LATVIJAS BANKA

Lessons from Latvia's internal adjustment strategy

Ilmārs Rimšēvičs

Governor of the Bank of Latvia

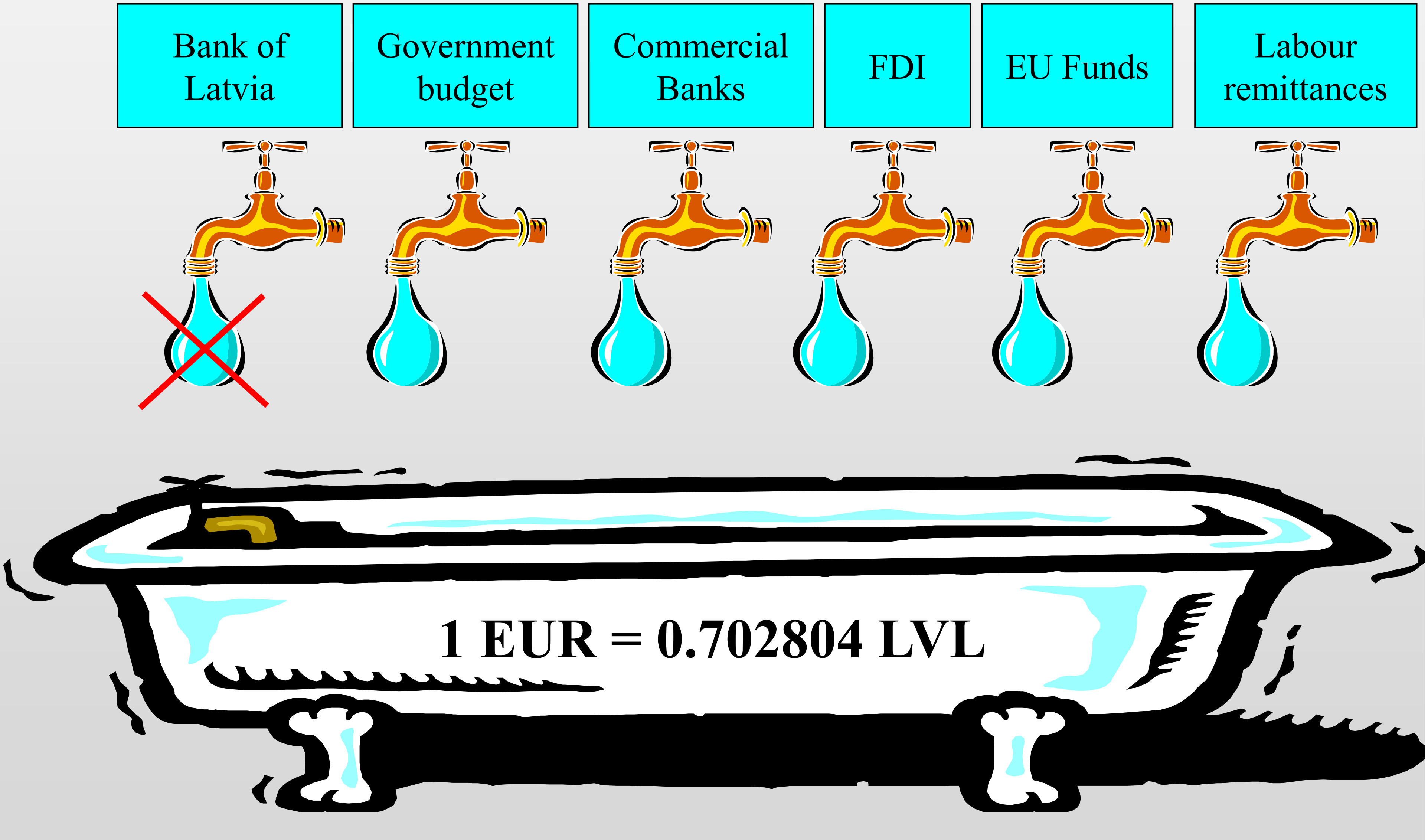
September 4, 2012

Presentation outline

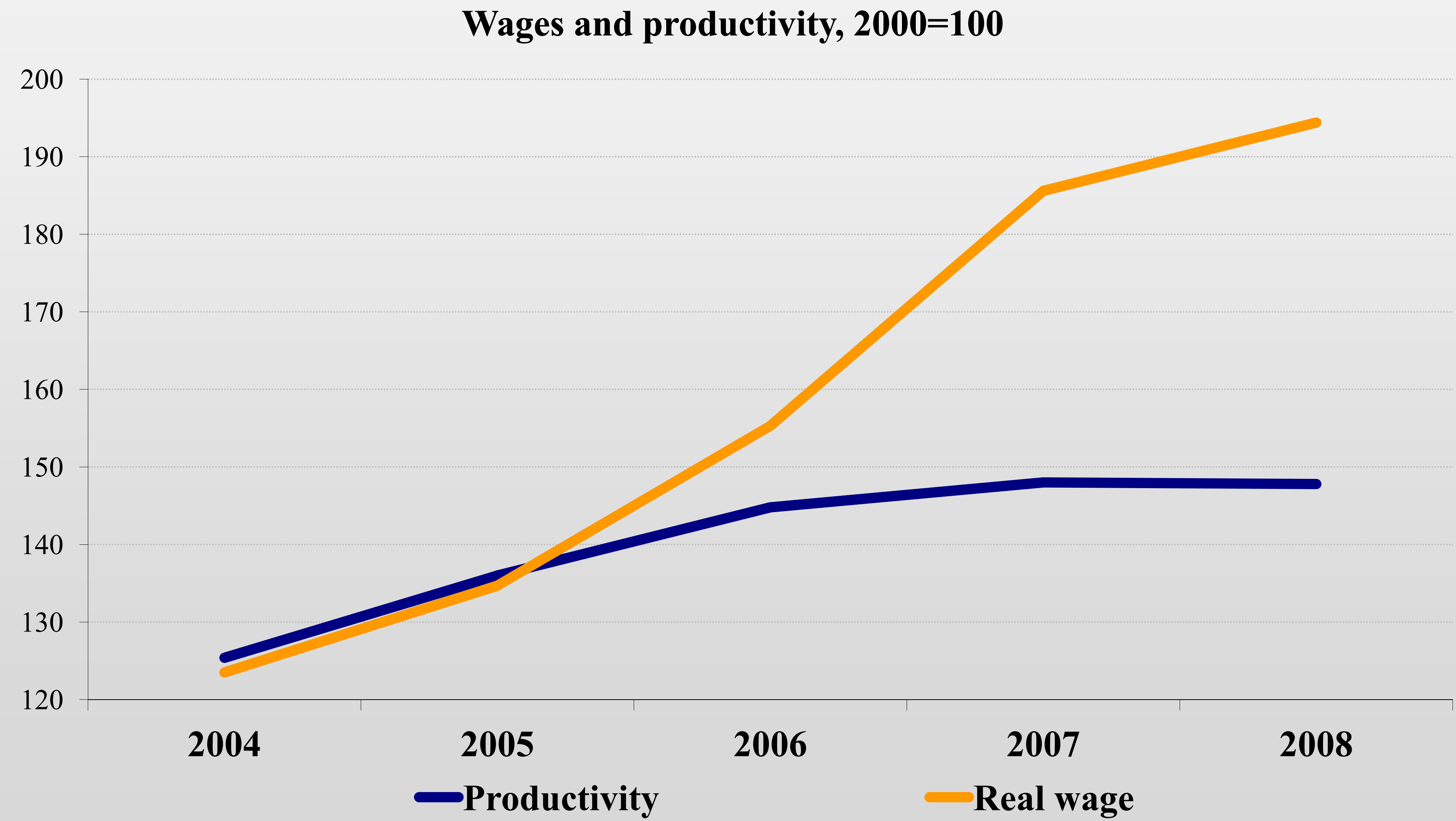
- **Overheating of Latvia's economy**
- **Expansionary consolidation**
- **Lessons learned**
- **Latvia's experience in global context**

Latvia’s economy was on a fast track during 2004-2007

Past growth was fuelled by massive capital inflows after the EU accession, adding considerably to a build up of excessive demand and real estate bubble

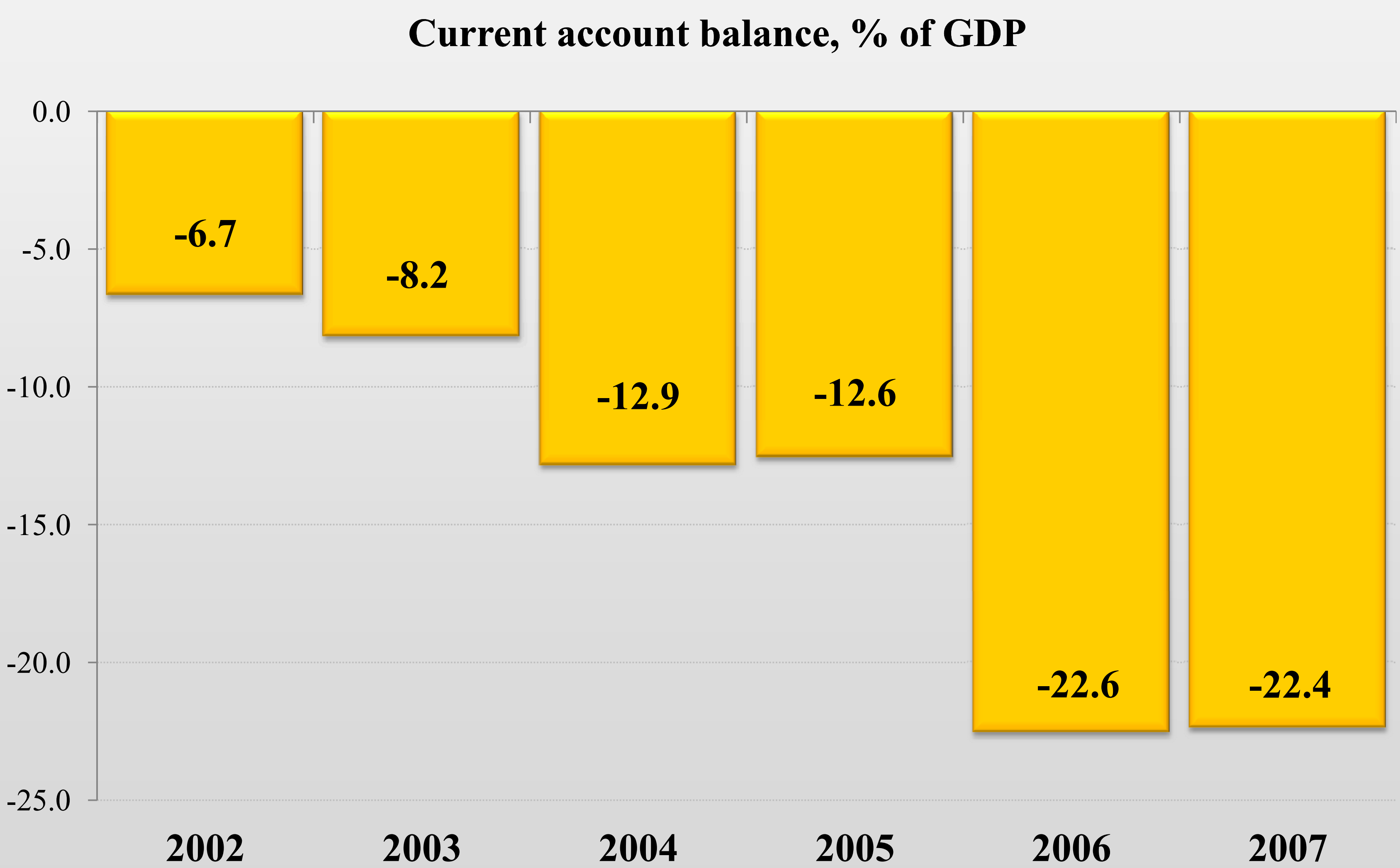


Labour market overheated significantly, driving wages above productivity and hurting competitiveness



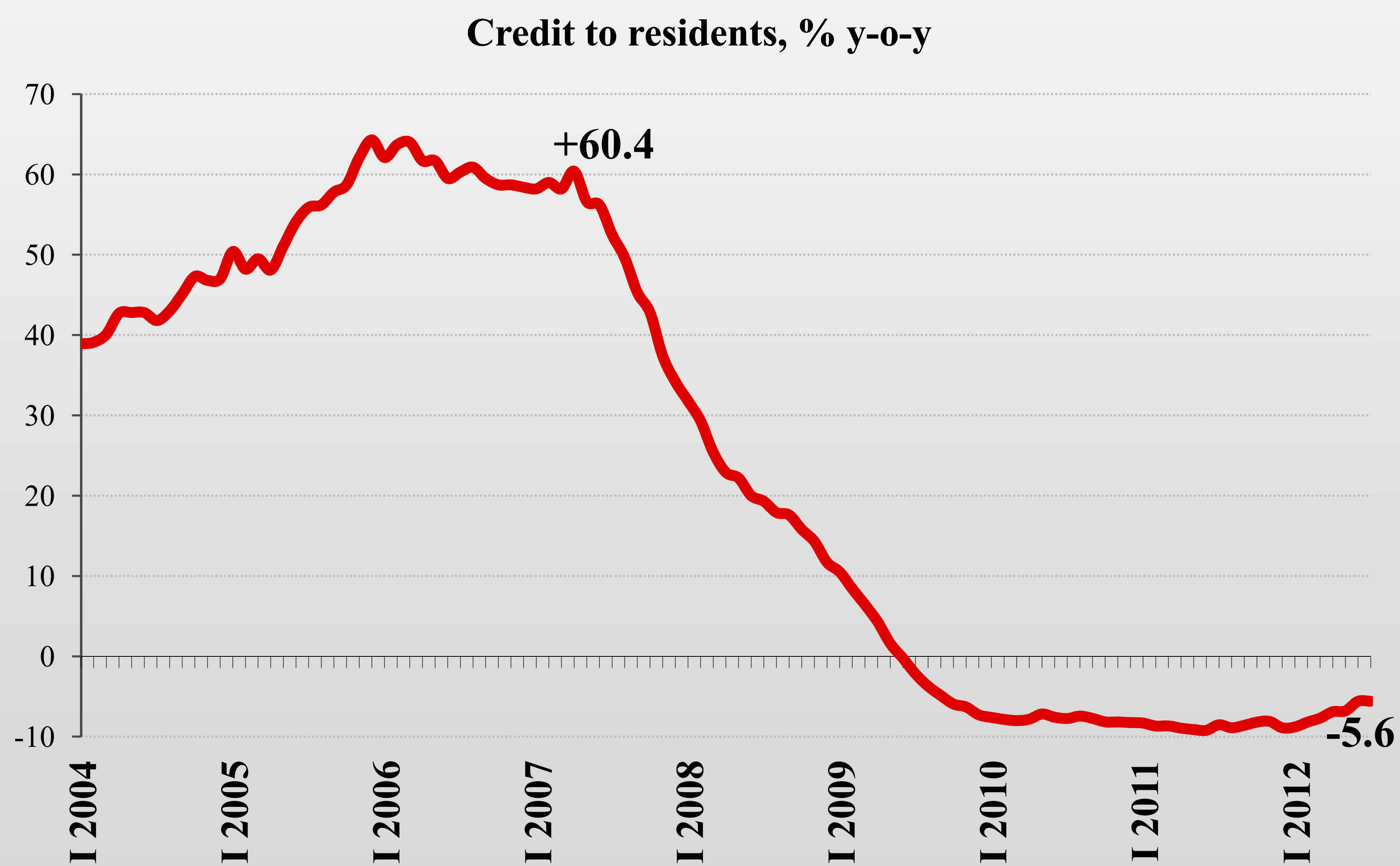
Source: CSB, Bank of Latvia staff calculations

Excessive demand showed up in massive current account deficits



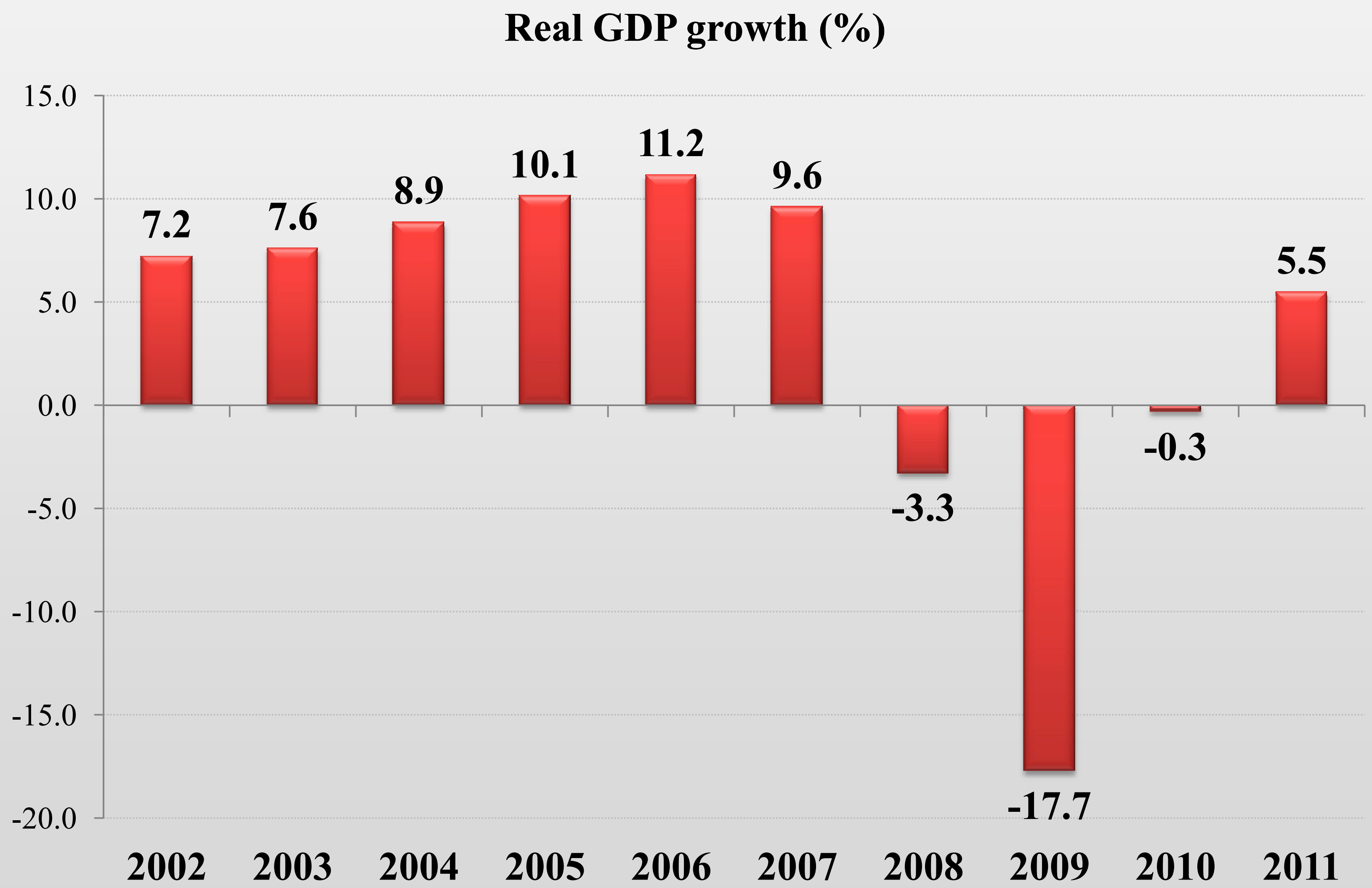
Source: Bank of Latvia

GDP was pushed up by banks borrowing abroad and channelling funds into economy to nurture massive lending boom, until the bubble collapsed



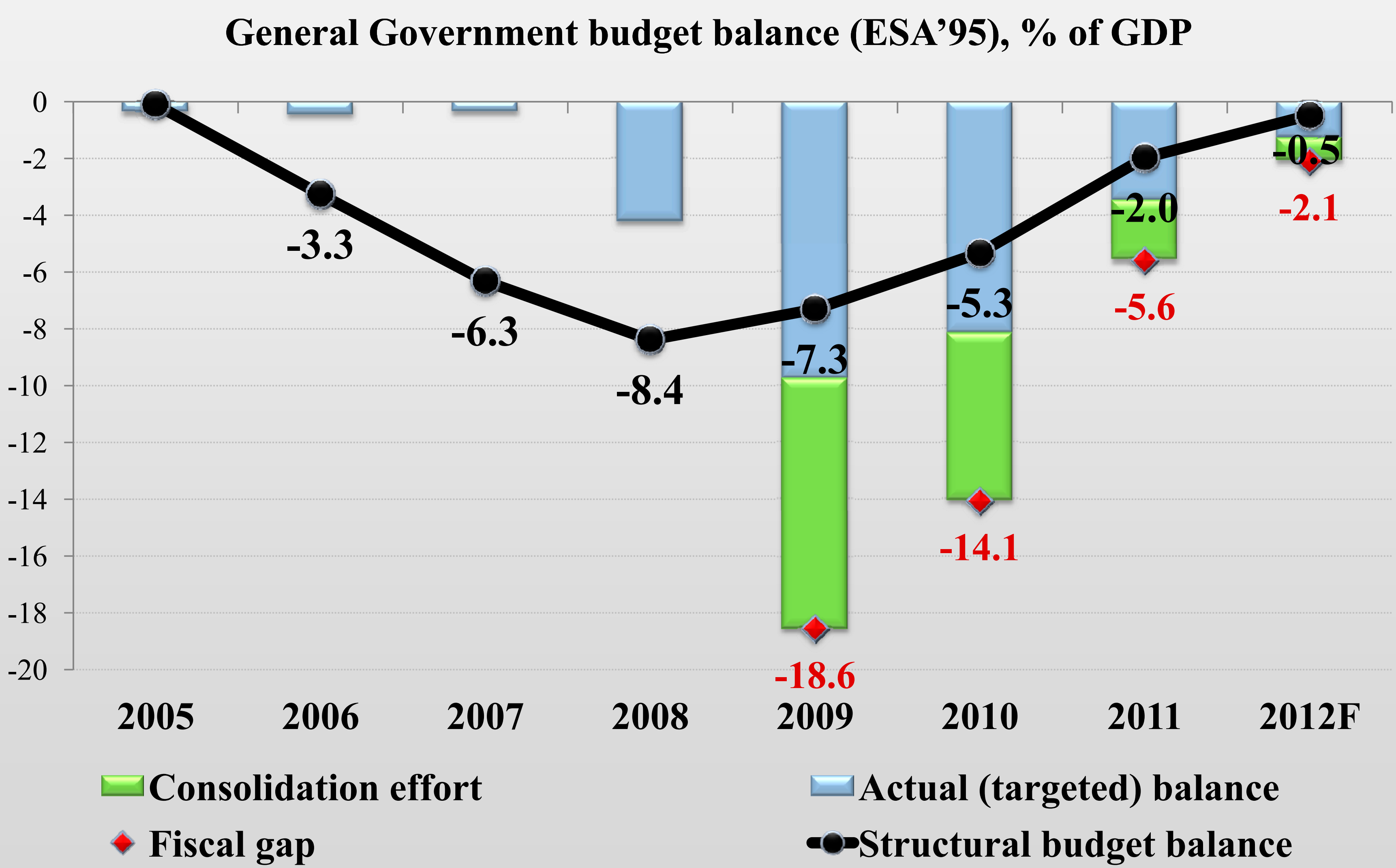
Source: Bank of Latvia

Latvia has lived through a boom-bust cycle: severe recession followed years of unsustainable double digit growth



Source: CSB

Over the past boom Latvia was running enormous underlying fiscal gap that played out fully during the recession years



Source: Eurostat, F – Bank of Latvia staff estimation

To be or not to be, was the question in 2008

Many suggested devaluation as a way out of the crisis.

Why devaluation was not an appropriate solution?

Devaluation is not a solution for Latvia

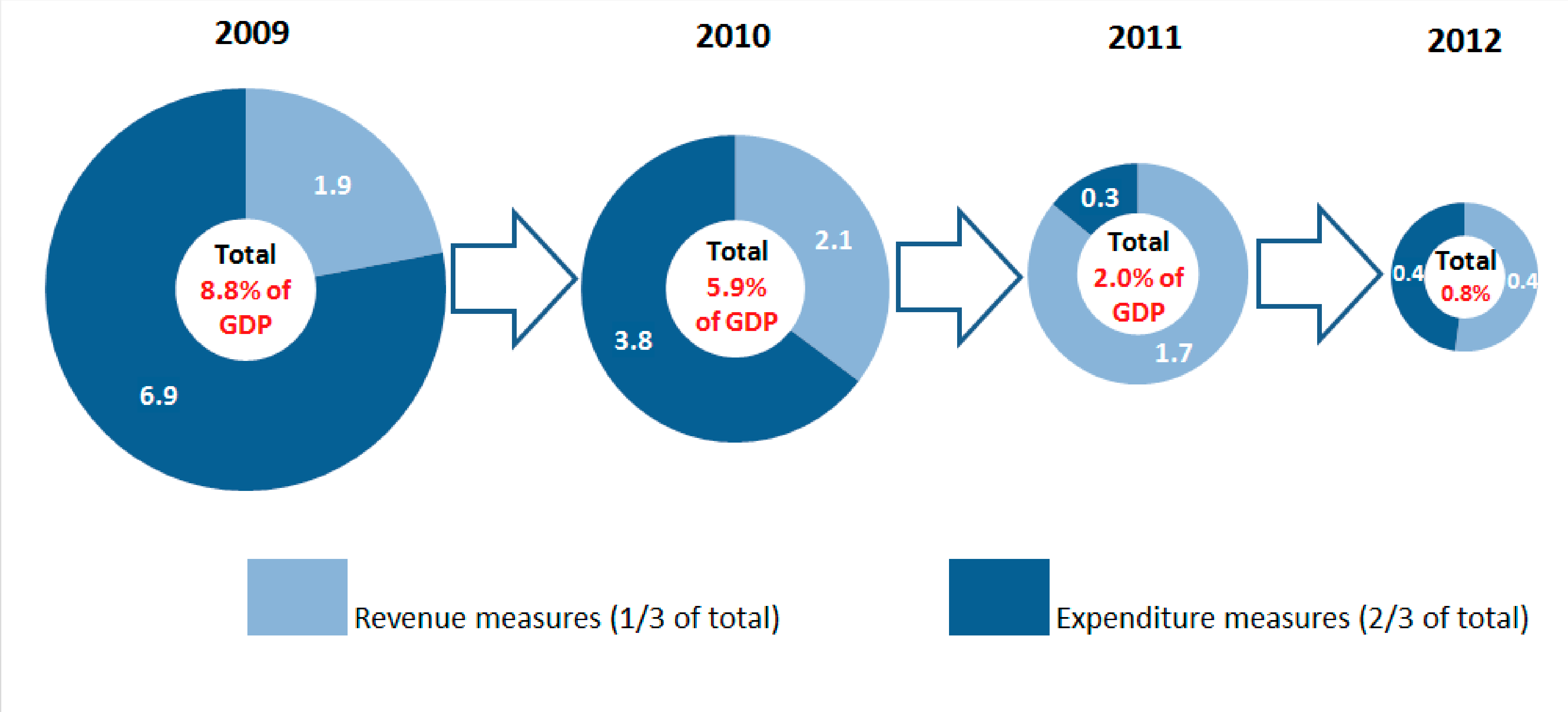
- **High import content** in exports and domestic production, competitive gains reduced by surge in input costs
- No immediate improvement in the current account **(Marshall-Lerner condition is not met)**
- **High share of FX liabilities:** many corporates would face negative equity immediately
- **Loss of credibility** and a likely run on banks
- **Court system unable to cope** with sharp increase in insolvency cases, inefficient insolvency procedure
- **No** motivation to improve **efficiency and productivity**

The internal adjustment was the only path to follow

- **Time bought for structural reforms** that smoothen adjustment
- Improvement of **public sector efficiency**
- **Less corporate bankruptcies** reduce costs for the economy
- More gradual adjustment motivates businesses for **productive improvements**
- Latvia's **economy is reasonably flexible** to adjust
- **Society** understands the root causes of crisis and **supports necessary austerity and reforms**

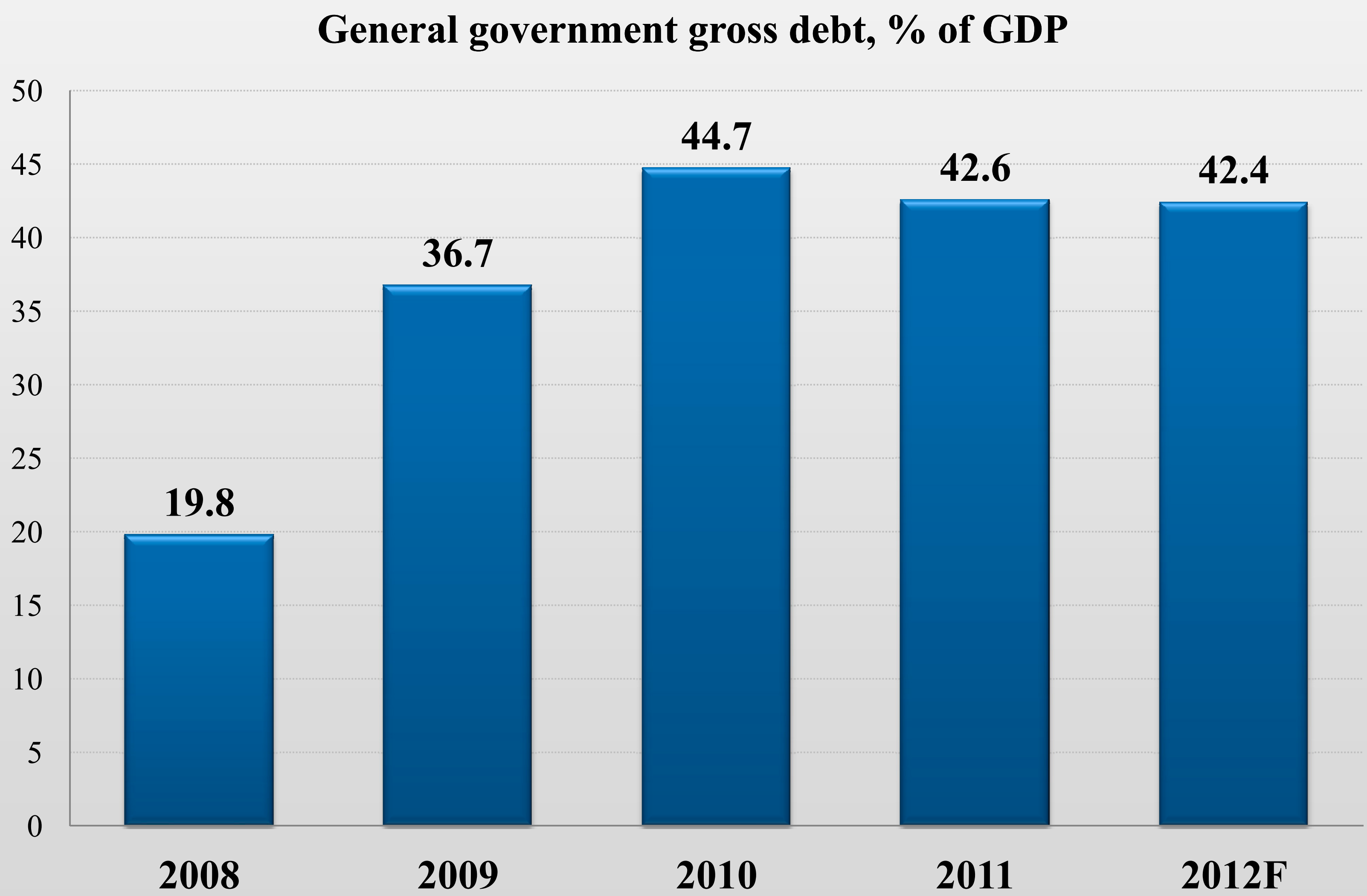
Latvia implemented massive frontloaded fiscal consolidation to regain confidence and put public finance on a sustainable footing

Breakdown of budget consolidation measures, % of GDP



Source: Ministry of Finance; Bank of Latvia staff calculations

Budget consolidation helped to stabilize debt at a moderate level and to avoid initially expected debt explosion



Source: Eurostat; Bank of Latvia staff estimation

How Latvia managed to accomplish what initially was claimed being impossible?

Speed

A speedy consolidation can be compared to a timely pruning an apple-tree – you earlier and richer harvest

How Latvia managed to accomplish what initially was claimed being impossible?

Ownership

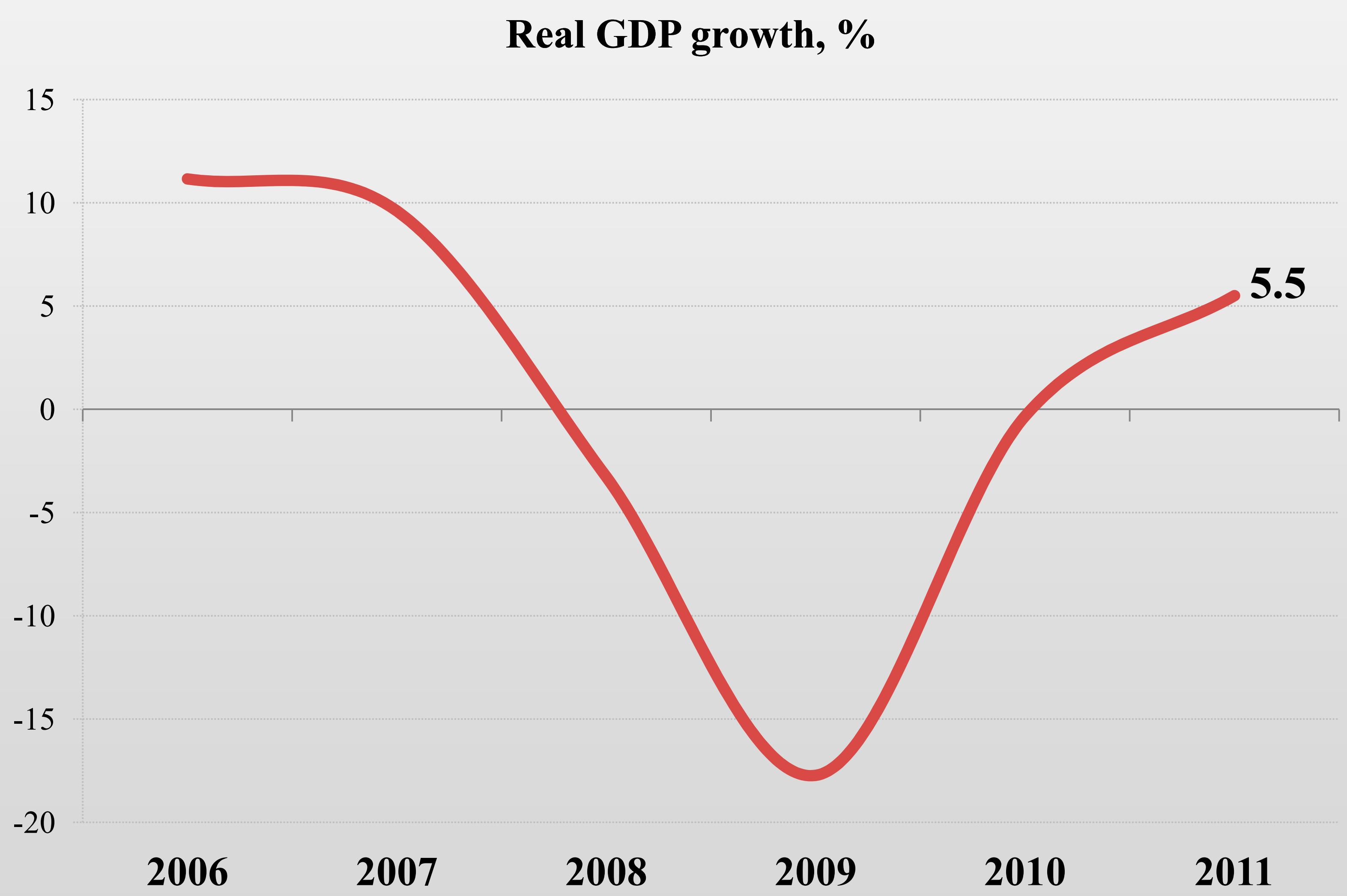
How Latvia managed to accomplish what initially was claimed being impossible?

Commitment

How Latvia managed to accomplish what initially was claimed being impossible?

Solidarity

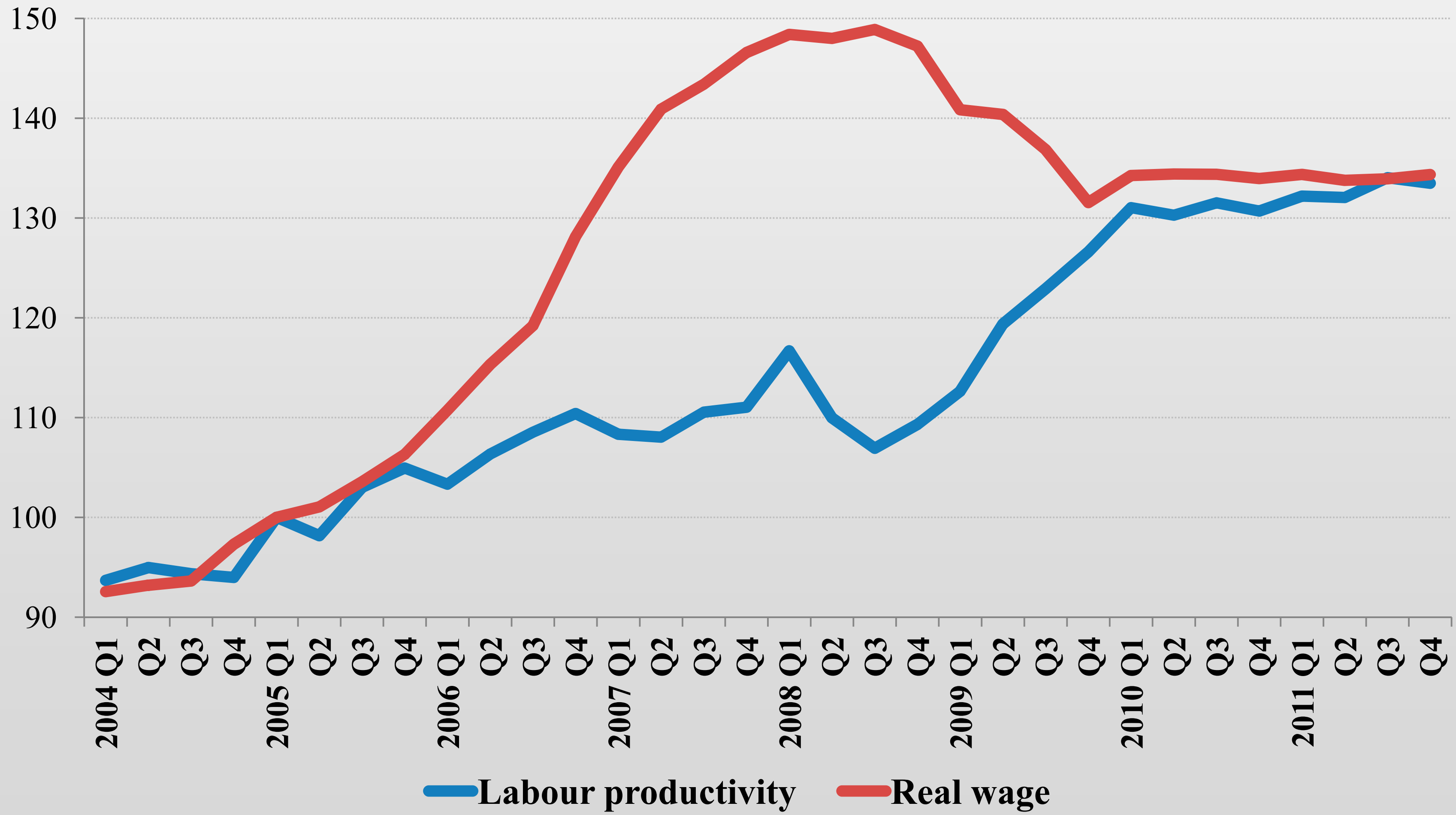
Despite loud ex-ante warnings of protracted recession risks under internal adjustment scenario, a strong "V" shaped recovery followed



Source: CSB

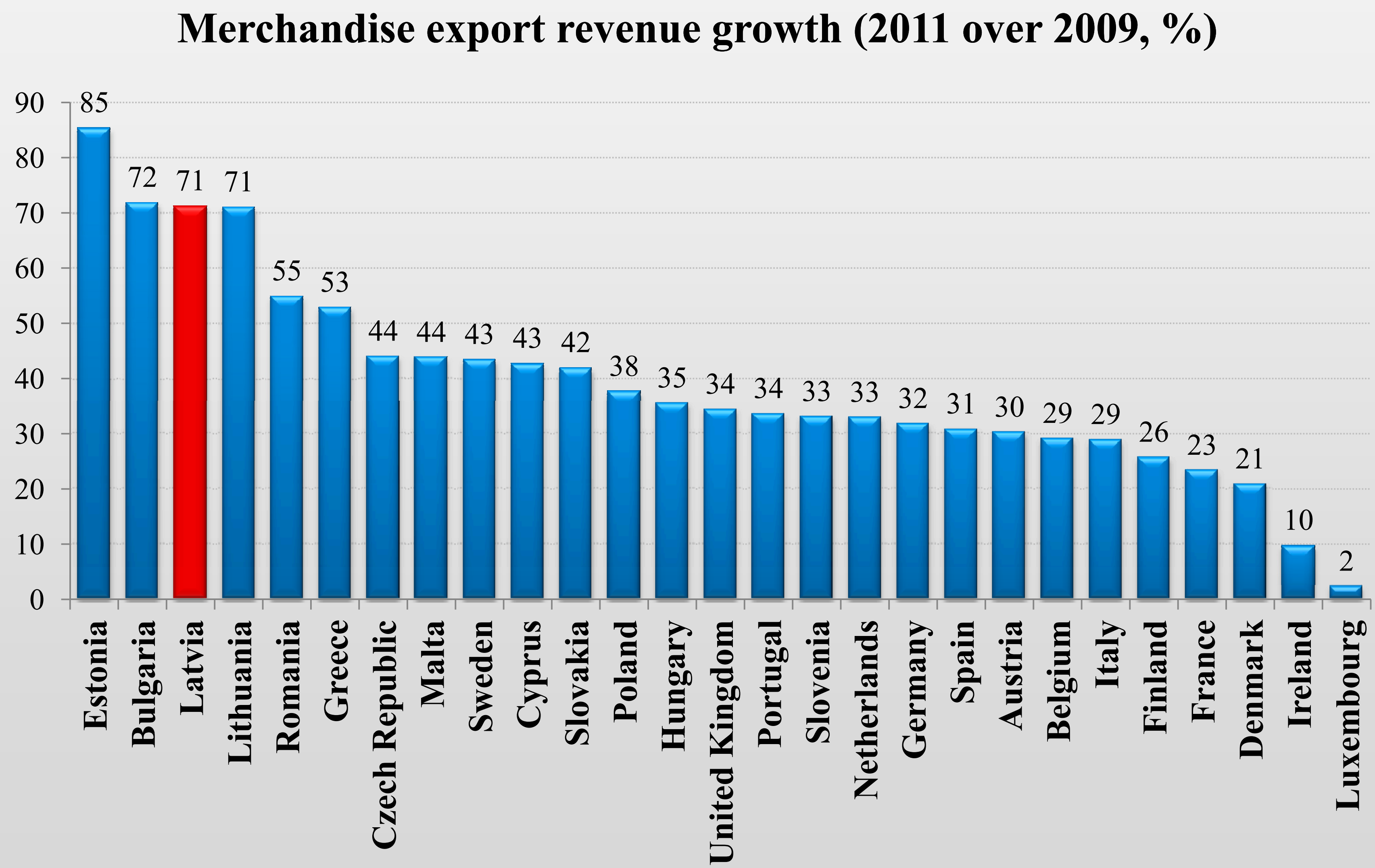
Growth has been supported by regained competitiveness: wage-productivity gap has been closed

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



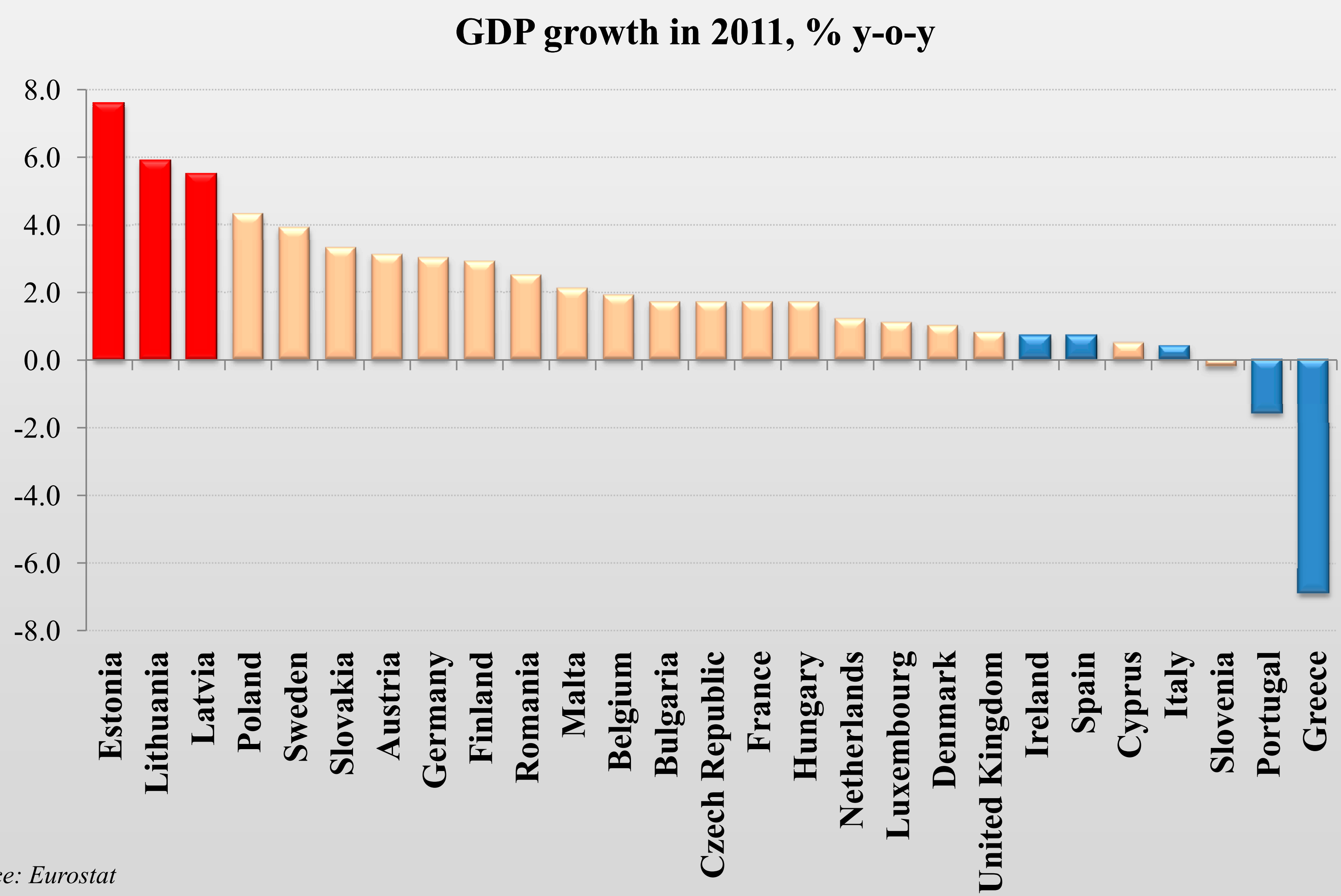
Source: CSB; Bank of Latvia staff calculations

Regained competitiveness has boosted exports: Latvia ranges among the export leaders in Europe



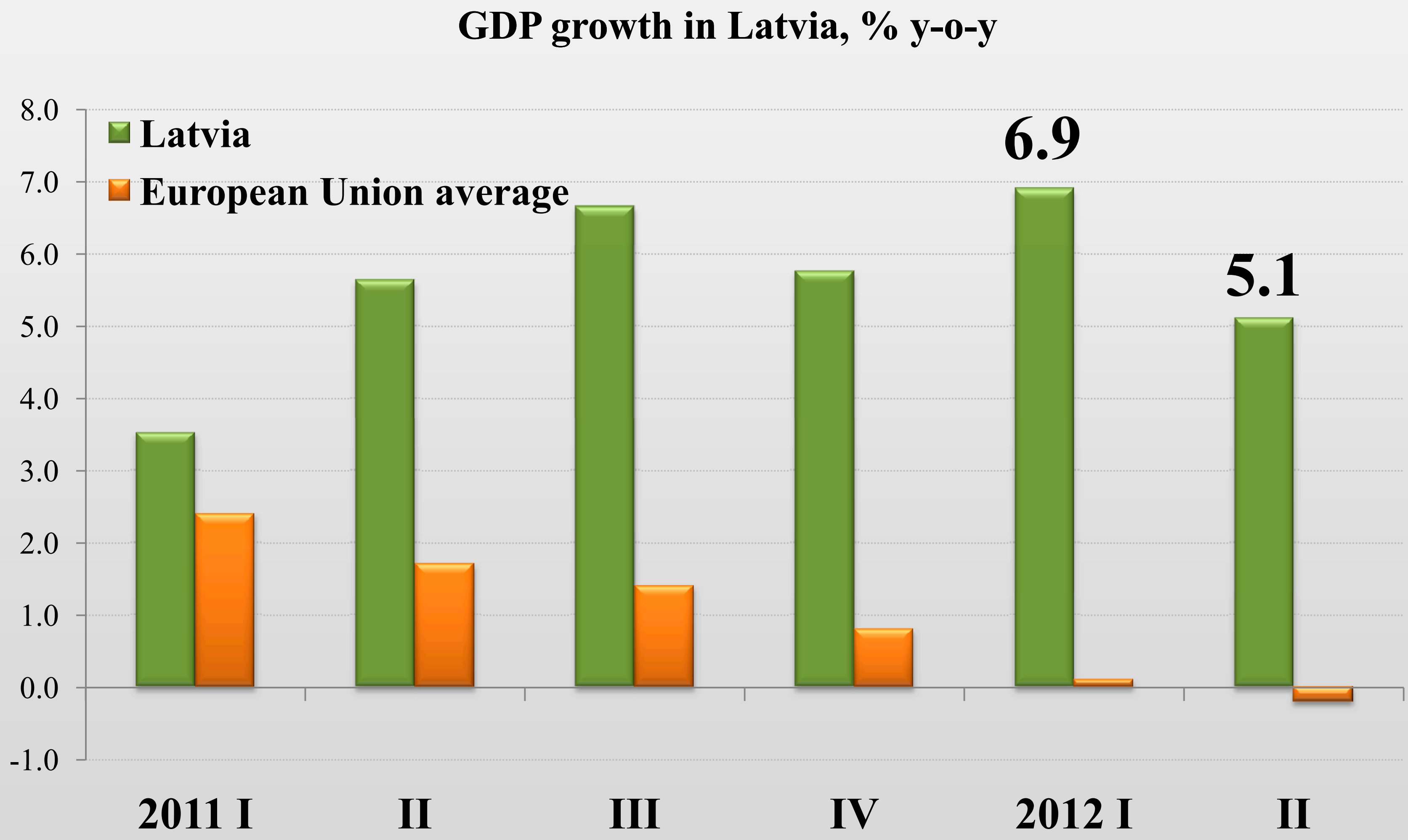
Source: Eurostat

Latvia and other Baltic countries have clearly benefited from getting through the internal adjustment at an early stage – now we are leading growth in Europe



Source: Eurostat

Indeed, Latvia has become the fastest growing economy in Europe this year



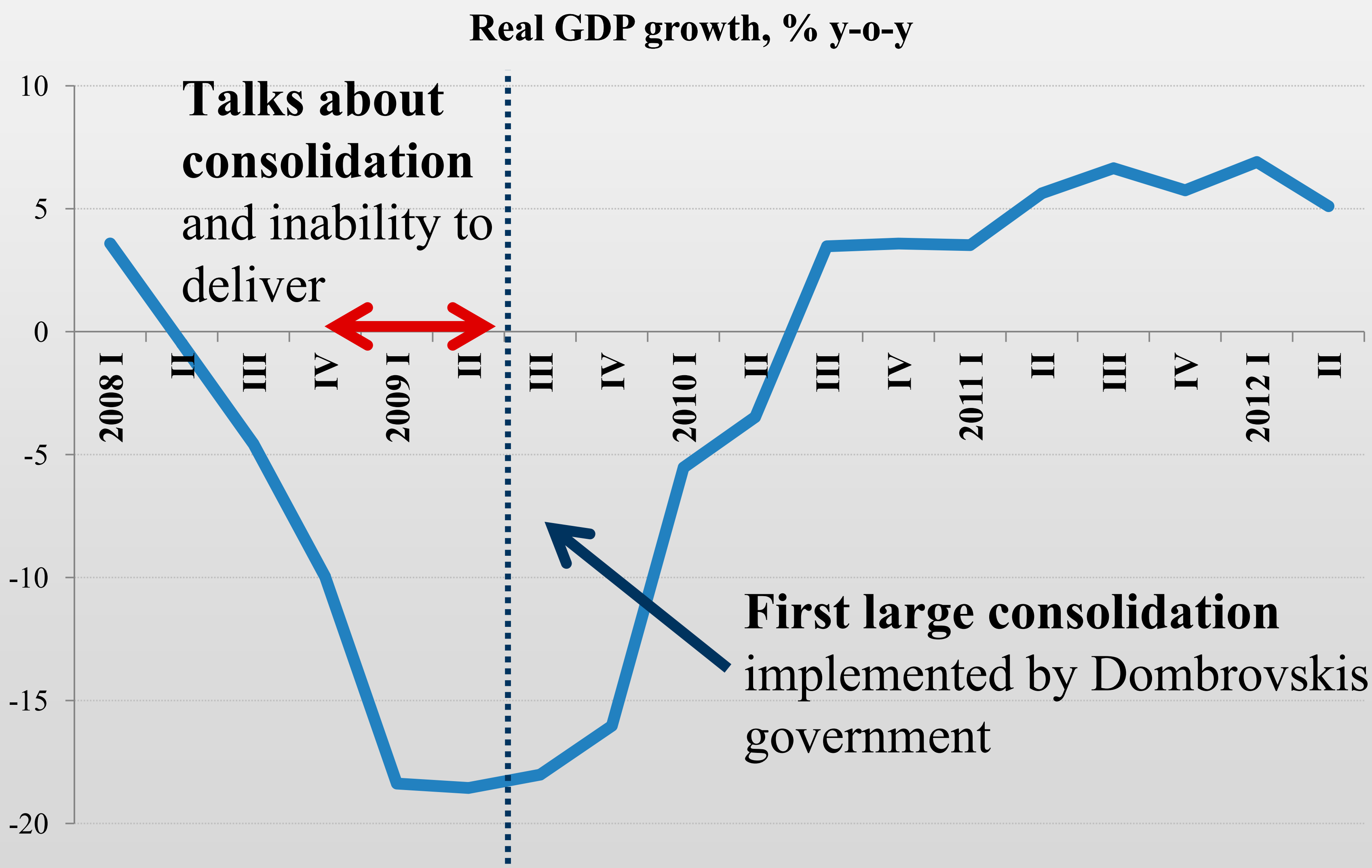
Source: CSB

What are the lessons learned?

This crisis has shown that

MORE is LESS and LESS is MORE

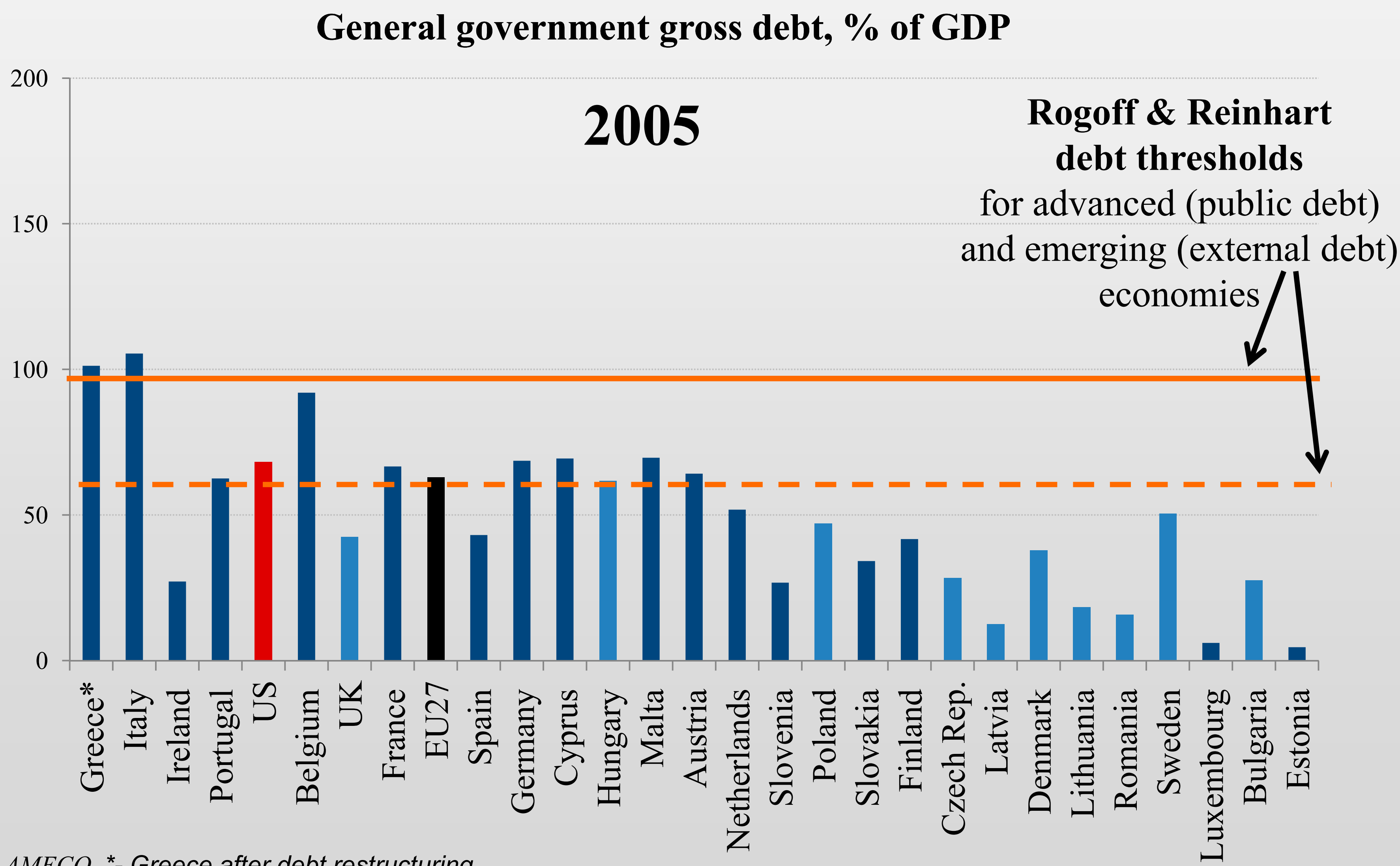
Latvia's example shows that Speed, Ownership, Commitment and Solidarity works



Source: CSB

How does this look from a global perspective?

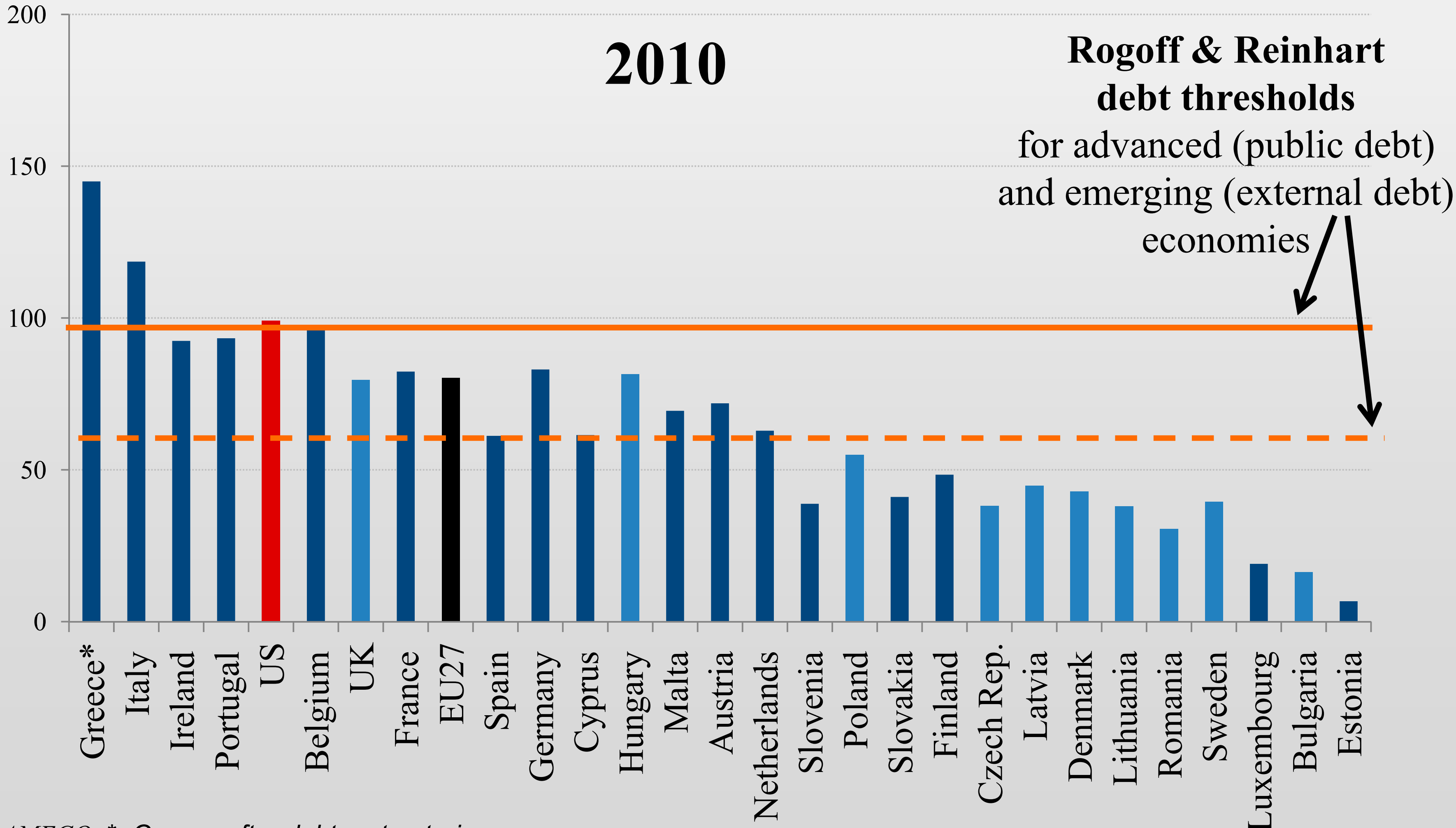
"One doesn't die from debt, one dies from not being able to borrow"



*Source: AMECO, *- Greece after debt restructuring*

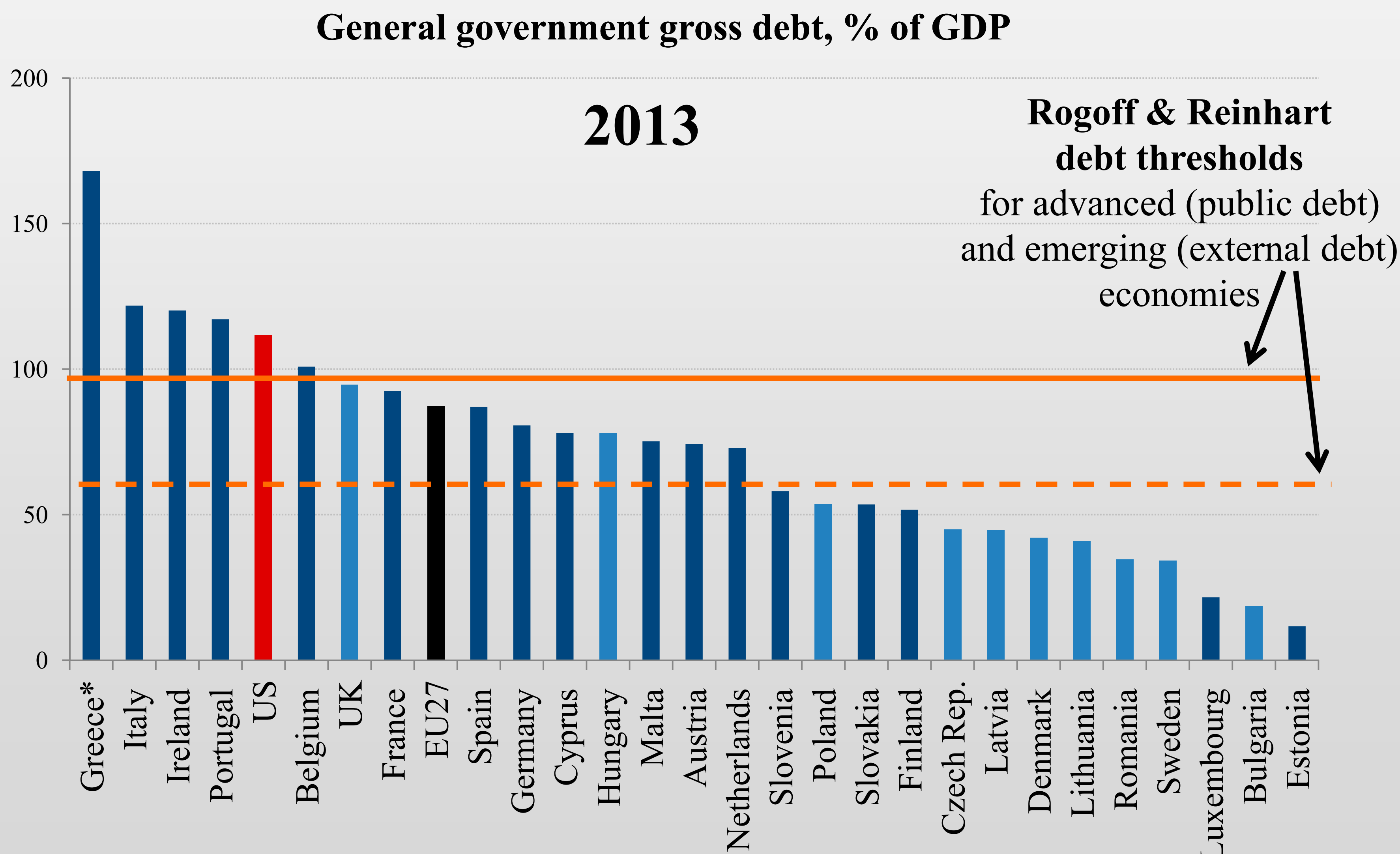
"One doesn't die from debt, one dies from not being able to borrow"

General government gross debt, % of GDP



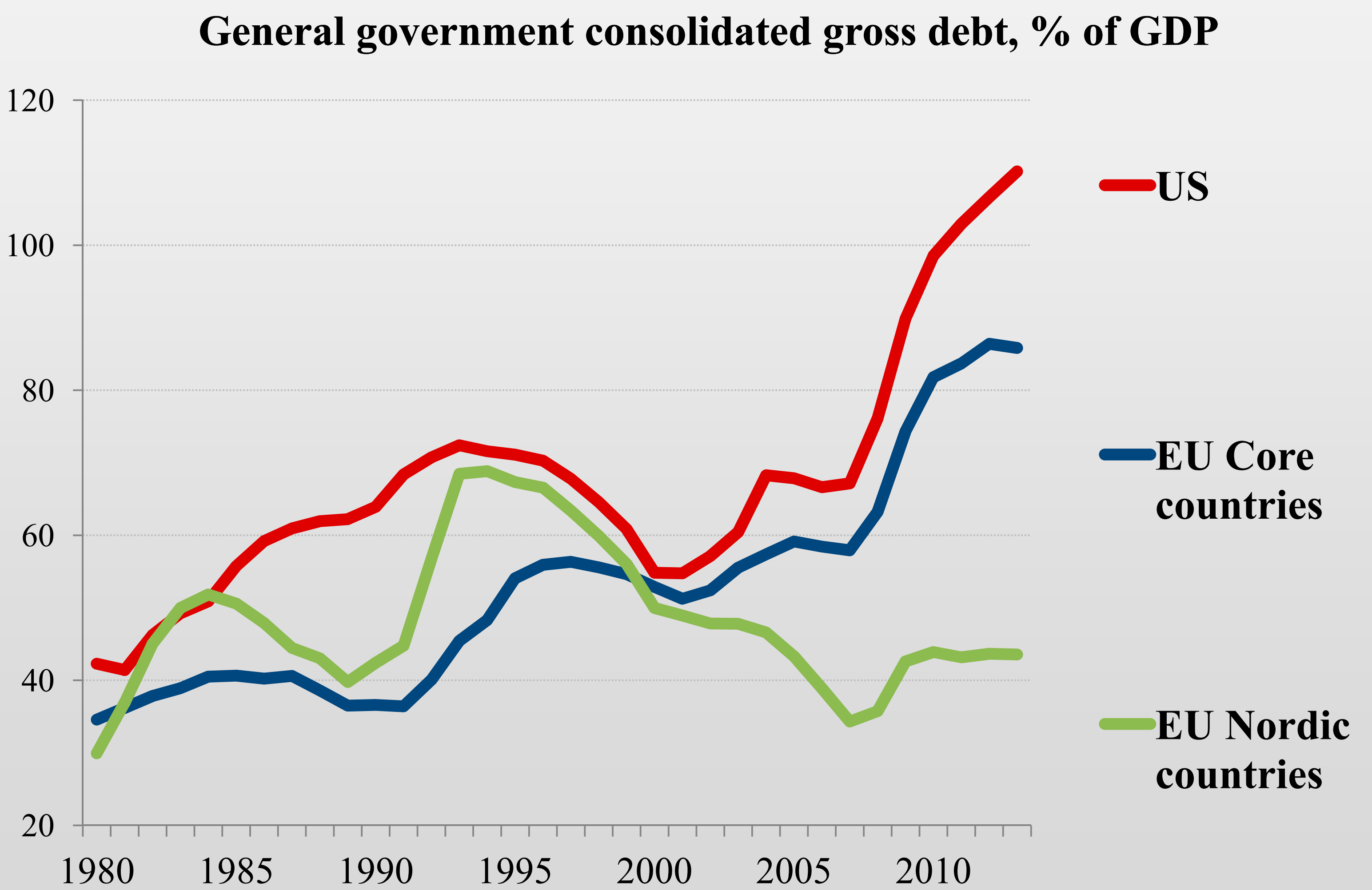
*Source: AMECO, *- Greece after debt restructuring*

"One doesn't die from debt, one dies from not being able to borrow"



*Source: AMECO, *- Greece after debt restructuring*

After the crisis in early 1990-ties, the EU Nordic countries adhered to prudent fiscal strategies as a contrast to the rest of Europe and US



Source: IMF, EC, BoL staff calculations; EU Nordic countries = Sweden, Finland, Denmark; EU Core countries = Germany, France, UK; unweighted average

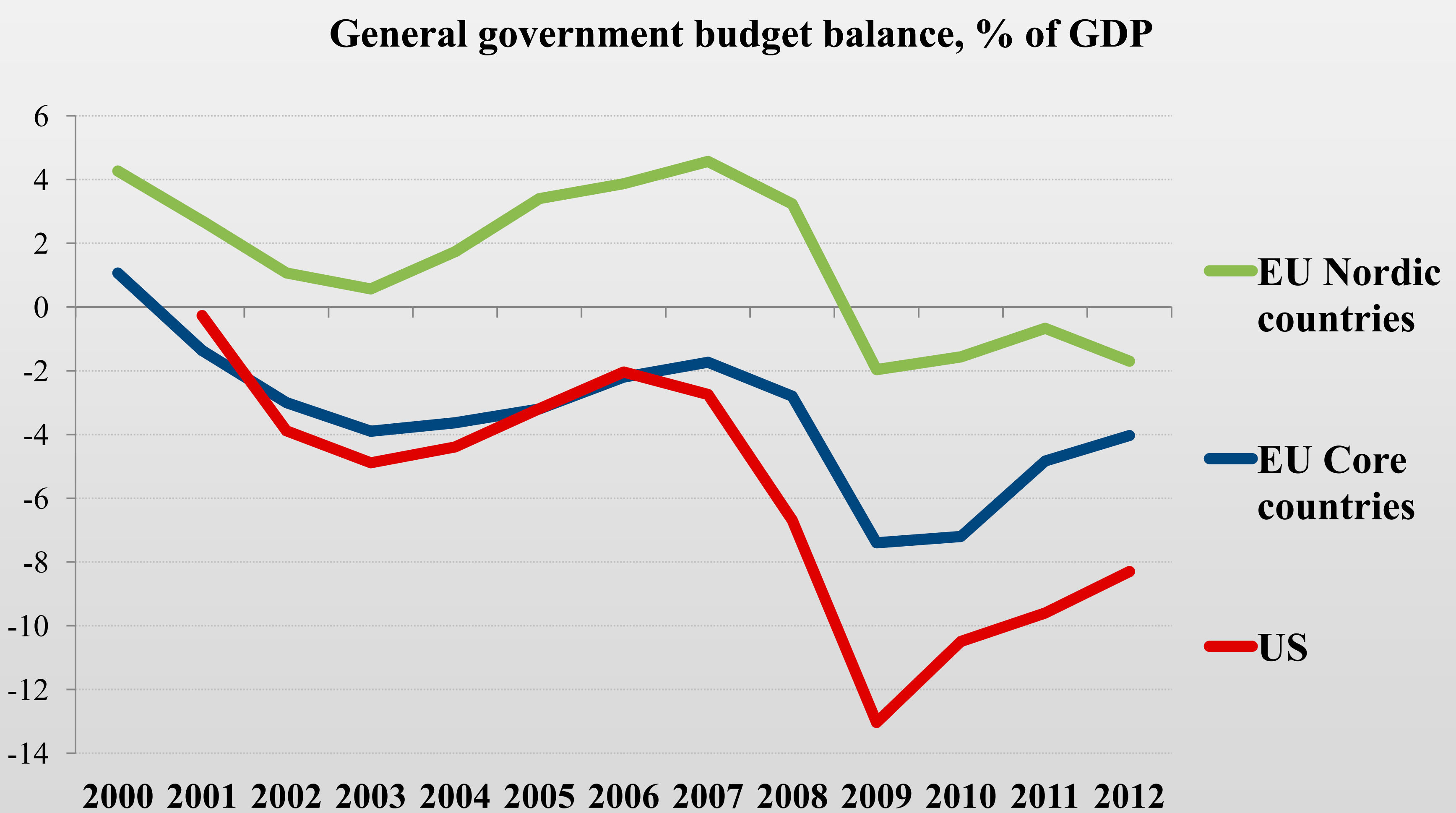
Despite fiscal prudence, EU Nordic countries have been able to sustain growth over past 20 years whereas US and EU Core countries have slowed down

Average annual real GDP growth, %

	1970-1990	1993-2013
EU Nordic countries	2.5	2.4
EU Core countries	2.7	1.8
US	3.1	2.6

Source: IMF, EC, BoL staff calculations; EU Nordic countries = Sweden, Finland, Denmark; EU Core countries = Germany, France, UK; unweighted average

Fiscal prudence has allowed EU Nordic countries to enter this crisis with low debt and small budget deficits



Source: IMF, EC, BoL staff calculations; EU Nordic countries = Sweden, Finland, Denmark; EU Core countries = Germany, France, UK; unweighted average

Thus in contrast to the rest of Europe and US, Nordic countries have sufficient fiscal space to accommodate future crises when they come

	Public debt, % of GDP*		Budget balance, % of GDP*		Interest payments, % of GDP	
	2011	**2012**	**2011**	**2012**	**2011**	**2012**
EU Nordic countries	44.5	42.3	-0.7	-1.7	1.3	1.3
EU Core countries	84.2	88.0	-4.8	-4.0	2.8	2.9
US	103.5	108.9	-9.6	-8.3	2.9	2.8

Source: IMF, EC, BoL staff calculations; EU Nordic countries = Sweden, Finland, Denmark; EU Core countries = Germany, France, UK; unweighted average


LATVIJAS BANKA