing by banks and companies, foreign direct investment, private cross-border payments) reached exceptionally high levels. Financial inflows of such a magnitude affected Latvia's overall development because it is a small economy. Starting from 2005, the GDP growth accelerated considerably against the background of the rapidly growing domestic consumption and reached double-digit figures (see Chart 7).

Overall, in the period 2004–2007 Latvia's economic growth was the fastest in the EU and one of the fastest in the world (see Chart 8). Other Baltic States also reported high growth rates within that period. Against this background, the success story of the "Baltic tiger" became increasingly more popular among politicians and economic experts, with the central question being the number of years it would take for Latvia and other Baltic States to catch up with the living standards of the developed EU countries. A period of 10 years was most often quoted as the average required time-span to reach this objective. Analysts from international organisations, so cautious on other occasions, also gave in to the general euphoria and came to believe that this episode of rapid economic growth was a long-term phenomenon.[6]

This optimism is understandable and can be explained: in the context of free liquidity and a shrinking pool of free labour force (inter alia supported by labour emigration), wages increased significantly, often exceeding the productivity growth as the businesses struggled to retain their staff (see Chart 9). At the beginning, however, the steeply rising wages did not cause any significant complications to the businesses as the peaking domestic demand fuelled by higher wages more than offset the increasing labour costs, pushing up the output prices. As a result, many sectors even saw an improvement in profitability in 2005–2007.

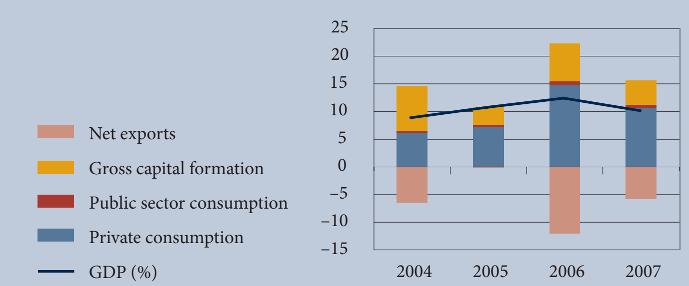
The probability that the economy could continue to develop this way in the long-term seemed realistic. However, on the back of the vigorous growth, the first tentative signs appeared and became stronger year-by-year that in the absence of any preventive measures this particular growth model, based on domestic demand and sustained by lending expansion, would create serious problems to each and every inhabitant of Latvia already in a not-so-distant future.

Chart 6. FOREIGN BORROWING BY BANKS AND CORPORATES (2000–2007; % of GDP)



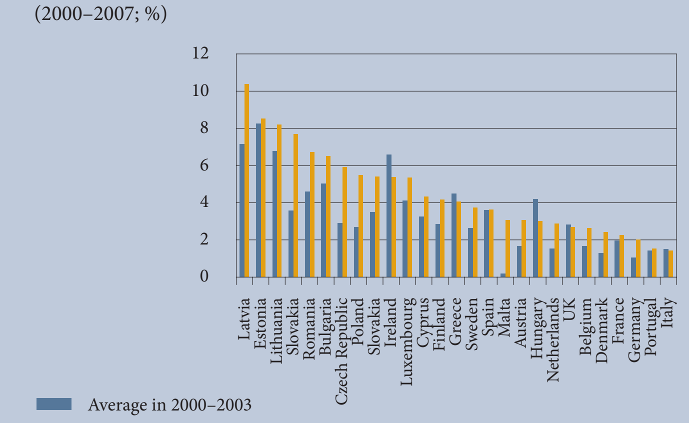
Sources: Bank of Latvia and CSB.

Chart 7. CHANGES IN LATVIA'S GDP BY MAIN DEMAND COMPONENTS (2004–2007; percentage points)



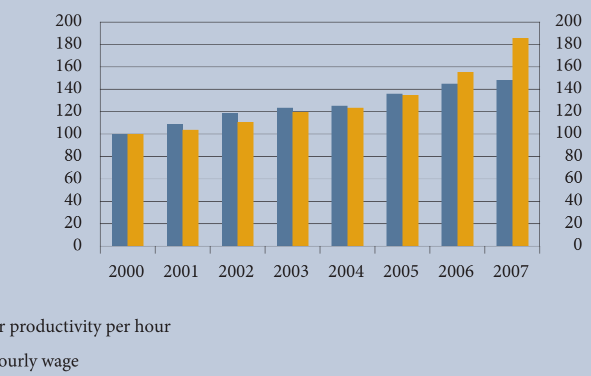
Source: CSB.

Chart 8. AVERAGE GDP GROWTH RATES IN EU MEMBER STATES (2000–2007; %)



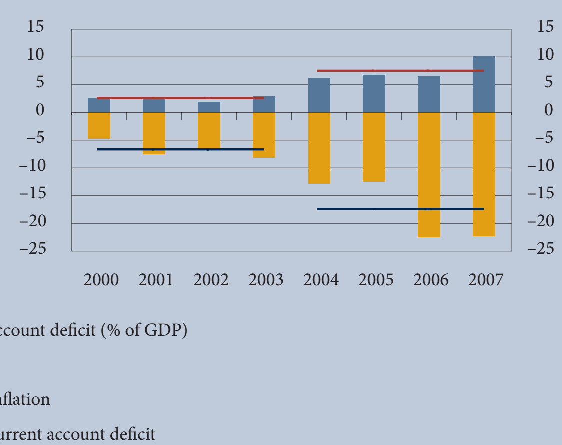
Source: Eurostat.

Chart 9. LABOUR PRODUCTIVITY AND WAGES DEVELOPMENT IN LATVIA (2000–2007; 2000 = 100)



Source: CSB.

Chart 10. DEVELOPMENT OF THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS AND INFLATION IN LATVIA (2000–2007; %)



Sources: Bank of Latvia and CSB.

With currency in circulation growing faster than the economy's capacity to absorb it, money depreciated inevitably, i.e. inflation increased. This was even further exacerbated by the price/wage spiral (in the circumstances of growing wages, production costs increase and that, in turn, makes businesses raise the prices on their outputs, thereby causing demand for higher wages etc.). The average annual inflation grew from 2.9% in 2003 to over 6% in 2004–2006 and exceeded 10% in 2007.

This price hike did not hit the population too hard, because wages also rose accordingly; nevertheless, selling the goods and services outside Latvia became increasingly more difficult, as the price increase in export markets was lower than in Latvia. The high inflation and rising labour costs had a negative effect on the competitiveness of Latvian exporters. Increasingly accelerating domestic demand also meant a rise in the demand for imports. With the export and import gap widening, the current account deficit of Latvia's balance of payments also increased. In 2003, it was slightly over 8% of GDP (a level that is generally considered quite a serious warning of economic overheating), whereas in 2006 and 2007 it already exceeded 20% of GDP (see Chart 10).

A current account deficit is the measure of the exports and imports gap, yet it also points to the need for external financing which in Latvia's case was mainly external borrowing of the banks. This financing source is considerably less stable than, for example, the foreign direct investment inflows. Therefore, with the above-mentioned growth model and its financing sources remaining unchanged, it became increasingly clearer that the economic growth in Latvia lacked sustainability.

Firstly, the private sector debt also expanded alongside with the loans granted. The ratio of debt to income for resident loans increased from 40% of GDP in 2003 to nearly 90% of GDP in 2007 (see Chart 11). One of the fundamental rules of economics is that a country's debt cannot rise infinitely. Sooner or later the national debt reaches the critical threshold where further financing of the debt becomes impossible due to an excessively high risk premium requested by investors. As a result of the strong lending growth, Latvia was rapidly approaching this debt threshold.

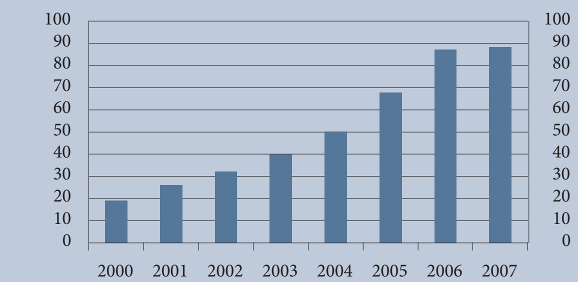
Secondly, with time, the banks themselves found it increasingly more difficult and complicated to maintain a constantly high rate of lending expansion. Contrary to the first years following the EU accession when the market was still under-developed and the demand for improvement of the living standards was high and the banks could handle the increase of their loan portfolios quite easily (there were rather many customers who could afford to undertake sizeable long-term commitments), with the time passing, the number of such potential bank customers started to decrease. In order to attract new customers and thus ensure stable lending growth, the banks had to ease their credit standards and in some cases the amount of the loan offered even exceeded the value of the collateral. Such practice also has its limits, as excessive easing of the credit standards leads to growing risks of potential future losses, something that even the most optimistic bank managers and shareholders cannot ignore.

Thirdly, the buoyant lending expansion also caused higher demand for real estate followed by quite a logical and equally steep rise in real estate prices. As a result of the strong demand and limited new offer, the real estate prices grew much faster than the average income of the population. Therefore, even though the lending expansion created an illusion that any resident of Latvia could afford to buy real estate easier than before, the reality, in fact, was quite the opposite: considering the ratio of their income to real estate prices, the number of people who really could afford those properties was constantly shrinking (see Chart 12). Thus initially the strong expansion of credit fuelled the rising demand for real estate. With time, however, the rising demand caused an even faster increase in real estate prices, which ultimately cooled off the demand.

The selected national growth strategy also entailed significant changes in the structure of the Latvian economy which had a negative effect on the long-term economic development. For example, the bulk of the loans granted and the foreign investment inflows were channelled to areas relating to trade, construction as well as real estate development and management rather than to the production sector. Thus the economic sectors that were dependent on domestic consumption grew more rapidly than the exporting sectors. The average annual growth of manufacturing output decreased from about 8% in the period 2000–2003 to 4.8% in 2004–2007, whereas that of the three domestic consumption oriented sectors (construction, trade and real estate activities) increased from 10% in 2000–2003 to 14.5% in 2004–2007 (see Chart 13 for the developments in the above sectors). The overall economic development was increasingly relying on the real estate sector development and the related sectors, whereas the export development potential decreased. In the circumstances of buoyant growth (and the respective rise in wages), the structure of the labour market also changed. Employment in construction, trade and real estate management sectors increased, whereas that in industry declined (see Chart 14).

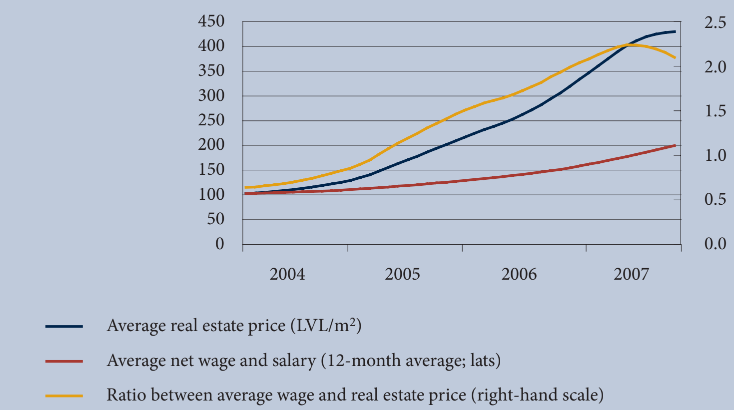
At the same time, the rise in predominantly foreign-currency-denominated debt supported by the active lending policies resulted in a need for unwinding: in order to be able to repay this debt in time and without any difficulty in the future, an increasingly larger part of the economy had to work for external

Chart 11. RATIO OF LOANS TO GDP (2000–2007; %)



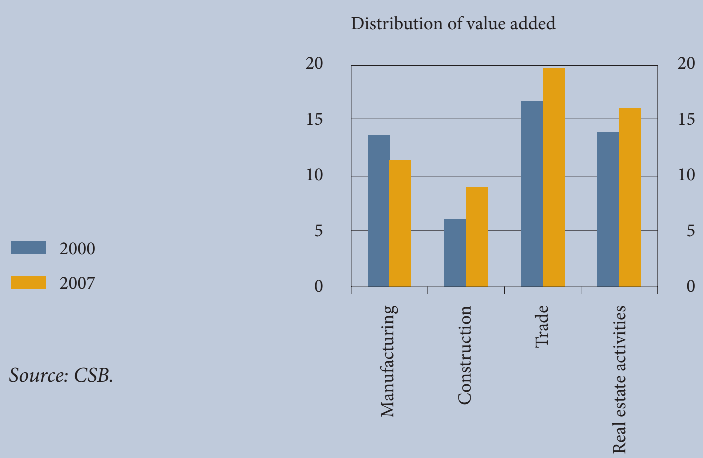
Sources: Bank of Latvia and CSB.

Chart 12. DEVELOPMENT OF REAL ESTATE PRICES AND AVERAGE WAGE IN LATVIA (2004–2007)



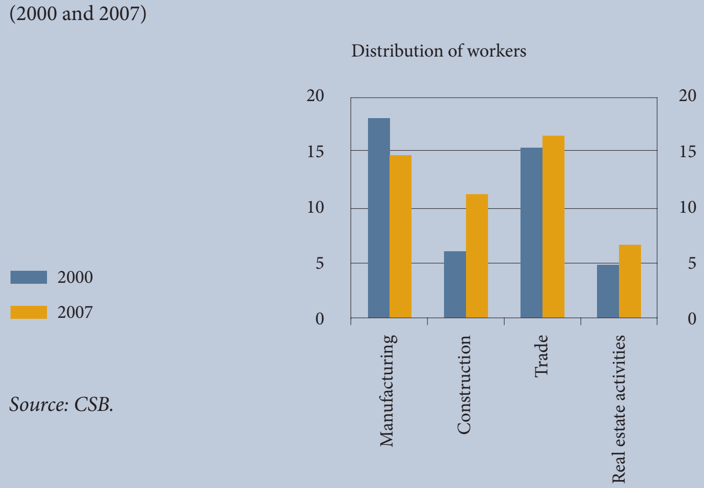
Sources: CSB, Latio Ltd. and Bank of Latvia.

Chart 13. CHANGES IN VALUE ADDED IN LATVIA (2000 and 2007)



Source: CSB.

Chart 14. CHANGES IN EMPLOYMENT STRUCTURE IN LATVIA (2000 and 2007)



Source: CSB.

trade to generate additional foreign currency income. This mismatch between the actual and the economically justified growth model gradually increased and the situation became similar to a time-ticking bomb: there was no longer any doubt whether it would go off, the only question was when it would happen.

The central bank has often been blamed that the fixed exchange rate of the lats vis-á-vis the euro stimulated capital inflows and the additional borrowing, further supported by the excessively low interest rates. Nevertheless, a deeper analysis suggests that Latvia's main problem was not the capital inflows in the economy *per se*. The stage of economic development in Latvia and the low level of domestic savings were the objective reasons that determined the dominance of foreign capital as the main source of investment in Latvia. In this regard, the EU accession opened up new opportunities for Latvia. The problems were caused by the fact that the investment was used for consumption and short-term gains instead of increasing the national production and export capacity, strengthening competitiveness and productivity gains. The fact that borrowed money was used to finance consumption boom both led to skyrocketing debt levels and at the same time worsened the economy's capacity to generate a sufficient stream of foreign exchange to repay those (ever growing) debts. So the opportunities provided by the EU accession were not explored properly (one can even almost say they were wasted).

ECONOMIC POLICY RESPONSE TO THE RISING RISKS OF OVERHEATING

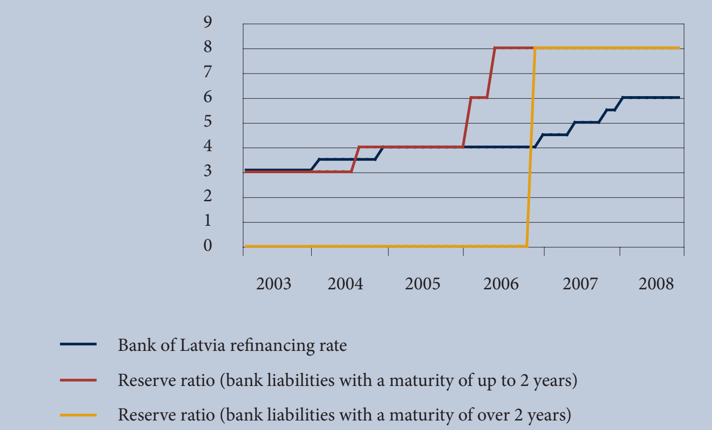
With the first signs that the Latvian economy had started to deviate from the sustainable development path and with the rising awareness that timely policy response was needed to prevent macroeconomic imbalances from growing further, the Bank of Latvia resorted to the monetary policy instruments at its disposal. It was possible to use two of them: the refinancing rate (the interest rate at which the Bank of Latvia grants loans to banks in exchange for an adequate collateral, usually government securities) and the reserve ratio (percentage of the minimum reserves used to calculate the average monthly amount of money that the banks are obliged to hold on their accounts with the Bank of Latvia and that they cannot use for further lending expansion).

Against the background of rising risks stemming from the rapid economic growth, the Bank of Latvia raised the refinancing rate for the first time already in 2004 (up to then the refinancing rate had only been reduced). Soon the reserve ratio was also increased. Overall, within a two-year period the reserve ratio was raised from 3% at the beginning of 2004 to 8% at the end of 2005. That was followed by expanding the reserve base at the beginning of 2006 to include also bank liabilities with a maturity over 2 years (before that, no reserve ratio was applied to longer-term liabilities in order to stimulate long-term financing inflows). In the next two years, the refinancing rate was further increased on several occasions until reaching 6% in mid-2007, a level twice as high as at the beginning of 2004 (see Chart 15 and Box 1).

These measures implemented by the Bank of Latvia, no doubt, had a certain role to play as they effectively dampened some lending activities by making them more expensive. These activities also signalled the growing risks to the macroeconomic stability and probably made some market participants to reconsider their choices. Nevertheless, it could not fully prevent the economic overheating and the soaring inflation in Latvia due to several reasons.

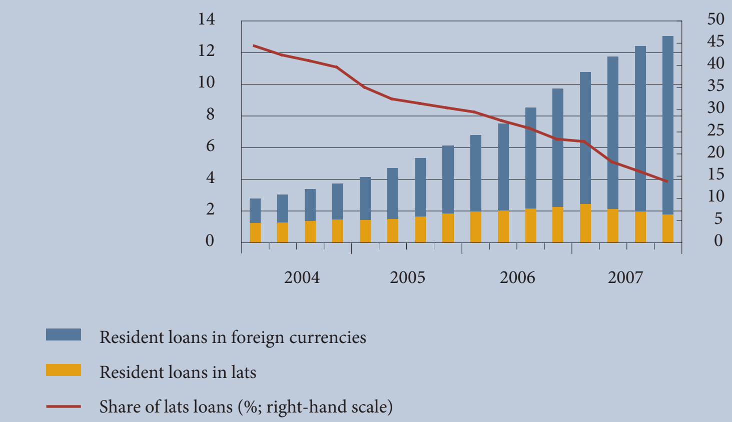
Firstly, in light of the free movement of capital across the borders of the EU Member States, the role and effectiveness of the traditional monetary instruments at the disposal of the national central banks of small and open economies decreased significantly. Higher refinancing rates imposed by the Bank of Latvia made borrowing in lats more expensive; therefore, the banks increased their supply of foreign currency (primarily euro) denominated loans and their customers' demand for them also expanded accordingly. Thus the share of the lats-denominated loans shrank from almost 50% to slightly over 10% in a couple of years (see Chart 16). Therefore, the effect of the interest rates set by the Bank of Latvia on the overall economic development became increasingly weaker, whereas the importance of the key ECB interest rates, on which the Bank of Latvia had no effect, grew.

Chart 15. BANK OF LATVIA REFINANCING RATE AND RESERVE RATIO (2004–2007; %)



Source: Bank of Latvia.

Chart 16. CHANGES IN THE CURRENCY STRUCTURE OF BANK LOANS (2004–2007; billions of lats; %)



Source: Bank of Latvia.

Box 1

INTEREST RATES AND RESERVE RATIOS SET BY THE BANK OF LATVIA

(annual; %)

Effective from (dd.mm.yyyy)	Bank of Latvia's refinancing rate	Interest rates on Lombard loans			Interest rates on time deposits		Reserve ratio (%)	
		Up to 10th day	11th–20th day	Over 20 days	7 days	14 days		
Status as at 01.01.2004	3.0	5.0	6.0	7.0	2.0	2.25		3.0
11.03.2004	3.5	–	–	–	–	–		–
24.07.2004	–	–	–	–	–	–		4.0
12.11.2004	4.0	–	–	–	–	–		–
24.08.2005	–	–	–	–	–	–		6.0
24.12.2005	–	–	–	–	–	–		8.0
							Liabilities with a maturity of over 2 years	Other liabilities included in the reserve base
24.05.2006 [1]	–	–	–	–	–	–	8.0	8.0
15.07.2006	4.5	5.5	6.5	7.5	–	–	–	–
17.11.2006	5.0	6.0	7.0	8.0	–	–	–	–
		Interest rates on the Bank of Latvia's marginal lending facility			Interest rates on the Bank of Latvia's overnight deposit facility			
24.03.2007	5.5			6.5		2.0	–	–
18.05.2007	6.0			7.5		–	–	
24.02.2008	–			–		3.0	7.0	–
		If the lending facility has been used no more than 5 working days within the previous 30 day period	If the lending facility has been used 6–10 working days within the previous 30 day period	If the lending facility has been used more than 10 working days within the previous 30 day period				
24.04.2008	–	–	–	–		–	6.0	–
24.10.2008	–	–	–	–		–	5.0	7.0
24.11.2008		–	–	–		–	4.0	6.0
09.12.2008	–	7.5	15.0	30.0		–	–	–
24.12.2008		–	–	–		–	3.0	5.0
24.01.2009	–	–	–	–		2.0	–	–
24.03.2009	5.0	–	–	–		1.0	–	–
24.05.2009	4.0	–	–	–		–	–	–
					Interest rates on the Bank of Latvia's deposit facility			
					Overnight	7 days		
24.03.2010	3.5	–	–	–	0.5	1.0	–	–
24.07.2010	–	–	–	–	0.375	0.5	–	–
24.11.2010	–	–	–	–	0.25	0.375	–	–
24.01.2012	–	–	–	–	–	–	2.0	4.0
24.03.2012	–	5.0	10.0	15.0	–	–	–	–
24.07.2012	3.0	4.0	7.0	10.0	0.1	0.125	–	–
24.09.2012	2.5	3.0	6.0	9.0	0.05	0.075	–	–

[1] As of 24.05.2006, the reserve ratio is also applied to the bank liabilities with an agreed maturity of over 2 years.

Secondly, it has to be kept in mind that the instruments at the disposal of a central bank are meant for adjusting small outbursts of inflation rather than for putting a stop to a major inflation rise.

Thirdly, even if the central bank had possessed a theoretical ability of fully discontinuing any lending (for example, by setting a reserve ratio in the amount of 100%), it would hardly have been a correct decision as such a step would have caused significant adverse consequences, such as a complete credit crunch, even for exporting companies. Latvia's main problem was the concentration of resources in some sectors of the economy that stimulated short-term consumption and did not improve the long-term development potential of the economy. Raising of the reserve ratio to a level that would discourage lending would have also made businesses fully unable to draw new investment (due to the low level of development, the capital market could not serve as a serious alternative to the bank loan channel) and thus it would have nipped any further growth opportunities.

Fourthly, considering the limited opportunities of applying the monetary policy instruments, the Bank of Latvia implemented the above measures hoping that other economic policy makers would also see the risks to macroeconomic stability and would act accordingly within the scope of their competence in order to stabilise the economy by implementing coordinated macroeconomic policies. That, however, did not happen (see Box 2). The banks focussed on conquering new markets, expanding the existing market shares and ensuring short-term profitability. The relatively low depth of the financial sector (in comparison with the developed EU Member States) was perceived as an indication of unused opportunities and high future growth, while disregarding the relationship between the depth of the financial sector and the income level (which in Latvia was also considerably lower than the EU average). As it turned out, the underestimation of risks dealt a painful blow to the banks, as they had to write down to losses amounts equalling the sizeable profits earned in the previous boom years.

The attitude of the government representatives and the Members of the Parliament towards the risks to the macroeconomic stability, at least initially, was not unanimous. On the one hand, there was a popular belief that the economic growth was more important than stability and high inflation was the price to be paid for the vigorous growth. On the other hand, the government members realised very clearly that the high inflation acted as an income diminishing factor and thereby as an obstacle also to attaining the government's goal of welfare improvement. In the circumstances of general uncertainty, the government formulated a significant dilemma for itself at the turn of 2004: to tackle the problem of the inflation hike immediately (yet risking to lose its popularity) or to postpone the addressing of the problem for as long as possible and meanwhile enjoy the short-term benefits of the economic boom (hoping that maybe with time the inflation problem will somehow sort itself out).

Shortly afterwards, at the beginning of 2005, it became obvious from the announcements made by the government members that the government had opted for the second option (the so-called "getting over the inflation"; see Box 2). This decision largely determined the future of Latvia's economy. It became clear that coordinated economic policy action to mitigate the risks associated with the economic overheating was something impossible to achieve, at least not while the government views on this issue remained unchanged. Therefore, in the years to follow the Bank of Latvia continued to pursue a tighter monetary policy where possible, while at the same time it continued to bring the issue of the growing risks to the government's attention and encouraged other economic policy makers also take preventive steps within their competence.

One of those attempts was related to the development of an anti-inflation plan. Initially, this plan which was developed with the participation of the Bank of Latvia experts included measures to limit mortgage lending, particularly with respect to cases when more than one real estate mortgage was registered in the name of a single person. The plan also provided that mortgage loans would only be granted to physical persons on the basis of their provable (legal) income. The Bank of Latvia advocated an immediate implementation of this plan, yet this view did not gain the support of other economic policy makers (see Box 3). Thus the implementation of the anti-inflation plan was delayed for far too long. Up until the beginning of 2007, the economic policy makers predominantly believed that the focus of attention and effort should be on achieving a maximum growth rate. The soaring inflation was accepted as an inevitable side-effect and the price to be paid for the rapid growth. The Bank of Latvia's remark that such a trade-off – higher inflation in exchange for more robust growth – was an illusion was disregarded.

The main reason why the government chose not to pay sufficient attention to macroeconomic stability issues was the fact that the impressive economic growth figures played to the government's advantage. Both the rising economic activity as well as the high inflation brought additional tax revenue to the government budget. The government could spend those windfall revenues on reaching various popular short-term objectives. In 2003–2007, the budgetary revenue regularly outperformed the targets planned at the start of the year and the government was equally regular in introducing amendments to the law on budget

Box 2

THE VIEWS OF ECONOMIC POLICY MAKERS AND EXPERTS ON LATVIA'S DEVELOPMENT (2004–2007)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2004 (inflation at the beginning and the end of the year: 3.9% and 7.3% respectively)	
It is clear that the 2004 budgetary deficit exceeding 2% of gross domestic product is inappropriately high and measures to reduce this budgetary deficit should be implemented within the nearest months. With the current development rate holding, the government must focus on further stability in the public finances system and the budgetary deficit for 2005 which should not exceed 1% of gross domestic product. The monetary policy instruments at the Bank of Latvia's disposal are insufficient to reduce the domestic demand: close cooperation between the Bank of Latvia and the Latvian government in the field of the national fiscal policy is also required. (11.03. 2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) The Bank of Latvia believes that although the current rise in inflation is primarily driven by several external supply factors, it is justified to conclude that the persistently high and even growing domestic demand has also started to have at least a partial effect on inflation. (An article by R. Pētersons in the newspaper *Neatkarīgā Rīta Avīze,* 12.03.2004) (..) the potential risks of overheating and a widening external current account deficit represent a challenge to Latvia's economy in the medium term. (..) Given the 2003 outturn and the potential risks of overheating, we urge the authorities to explore the possibilities for fiscal tightening in 2004, and, at a minimum, use any additional revenues to lower the deficit. (Latvia – 2004 Article IV Consultation Concluding Statement of the IMF Mission, 29 April 2004) In the circumstances when the domestic demand in the economy is already high (..), it is particularly alarming to see that Latvia's fiscal position has deteriorated in May and June. Concerned about the sustainability of the so-far buoyant growth of Latvia's economy and wanting to prevent serious deterioration of Latvia's international prestige, the Council of the Bank of Latvia again urges the government not to allow the budgetary deficit of this year to exceed 1.5% of GDP. (15.07.2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Attempts to secure sustainable national growth on account of raising the budgetary deficit would be clearly contrary to the fundamental laws of economics. So far, no country has managed to achieve significant improvement in its welfare by increasing the budgetary deficit. (09.09.2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) It has to be noted that the current lending development is primarily based on loans designated for consumption. Mortgage loans are predominant instead of loans for expansion and modernisation of production which could increase Latvia's production potential in the future. (11.11.2004 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Aigars Kalvītis, the newly-appointed Prime Minister, points out that the government will have to decide between either letting the state get over the inflation or implementing unpopular restrictive measures. (An article by I. Šķepaste and I. Mārtiņa in the newspaper *Dienas Bizness*, 06.12.2004)	The Prime Minister Indulis Emsis (Union of Greens and Farmers) has no intention of listening in to the Bank of Latvia's appeal to reduce the budgetary deficit..."We would love to have a balanced budget, but not at any price. We have to look at what is happening in the streets, in real life. We cannot be sterile figure admirers. And we won't be!" says the head of the government. (An article in the newspaper *Latvijas Avīze*, 27.04.2004) Inflation is no threat to the macroeconomic stability. This is the opinion of the Ministry of Economics. Namely, although inflation was higher at the beginning of this year than the one observed previously, it is not as high as to threaten the macroeconomic stability in Latvia and to require new and crucial measures. (An article in the newspaper *Latvijas Vēstnesis*, 13.05.2004) A balanced budget is not an end in itself. A budget should serve the national development. We are not afraid to undertake risks saying that there is no need to warn about any overheating in Latvia's situation, we have to "go full throttle". (A. Šlesers, Deputy Prime Minister, in an article in the newspaper *Diena*, 09.08.2004) Gundars Bērziņš (Popular Party), Head of the Saeima Budget and Finance Commission: I think that the Bank of Latvia exaggerates the inflation threats and the government's responsibility. The Bank of Latvia speaks of the truths that are suitable for countries with 50–100 years of a market economy, while the Latvian economy is a fast growing economy and it has to be approached creatively. The Bank of Latvia bases its opinion on clever books, but the ideas expressed therein cannot be applied to Latvia directly as they are. Maybe after some years new laws will be written in economics textbooks based on the example made by Latvia and other growing economies. (An article by J. Sizova in the newspaper *Diena*, 15.09.2004) Teodors Tverijons, the President of the Association of Commercial Banks of Latvia, believes that the totally ungrounded discussions about Latvia's economic overheating benefit various political speculations. "A 40% credit growth maybe would be something fantastic in Germany or Sweden, but it is a normal rate in Latvia. What is abnormal for others, can be normal for us", says Mr Tverijons (An article by B. Latkovskis in the newspaper *Neatkarīgā Rīta Avīze*, 15.10.2004) O. Spurdziņš: Some negative trends have also appeared: for example, the relatively high inflation "eating away" the income of both the population and the country overall. It seems, however, that we have reached a certain turning point in October and the inflation could go down. (Oskars Spurdziņš, the Minister of Finance, with the end of Indulis Emsis' government and the year 2008 approaching, is discussing the European Union, customs, taxes and inflation issues, *Latvijas Ekonomists*, No. 12, 2004) "This is my belief and not a forecast: the Latvian economy has no reason to overheat!" said Juris Lujāns, the Minister of Economy (An article by A. Vaivars in the newspaper *Dienas Bizness*, 02.11.2004)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2005 (inflation at the beginning and the end of the year: 6.6% and 7.0% respectively)	
We believe that the persistently high lending growth confirms the need for the government to consider seriously measures to decelerate this process, particularly in the area of real estate lending. It has to be noted that these measures should reduce the attractiveness of profiteering, whereas no loan tax or duty should be applied to, for instance, a new family taking their first loan for the purchase or repairs of a house or an apartment. (21.03.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) It is wrong to wait until we just "get over" the inflation rise. Sooner or later, high inflation dampens the economic growth. Attempts to address the inflation problem with wrong instruments can only make it bigger and the future consequences even more serious. (19.05.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) As the inflation in Latvia remains higher than previously forecast, Ilmārs Rimšēvičs, the Governor of the Bank of Latvia, believes that specific measures to push it down should be implemented, otherwise our economy may not witness growth rates equal to the steep ones experienced last year. The Governor of the Bank of Latvia stresses that under such circumstances the government has to increase its focus on ensuring further decline in the budgetary deficit. (An article by G. Kronberga in the newspaper *Latvijas Vēstnesis*, 20.05.2005) At present, however, the pace of economic expansion is creating challenges for macroeconomic stability. With output slightly above potential, the mission stressed the need for a firmer fiscal stance than planned. (2005 Article IV Consultation – Staff Report, 14.07.2005) At the moment, there are already the first signs of a price spiral in Latvia, i.e. an increase of prices in one sector of goods or services is mentioned as the reason for raising prices in other sectors. One of the main factors sustaining the domestic demand at a high level remains the active lending policies pursued by the banking sector. Namely, there are already some indications that could suggest that, with the number of debtors increasing, the quality of the banks' loan portfolio could be deteriorating. This will make the banks review and change their lending policies sooner or later. Therefore, the currently observed lending development rates should be considered excessively elevated and lacking long-term sustainability. (22.09.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) In the current conditions of rapid growth and high inflation, the fiscal policy should be aimed at reaching a completely balanced budget, using the windfall tax revenue to contain the budgetary deficit rather than to finance additional expenditure. (17.11.2005 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia)	The government has no intention to combat the inflation growth by imposing restrictions and the country will be allowed "to get over this disease", said the Prime Minister Aigars Kalvītis in his interview with Latvijas Radio. (An article by V. Dzene in the newspaper *Dienas Bizness*, 03.01.2005) Although the issue of whether we should or we should not take over Ireland's experience with taxing mortgage loans is currently being considered, the Minister of Finance Oskars Spurdziņš believes that it is unlikely that it will be done. (An article by E. Lidere in the newspaper *Neatkarīgā Rīta Avīze*, 26.01.2005) "Latvia's economy is healthy", says the Prime Minister Aigars Kalvītis. He stresses that nothing will be done to reduce the inflation also in the future, because the situation will stabilise on its own by the end of the year. (An article by I. Veģe in the newspaper *Dienas Bizness*, 11.03.2005) O. Spurdziņš: Considering Latvia's high economic development rates, the current inflation is at an acceptable level. It would be tragic if the inflation reached double-digit figures. It is not time for strict measures as we have not yet approached the critical border. (An article by G. Kronberga in the newspaper *Latvijas Vēstnesis*, 07.07.2005)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2006 (inflation at the beginning and the end of the year: 7.5% and 6.8% respectively)	
At the same time, what we could expect from the government is solutions to push down the inflation. (..) Two serious problems have emerged. First: money has started to lose its function as a store of value. (..) Second: once the wage spiral has started, one sector will face problems sooner, another maybe later, but we are all losing competitiveness anyway. (O. Kehris, President of the Economists Association 2010, to the newspaper *Lauku Avīze*, 10.03.2006) One of the biggest problems related to the strong domestic demand which prevents the inflation and the current account deficit from declining substantially is the incommensurate development of lending. The annual increase in resident loans (over 60%) observed during the last months is too steep from the point of view of both the macroeconomic risk as well as the stability of public finances. Moreover, the tendency for lending to develop vigorously on account of expanding foreign debt instead of domestic deposits is also becoming increasingly more pronounced. Thus the economy receives inflows of financial resources via loans which, considering the currently strong domestic demand, acts as an additional upward factor to the inflation. (14.03.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Inflation, above 6% for the third consecutive year, has started to erode the competitiveness of Latvian exporters on foreign markets which with some time may result in deceleration of the overall economic growth as well. (11.05.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Unfortunately, several signs have appeared in the economy signalling that the current rate of development cannot be sustained in a longer term and the hiking inflation has already started to threaten further growth of the national economy. (M. Bitāns, Advisor to the Governor of the Bank of Latvia, in an article in the newspaper *Dienas Bizness*, 19.05.2006) We can see from the latest statements by our politicians and some economists that the experience of other countries in addressing similar problems is not being taken on board. Firstly, under these circumstances of high inflation the government should restrict any further stimulation of demand and avoid increasing the budgetary deficit. On the contrary, as a minimum, it should form a balanced budget, if not a surplus budget. Secondly, politicians should return to the development of a real inflation rate reduction plan. (I. Rimšēvičs in an article by the newspaper *Diena*, 09.06.2006) The Governor of the Bank of Latvia stresses: if we fail to rein in inflation, it will cost us dearly! (An article by G. Grūbe in the newspaper *Latvijas Vēstnesis*, 16.–22.06.2006) I. Rimšēvičs: The Bank of Latvia certainly does not wish to court disaster, yet an inflation rate rising over 6% in one and a half year is a dangerous tendency. (An article by A. Dunda in the newspaper *Bizness & Baltija*, 19.06.2006) An upfront policy tightening is needed to contain near-term overheating and secure a soft landing. A sizable front-loaded fiscal adjustment, combined with more subdued wage and credit growth, would help unwind the output gap, slow inflation, narrow the current account deficit, and stabilize external liabilities. (IMF Staff Report for the 2005 Article IV Consultation, 13.09.2006) This is the right moment to make savings in the budget for the time when the growth decelerates. (07.09.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) Inflation expectations become an increasingly more important factor is sustaining a high inflation rate: under the circumstances of persistently high inflation they become increasingly stronger and cause an increasingly tighter "vicious" spiral of wages and prices interaction. At the moment, it seems that the inflation expectations are underestimated in Latvia and not considered a sufficiently serious inflationary factor. This is confirmed by the wide-spread belief that high inflation is inevitable at times of rapid growth. (..) Unfortunately, we have to conclude that, so far, we have not used the unusually favourable and stimulating economic conditions determined primarily by the comparatively low interest rates and the favourable exchange rate in order to significantly strengthen the production capacity in Latvia and improve the competitiveness of Latvian producers. Instead, domestic-consumption-based sectors have been developed, thereby supporting higher growth only in the short-term! (16.11.2006 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia)	"A balanced budget is an ideal model for any Minister of Finance, and maybe we would have had it this year at some point; however, there has never been a balanced budget in the year preceding the elections, as the society has many wishes", says Oskars Spurdziņš. (An article by Z. Dūmiņa in the newspaper *Diena*, 15.02.2006) T. Tverijons: It is not that important what we call a particular stage of the economic development; nevertheless, it has to be mentioned that overheating also is no tragedy, no catastrophe: it is a very beautiful name for an economic development stage, which does not carry any clearly negative connotation. Considering the growth of the gross domestic product, average wage and salary increase achieved last year, 7.5% inflation yields a wonderful result and there is no reason for grief. (An article by A. Vaivars in the newspaper *Dienas Bizness*, 05.06.2006) O. Spurdziņš stressed: "A balanced budget would be my dream in the capacity of the Minister of Finance, yet I cannot promise to achieve it." (An article by B. Rulle in the newspaper *Diena*, 11.10.2006) T. Tverijons: Firstly, the talks about the excessively high inflation in our country are way too much exaggerated. At the moment, it is consistent with the rapid economic development of our country and it is not something to be worried about. (An article in *Neatkarīgā Rīta Avīze*, 19.12.2006) O. Spurdziņš: The expected inflation is not high. I really have to agree with the Prime Minister A. Kalvītis on this: he said that inflation is a popular subject today. (An article by A. Vaivars in the newspaper *Dienas Bizness*, 19.12.2006)

Inflation and economic overheating is a problem	Inflation and economic overheating is not a problem
2007 (inflation at the beginning and the end of the year: 7.1% and 14.1% respectively)	
At the moment, when we have already had three years of an exceptional price rise, it is clear that we shall not be able to do completely without involving the heavy artillery in the national macroeconomic policy. The government together with the Bank of Latvia is ready to implement a set of measures to curb inflation. It is possible that some steps will be unpopular, but we should not hesitate with their implementation. (O. Spurdziņš in an article by the newspaper *Diena*, 07.03.2007) The population of Latvia should choose less to live in debt and, prior to taking loans, assess their financial capability more carefully, [..] said Aigars Kalvītis, the Prime Minister (Popular Party), when explaining the government's ideas for fighting inflation. Mr. Kalvītis believes that the scale of lending in Latvia has exceeded "all ceilings". (An article in LETA, 07.03.2007) All major macroeconomic performance indicators indicate that Latvia has continued steering towards overheating during the last quarters. Therefore, the action plan for stabilisation of the national macroeconomic situation approved by the government is highly appreciated. [..] those who have already come to a conclusion that such an economic stabilisation plan and the measures contained therein would have been more effective if launched a year or two ago are partly right. (15.03.2007 Press conference by I. Rimšēvičs, Governor of the Bank of Latvia) There is an urgent need for decisive action to unwind overheating pressures and narrow external imbalances by sharply curtailing domestic demand. A comprehensive strategy is therefore needed to curb domestic spending and wage growth, and moderate real estate prices to rebalance incentives for investing in tradables sectors. (Statement by IMF Mission to Latvia on 2007 Article IV Consultation Discussions, 04.05.2007) "Inflation was expected to rise in the first four months of this year; nevertheless, it becomes increasingly clearer that measures to decelerate the inflation rise are required", BNS news agency was told by Oskars Spurdziņš, Minister of Finance. The Prime Minister Aigars Kalvītis, in turn, told the BNS agency that the inflation rise was "serious". (An article by M. Cerava featured by the BNS, 10.05.2007) When adopting amendments to the 2007 law on the state budget, it is intended to target a balanced budget. (An article by M. Fridrihsone in the newspaper *Dienas Bizness*, 22.08.2007)	Arno Pjatkins, the Advisor to the Prime Minister Aigars Kalvītis (Popular Party), also said that there were objective reasons for the high inflation rate. At the same time, he highlighted Latvia's buoyant economic development. (An article by J. Bagātais, LETA, 08.02.2007) T. Tverijons: At the Association, we believe that the existing level of inflation is the objectively necessary level resulting from the national economic development. (An article by V. Stepanovich in the newspaper *Час*, 01.08.2007)

Box 3

THE VIEWS OF POLICY MAKERS ABOUT THE NEED FOR AN ANTI-INFLATION PLAN

As the Prime Minister explained, at the moment the inflation plan cannot be made public because it may contain ideas which, even though just rumours, could cause turbulence in the business environment. (Kalvītis to the BNS, 27.07.2005)

T. Tverijons: "These restrictions on mortgage lending or restrictions on lending – to hope that this will curb the inflation – we are saying – it is bluff. It will not." (A feature by I. Elksne on LNT news, TVNET, 25.07.2005)

After several months of working on the confidential anti-inflation plan, the government, however, agreed on Tuesday not to implement any consumer price restricting measures in Latvia at the moment. Oskars Spurdziņš, the Minister of Finance, explained to the journalists that the government has taken stock of its "arsenal of weapons" but it not going to use it at the moment as currently the inflation is not rising rapidly. Some of the measures included in the plan for reducing the price rises could have an adverse effect on Latvia's economic development.
Teodors Tverijons, the President of the Association of Latvian Commercial Banks, admitted to the BNS agency that the decision not to implement the anti-inflation plan was a "very wise decision". (An article by A. Brasliņa, A. Skurbe featured by the BNS, 16.08.2005)

"We hope that the government understands the gravity of the situation, that it will not be too late with launching the plan and that it will act consistently at a crucial moment", BNS agency was told by Ilmārs Rimšēvičs, the Governor of the Bank of Latvia. (An article by A. Brasliņa, A. Skurbe featured by the BNS, 16.08.2005)

The Bank of Latvia indicated to the BNS agency that the government should immediately launch the anti-inflation plan, in order to ensure buoyant long-term development of Latvia's economy. (An article by R. Zemdega in the newspaper *Diena*, 11.10.2005)

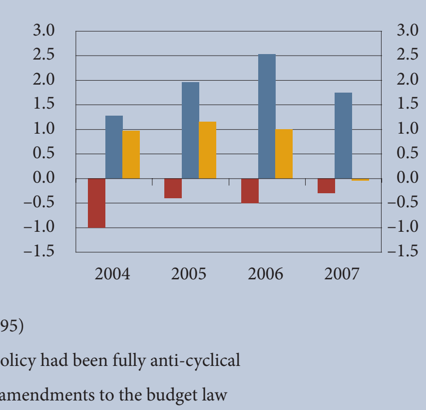
A. Štokenbergs (Economic Advisor to the Prime Minister): the government decided not to implement any measures that would reduce consumption. It was decided to analyse the situation every month. (..) Some measures featured in the confidential plan were adopted and they reduced the inflation by 0.1%–0.2%. At the moment, the inflation has been reined in. (An article by A. Elkin in the newspaper *Вести сегодня*, 07.10.2005)

Table 1. ORIGINAL AND AMENDED BUDGET EXPENDITURE OF THE CENTRAL GOVERNMENT

	Original budget expenditure (thousands of lats)	Date of amendments to the budget law	Amended budget expenditure (thousands of lats)	Expenditure increase (% of the original)
2004	2 079.7	26.08.2004	2 199.6	5.8
		16.12.2004	2 226.1	7.0
2005	2 709.9	30.08.2005	2 851.0	5.2
2006	3 362.7	19.10.2006	3 530.6	5.0
2007	4 396.4	20.09.2007	4 434.7	0.9

Source: Saeima of the Republic of Latvia.

Chart 17. ACTUAL AND THEORETICALLY PROBABLE LEVEL OF BUDGETARY DEFICIT (2004–2007; % of GDP)



Sources: Eurostat and author's estimates.

in the second half of the year which reviewed and increased the expenditure part. In 2004, the government even managed to amend the law and increase the spending twice (see Table 1).

This ensured certain popularity for the government; nevertheless, it did nothing to help reduce the budgetary deficit and ran contrary to economic sense. Figuratively speaking, it was like pouring oil into an already burning inflation fire: not only did it fail to put out the flames, but made them more powerful. Starting from 2004, the gap between the actual budgetary deficit and the deficit that would be considered adequate in light of the economic situation of that time regularly reached several percentage points of GDP (see Chart 17). In the perception of the politicians, a balanced budget was a huge accomplishment and a goal to be kept in mind, while the economic developments in Latvia required a government budget that was in considerable surplus (see Box 2).

Moreover, this overly loose fiscal policy not only stimulated the inflation rise, but also made it impossible for the government to build contingency reserves or safety buffers to be used in periods when the economic growth would decelerate. Implementation of anti-cyclical fiscal policies would have helped accumulate over 1 billion lats in the general government budget by the end 2007 (this amount would have been useful in the years to follow).

Even if the politicians had decided to do nothing in the fiscal front during that time it would have been a rather good policy. If the government had abstained from introducing any budgetary amendments boosting the spending in the second half of each year, it is most likely that the government budget would have run a considerable surplus in the period 2004–2006. Consequently, it would have been much closer to the economically adequate level. Moreover, at the end of 2007 the government budget would have accumulated an almost 500 million lats large reserve which could have been potentially used by the government in the years to follow.

Unfortunately, the budget was all spent and no savings were made as the predominant view was that Latvia would remain amidst this cycle of extremely fast growth for a long time. Only at the beginning of 2007 when the annual inflation in Latvia jumped from 7.3% to 8.5% in a month and it became clear that it would climb even higher in the near-term and reach a double-digit figure, the government's mood changed.

In February, the government representatives still believed that there was an objective reason for the high inflation, while already in March their announcements carried a message that it would be impossible to solve the inflation problem without the government intervening. Finally, the anti-inflation plan was adopted and the government was committed to end the year with a balanced budget.

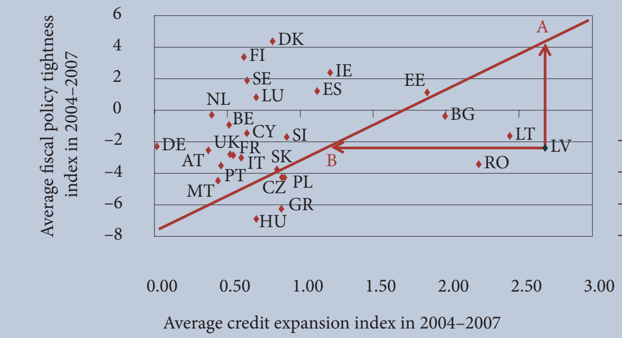
Alas, a lot of precious time had already been wasted. Moreover, some of the decisions taken were insufficiently firm, as the current economic situation warranted a budget with a considerable surplus and not just a balanced budget (and even that, by the way, was not achieved in 2007 anyway, if calculated according to the generally accepted EU methodology). Despite the clearly rising inflation and the deepening risks of economic overheating, the banking sector also stubbornly held to the belief that the economic development in Latvia did not require any adjustment.

Thus the overall economic policy in Latvia within the period of 2004–2007 lacked any coordination. The central bank was well-aware of the risks potentially stemming from the overly rapid economic development and tried to change the situation as much as it could, but it did not have any sufficiently strong instruments at its disposal to change the course of the economy. Banks focussed on conquering new markets and in the middle of this fight underestimated the risks to stability associated with the economic growth. Government was preoccupied with allocation of the windfall budgetary revenue to gain short-term popularity and did not make any savings.

Thus at the end of 2007 the accumulated fiscal and financial imbalances in Latvia started to threaten its further economic development. Latvia was not the only country facing such fiscal and financial imbalances. At that time, problems emerged in many EU Member States either in the fiscal area (Hungary and Greece; see Chart 18) or in terms of an excessively rapid credit expansion (Lithuania, Romania and Bulgaria). Nevertheless, Latvia was a unique case as it had obvious and significant problems in both areas. As can be seen in the following Chart, other countries where the lending boom developed similarly to that in Latvia implemented much tighter fiscal policies (Bulgaria and Estonia), whereas the countries pursuing even more expansionary fiscal policies in comparison with Latvia (Poland and the Czech Republic) had much lower lending growth.

Seeing this incongruity, the Bank of Latvia tried to convince the government of the need to tighten the fiscal policy (dot A in Chart 18). Considering the reserved attitude of the government, an alternative option would be to limit the lending expansion (dot B in Chart 18), yet the banking sector representatives were also not particularly happy with this idea. Consequently, the probability that significant and unpleasant adjustments in the Latvian economy were inevitable became stronger and stronger already at the end of 2007 and the beginning of 2008. Some hope remained that these would be gradual and it would be possible to avoid major turbulances. Alas, the hopes were crashed.

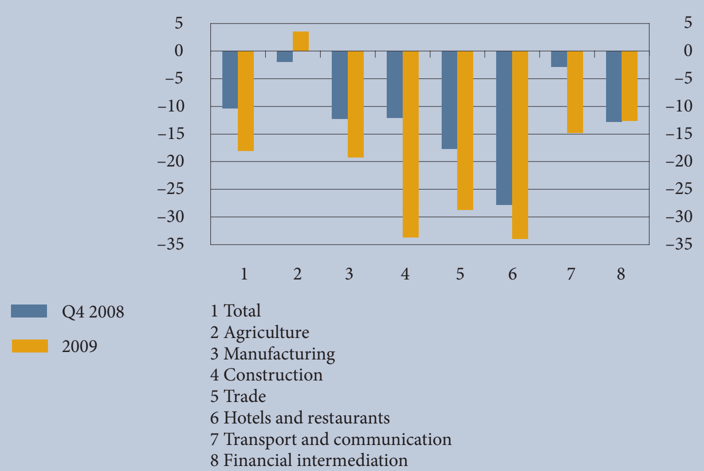
Chart 18. MACROECONOMIC STABILITY ENVIRONMENT IN EU MEMBER STATES (2004–2007)



Sources: Eurostat and the author's estimates.

CRISIS AND THE POLICY RESPONSE

Chart 19. CHANGES IN GDP BY TYPE OF ACTIVITY
(Q4 2008 and 2009; year-on-year; %)



Source: CSB.

Chart 20. UNEMPLOYMENT RATE IN LATVIA (2007–2009)

Source: CSB.

It is commonly believed that the latest global crisis was triggered by the default of *Lehman Brothers*, a US investment bank, in September 2008 which caused panic waves and dealt a serious blow to the overall stability of the global financial sector. However, in reality, the macroeconomic imbalances had increased steadily in several countries in the period leading to 2008 and in the absence of sufficiently active government measures to restore the stability the crisis was an inevitable result of the long-lasting build-up of these imbalances. The bankruptcy of the above-mentioned investment bank merely accelerated the process. The fact that the main reasons for the economic instability stemmed from the domestic environment is confirmed by the huge differences in the impact of the global crisis on various countries. The countries having accumulated significant macroeconomic imbalances in the pre-crisis years are currently facing the steepest economic downslide (Greece), whereas the countries having paid more attention to the macroeconomic stability issues are less affected by the economic crisis or do not feel it at all (Germany, Sweden and the Netherlands).

As already mentioned before, Latvia also managed to build up one of the heaviest burdens of macroeconomic imbalances in the EU during the years of its booming growth. Therefore, it was logical that the subsequent fall was also one of the deepest. The international and inter-bank credit crunch observed at the turn of 2008 was close to fatal for Latvia's economic development model which was based on free access to loans.[7]

With the financing conditions of Latvian banks and their foreign parent banks deteriorating as well as the management of the banks refocusing from conquering new markets to more adequate risk assessment, loans available to Latvian businesses and households contracted sharply. While at the beginning of 2008 an average amount of 200 million lats was granted in resident loans every month, at the end of the year the amount of new bank loans was smaller than the received interest and principal repayments of the previously granted loans; as a result, the loan portfolio of banks in Latvia started to shrink. These changes had a significant effect also on other sectors of the Latvian economy, particularly those where the growth was directly dependent on lending developments (see Chart 19).

Mirroring the general decline in the economic activity, unemployment rose considerably in Latvia, additionally supported by the fact that the sectors where the decline was the steepest were the ones registering the largest inflows of labour in the previous years (see Chart 20).

The primary operational principle of economic policy makers in an economic downturn is anti-cyclical fiscal and monetary policies. Therefore, considering the adverse economic development trends and their negative effect on the price stability (manifesting itself as deflation), the Bank of Latvia reduced the reserve base on several occasions in 2008, in order to increase the free liquidity of the banks and thereby try to encourage lending. Nevertheless, as the time went by, it became apparent that the banks chose to continue holding their free liquidity on their accounts with the Bank of Latvia instead of investing in the economy. Thus in the circumstances when the lending growth is negative and the banks generally do not need to resort to the central bank financing, the refinancing rate of the central bank also loses its practical importance and the interest rates on the central bank's deposit facilities offered to the banks become the main monetary policy instrument. Therefore, in order to discourage the banks from keeping their money with the central bank, the Bank of Latvia topped the reductions of the refinancing rate since the beginning of 2010 with several reductions of the Bank of Latvia deposit facility rates, approaching zero at the end of 2010 (see Box 1). However, with each occasion of reducing the interest rates, the effectiveness of the monetary policy and its power to continue stimulating the economy decreased (as the possibility to introduce further interest rate cuts also declined).

In such circumstances, the fiscal policy implemented in Latvia and its course was of an utmost importance. Once the economic growth starts to decelerate, the fiscal policy automatically becomes counter-cyclical: tax revenue shrinks, whereas the government spending increases as a result of growing unemployment and hence also the number of people receiving unemployment benefits, thereby pushing up the budgetary deficit as well. The growing deficit, on the one hand, helps to soften the fall in the economic growth, whereas, on the other hand, it is an additional source of macroeconomic instability, particularly in circumstances when this deficit has to be financed by foreign borrowing and the concerns of the financial market participants and potential lenders about the ability of the state to repay the already received loans have deepened. Unable to convince the investors of the sustainability of the country's fiscal position and find financing to cover the planned budgetary deficit, the government would either have to go bankrupt (i.e. go in default, including discontinue the payments of pensions, benefits and salaries from the budget) or balance the budget expenditure with the actual revenue immediately, thereby accelerating the economic downturn.

Therefore, the most effective fiscal policy in a period of an economic downturn can be implemented if the government has been able to hoard liquidity in the previous years by formulating surplus budgets during the years of booming growth, as it was done by Estonia. Latvia failed to do the same; therefore, at the end of 2008 the government had to choose between trying to convince foreign investors that Latvia's fiscal position was sustainable (but that would mean government spending cuts and thereby reduce the anti-cyclical effect of the fiscal policy) or abstaining from doing it and hoping that it would be possible to find all the required financing in the international financial markets dominated by uncertainty and intensifying tensions (yet realising that should it turn out to be impossible to find the financing, the sovereign default probability would come to the forefront). The fact that even in November 2008 the government planned the next year's budget with expenditure exceeding the 2008 spending by roughly 500 million lats despite the clearly downward trend observed for tax revenue suggests that it preferred the second option.

The potential consequences of this decision are unknown as the government had to adjust its plans significantly as a result of the financial problems associated with the JSC *Parex banka*. Contrary to other major Latvian banks (which drew financing from their parent banks in the Scandinavian countries), this bank primarily tapped the financial markets (*inter alia* taking syndicated foreign bank loans and issuing Eurobonds) to raise the foreign financing required to fund the lending expansion. Against the background of sharply contracting liquidity and growing tensions in the global financial markets, it became impossible to refinance those loans, while the bank's assets were seriously impaired. As a result, the bank was facing serious liquidity and solvency problems further exacerbated by the deposit run. It became obvious that the bank required financial assistance from the government to continue its business. Taking into account the systemic nature of the bank and the huge direct and indirect losses caused by the potential closure of the JSC *Parex banka*[8], the government decided to bail out the bank by taking over the bank's assets and undertaking also the outstanding liabilities of the bank. This step, no doubt, shielded Latvia's economy from unpredictable shocks and, possibly, from an economic catastrophe. At the same time, it deepened the concerns of foreign investors about the fiscal position of the government and its sustainability, as the government did not have the money required to meet the bank's liabilities and inject capital at that moment. Budgetary reserves accumulated in the previous years would have come in handy. Unfortunately, there were no such reserves and that meant that a failure to receive financial assistance from international donors would have seriously undermined further legal capacity of Latvia's government.

In order to prevent the looming sovereign default, Latvian government struck an agreement with the IMF, EC and several other countries on granting financial assistance in the amount of 7.5 billion euro conditional on implementation of an economic stabilisation programme aimed at ensuring Latvia's fiscal sustainability and the stability of the financial sector as well as restoring its competitiveness.[9] One of the main elements of the programme was gradual reducing of the budgetary deficit from almost 10% of GDP to a level consistent with the Maastricht criterion in four years. Overall, the government expenditure was cut by more than 11%: the 2011 general budget expenditure was approximately at the level of 2007. Nevertheless, considering that the expenditure cuts practically did not affect the social area, the decline in other areas was even more impressive: the central government basic budget spending was reduced by more than 17% in four years and the general expenditure as at the end of 2011 stood at the same level as in 2006–2007.

This impressive fiscal consolidation resulted in significant easing of the concerns about Latvia's fiscal stability as well as supported the restoration of competitiveness and re-focussing of the economy on a growth model based on exports instead of domestic consumption. At the same time, this decrease in the government spending caused a fall in domestic consumption. It has to be realised that fiscal consolidation is not an ideal economic policy in the circumstances of a shrinking gross domestic product. Nevertheless, it is significantly better than the alternative lying ahead for Latvia if the international financial assistance had not been granted: immediate balancing of the budgetary revenue and expenditure, followed by an even deeper economic downslide.

The second key element of the programme was the preserving of the existing fixed exchange rate. Initially, at the end of 2008, the IMF analysed also alternative exchange rate strategies, for example, broadening of the exchange rate fluctuation band to ±15% or unilateral euro implementation. Nevertheless, at the discussions with the IMF representatives, the Bank of Latvia secured an agreement that preserving an unchanged fixed exchange rate was the safest and optimum way of overcoming the crisis in Latvia's circumstances. The main arguments in favour of keeping an unchanged exchange rate were as follows. Firstly, an exchange rate adjustment would not improve the situation significantly given the notable increase in both the government debt as well as the private sector debt as a result of the intensive lending. Considering that the debt was mostly denominated in foreign currencies, devaluation would (on the contrary) result in even higher government debt and also the interest payable.

Secondly, a side effect to devaluation would be higher costs of raw materials, fuel and other imported commodities which would also have a negative impact on the prices of outputs produced in Latvia. Given the fact that due to the weak domestic demand the rising costs could not be offset by raising the output prices, the solvency of Latvian businesses would deteriorate and they would face bankruptcy, thereby increasing unemployment.

Thirdly, the quality of the banks' assets would also be significantly impaired and thus the opportunities to raise the financing required for new investment as well. In its report, the IMF also recognised that with devaluation the initial contraction of the GDP would be approximately one third larger than in a no-devaluation scenario (in Latvia's case it would have meant a decline by more than 23% in the economic activity in 2009), whereas the hypothetical subsequent even more buoyant growth phase could remain hypothetical mainly due to the negative effects caused by devaluation in the financial sector (definitely exacerbated by the extreme sensitivity to adverse banking developments characteristic of the Latvian market and depositor panic waves).

Moreover, currently the IMF also admits that liberating the exchange rate would not have ensured more rapid and successful overcoming of the crisis: analysis of economic development trends in various countries of the world in the context of the global financial crisis leads to a conclusion that countries with a fixed exchange rate are overall doing neither better, nor worse than countries with a floating exchange rate in this crisis.[10] In small countries, exchange rate fluctuations quickly pass through to the domestic market prices, thus the impact on the real sector is minimal. Moreover, a floating exchange rate does not free a country from the necessity to align its expenses with its income. In its latest reports on Latvia, the IMF also admits that despite the initial concerns the implementation of the existing programme (including the preservation of a fixed exchange rate) has ensured economic recovery.[11]

THE CONSEQUENCES OF THE CRISIS

Although the financial assistance received from the international institutions enabled Latvia to implement the set of measures required to stabilise the fiscal situation in a longer time-span and thereby considerably mitigate the adverse economic and social consequences of the financial crisis, none of the options available would have managed to protect the society completely from taking painful decisions and from their consequences. Return from an illusionary euphoria created by the financial bubble to economically justified reality always involves socially unpleasant measures. In Latvia's case, this bubble of macroeconomic imbalances was particularly big; therefore, the return to the economically justified level was complicated. With easy and almost unlimited financing flows drying out, the time of debt-based consumption and growth was over and it was the time to reduce the accumulated debt burden. This process was particularly painful because of understanding that the level of income achieved in Latvia in 2005–2007 could not be sustained by Latvia's current structure of the economy and the economically justified income level was about one fourth lower than the one achieved in the years of the buoyant growth.

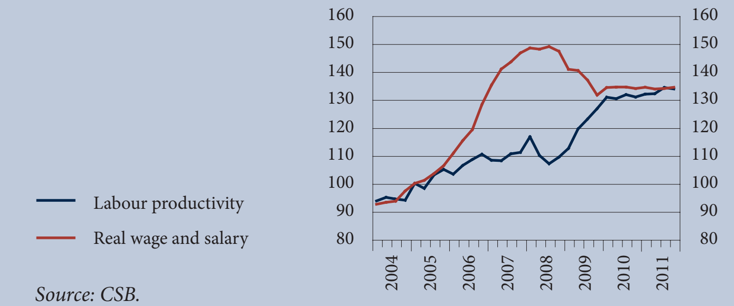
Despite their socially complicated nature, the implemented measures have yielded tangible results, particularly in the area of the macroeconomic stability where the previously dominant risks have been prevented or substantially reduced. For example, unit labour costs have improved significantly as a result of shrinking wages and increased productivity, and the wage-productivity gap observed in 2005–2007 has fully closed (see Chart 21).

Thus the Latvian producers have regained their competitiveness on the external markets. It is confirmed also by the export growth. In absolute terms, the exports of Latvian goods have exceeded the pre-crisis level (see Chart 22).

This, in turn, has resulted in a significant improvement of the current account of Latvia's balance of payments which has become positive for the first time since 1994 (see Chart 23). Even assuming that, with the economic growth picking up again and banks gaining profit, the current account will return to a negative territory (as it usually happens in countries where the growth rate exceeds those of its trade partners, i.e. in developing countries, including Latvia), it is justified to believe that a current account deficit exceeding 20% will no longer be observed in Latvia in a foreseeable future.

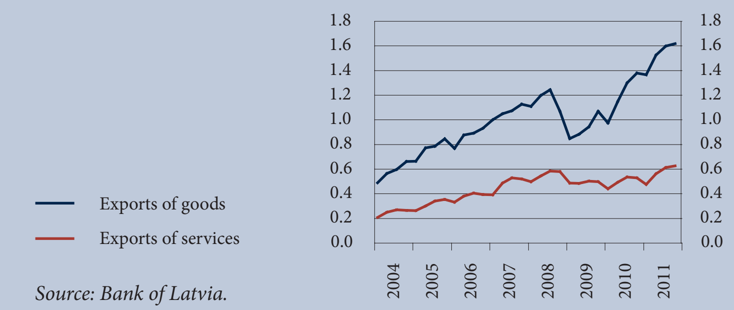
In terms of inflation, the situation has also improved considerably. Following a short period of deflation, inflation has returned, albeit remaining relatively low. Inflation growth was supported by a combination of various external factors (rising oil and food prices), as currently there is no domestic pressure on the prices caused by the wage-productivity gap (see Chart 24).

Chart 21. DEVELOPMENT OF LABOUR PRODUCTIVITY AND REAL WAGE AND SALARY (2004–2011; Q1 2005 = 100)



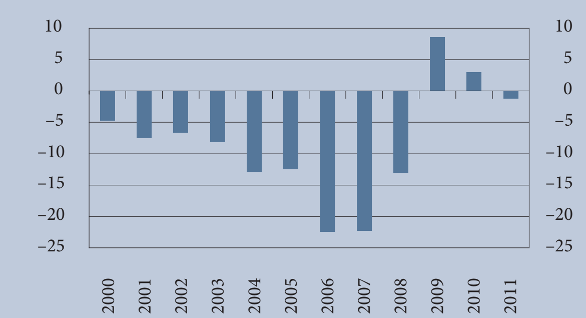
Source: CSB.

Chart 22. LATVIA'S EXPORT DYNAMICS (2004–2011; billions of lats)



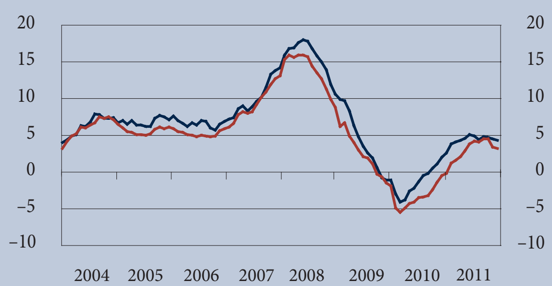
Source: Bank of Latvia.

Chart 23. BALANCE OF THE CURRENT ACCOUNT OF LATVIA'S BALANCE OF PAYMENTS (2000–2011; % of GDP)



Sources: Bank of Latvia and CSB.

Chart 24. ANNUAL CHANGES IN CPI IN LATVIA
(2004–2011; year-on-year; %)

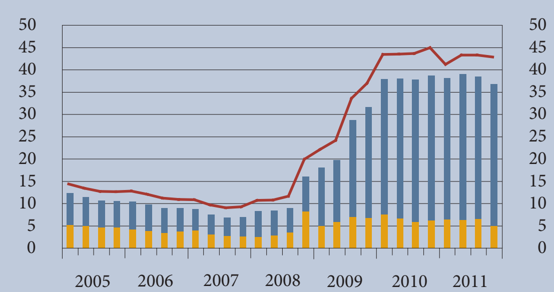


CPI

Core inflation

Sources: CSB and Bank of Latvia estimates.

Chart 25. LATVIA'S GOVERNMENT DEBT (2005–2011; % of GDP)



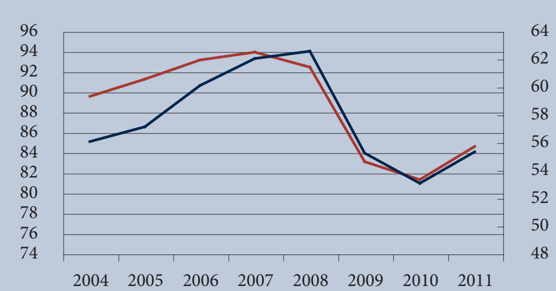
External debt

Domestic debt

General government debt (ESA 95)

Sources: The Treasury and CSB.

Chart 26. EMPLOYMENT DYNAMICS IN LATVIA (2004–2011; %)



Employed/economically active

Employed/population aged 15–74 (right-hand scale)

Source: CSB.

The situation in the financial sector has also improved notably. With the quality of their loan portfolios deteriorating and the share of non-performing loans growing, the banks were forced to build additional provisions. In order to offset the incurred losses and meet the regulatory requirements, the banks raised additional capital. Currently, the banks have resumed earning profit, their liquidity remains ample and, with the improvement of the government's fiscal situation, stability has returned to the money market and interest rates have retreated considerably below the pre-crisis levels.

Nevertheless, although there are significant improvements in the area of the macroeconomic stability, several serious structural problems still persist in Latvia's economy which have emerged or aggravated as a result of the crisis and which require more time to address and fully eliminate.

Firstly, the high budgetary deficit observed since 2009 caused a sharp increase in the government debt. The government debt grew from the level of below 10% of GDP to 45% of GDP at the end of 2010 based on ESA 95 methodology (see Chart 25). Thus the government debt which was insignificant prior to the crisis has expanded to a substantial level and its servicing requires significant budgetary contribution, thereby compressing the financing available to other areas funded from the budget. The growing debt service costs and budgetary spending on the debt service are the price Latvia's government has to pay for the opportunity not to implement an outright fiscal consolidation and expenditure cuts at the end of 2008.

Secondly, the years of buoyant growth have brought about some adverse changes in the structure of Latvia's economy. Considering that the share of sectors relying on domestic demand expanded significantly in Latvia's economy prior to the crisis, in the circumstances of a sharp dive in the growth of those sectors, the capacity of other sectors was no longer sufficient to offset the considerable growth deceleration. Therefore, the overall employment in Latvia decreased notably. With turnover on a downward path, employment in construction and trade sectors declined and at the same time, jobs were cut in the public sector, while the sectors that performed comparatively better were unable to generate new jobs equally quickly (see Chart 26).

Construction and public administration are the areas where the employees were the most heavily affected by the changes in the economic environment. Nevertheless, in some sectors (e.g. in transport and communication), employment is even higher than before the crisis (see Chart 27).

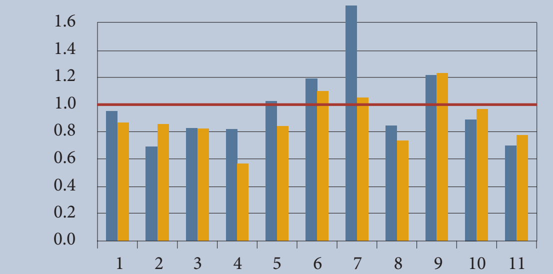
This is a clear indication of the structural nature of unemployment. One of the reasons for the high unemployment is not insufficient demand, but rather the need for the labour force to upgrade and change the set of skills as it moves over time from sectors relying on domestic demand to those servicing the external sector. Yet this does not mean that the level of unemployment that has risen considerably under the impact of the crisis will decline automatically once the economy recovers. Workers who have been long absent from the active labour market face a significantly growing skills mismatch risk and the level of long-term unemployment could thereby also increase notably. To reduce it, active labour market support measures are required, as the high structural unemployment may act to seriously hinder further economic development.

Thirdly, despite significant stabilisation signs evident in the country's financial sector, the loan portfolio of banks continues to shrink. This can be only partly explained by the falling demand. During the years of booming growth, the rise in resident deposits could not fully finance the loans granted; therefore, the ratio between the bank loans granted and deposits received grew significantly. Affected by the crisis, banks have started to pay much more attention to financial stability issues, thus they are concentrating more on attracting additional deposits and restructuring the existing loans than on granting new loans (see Chart 28). Lower level of income also means that amount of liabilities that can be safely undertaken by households and businesses is smaller than before; moreover, banks can no longer rely on a constant increase in the value of collateral in the future.

Such lending development has had a negative impact on the overall investment level in Latvia. Prior to the crisis, the overall investment in fixed capital formation exceeded 30% of GDP, whereas the crisis caused the investment shrink more than twofold. Although the level of investment has slightly increased (currently about 20% of GDP), it is too low for successful long-term development of the economy (see Chart 29).

If the lending does not recover significantly, the growth rate can be expected to remain low, as confirmed also by international research.[12] The good news for Latvia is that despite the losses incurred due to the crisis the biggest and most significant banks have not left Latvia and are ready to continue their business also within foreseeable future. Nevertheless, it would be wrong to rely fully on the bank lending channel as the main driver of the economy. Latvia's experience shows that more loans do not automatically guarantee a higher living standard. Therefore, alternative sources have to be found at the same time, using foreign direct investment as well as tapping capital markets. Maintaining an investment-friendly environment and developing the export potential should thus become one of the main national priorities. Accession to the euro area is only one of many measures to be implemented within this context.

Chart 27. UNEMPLOYMENT RATE CHANGES IN LATVIA BY ECONOMIC SECTOR



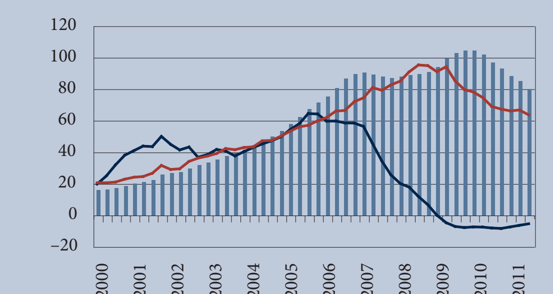
Number of employed in 2011/ number of employed in 2004

Number of employed in 2011/ number of employed in 2007

1 Total
2 Agriculture
3 Industry and energetics
4 Construction
5 Trade, accommodation and catering services
6 Transport and storage
7 Information and communication services
8 Public administration and defence
9 Education
10 Health and social care
11 Other business activities

Source: CSB.

Chart 28. CHANGES IN RESIDENT LOANS AND RESIDENT DEPOSITS IN LATVIA (2000–2011)



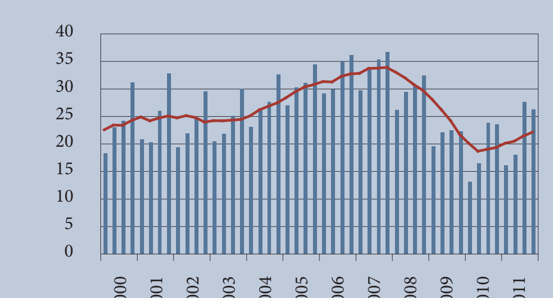
Loans/GDP

Changes in loans (%)

Loans/deposits

Source: Bank of Latvia.

Chart 29. INVESTMENT IN LATVIA (2000–2011; % of GDP)

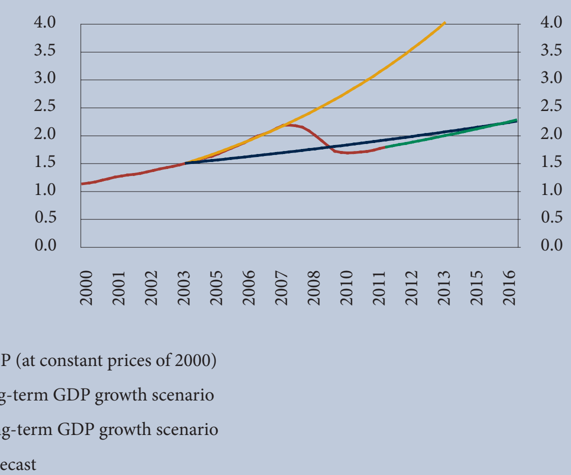


Investment in equity

4-quarter moving average

Source: CSB.

Chart 30. LATVIA'S ECONOMIC GROWTH AND ITS SCENARIOS
(billions of lats)



Sources: Eurostat and the author's estimates.

CONCLUSIONS

The economic developments observed during the last 10 years have proved that a small and open economy cannot achieve sustainable economic development and improve its welfare based on rising domestic consumption alone. The attempts to sustain high domestic consumption without the support of export growth result in a loss of competitiveness and build-up of macroeconomic imbalances, thereby accelerating the set-in of a crisis. Conversely, with national exports developing successfully and export revenue increasing, the amount of money in the economy also grows. This creates a basis for sustainable development of domestic-market-oriented sectors. Latvia's only option is an export-based growth model.

Maintaining a fixed and unchanged national exchange rate has been and remains a vital component of this model. Ability to prevent any attempts to manipulate with the exchange rate has enabled Latvia to overcome the financial crisis successfully and ensure the restoration of the macroeconomic stability. At the same time, it has to be remembered that the exchange rate is only one, albeit important, instrument of the overall economic policy and it cannot help solving all economic problems in Latvia. For example, no manipulation with the exchange rate would help reducing the high unemployment rate. As the reasons behind it are mainly structural, structural solutions are required.

The developments observed in the recent years have clearly proved the importance of an anti-cyclical fiscal policy as well as the substantial risks to the economy and, in fact, to every individual if such a policy is not implemented. Moreover, it is important to remember that the need for fiscal stimulus in periods of an economic downslide is only one part of such an anti-cyclical policy. In order for such a policy to be effective, it is also necessary to build sufficiently large reserves during the years of booming growth. Ignoring this important rule may involve serious consequences. The price of a single mistake, an excessively loose fiscal policy in Latvia during the years of buoyant growth, is a much higher debt level which, in turn, means that significant budgetary funding will be channelled to debt repayments in the near future instead of spending it on benefits, pensions and infrastructural investment. Failing to implement measures to reduce the debt and making a similar mistake in the future could push the government debt to a level posing a threat of sovereign default or even endangering the country's existence. Hopefully, the future policy makers will be wiser and will not repeat the mistakes of their predecessors.

Thirdly, the EU accession was not and still is not a remedy to all economic and financial problems. Yet the participation in this union provides a country with opportunities that would otherwise be out of reach. Each country uses those opportunities as allowed by its administrative capacity. Therefore, the EU participation can turn out to be a story of success and can also be considered a failure. The story is similar with participation in the euro area and the euro implementation. The euro is used in Germany, the Netherlands and Estonia as well as in Greece and Portugal, yet the economic development in each particular country is determined by the ability of the economic policy makers of each country to use the benefits provided by the euro rather than the euro itself. Even in the history of a single country one can find both periods of successful growth as well as periods when governments have chosen to take the easiest path associated with the participation in a monetary union and allowed the build-up of an asset price bubble creating a short-lived economic growth illusion, inevitably followed by economic stagnation (Ireland). This proves that success at one stage does not guarantee success at the following stages. On the other hand, if a country has had bad luck with the economic development, this does not mean that it is doomed forever. Latvia made its mistake while being outside the euro area and thus, possibly, managed to escape the build-up of even larger macroeconomic imbalances followed by an even more painful fall. Being in the euro area will require more careful thinking behind the economic policy decisions than before, so that fully-fledged participation in the EMU can make a positive contribution to the Latvian economy.

The most recent history of economics in Latvia clearly proved that the conviction of being able to catch up with the living standards of the most developed European countries quickly was delusional. During the years of the booming growth, the prevalent belief was that Latvia could manage to do so in as little as 10 years and it was based on the assumptions that the Latvian economy would continue to grow and its growth would continue to be measured in double-digit figures. It turned out, however, that it was impossible without taking measures to improve Latvia's external competitiveness and ensure sustainable development. The average growth rate of the last 10 years, despite being high in some particular years, overall fluctuated around 4% (see Chart 30).

If Latvia's economy continues to develop at the same rate, even if all the best circumstances combine, catching up with the average EU income level would require 40–50 years. In the worst case scenario, this level of welfare may turn out a dream never to be fulfilled. Hopefully, these conclusions with be an additional incentive to carry out the required economic and structural reforms to avoid this adverse development scenario and to ensure that further development of the economy finds a positive reflection in improved welfare of each resident of Latvia.

ENDNOTES

[1] Free movement of workers initially worked only partly, as several of the old EU Member States (e.g. Germany) had set a transition period for opening their labour markets to the new Member States.

[2] Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union (2006/C 73/08), *Official Journal of the European Union*, C 73, 25.03.2006, pp. 21–27.

[3] See more details at *http://www.bank.lv/publikacijas/averss-un-reverss/2004-4/latvijas-bankas-eiro-ieviesanas-strategija-un-tas-ekonomiskais-pamatojums/4502.*

[4] *http://www.ecb.int/press/pr/date/2005/html/pr050429.en.html.*

[5] *http://ftp.iza.org/dp5878.pdf.*

[6] See, for example, Schadler, S., Mody, A., Abiad, A. et. al. *Growth in the Central and Eastern European Countries of the European Union*. IMF Occasional Paper, No. 252, Washington DC, January 2007; *World Bank EU8 Quarterly Economic Report*. World Bank, July 2005.

[7] Another characteristic trait of Latvia's economic development of that time was the rapidly growing public sector debt. Consequently, Latvia would have inevitably reached a level of debt where refinancing is practically impossible even without the global financial crisis which started at the turn of 2008 and the economic consequences would have been identical to the ones actually observed.

[8] According to the Bank of Latvia's estimates, the overall loss to Latvia brought about by winding up the business of the JSC *Parex banka* would have amounted to approximately 3 billion lats (see *http://www.bank.lv/presei/parex-bankas-parnemsana/parex-bankas-slegsana-butu-katastrofa-latvijas-tautsaimniecibai*).

[9] See *http://www.imf.org/external/pubs/ft/scr/2009/cr0903.pdf.*

[10] *http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/c1.pdf.*

[11] See *http://www.imf.org/external/pubs/ft/scr/2011/cr11126.pdf.*

[12] See, for example, *http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/c4.pdf.*

SOURCES AND LITERATURE

Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union (2006/C 73/08). *Official Journal of the European Union*, C 73, 25.03.2006, pp. 21–27. Available: *http://www.ecb.int/ecb/legal/pdf/c_07320060325en00210027.pdf*.

Bank of Latvia Annual Reports for 2005–2011. Available: *http://www.bank.lv/en/publications/annual-report/2782*.

Bank of Latvia's statistical data room. Available: *http://www.bank.lv/en/statistics/data-room/main-indicators*.

Eurostat database. Available: *http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database*.

Hazans, Mihails, Kaia, Philips. *The Post-Enlargement Migration Experience in the Baltic Labor Markets*. IZA DP, No. 5878, July 2011. Available: *http://ftp.iza.org/dp5878.pdf*.

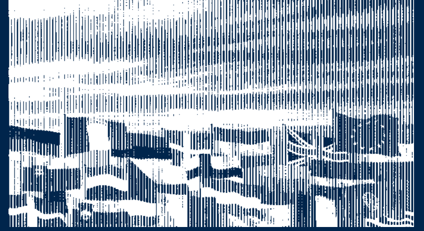
IMF reports on the latest economic development trends in Latvia. Available: *http://www.imf.org/external/country/LVA/index.htm*.

Schadler, Susan, Mody, Ashoka, Abiad, Abdul et. al. *Growth in the Central and Eastern European Countries of the European Union*. IMF Occasional Paper, No. 252, Washington DC, January 2007, 64 p.

Statistical data by the Finance and Capital Market Commission. Available: *http://www.fktk.lv/en/statistics/latest/*.

Statistical database of Central Statistical Bureau of Latvia. Available: *http://www.csb.gov.lv/en/dati/statistics-database-30501.html*.

World Bank EU8 Quarterly Economic Report. World Bank, July 2005, 20 p.



XC

Dr. oec. Vita Pilsuma

THE ROLE AND ACTIVITIES OF THE BANK OF LATVIA IN EUROPEAN MONETARY INTEGRATION (2004–2012)