The Adjustment in Latvia

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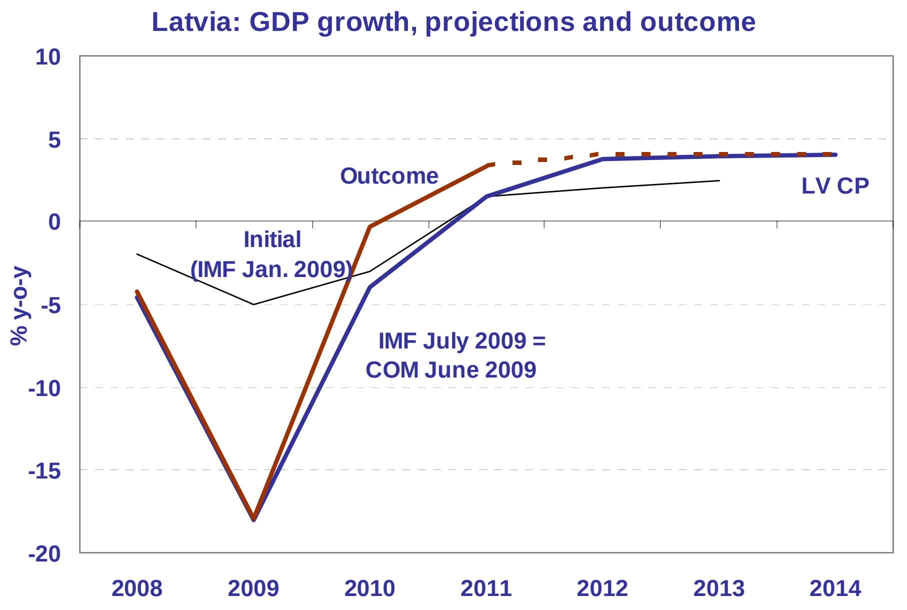
Latvia: crisis in 2008, in the midst of a storm by 2009

2008: Access to international capital markets closed (Parex Banka)
→ Multilateral support (€7.5 bn over 3 years from EU, IMF, others)

But in early 2009:

- Economy free-falling
- Government resignation
- Confidence very low
- Concerns about insufficient action taken
- Path to euro adoption (2012) no longer credible
- Doubts about the peg: Latvia under financial attack (6/2009)



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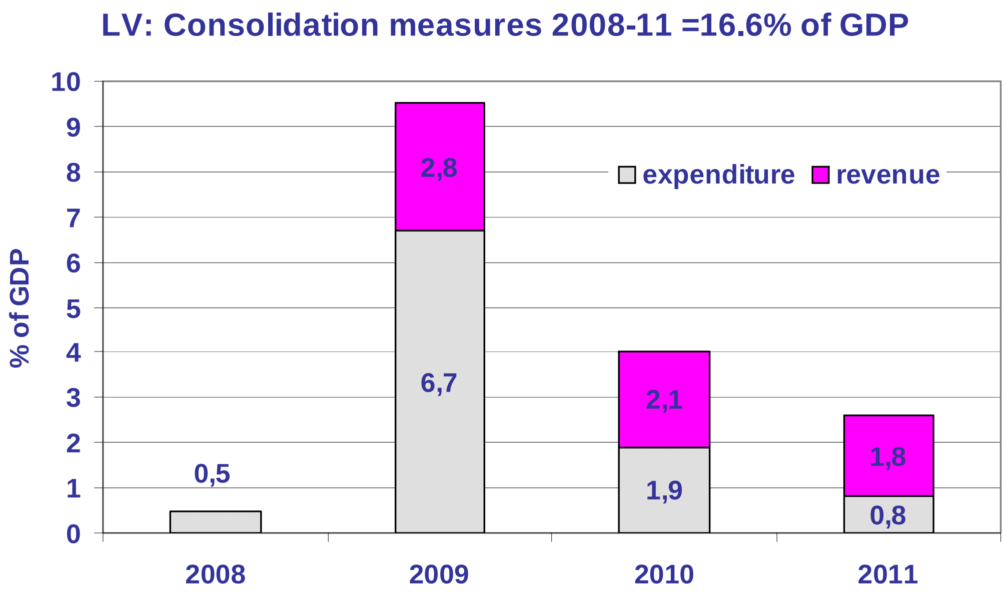
Budget running out of hand
after some hesitation, strong reaction

- Most of the adjustment decided between June and December 2009
- Fiscal consolidation over 16 % of GDP since end 2008
(though several measures not of best quality, nor permanent)
- two-thirds expenditure cuts, in line with international best practice

- 25% wage cuts
- Major lay offs
- Public administration reform
- Local administrative entities down by 80%, lower transfers
- Cuts in hospitals and schools by 30%, subsidies
- VAT, PIT, special levies, Real estate, car taxation, fight to the grey economy



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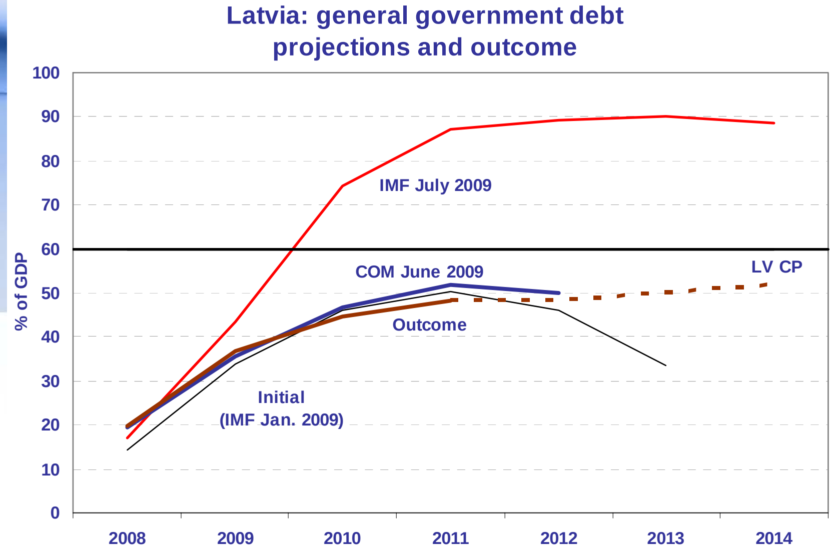
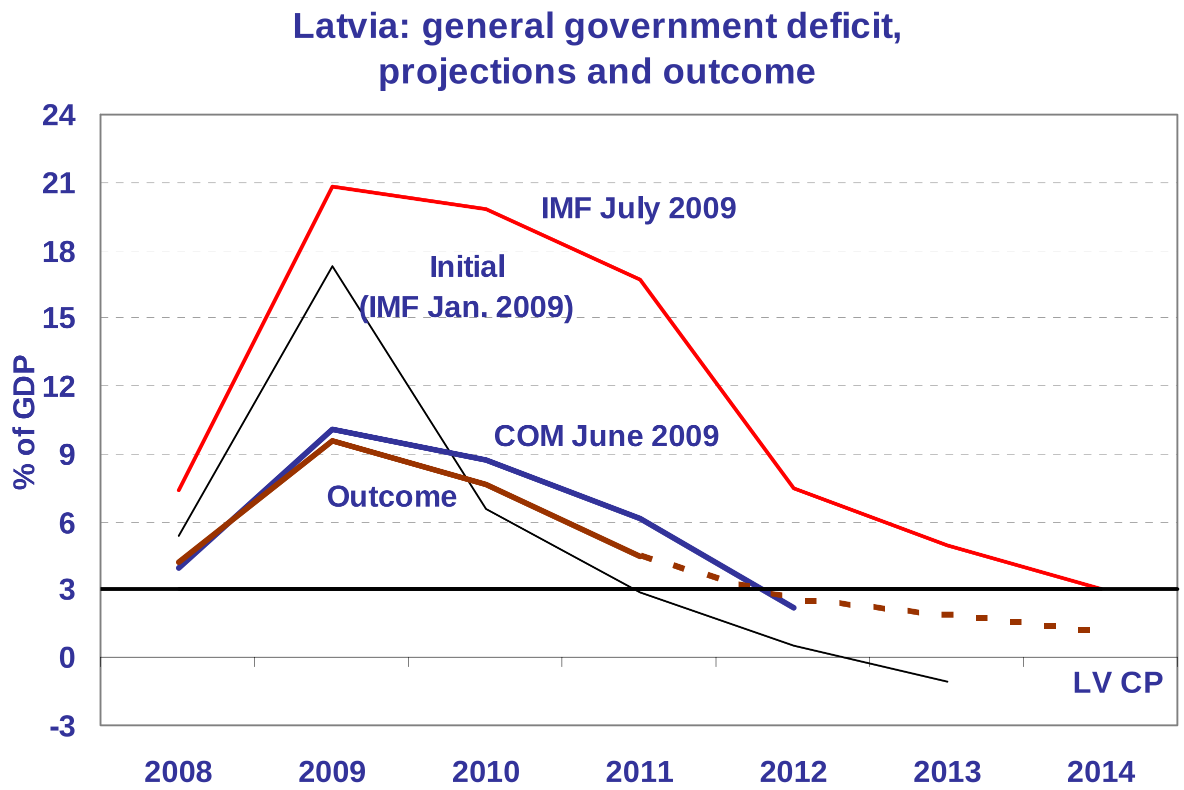
Multilateral external support: Not free from tensions



Summer 2009:

- IMF doubted whether to continue support
- Had too negative fiscal projections
- Underestimated implications of its inaction (devaluation and contagion)
- Commission believed in possible adjustment and necessity of acting quickly and decisively

Ultimately, the European Council supported the Commission: the EU acted for the first time ever ahead of IMF



From crisis to stabilisation and recovery

- Global economy and financial system stronger

- Domestic factors
  - Strong budgets, good implementation
  - Financial sector stabilisation
  - Internal adjustment for competitiveness
  - Active labour market policies and social focus

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Strong budgets, good implementation

- First, prudent approach to economic scenario = positive surprises
- Consolidation implemented without serious slippages (but not all as expected), which was a risk given the size and also in view of electoral temptations (and again with possible new election this year…).
- Aim to bring deficit below 3% of GDP in 2012 is realistic, though still requires a consolidation of about 1 to 1½ % of GDP, and - as usual - risks remain…

Financial sector stabilisation

- Second, confidence in the financial system – which triggered the crisis in 2008 – now restored
- Latvian authorities remained strongly committed to the long-standing monetary and exchange rate arrangement.
- Took significant financial system stabilisation measures, notably by restructuring Parex Banka and MLB, while prudential supervision and regulation has been strengthened further.
- Private sector remained involved in the country

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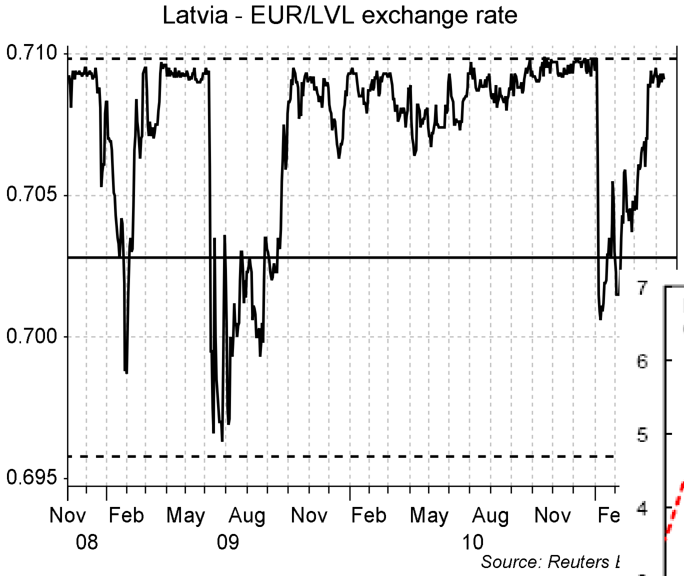
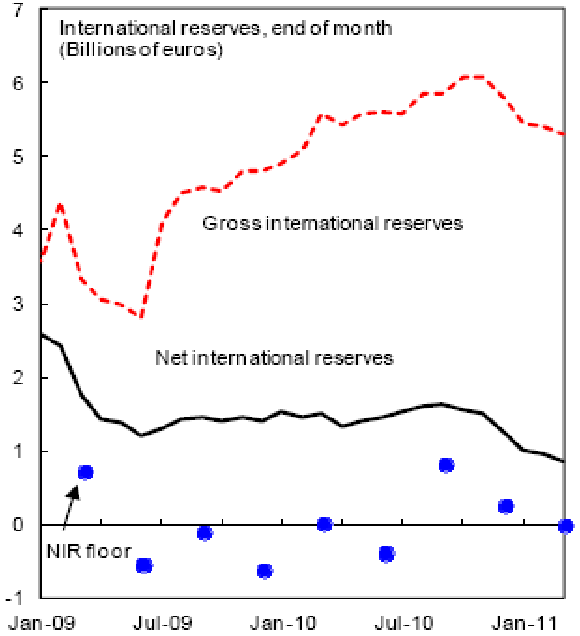
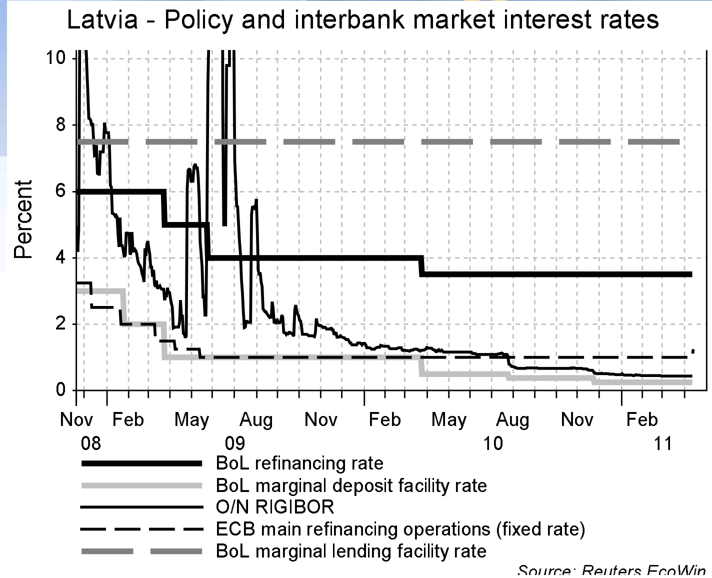
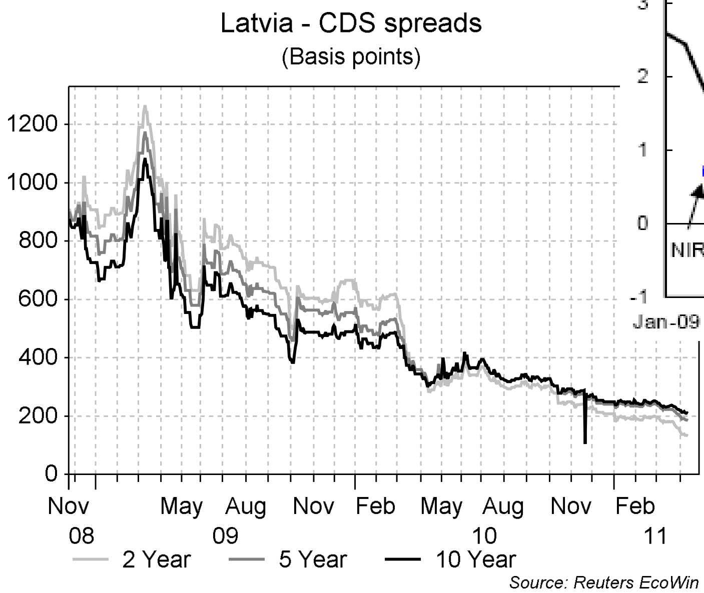
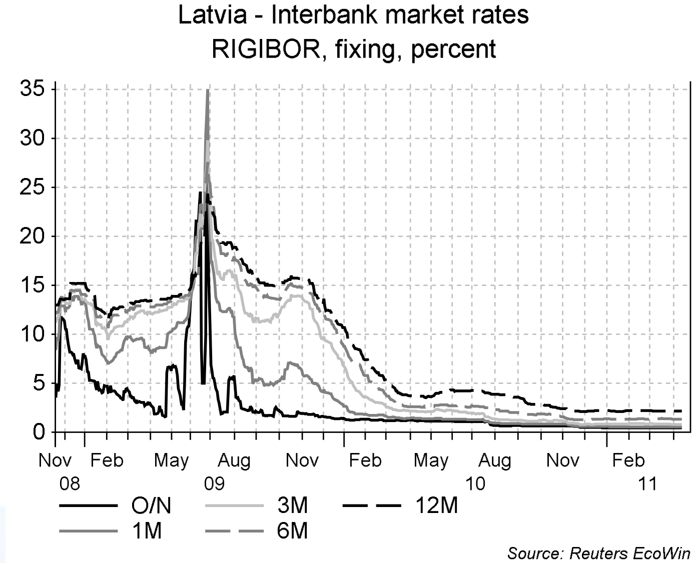
Calm(ing) after the storm











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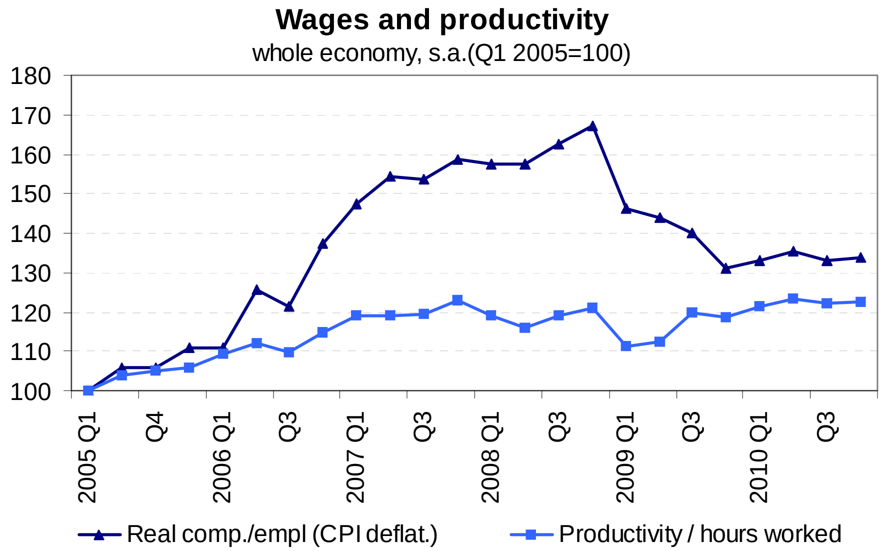
External competitiveness

- Third, external competitiveness is improving, following an adjustment of wages and employment of a massive scale.
- But also a change in the structure, quality, more investment (EU Funds)
- There is <u>no need of a significant price deflation</u>
- Exports are picking up strongly and export market shares are increasing.
- However, risks from surging imports and accelerating inflation and wages should not be overlooked

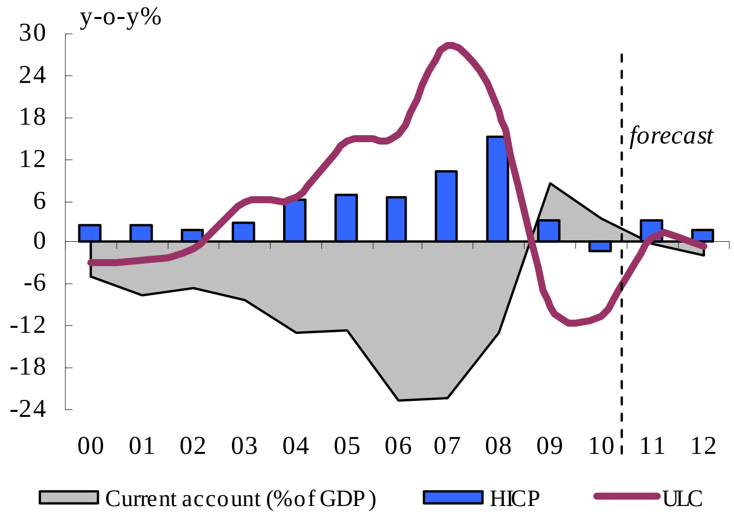
Internal 'devaluation'

- Institutional fundamentals helped wage flexibility in Latvia (low unionisation, private labour law contract in public administration, easy dismissal rules)
- Cost optimization and enhancing productivity contributed to narrowing the wage-productivity gap
- Gains in competitiveness are reflected by increases in market shares in trading partner countries and a broadly balanced C.A.



Sources: Statistics Latvia, Eurostat, COM calculation

Graph II.13.3: **Latvia - Current account, inflation, unit labour cost**



Labour markets improving while seeking ‘social fairness’

- Fourth, unemployment is still vey high (16%), but receding quickly from record levels (>20%)
- Steps have been taken to help the labour force remain active, retrain and strengthen its skills, cover the social needs, using effectively the EU funds
- Perhaps this is one of the reasons Latvia has managed to avoid widespread social unrest

Latvia's experience with crisis: what lessons for Europe?

- **Can be overcome** if there is, first and foremost, **national commitment and incisive action** to ensure solvency
- Adjustment **does not need a devaluation nor a sustained deflation** (good for debt dynamics)!
- **Growth can return faster**, esp. if adjustment based on **reforms**
- Liquidity problems must not lead to insolvency : **important that EU provides ample support and shelter**
- Ultimately **much less money needed** : LV only €4.3bn out of 7.5, the EU banking sector also used a fraction.
- Paradox of Latvian PM: **re-elected** after massive consolidation and reform (the same in Estonia).
- However, **realism is necessary**, more needs to be done, including to avoid the pitfalls of the next boom

Thank you for your attention!

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