On the Road to Recovery

Imprudent car driving often ends up with the car stuck in a ditch: this metaphor pictures well the Latvian economy, which - despite many warning blinkers - went at a wild speed, to then fall into the deepest recession recorded in the EU. To get out from the ditch, Latvia has needed a hoist and petrol provided by friends (the international lenders) and a decrease in the car's weight (slimming budget deficits and enacting structural reforms).

With their funds, international lenders provided the petrol to keep the engine turning, allowing the government to pay wages and pensions during the worst of the crisis. And together with the hoist, they gave advice on how to pull the car up. Building on such advice, the decisive steps taken by the Latvian government and Parliament – several 2009 budgets followed by an ambitious 2010 budget, and reforms in many key sectors of the economy – turned events into a positive course: Latvia is gradually regaining international trust and even set as an example for other EU countries, for which substantial budget deficit cuts and structural reforms still lie ahead.

True, making the car lighter is not without pain. The reversal of the boom has brought along very high unemployment. Latvia is rebuilding the fundamentals of the economy which have turned out to be weak and unstable. It is now painfully clear to everyone that a country cannot develop in the longer term by relying heavily on sectors such as real estate, construction, and finance. The ongoing shift to other sectors that add value and contribute to the competitiveness of the whole economy will continue to take a toll on the labour market. Hopefully, much of this will be temporary. It is encouraging to hear success stories where Latvian companies or individuals have gained new export markets, implemented innovative business ideas, or set up new working places. In this context, banks also have a crucial role in supporting economic activity by adequate lending, and their commitment to remain engaged in Latvia is important in this perspective.

To lessen the effects of this adjustment, help people stay on the job and acquire new skills has been a key priority for the government and the EU. The European Social Fund has been reoriented to finance the temporary social work – the 100 lats working stipend – and reduce social hardships, and to promote active labour market measures, including the training and requalification of unemployed and self-employed. At the same time, despite the significant fiscal consolidation, the authorities have maintained or even increased the co-financing for EU Structural Funds projects, thus providing significant investment and stimulus to the economy. Structural Funds are like high-octane petrol: every 'national' lat spent brings in four completely 'free' lats from Brussels. To effectively propel the real economy and support employment, however, this money must be spent rapidly and in the most efficient and transparent way.

Lately, some signs show that the car is moving out of the ditch. However, realism is necessary: it took several years of imprudent policies and unsustainable growth to bring Latvia to the crisis and the current standstill, so patience and skilful driving are needed to get back on the road again, keep the car light and eventually allow it to run at cruise speed.

But where should the country go? Euro membership is the next shelter, even if to some it may look distant. As the current experience of Estonia shows, by following a credible path towards the euro, the country can quickly gain, inter alia, a stronger investor confidence. The euro is an immense opportunity for more integration and stronger growth. But these snowy winter months, besides bringing Olympic medals, are showing that perilous winds can blow in the euro area too. Hence, the car should be as solid and enduring as possible: fiscal consolidation needs to continue and more reforms in consultation with social partners are necessary to ensure Latvia can fulfil the Maastricht criteria, thrive in the euro area and gradually catch up to the living standards of its richer countries.

Living up to the national commitment set in the Latvian economic stabilization and growth recovery program is a precondition for dealing with this challenge. Whoever will govern over the next years cannot escape this hard truth. To avoid losing precious time, the next months offer an opportunity – to all Latvian parties and the current government – to do the groundwork for the main elements of the budget 2011. The latter should bring a significant part of the budgetary adjustment of 800-900 million lats to be done in the next two years if the deficit is to be brought below 3% of GDP by 2012. Preparing in advance will help avoid a situation, after the elections, where hasty, incoherent decisions may be taken. More generally, it could be beneficial if all campaigning parties would disclose high quality consolidation and reforms plans.

The essence of the main reforms and avenues for action can be found in the *Supplementary Memorandum of Understanding,* the agreement which has been concluded between Latvia and the EU and is available for reading to anyone. It focuses on the needed fiscal adjustment and on other essential reforms as regards fiscal governance, the financial sector and structural issues, including steps to improve the business environment, tackle the grey economy, and increase the absorption and effectiveness of the EU Structural Funds. These long-overdue steps are ambitious but necessary, and will make the economy stronger and the budget sounder.

The efforts and sacrifices Latvia is undertaking will not be in vain and – indeed – are unavoidable, and the Latvian society is showing a remarkable responsibility in dealing with its challenges. Building a stronger economy and progressing credibly on the road towards eventually joining the euro area will bring Latvia advantages in the short run and allow it to become a more prosperous country in a few years time. The Commission, in close cooperation with the IMF, will continue helping Latvia on this road.

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