



Lessons from Latvia's internal adjustment strategy

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Presentation outline

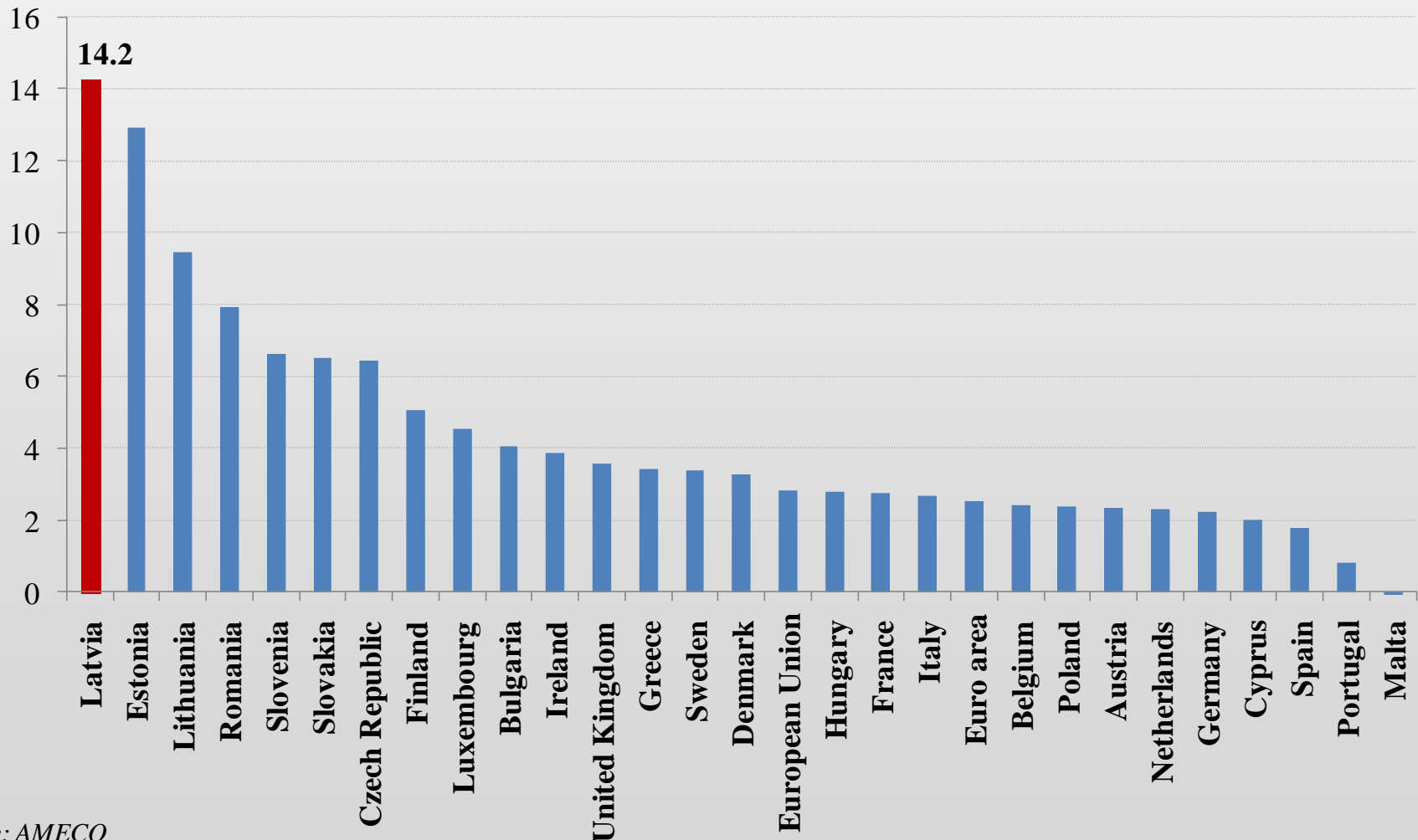
- Snapshot of Latvia's economy before crisis
- Latvia's recipe (policy solutions and post-crisis experience)
- Policy relevant lessons learned

Status quo

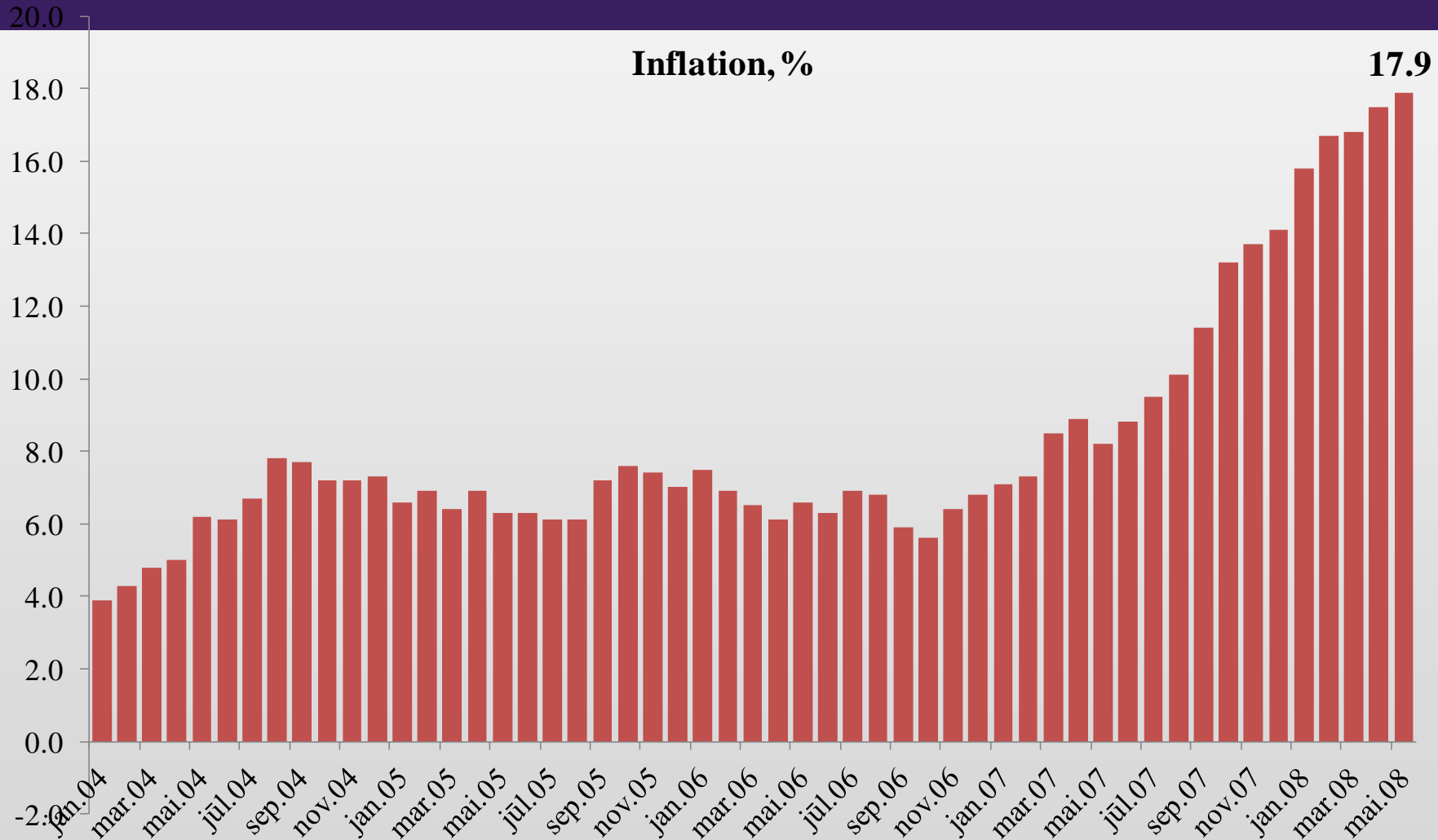
- Severely overheated economy
 - Initially: EU accession led export boom
 - Later on: foreign inflows nurtured domestic demand boom
- Weakened external competitiveness
- Large external shock, both through trade and financial channels

Financial deepening resulted in exceptionally strong positive output gap ...

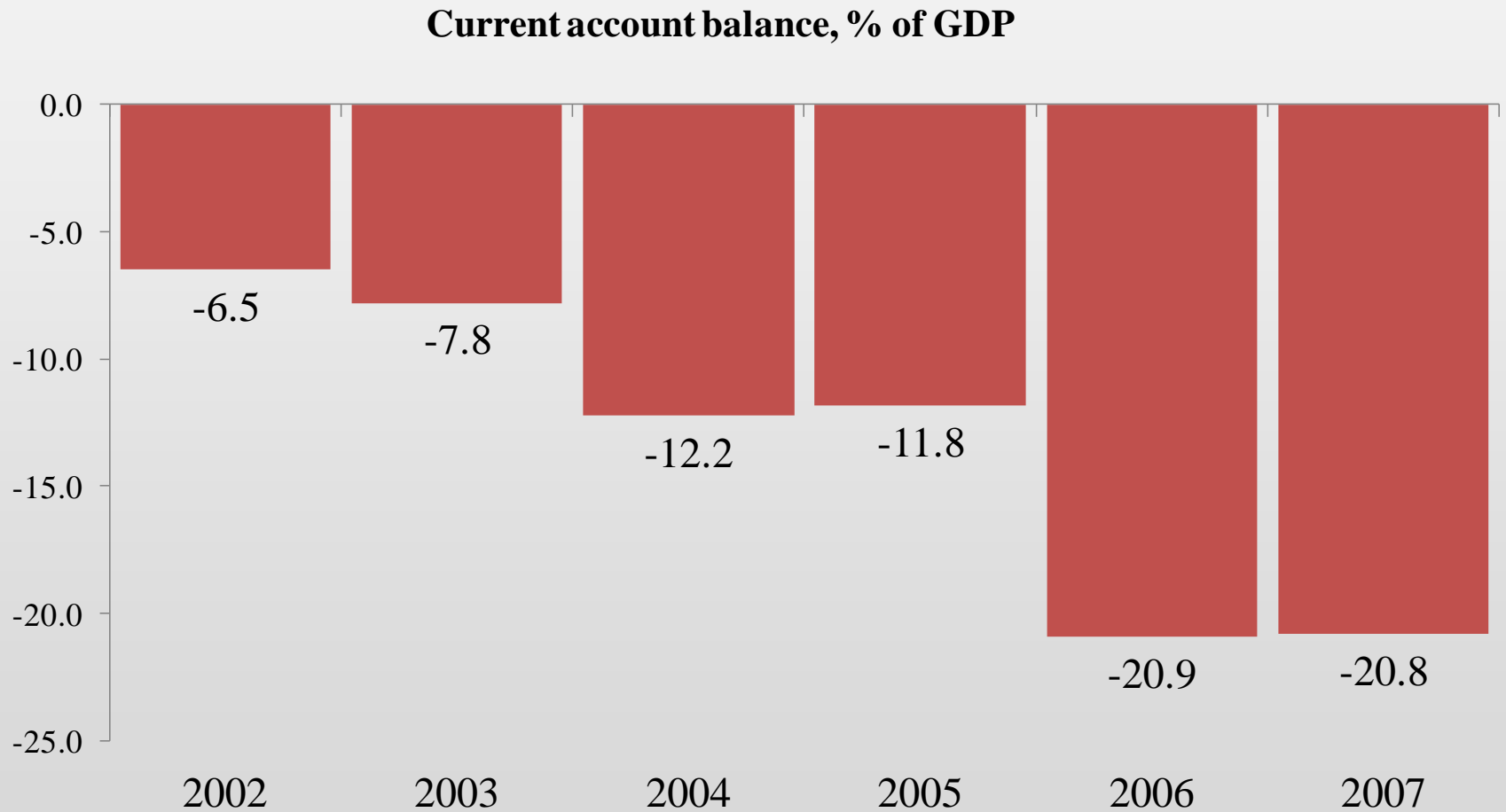
Output gap in 2007 (% of potential output)



... leading to both, domestic imbalances ...

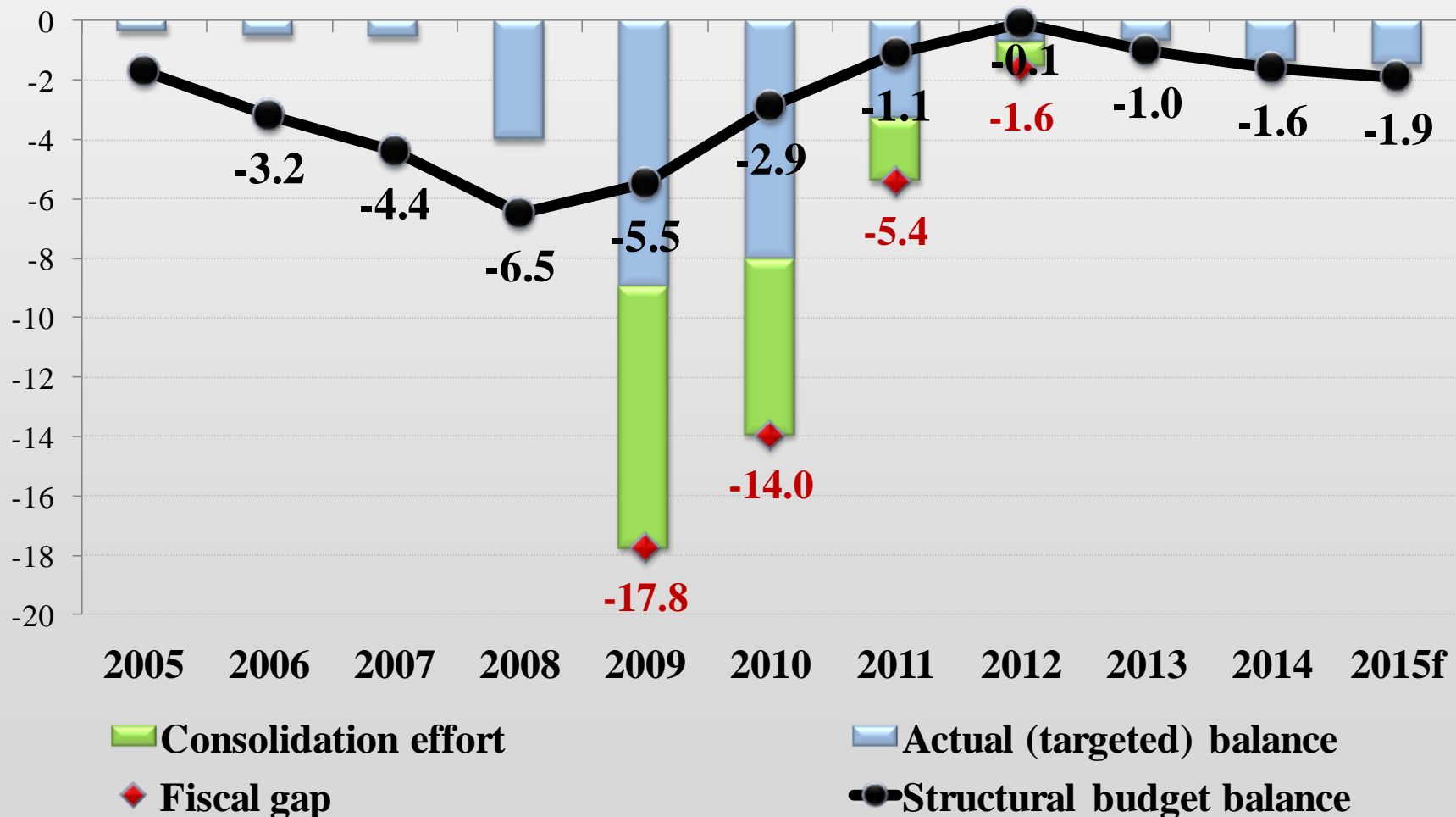


... and external imbalances



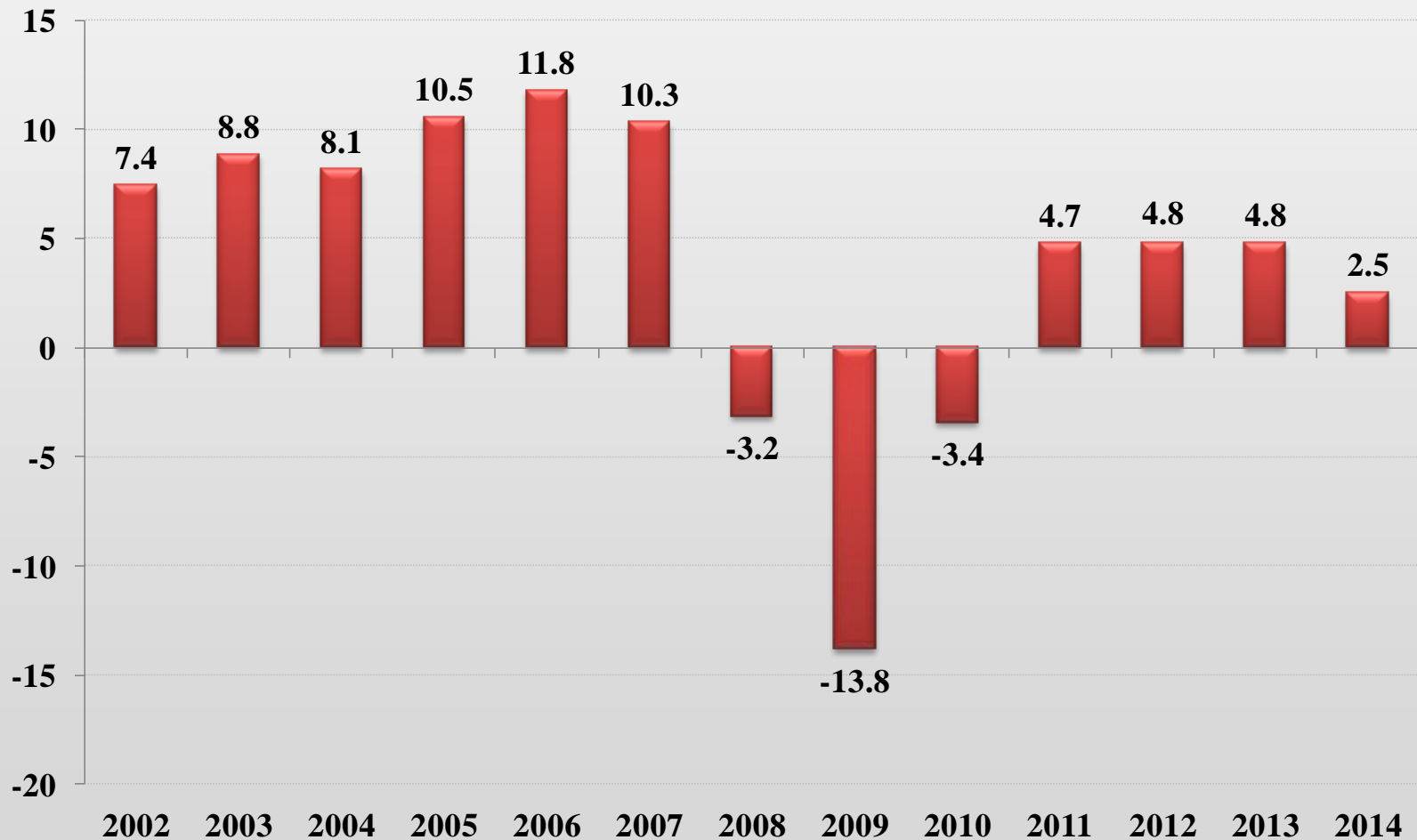
Over the past boom Latvia was running enormous underlying fiscal gap

General Government budget balance (ESA 2010), % of GDP



The rapid growth of economy was unsustainable

Real GDP growth (y-o-y, %, wda and sa data)



Policy dilemmas (as seen from outside)

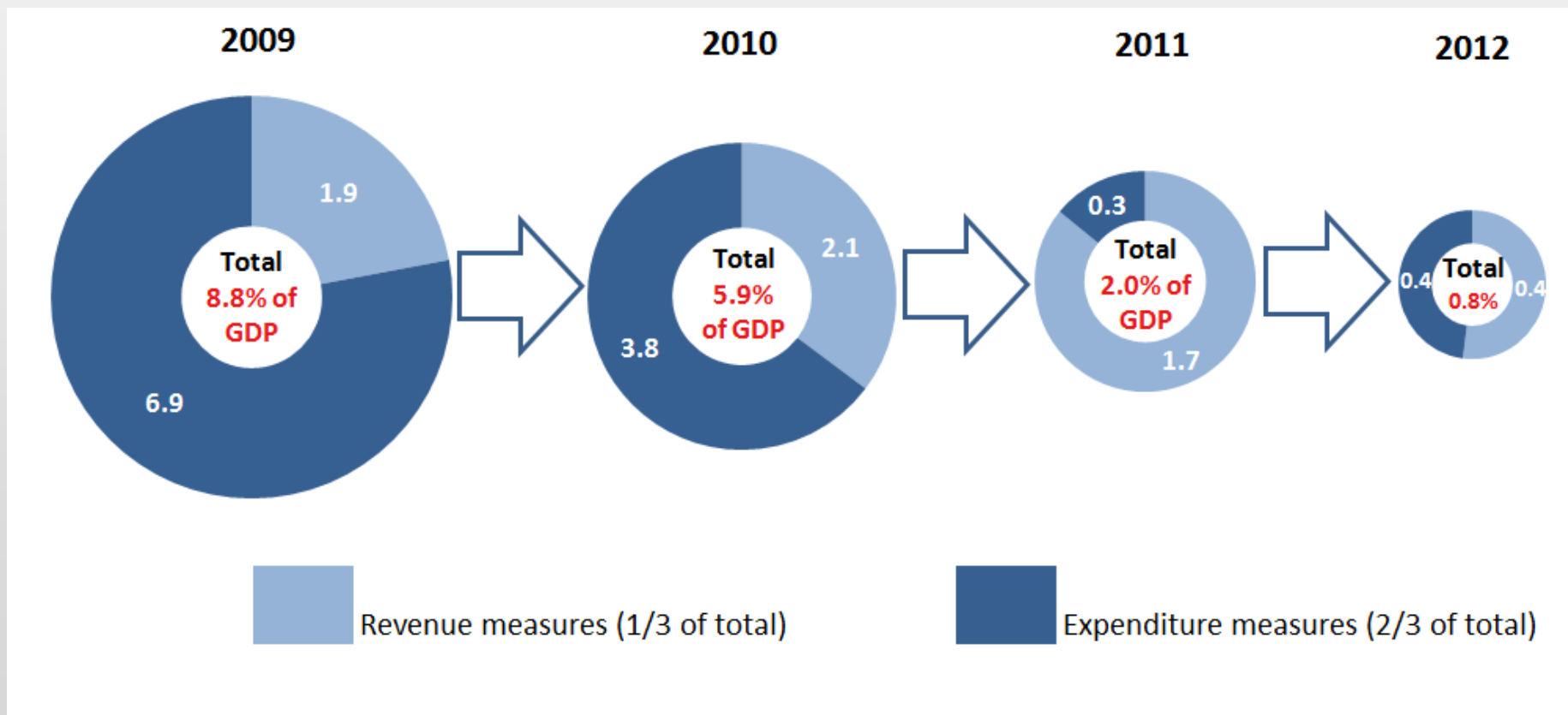
- Nominal devaluation vs internal adjustment
- Frontloaded vs backloaded adjustment

Devaluation was not a solution for Latvia

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

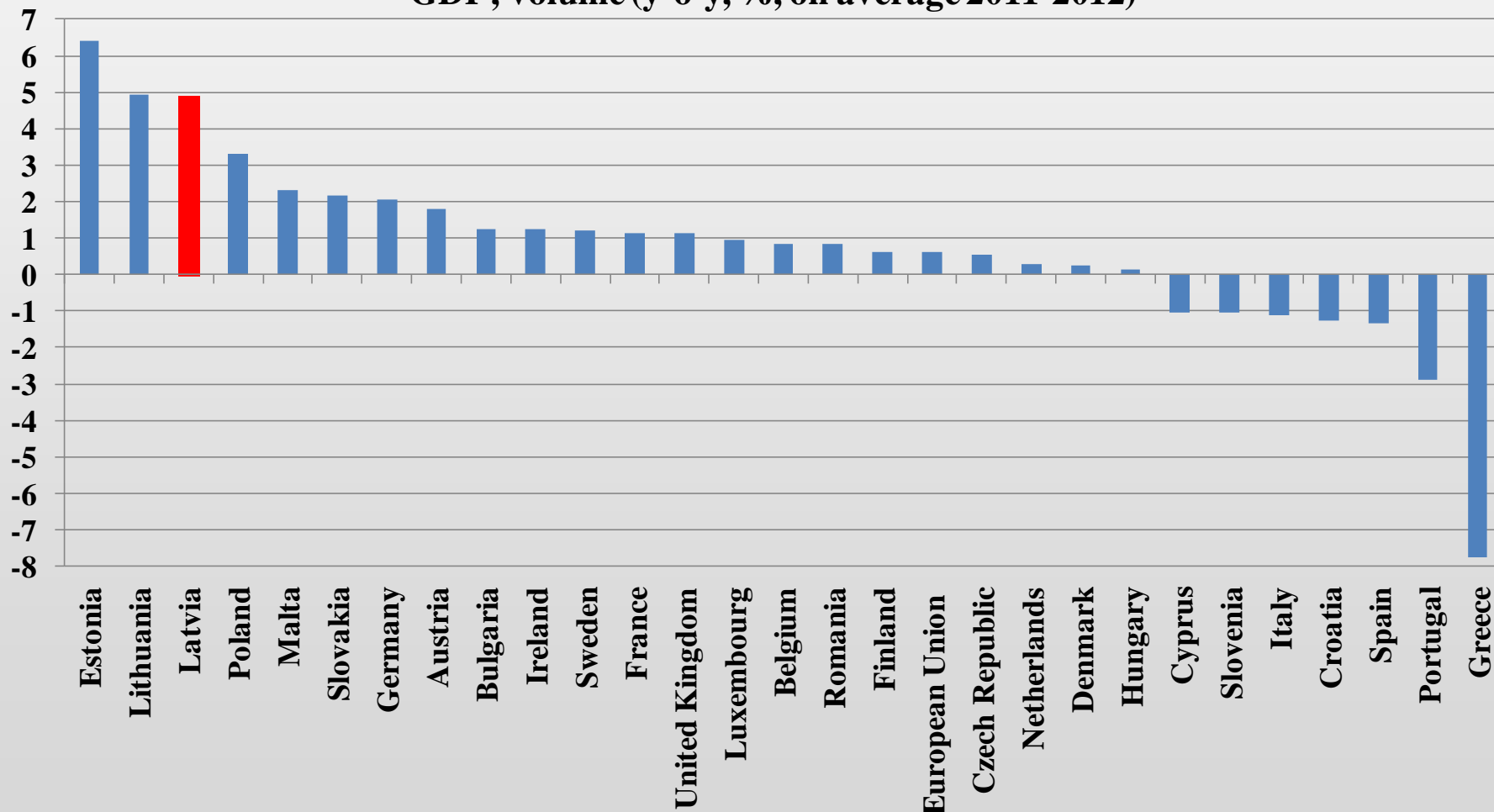
Latvia lost market access already at the outset of the recent crisis and the fiscal gap had to be closed quickly by massive consolidation

Breakdown of budget consolidation measures, % of GDP



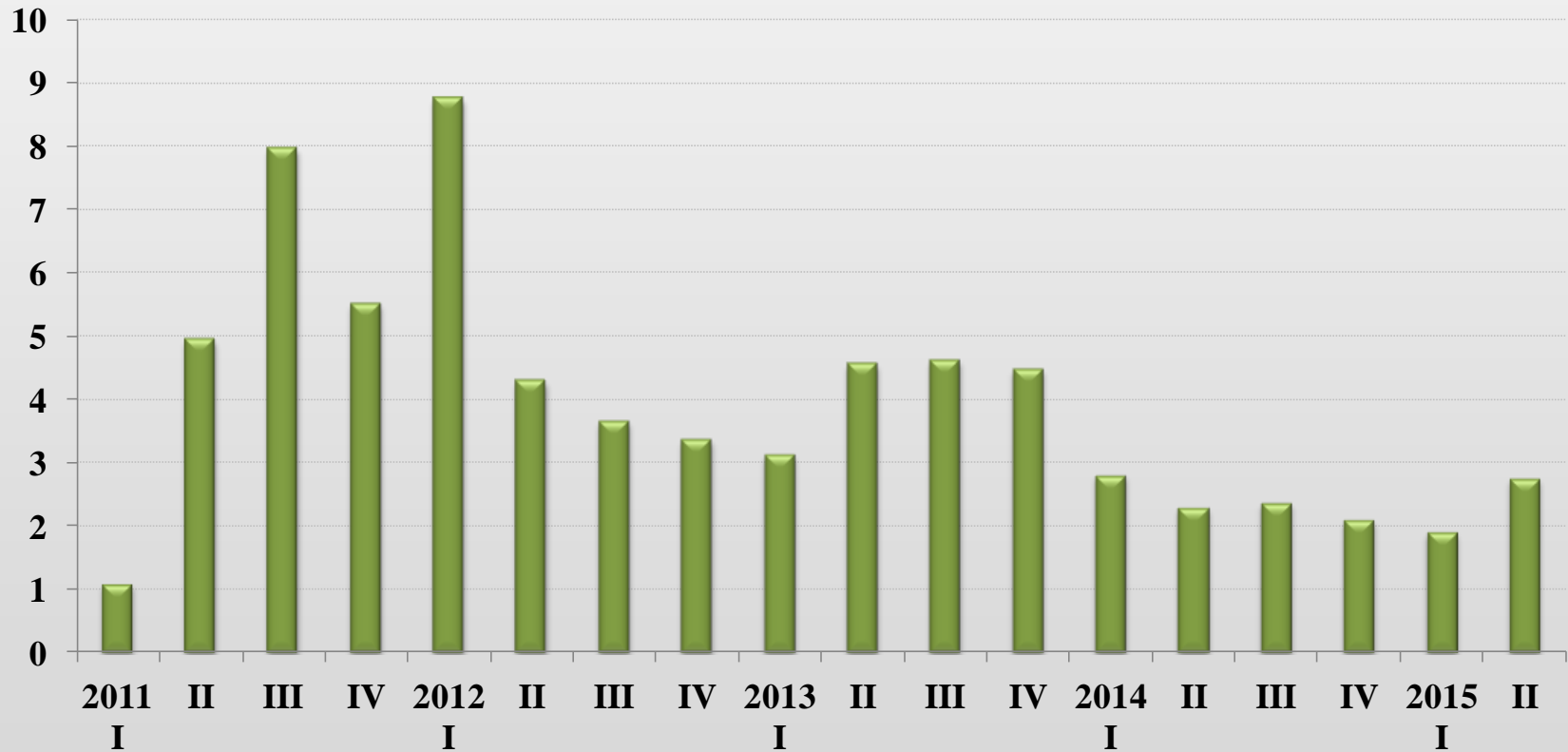
Against the odds, Latvia posted one of the fastest post-crisis recovery among the EU economies

GDP, volume (y-o-y, %, on average 2011-2012)



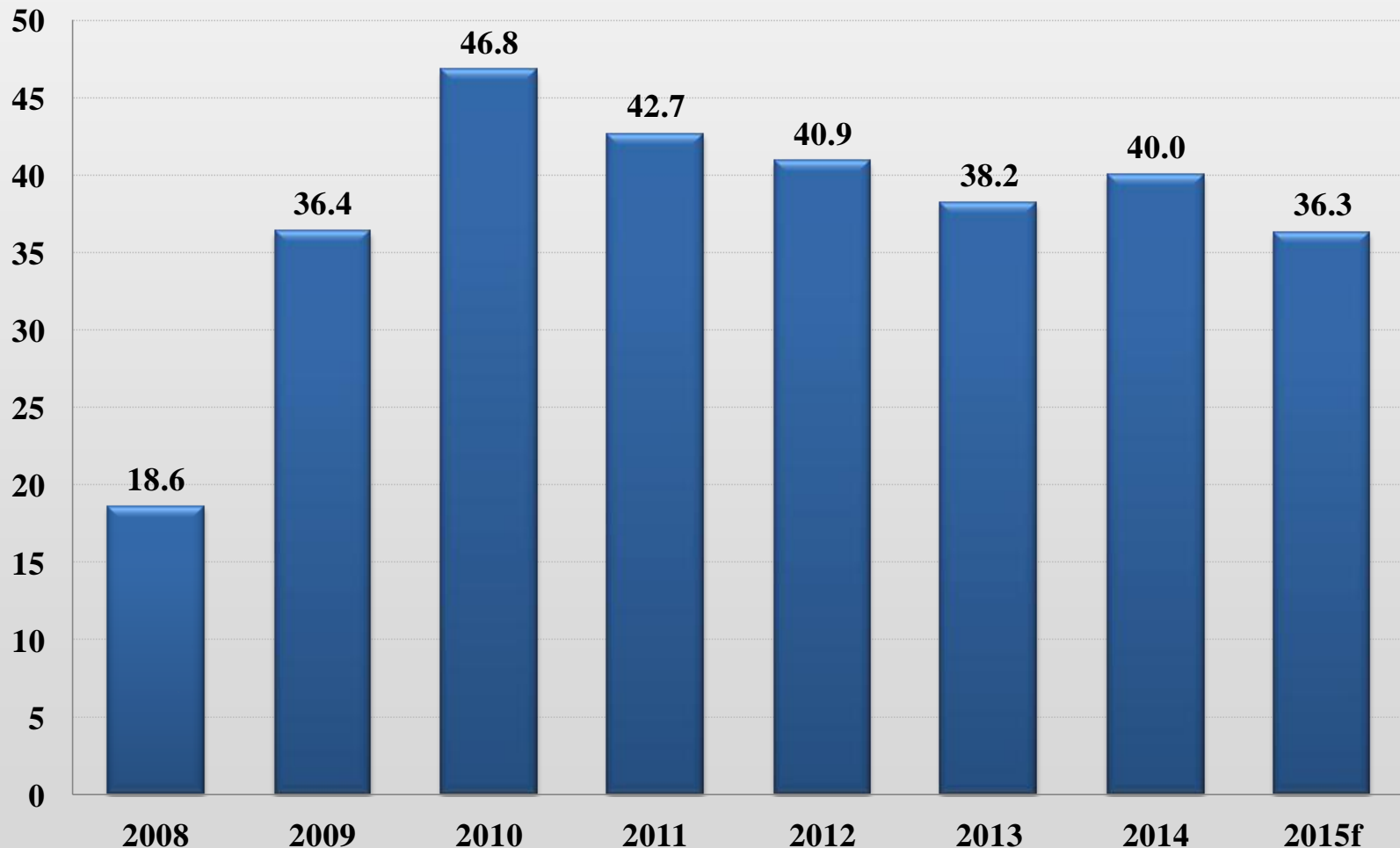
Despite regional and global uncertainty, GDP growth remains around 2% at the moment

GDP growth in Latvia, % y-o-y



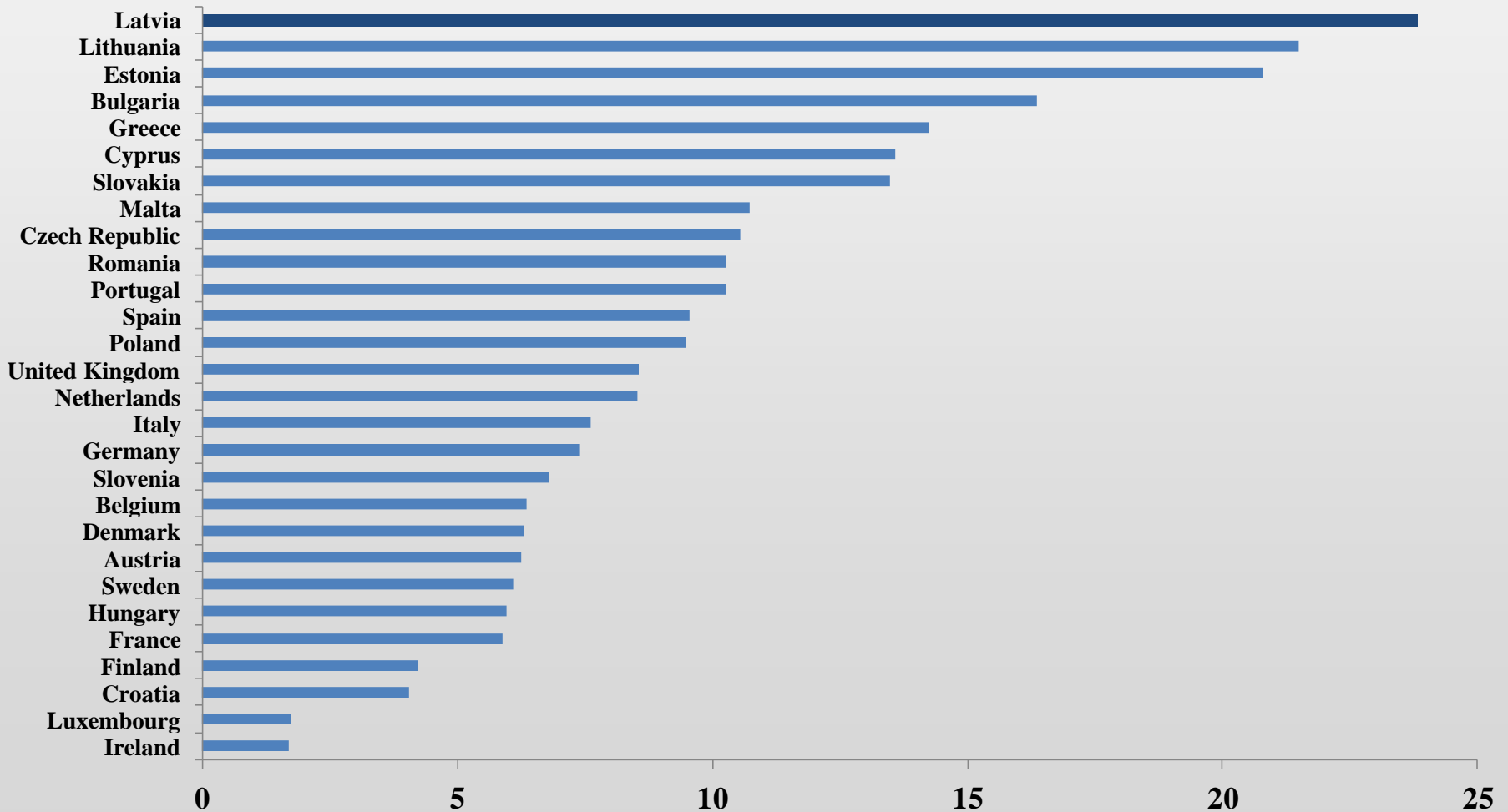
Latvia has managed to stabilize debt at moderate level and to avoid initially expected debt explosion

General government gross debt, % of GDP



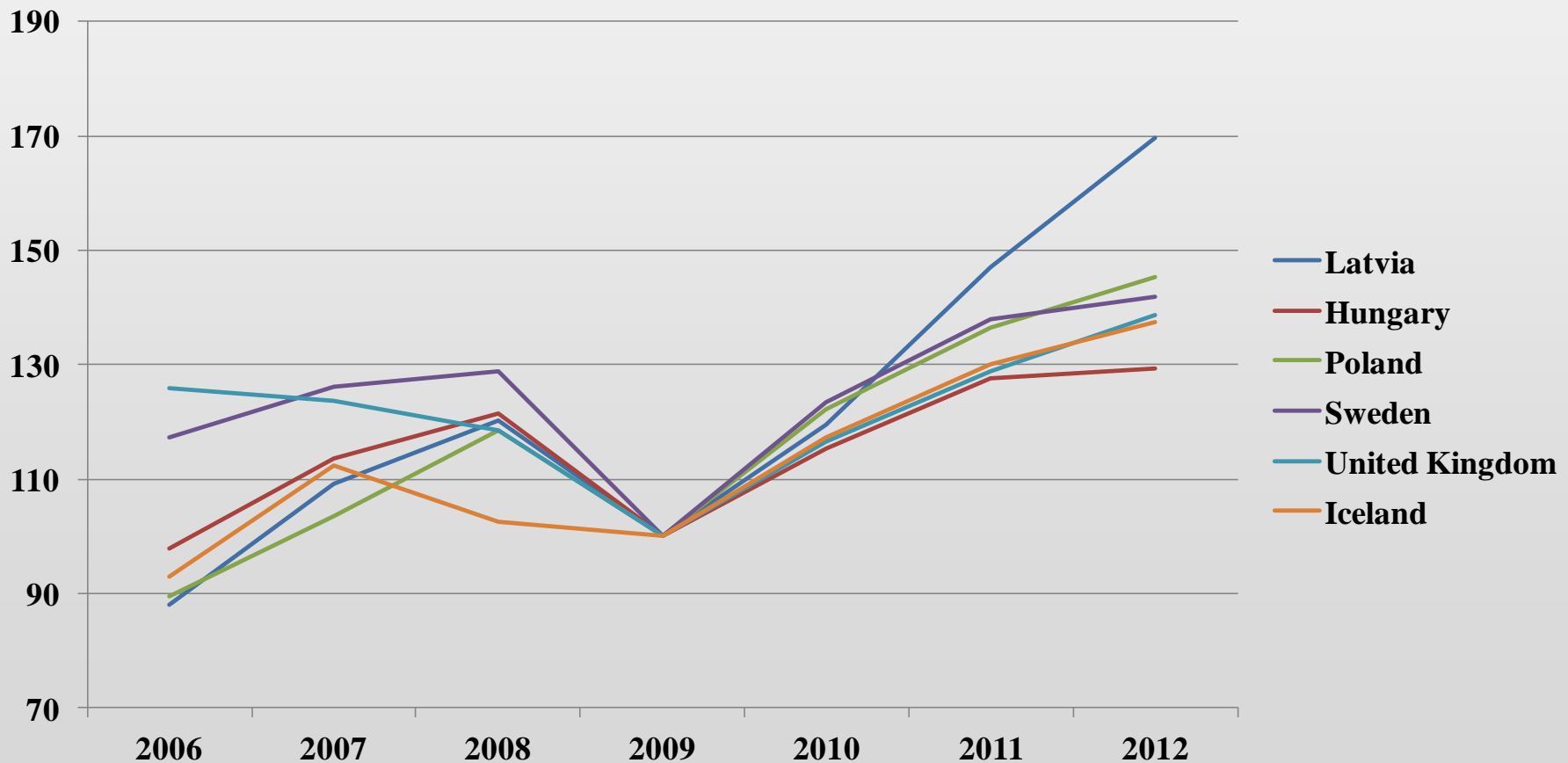
Export growth was among the highest in the EU

Mechandise export growth, nominal (y-o-y percentage change, on average 2011-2012)



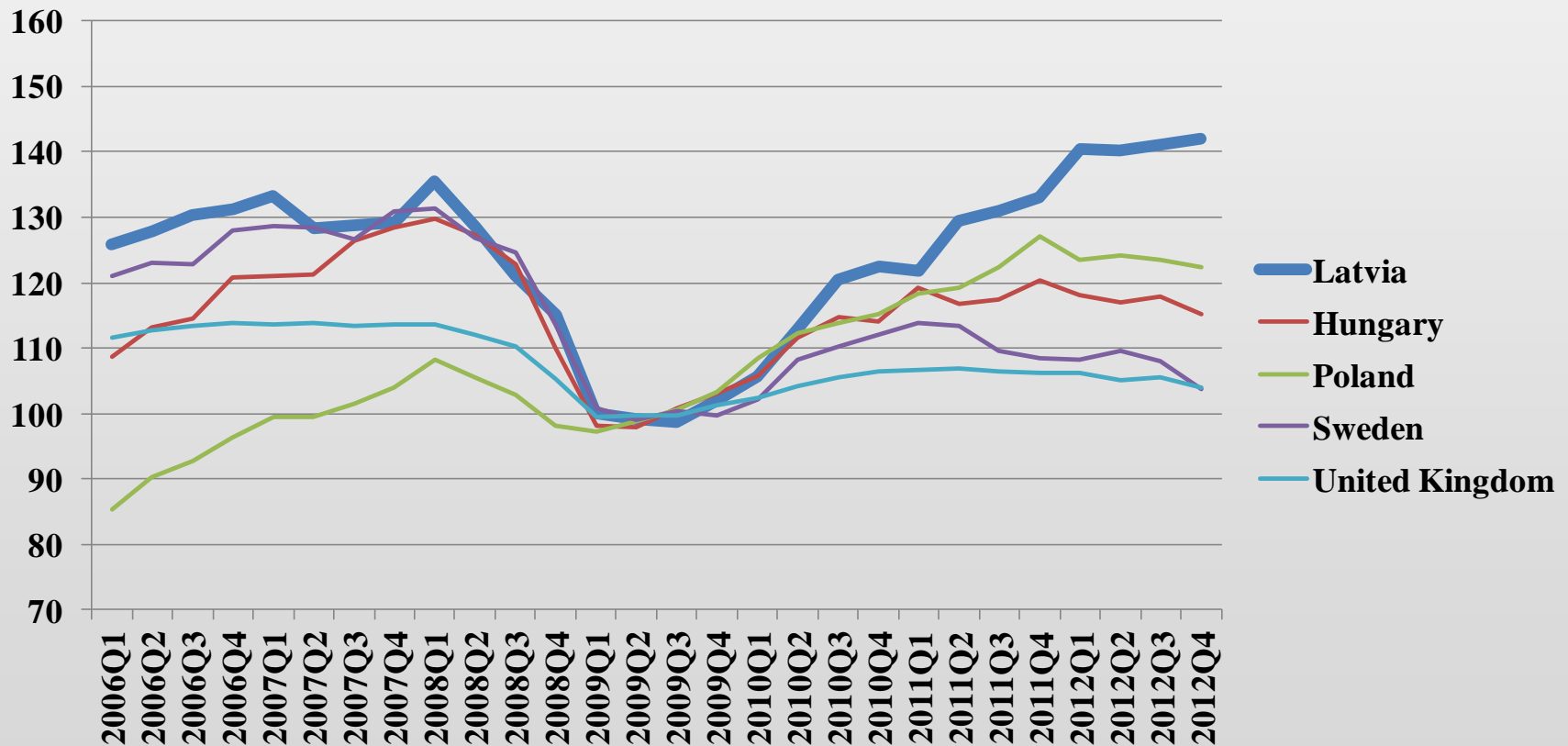
Exports rebounded faster than in countries where currency depreciated (1)

Exports of goods and services (in EUR), 2009=100



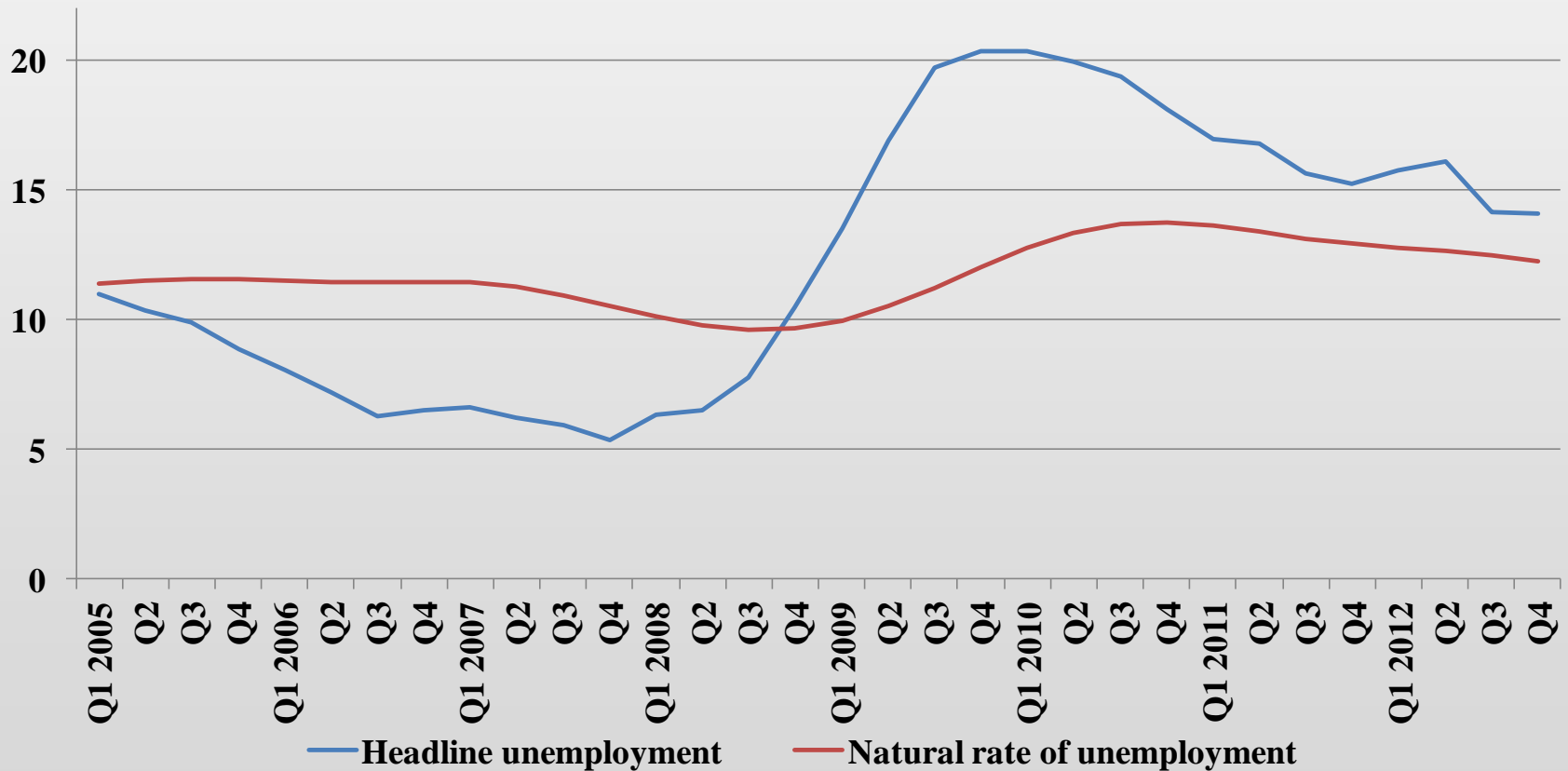
Exports rebounded faster than in countries where currency depreciated (2)

Real manufacturing output, 2009=100



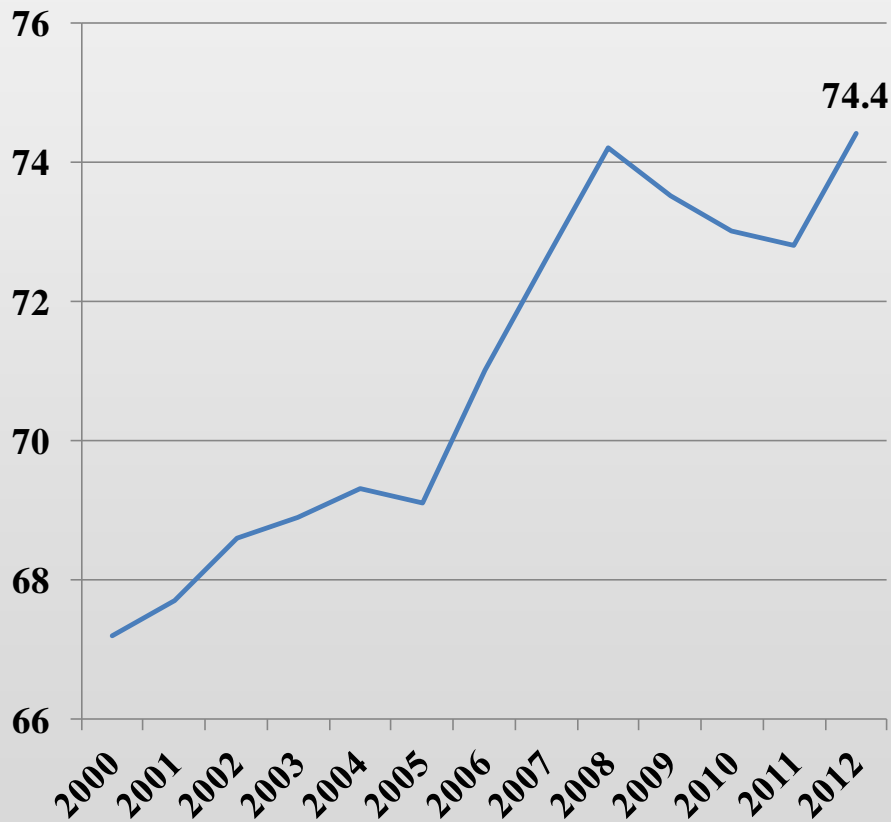
Unemployment declined close to its natural rate

Headline and natural rate of unemployment
(seasonally adjusted; age 15-74; % of economically active population)

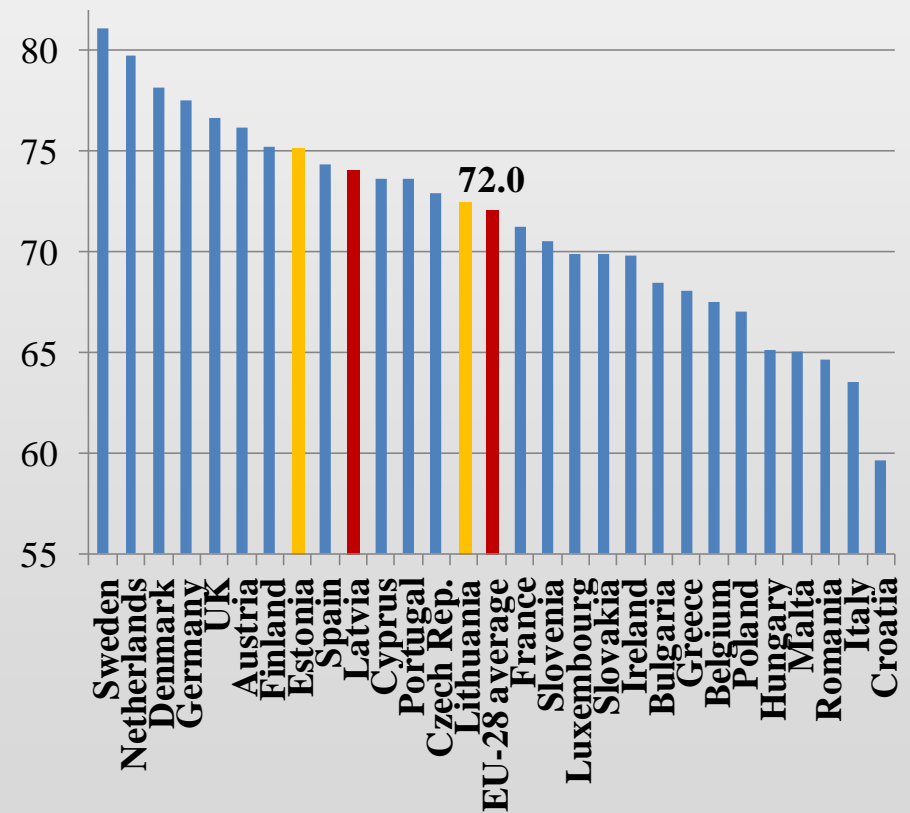


Participation rate at pre-crisis height

Participation rate in Latvia (age 15-64)

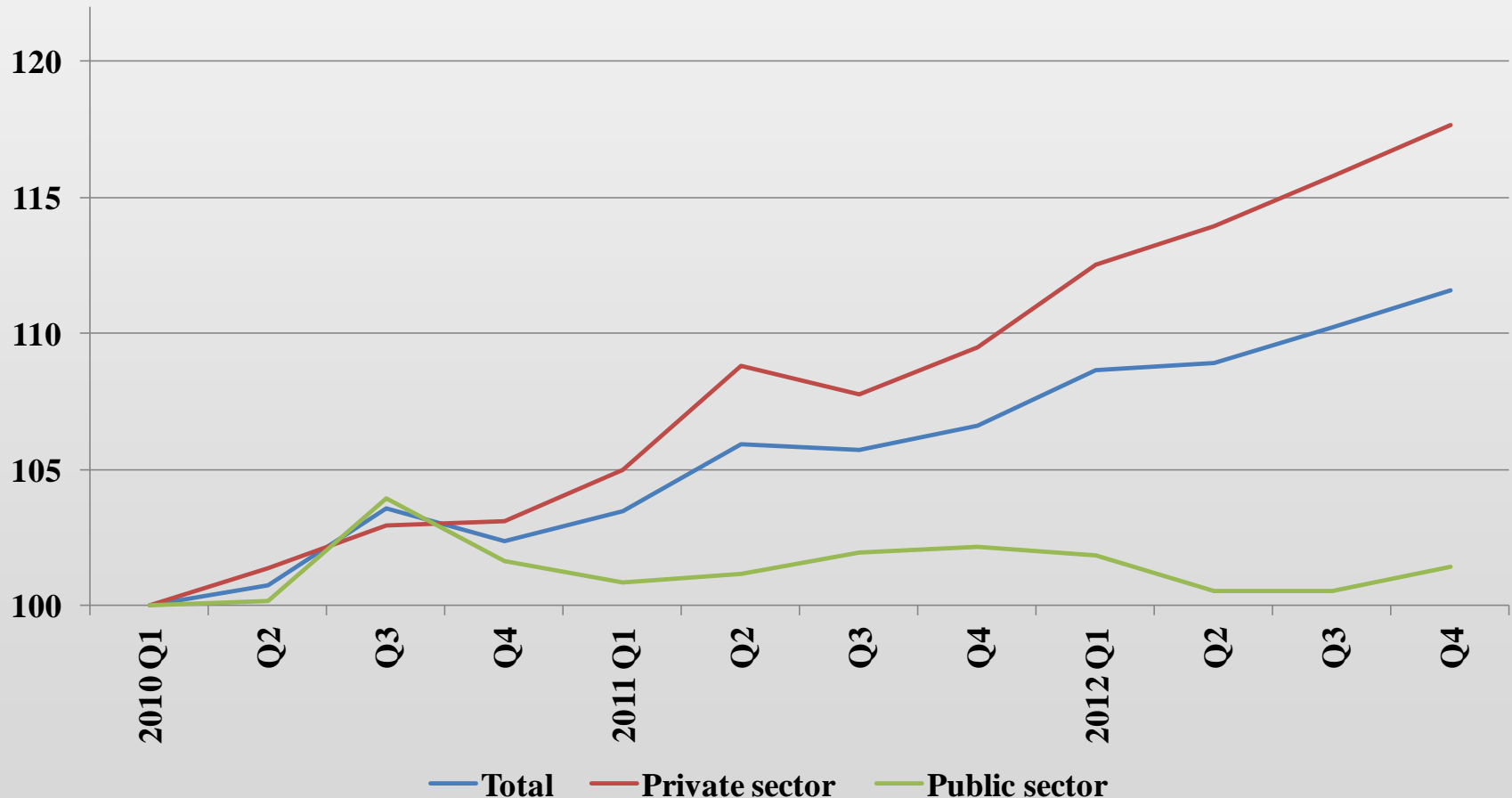


Participation rate in 2013 (age 15-64)



Employment growth was driven by the private sector

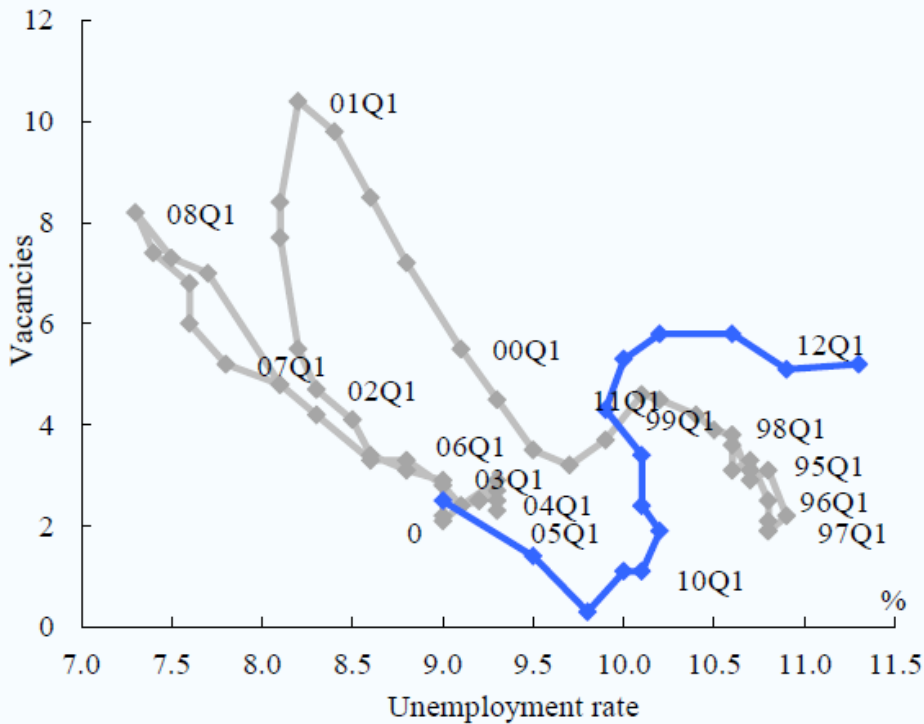
Number of occupied posts (index; 2010 Q1 = 100; seasonally adjusted data)



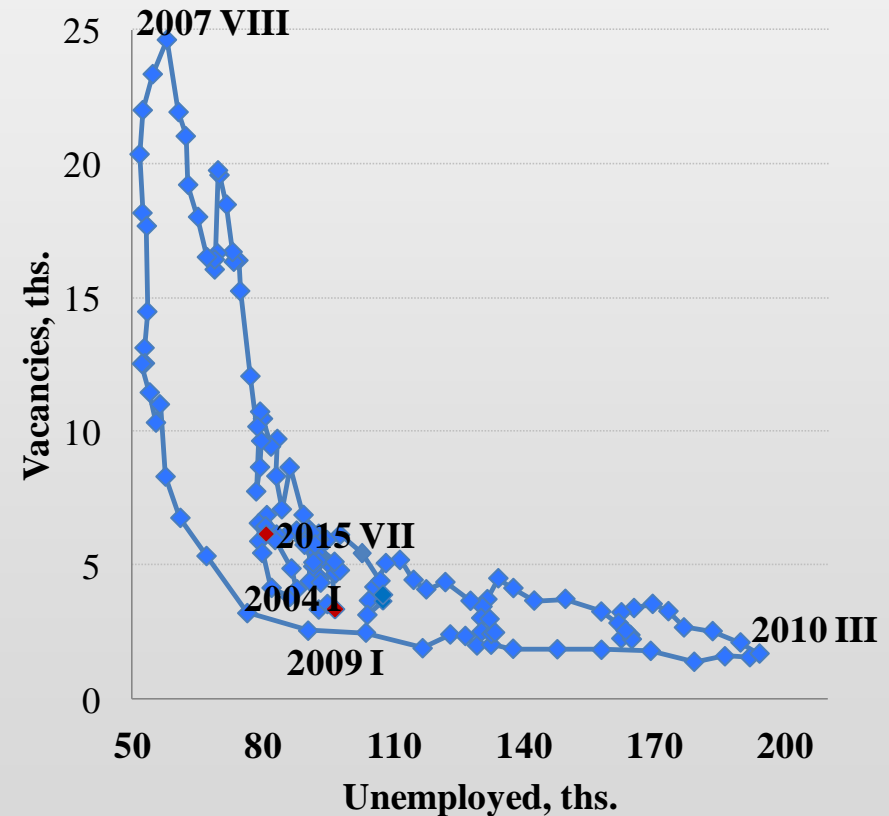
Latvia's labor market functions smoothly; no evidence of hysteresis in the labour market

Beveridge Curve in the euro area

Graph 5: Beveridge curve 95Q1 - 12Q2, euro area

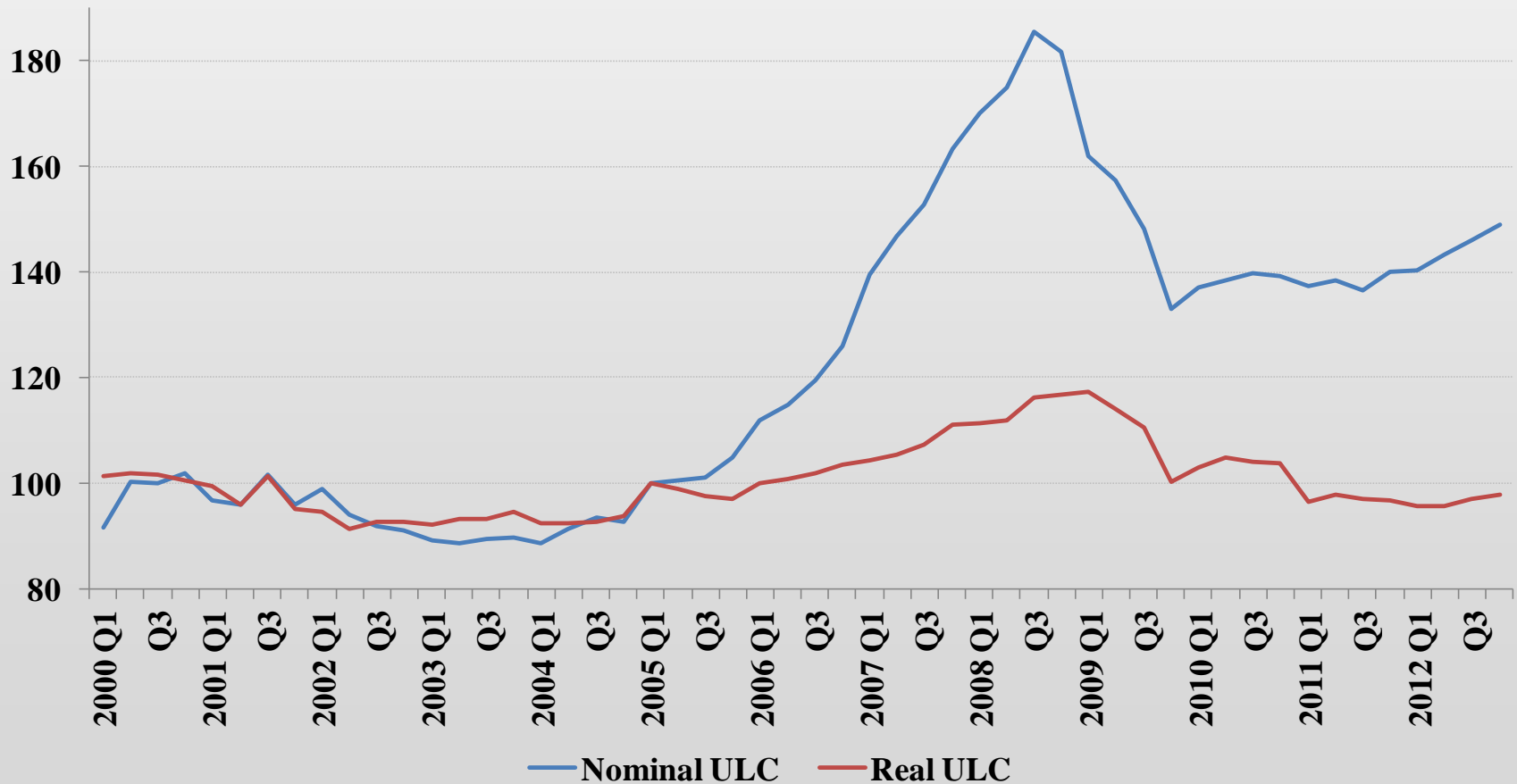


Beveridge Curve in Latvia



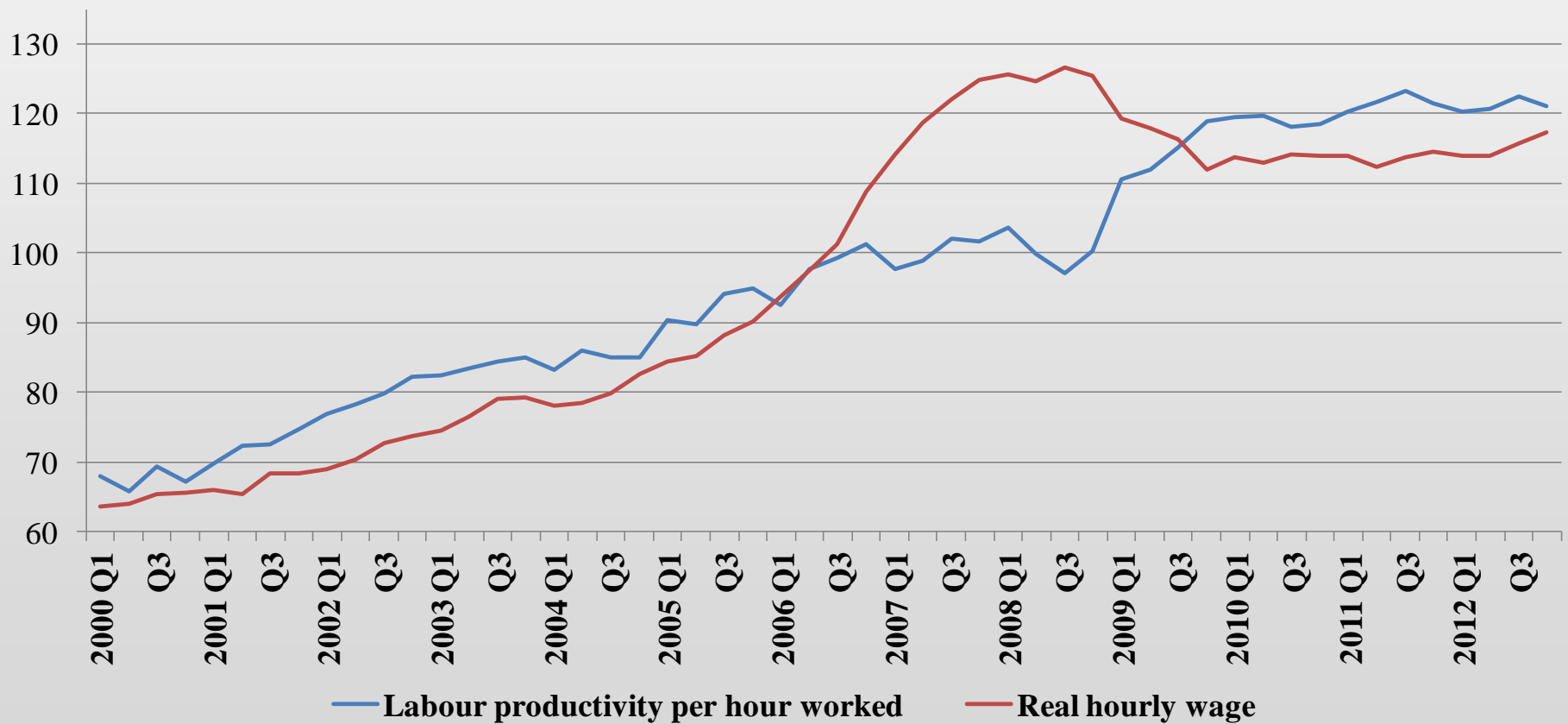
Labour and product market flexibility reflected in a significant adjustment of unit labour costs

Unit labour cost index (2005 Q1 = 100; seasonally adjusted)



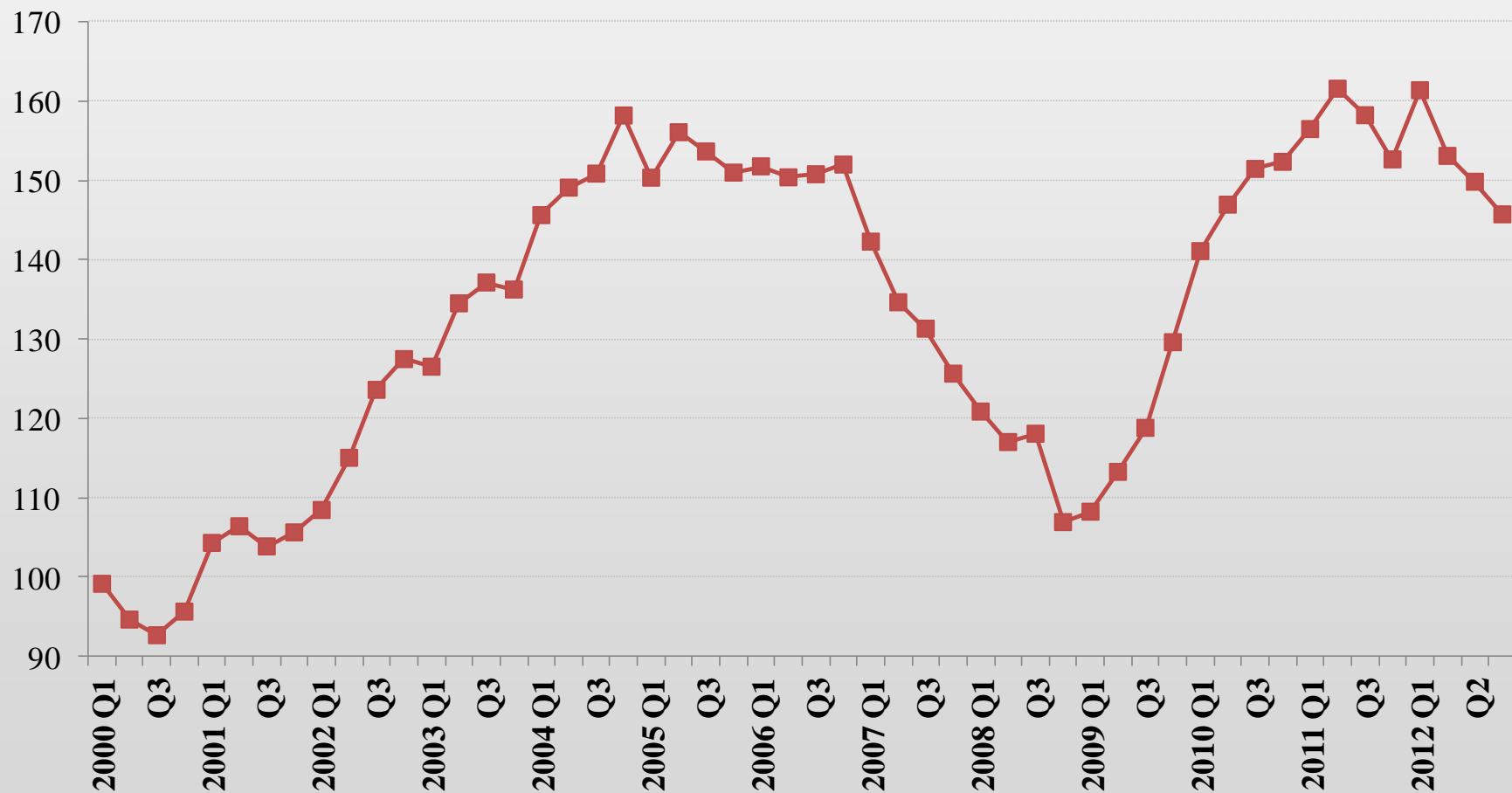
Wage-productivity gap was closed quickly

Real wage and labour productivity index (historical average = 100)



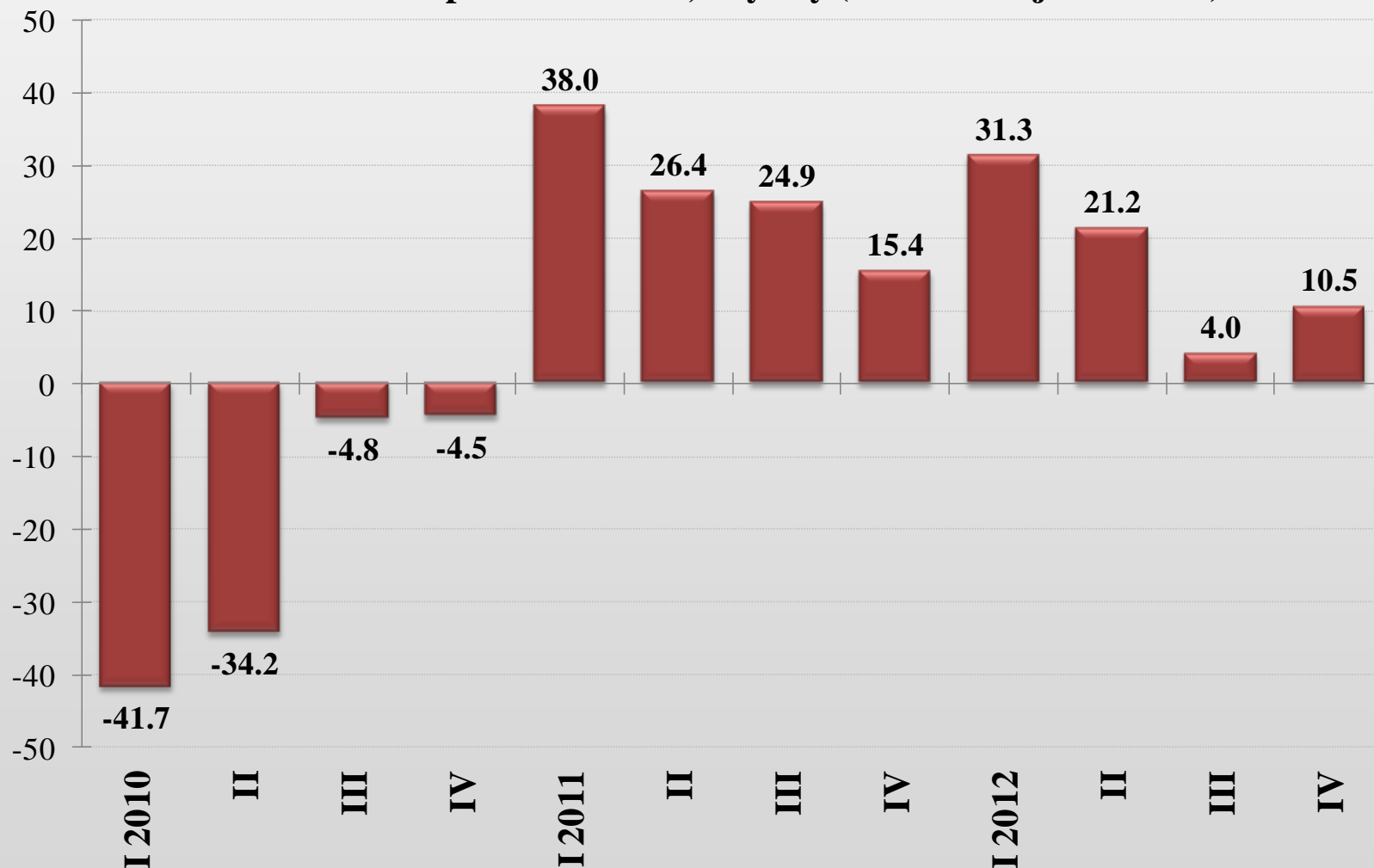
Recovery of tradable sector profit margin points to improved competitiveness

Export unit value to ULC in manufacturing (2000Q1=100)



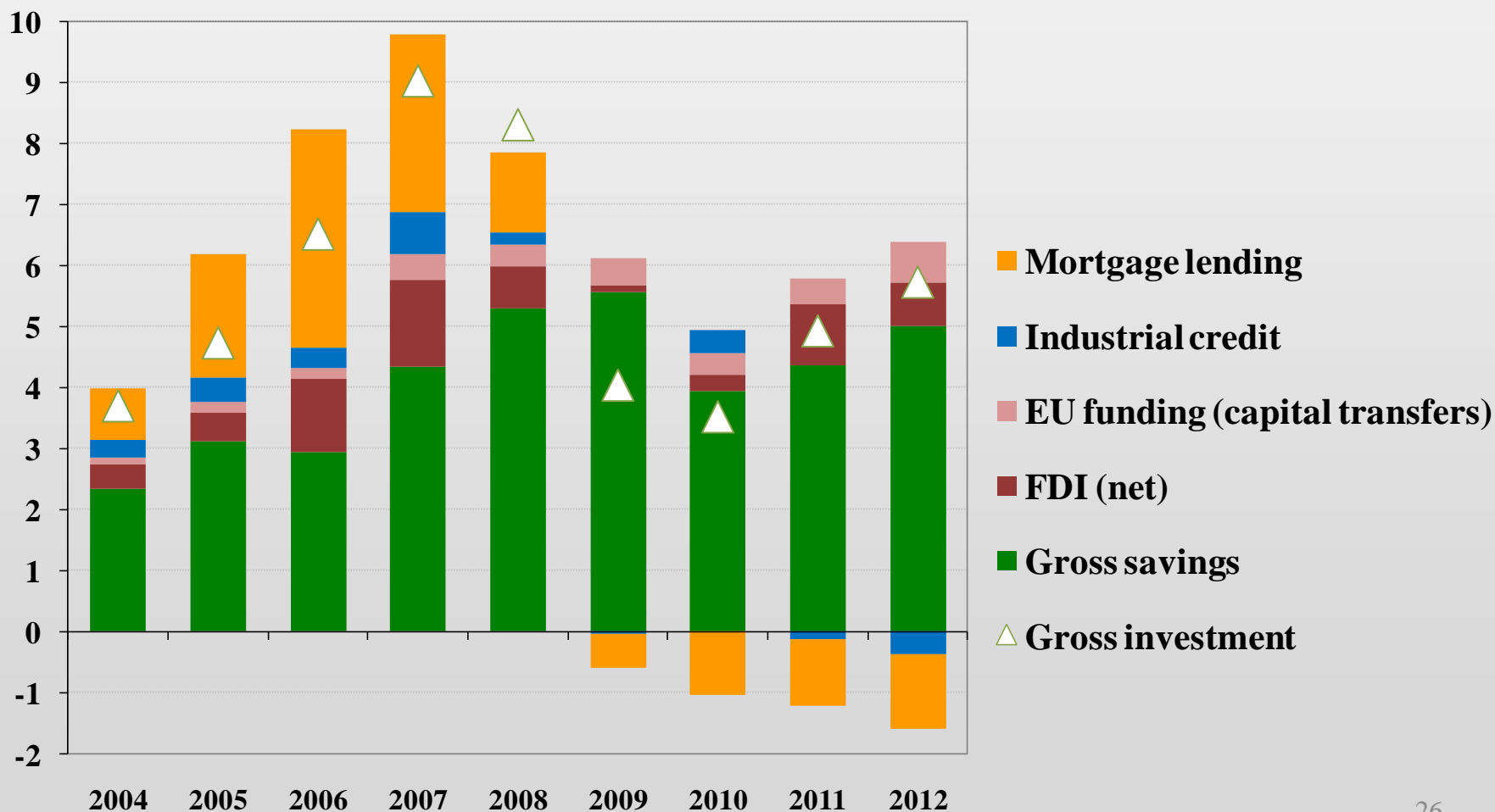
Strong competitive position and recovering profitability pushed up investment

Gross fixed capital formation, % y-o-y (calendar adjusted data)



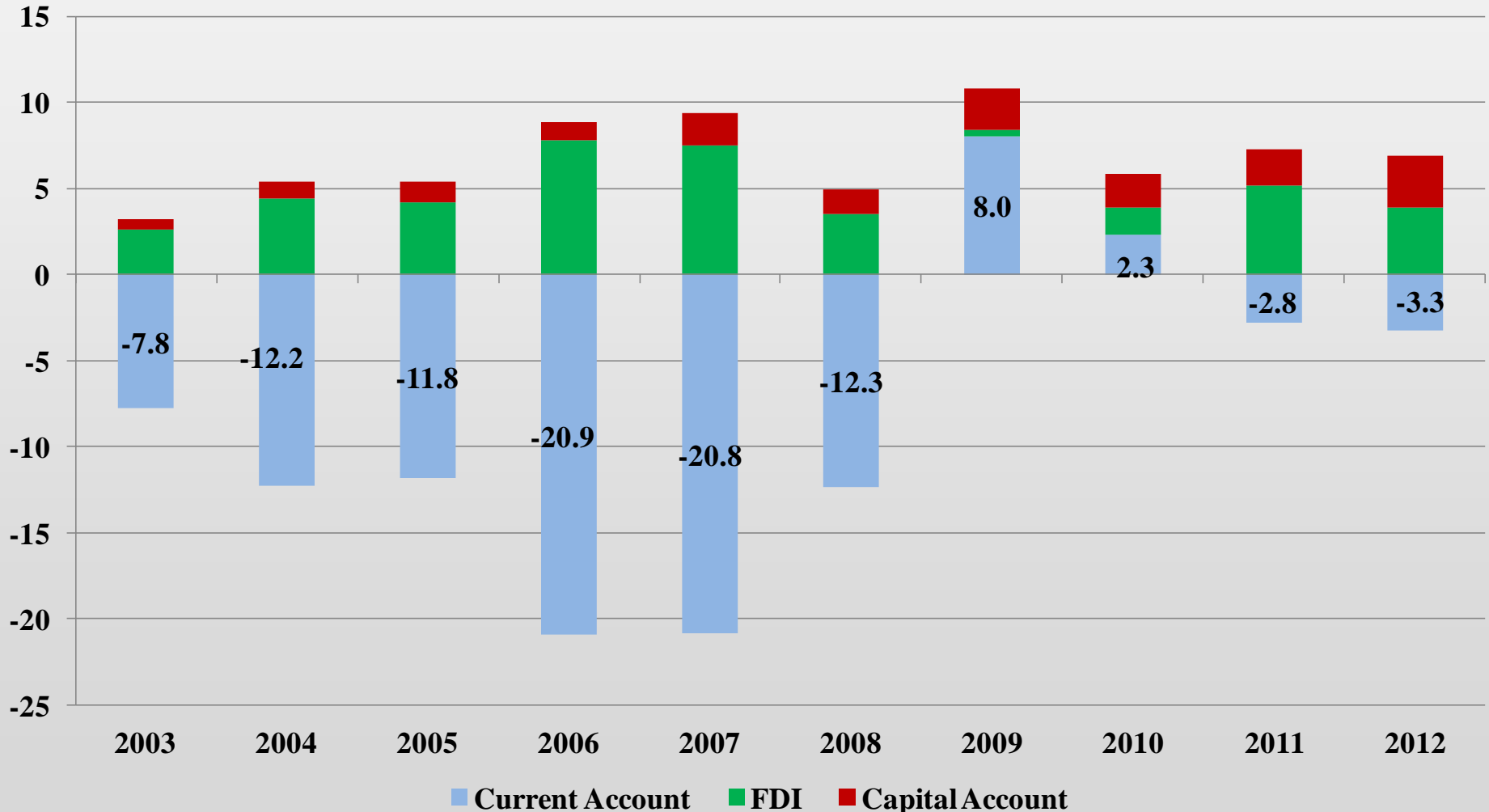
Investment funding was supported by corporate savings

Financing of gross investment (in billions of euro, nominal)



Moderate current account deficit is seen sustainable for Latvia and is fully financed by FDI and capital transfers

Current account, FDI and Capital account in Latvia (% of GDP)



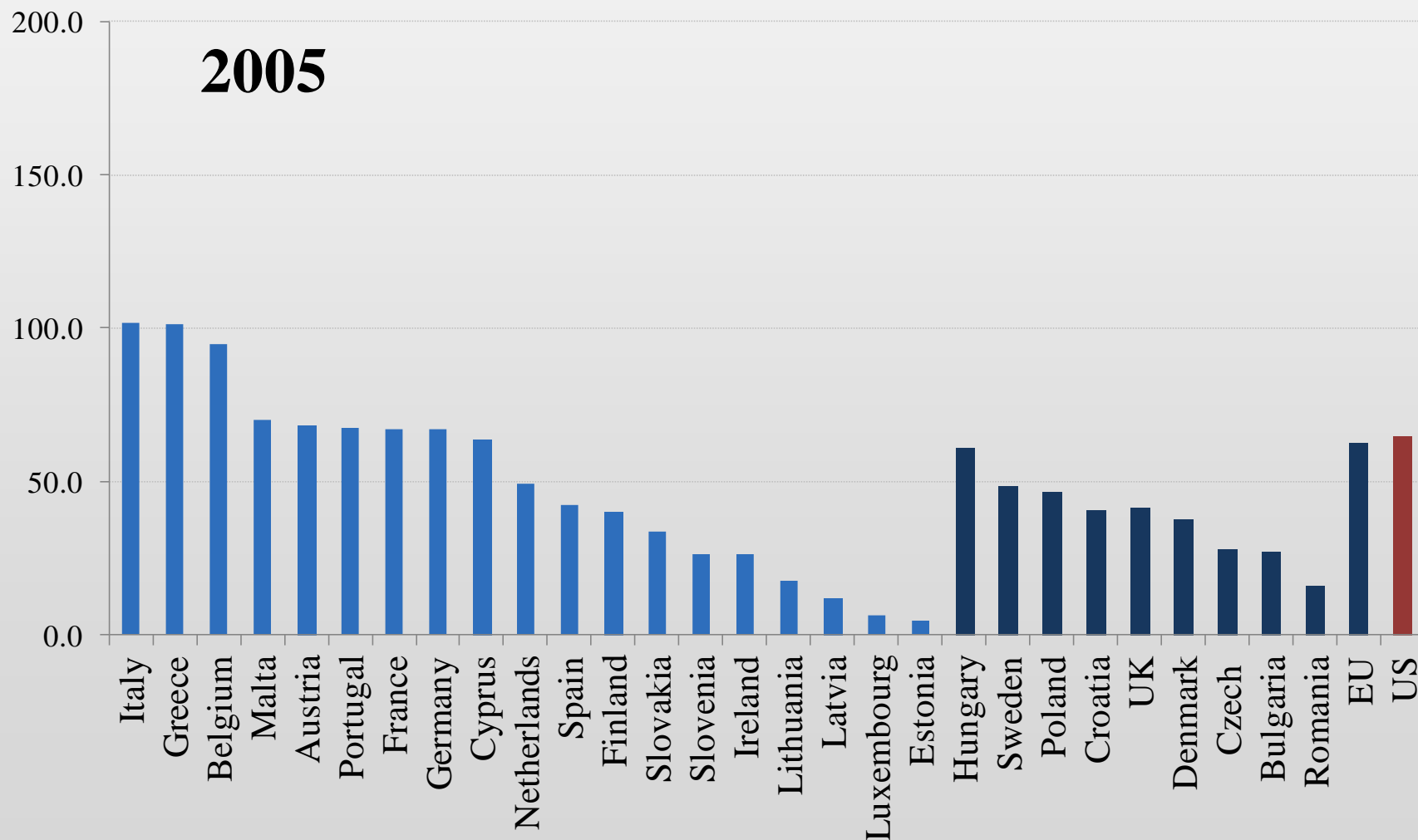
**What are the lessons
learned?**

This crisis has shown that
MORE is LESS and LESS is MORE



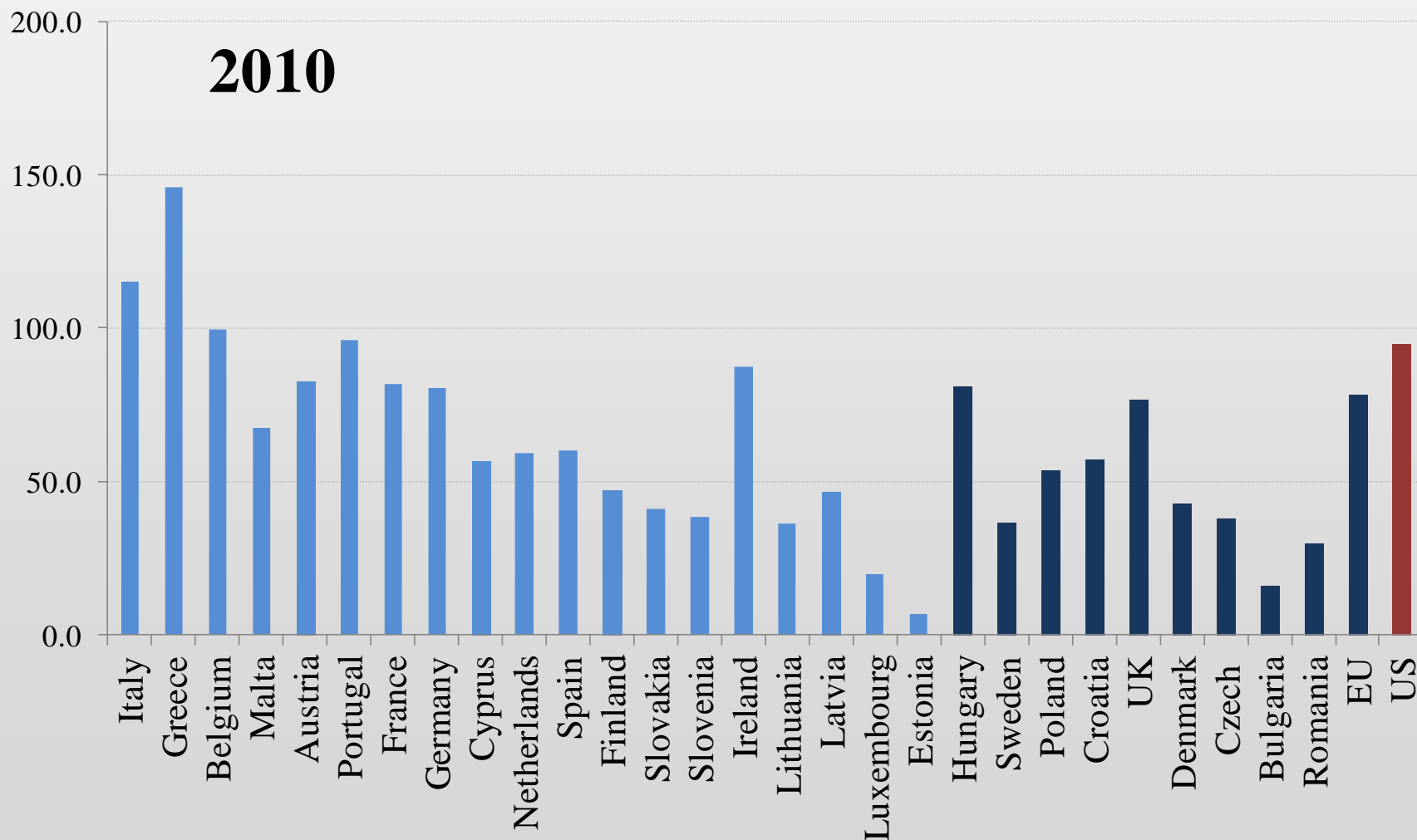
"One doesn't die from debt, one dies from not being able to borrow"

General government gross debt, % of GDP



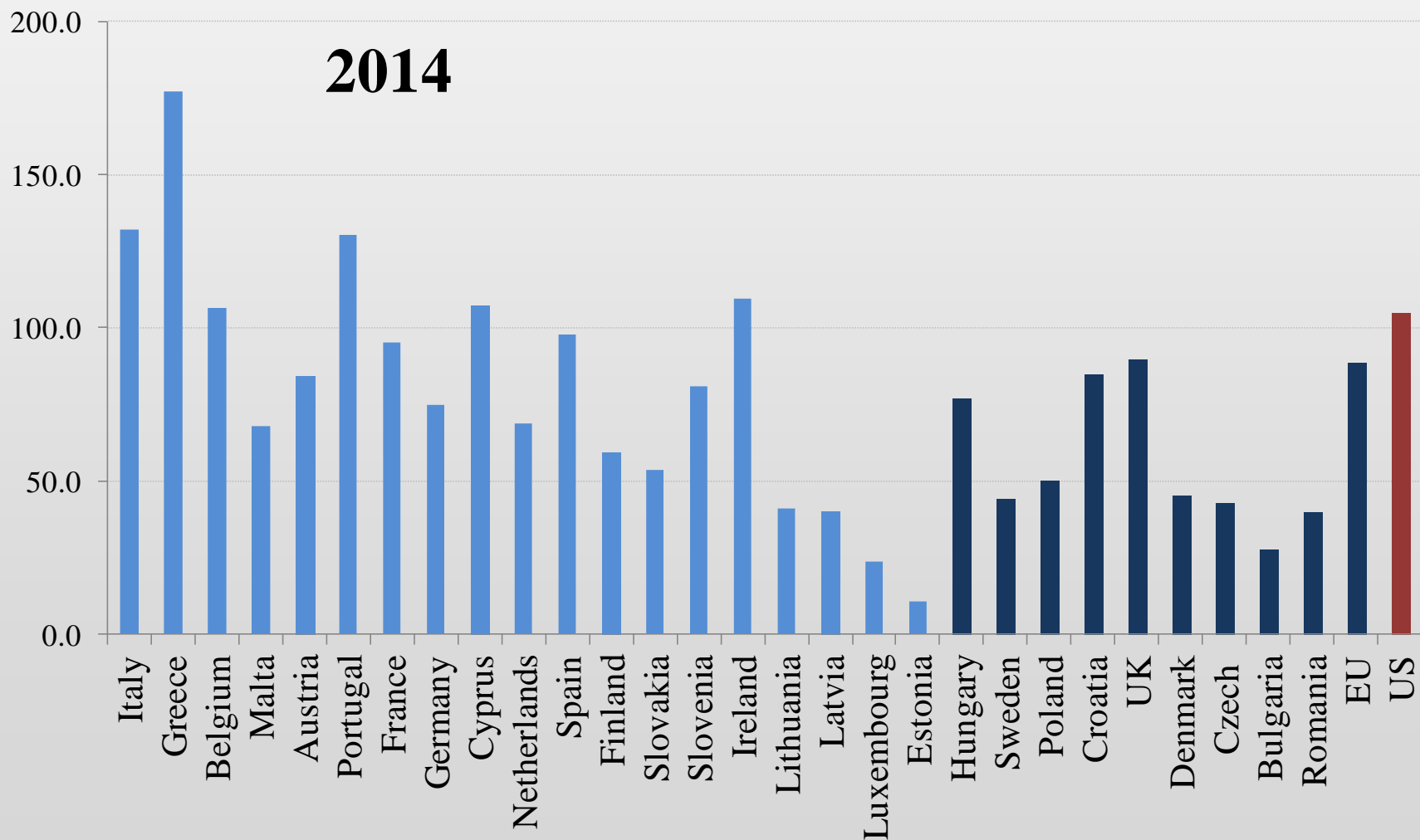
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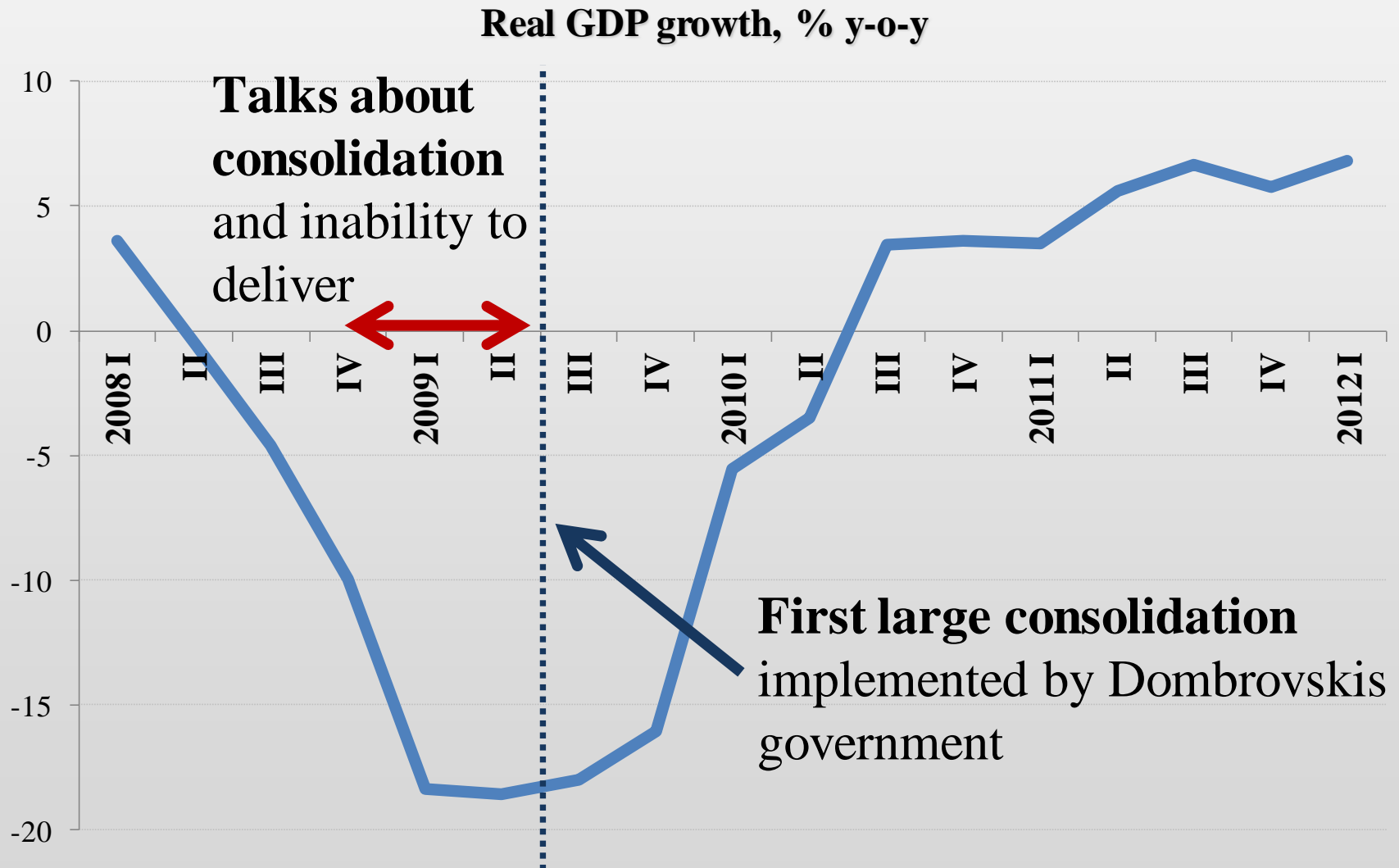


Most Euro area countries suffering from high debt are still running large budget deficits

Euro area fiscal indicators, % of GDP

	General government gross debt				General government budget deficit			
	2000	2005	2010	2014	2000	2005	2010	2014
Greece*	104.4	101.2	144.9	177.1	-3.8	-5.6	-10.8	-3.5
Ireland	37.5	27.2	94.9	109.7	4.7	1.7	-31.3	-4.1
Italy	108.5	105.4	118.4	132.1	-0.9	-4.5	-4.5	-3.0
Portugal	48.5	62.8	93.3	130.2	-2.9	-5.9	-9.8	-4.5
Belgium	107.8	92.0	96.2	106.5	-0.1	-2.8	-4.2	-3.2
France	57.4	66.7	82.3	95.0	-1.5	-3.0	-7.1	-4.0
EU27	61.9	62.9	80.3	88.6	0.5	-2.5	-6.6	-2.9
Germany	60.2	68.6	83.2	74.7	1.1	-3.3	-4.3	0.7
Spain	59.3	43.0	61.0	97.7	-1.0	1.3	-9.3	-5.8
Austria	66.2	64.2	71.8	84.5	-1.8	-1.8	-4.4	-2.4
Malta	55.0	69.7	69.0	68.0	-5.8	-2.9	-3.6	-2.1
Cyprus	59.6	69.4	61.5	107.5	-2.3	-2.4	-5.3	-8.8
Netherlands	53.8	51.8	62.9	68.8	2.0	-0.3	-5.0	-2.3
Slovenia	26.3	26.7	38.8	80.9	-3.7	-1.5	-5.8	-4.9
Finland	43.8	41.7	48.3	59.3	6.8	2.5	-2.8	-3.2
Slovakia	50.3	34.2	41.0	53.6	-12.3	-2.8	-7.7	-2.9
Luxembourg	6.2	6.1	19.1	23.6	6.0	0.0	-1.1	0.6
Estonia	5.1	4.6	6.7	10.6	-0.2	1.6	0.3	0.6
Latvia	12.2	11.7	46.8	40.0	-2.8	-0.4	-8.1	-1.4
Lithuania	23.6	17.6	36.2	40.9	-2.8	-0.3	-6.9	-0.7

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

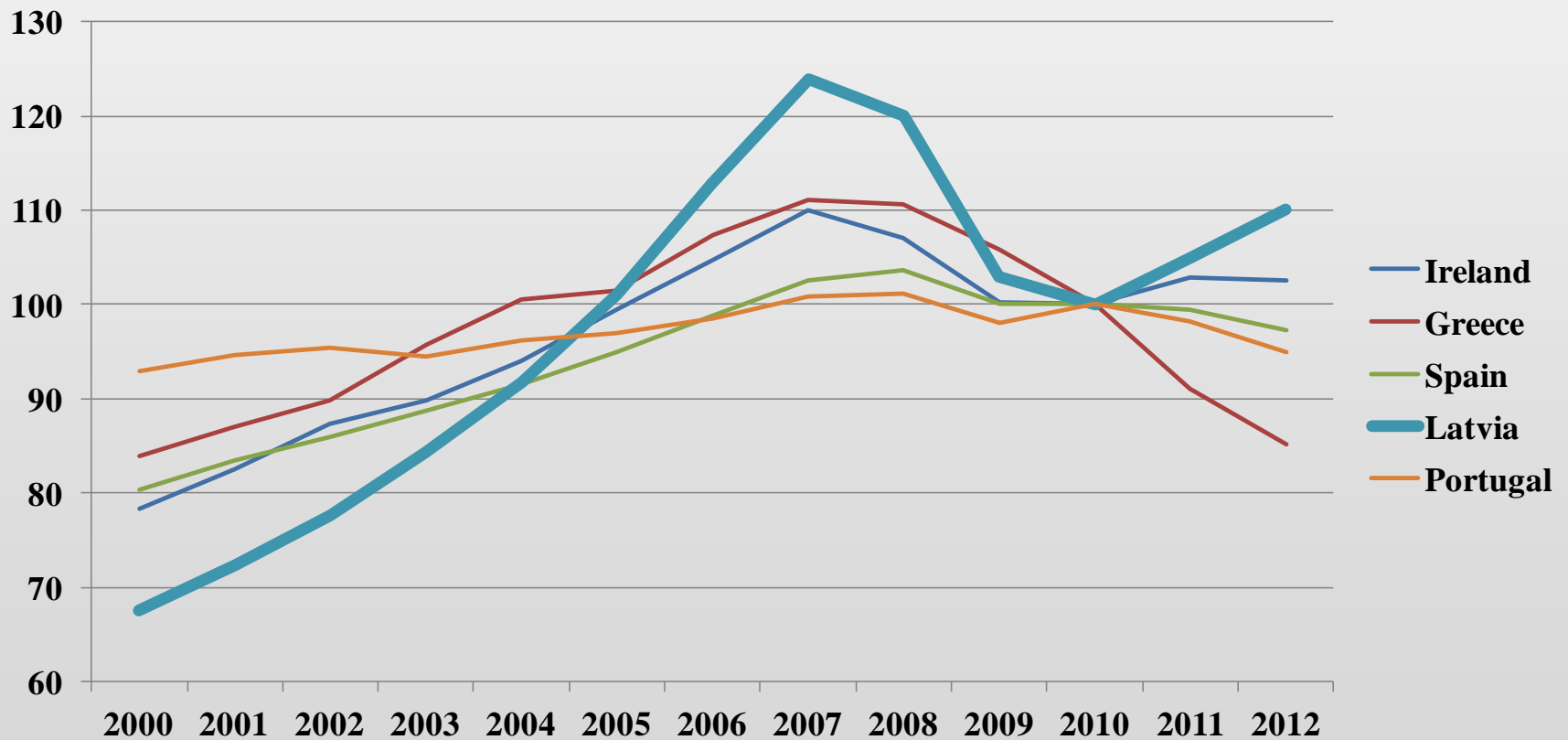


Ingredients for success

- Diagnosis of what was wrong with the economy
 - the problem was too lax fiscal policy amid very rapid domestic demand growth, not that much overvalued currency as some claimed
- Treatment through appropriate mix of economic policies
 - ensure soundness of public finances
 - restore financial stability
 - focus on structural reforms to improve efficiency and restore long-term economic growth
- Structural features of the economy matter
 - high degree of trade openness
 - flexible labor markets
 - low initial debt level
 - exchange rate and competitiveness – a need for thorough assessment

Frontloading vs backloading?

Real GDP, 2010=100



Speedy fiscal adjustment helped to decrease uncertainty and regain growth momentum

Figure 4.7: Quarterly account of GDP growth and fiscal consolidation measures

