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Assessment of Past Developments and Economic Policy Challenges in Latvia

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1. Macroeconomic Risks and Policy Responses

Latvia's accession to the EU has presented both opportunities and challenges. It provided many opportunities for the free flow of goods and services and marked a step toward a the free movement of labour. The availability of EU Structural Funds and the EU membership being a guarantee to investor confidence triggered capital inflows. Investors' perception of Latvia as a location with high capital yields has allowed to increase productivity and contributed to income growth.

At the same time, while the rapidly developing economy brought important benefits it also accumulated long-term risks. In itself strong economic growth is desirable, because it allows for an increased standard of living. However, EU accession fostered over-optimistic expectations of the economic agents thus boosting real estate and consumption-oriented economic growth. This period was characterized by real GDP growth rates of over 10% on average, which led to an accumulation of macroeconomic risks and so-called overheating of the economy.

Acceleration of inflation and widening of the current account deficit to double digit figures, tensions in the labour market, and accumulating foreign debt were the most obvious macroeconomic consequences of such a rapid expansion. Capital inflows, in particular into the banking sector, fuelled domestic demand and gradually boosted consumption based on over-optimistic expectations regarding real estate prices and future earnings. The annual rate of domestic demand growth until 2007 exceeded 12% on average in real terms. If initially both private consumption and investments contributed equally to the economic growth, then from mid-2005 private consumption took the leading role, growing by 30% at the beginning of 2007.

In addition, the improvement in supply side conditions was not sufficient. Despite the fact that during the period of 2004-2007 investment volumes in the

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Latvian economy almost doubled, rapid growth of investments in the real estate sector and its dominance in the investment structure in 2007 played a crucial role in stimulating consumption as well as causing labour shortages in productive sectors of the economy. Tight labour market conditions have resulted in strong wage growth that outpaced productivity improvements, exerted upward pressure on inflation and undermined competitiveness.

The years 2007-2008 demonstrated clearly that the period of buoyant development was over. Instead of the expected gradual adjustment of domestic demand concerted by domestic policy measures, the global financial market turmoil has magnified accumulated risks and led to a severe economic downward adjustment.

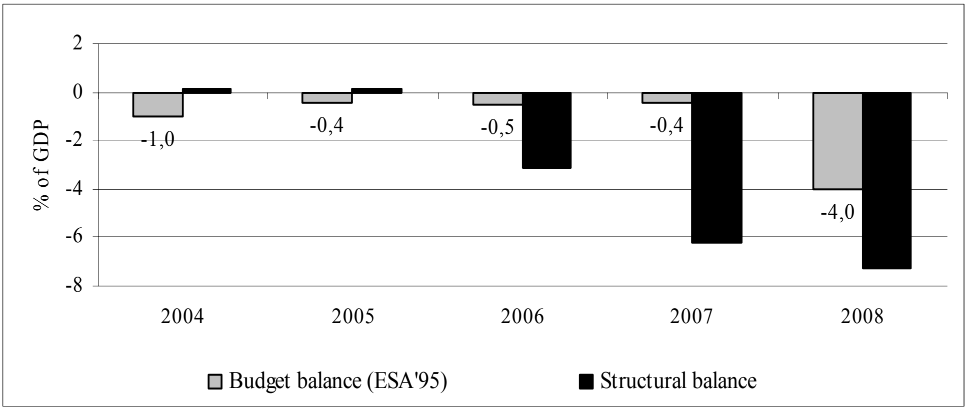
1.1 Fiscal Leverage: Was It Used?

The new EU Member States, including Latvia, are expected to enter the euro area as soon as they fulfil the necessary conditions. The gradual increase of the euro's role in the domestic economy and future euro introduction plans were behind Latvijas Banka (LB) decision to repeg the lats to the euro in January 2005 and to join the ERM II in May 2005. Bearing in mind that under a fixed exchange rate regime the monetary policy options are limited, fiscal policy should have taken the leading role in demand management.

As the risks of overheating continued to rise, the LB, beginning in 2004, implemented monetary policy measures at its disposal aimed at the reduction of macroeconomic imbalances and at curbing the overly vigorous domestic demand. More specifically, the LB has raised the refinancing rate (from 3.0% in 2004 to 6.0% in 2007) and increased the minimum reserve ratio (from 3.0% in 2004 to 8.0% in 2007). However, taking into account the dominance of euro loans in the loan structure, it was obvious that the LB policy should have been complemented by restrictive fiscal policy for which the Government is responsible. Was fiscal policy used adequately?

The level of the General Government budget balance recorded in previous years indicates that additional income brought about by the above potential economic expansion was spent, thereby fuelling the already high domestic demand. Despite the rapid GDP increase in the course of five years starting from 2004 the ratio of General Government expenditure to GDP has grown by close to 4%age points. Government borrowing in the domestic market to fund additional spending tended to crowd out productive investments of the private sector.

Chart 1: Structural Budget Balance in Latvia 2004 – 2008



Source: Central Statistical Bureau in Latvia, Bank of Latvia's calculations

Bearing this in mind, even though the budget balance has improved gradually in nominal terms, it has worsened considerably as of 2006 in cyclically adjusted terms, substantially exceeding the medium term objective which is set at -1% of GDP in the latest Convergence Programme of the Republic of Latvia[2] according to the Stability and Growth Pact provisions. International institutions, including rating agencies, the European Commission and the IMF stressed the procyclical nature of the fiscal policy implemented by Latvia's Government.

As the economic growth was expected to slow down and the inflationary pressures started to abate, the LB has started to ease monetary conditions already since February 2008. The LB cut the minimum reserve ratio for bank liabilities in 2008 in five steps: from 8% to 3% for bank liabilities with agreed maturity over two years and from 8% to 5% for bank liabilities with agreed maturity up to two years. In 2009, against the background of falling economic activity, inflation deceleration and weak lending activity, the LB reduced in two steps its refinancing rate from 6.0% to 4.0%. The implementation of the fiscal measures stimulating the economy proved to be a very complicated task since the Government has not accumulated any reserves in "good times".

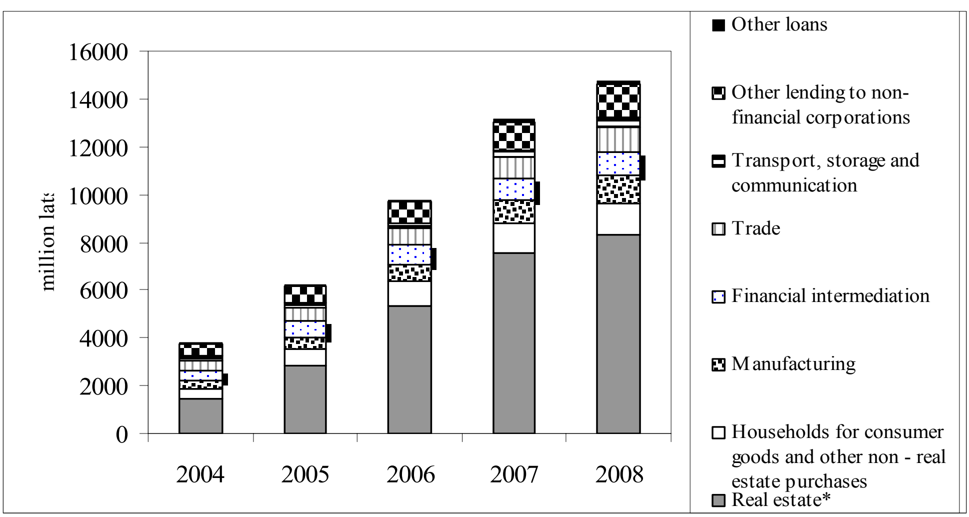
[2] Convergence Programme of the Republic of Latvia 2008–2011. Ministry of Finance of the Republic of Latvia, January 2009.

1.2 Positive and Negative Aspects of Lending

Credit availability is a crucial prerequisite for growth, especially for a catching up economy. Rapid growth of lending was facilitated, on the one hand, by both favourable global financing conditions (and thus inflows of cheap financial resources) and bank competition for market shares and, on the other hand, by optimistic expectations regarding the future development of real estate prices and private sector income levels.

The pace of lending growth reached 60% annually in 2005 and 2006, with the loan stock increasing by 300 million lats a month. In addition, real estate related lending became dominant, particularly as of the second half of 2006. Until mid-2007 the banking sector portfolio of loans granted to the real estate related segments grew by more than 500 million lats a quarter for five consecutive quarters, indicating an inefficient use of credit resources. Bearing in mind the strongly cyclical nature of the real estate sector, it could be expected that during an economic downturn such investments would not generate profit, becoming a risk factor both for the private sector involved in real estate development and trading and for the banking sector and borrowers.

Chart 2: Loans Granted to Residents in Latvia by Lending Segment, from 2004 – 2008



** Real estate includes loans to real estate activities sector and household mortgage loans.*

Source: Financial and Capital Market Commission in Latvia.

The first measures to contain excessive real estate related borrowing were implemented by the Government in 2007 as part of the so-called counter-inflation or economic stabilisation plan. To slow down the rapid pace of real estate orientated lending growth, several new requirements and changes in taxes and duties were adopted. For instance, the amount of the mandatory first down payment on loans for real estate purchase and the loan-to-value ratio of mortgage-backed loans were set; loans in excess of 100 minimum monthly wages could only be granted based on legal income; income from the sale of a real estate property that had been owned by the seller less than five years was taxed; the duty amount for registering the real estate with the Land Register was varied depending on the number of properties owned and the state duty for securing the collateral rights in the Land Register was increased and varied. These measures were expected to promote a gradual correction in the real estate market and mitigate the related macroeconomic risks.

However, it is difficult to assess the impact of measures taken by the Government of Latvia in 2007 as part of the counter-inflation plan since their adoption coincided with the beginning of the global financial crisis. Increased funding costs, lack of confidence and limited resource availability in the global financial markets adversely affected the Latvian banking sector, resulting in much more conservative lending standards thus leading to real estate price corrections in Latvia.

The risk of corrections in the real estate market and a contraction of domestic demand has materialized. Standard apartment prices have already dropped from their historical peak-level by more than 60%. Severe price correction is triggering other risks, e.g. related to the ability to repay loans as well as to the decreasing value of collateral. In economic downturns investments in productive sectors become supportive for the recovery, while the dominance of investments in real estate and its related sectors could hinder the economic recovery.

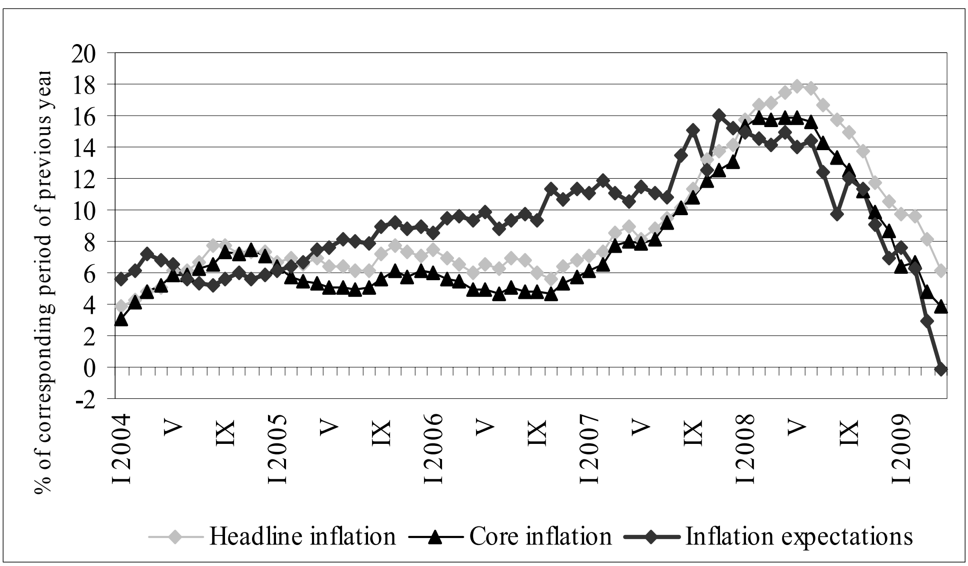
1.3 Fighting Inflation: Plans or Action?

The strong increase in domestic demand facilitated by the lending boom was accompanied by inflation acceleration. In 2004 and 2005 the pick-up of inflation was determined largely by cost-related factors and one-off effects stemming from EU accession. Gradually demand-side pressures became increasingly pronounced as well. For three years, inflation increased above 6% annually reaching double digit level in 2007 and 2008. Strong credit expansion had played an obvious role among other demand-driven factors pushing up inflation.

At this stage, a clear set of policy measures aimed at containing inflation would have had a stabilizing effect on inflation expectations and could have prevented the formation of a price-wage spiral. The inflation acceleration was not only a social problem as it had two other adverse effects. First, as domestic prices and (through the price-wage spiral) wages grew, the competitiveness has deteriorated; second, since the euro introduction was a Government-declared strategic goal, accelerating inflation gave rise to concerns regarding the ability to meet the Maastricht criteria.

In view of all this, an inflation-fighting ad hoc group started work in 2005. However, real actions were taken only in 2007 when the above mentioned counter-inflation plan was adopted. The reduction of inflation caused by demand pressures was expected to be achieved primarily through measures aimed at regulating the real estate market and moderating real estate oriented growth. However, instead of the expected gradual adjustments of domestic demand and the alleviated inflationary pressure, the changing economic and financial environment resulted in a very strong and painful reduction of domestic demand. Owing to the sharp contraction of domestic demand and economic activity and to the declining import prices and inflation expectations the inflation rate is expected to continue decelerate significantly.

Chart 3: Inflation and Inflation Expectations in Latvia, 2004 – Q1 2009



Source: Central Statistical Bureau in Latvia, Bank of Latvia's calculations[3]

[3] Calculations based on Benkovskis and Paula (2007).

2. Lessons and Opportunities Brought by the Crisis

Could this outcome have been predicted? The experience of other countries[4] and the adverse changes in the structure of the economy indicate that economic growth rates such as those experienced in Latvia in recent years cannot be sustained in the long term. However, the point of evaluating past events and assessing the policies implemented at the time is not necessarily to conclude what would have been the case if these actions were different. It is rather necessary to understand what lessons should be learnt from this experience.

- Rapid growth of real estate related lending based on over-optimistic expectations of real estate price movements raises macroeconomic vulnerabilities and is not sustainable in the long term;
- As the risks accumulate, under the conditions of a fixed exchange rate, a timely and adequate fiscal policy should be implemented before the accumulated economic risks become an impeding factor for policy action.
- Since euro adoption is a strategic goal of Latvia and given the obvious advantages that euro area accession could bring, all important decisions must be taken keeping in mind the conditions for euro introduction.

Can the crisis present new opportunities? On the macroeconomic level, it can already be observed in Latvia that a lack of labour is no longer a business-impeding obstacle: employers have a chance to hire better qualified workforce, thus improving productivity. On the enterprise level too the economic crisis can serve as an opportunity to optimize business operations and find new market segments. The available resources should be directed to the increase of production and export capacity. In other words, measures taken should not amount to "patching up" the existing problems, but must be effective also in the long term in order to ensure that investment generates income. Science and education should not be neglected as it is crucial to achieve that the Latvian economy will become strongly based on efficiency-driven growth and will smoothly move towards an innovation-driven stage of development.

3. Key to Economic Recovery in Latvia: Stable National Currency and Tight Income Policy

At the end of 2008, as a result of the global economic crisis and against the background of macroeconomic risks, the direction of capital flows in Latvia has changed. To relieve tensions in financial markets and promote confidence in the financial system, Latvia was granted international financial assistance. To set a clear course for the Latvian economy, the government developed a program for

[4] See e.g. Drees and Pazarbasioglu 1998.

economic stabilization and recovery. The exchange rate strategy that has been successful for 15 years (i.e. fixed exchange rate with a narrow +/- 1% fluctuation band) was retained as a cornerstone for future development. It will serve as a basis for sustained convergence and the attainment of Latvia's goal to enter EMU as soon as possible.

The Latvian authorities are strongly committed to maintain the exchange rate peg as the estimated costs associated with a forceful weakening of the national currency would outweigh potential competitiveness gains which are typically observed in large economies. Latvia is a small, open, foreign-trade-reliant economy and a price taker in international markets with low price elasticity of exports and imports – therefore, the so called Marshall-Lerner condition[5] is not met. The import component is high in Latvia's exports and consumption, and balance-sheet effects would have a significant adverse effect on domestic demand. Moreover, investors' confidence is crucial for economic recovery in Latvia.

A monetary policy framework with a fixed exchange rate regime requires vitally important fiscal and income policy adjustments. The bulk of the short-term fiscal adjustment comes from public sector expenditure cuts that will be supported by institutional and structural reforms to promote the effectiveness of the public sector and to ensure the mid-term fiscal sustainability. The Latvian Government[6] is strongly committed to wage restraint, which is seen as the most effective tool for the correction of imbalances in the economy and the restoration of competitiveness and also as a precondition for economic recovery in Latvia. The reductions of remuneration in the public sector supported by loose labour market conditions should further enhance and contribute to the correction of wages in the private sector. In addition, the National Tripartite Co-operation Council has been established to monitor the implementation of measures to reduce nominal wages in the public and private sectors.

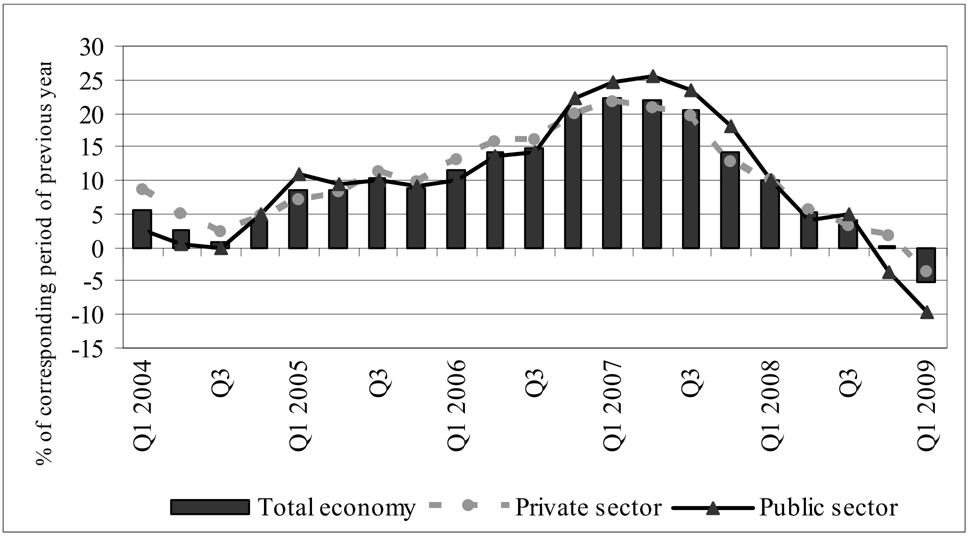
As estimated by Zasova and Melihovs (2005), the labour market in Latvia is flexible and the main adjustment comes through the flexible wage setting mechanisms. There are strong institutional fundamentals for that – trade unions play a limited role in the wage bargaining process which is highly decentralized at company level. Also according to international comparisons, Latvia has one of the lowest trade union density and wage bargaining coverage levels in the EU (Keune 2006). Falling labour demand in all sectors of the economy and tight income policy in the public sector led to a deceleration of the annual growth rate of real wages already in the second half of 2008 and a drop in the 1st quarter of 2009. In the

[5] Calculations based on Krugman and Obstfeld 1994.

[6] As defined in the Latvia's Economic Stabilisation and Growth Revival Programme. Riga: Cabinet of Ministers, 2008.

Global Competitiveness Report 2008/2009 the flexibility of wage determination is assessed as a competitive advantage for Latvia (Porter and Schwab, 2008).

Chart 4: Growth Rate of Real Wages in Latvia, 2004 – Q1 2009



Source: Central Statistical Bureau in Latvia, Bank of Latvia's calculations

With the easing of global deleveraging pressures and the recovery of the global economic environment it is expected that the improved cost competitiveness largely through tight income policy in the public sector and the flexible wage setting mechanisms and a rebalancing of the economy towards the tradable sector will create good prospects for an export-based economic recovery in Latvia.

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