Latvia: Experience from the internal devaluation process and the road to EMU

Bayreuth, 11 January 2012

Morten Hansen
Head of Economics Department
Stockholm School of Economics in Riga
morten.hansen@sseriga.edu
Latvia:
Experience from the internal devaluation process and the road to EMU

Outline:

1. Background
   1. The boom
   2. The bust

2. The IMF-EU programme

3. Current status
   1. Internal devaluation; evaluation
   2. Lessons for other countries

Additionally:
Latvian anomalies
Then (prior to 2008):
The **Baltic Tigers**
Now....

(“Bankruptcy prices”)
Economic growth in the Baltics
From massive boom to massive bust
GDP growth rate ranking, EU27

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>EE</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>5</td>
<td>2</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>LV</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>LT</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>2</td>
</tr>
</tbody>
</table>
GDP at constant prices, Latvia, 1995 = 100
The economy "bombed back" 5 years – recession for 8 quarters – accumulated GDP drop: 25.1%
GDP, quarterly, seasonally adjusted

2004 Q1 = 100

2007 Q4 (peak) = 100
Example: Credit growth in Latvia
BLUE: to households, PURPLE: to firms
- extreme numbers
Unemployment rates (LFS data)
Credit bust vs no credit bust: **Sweden** vs **Baltics**
- massive difference
Latvia
Current account as % of GDP
- swift and massive turnaround
Fiscal policy response

Government budget seasonality

Public expenditure, mill. LVL, quarterly
Actual and structural budget balance
Strongly procyclical fiscal policy
Latvia’s IMF-EU* package:

7.5 bill. EUR (35% of LV GDP)
27 months

“Plugging holes”:
Banking sector (Parex)
Government (budget deficit)

Current account

Restoration of competitiveness and sustainable growth:

Ultra-harsh fiscal policy (substantial wage cuts – undoing the past)
Structural reforms

* IMF, EU, World Bank, EBRD, Sweden, Denmark, Estonia, Czech Republic, Poland
Austerity and internal devaluation:
Wage increases, y-o-y
- again, extreme...
Real Effective Exchange Rate (REER)
ULC-based, 36 trading partners
- the familiar picture
Real Effective Exchange Rate (REER)
ULC-based, 36 trading partners
- and with Latvia added
Example: Economic flexibility
Latvian inflation, y-o-y, monthly data
- 22 percentage points decline in 21 months
Short digression:
Austerity, **Estonian** style
- check 2009: Impossible anywhere else
By international standards fiscal adjustment in Latvia has been very substantial (borrowed from Bank of Latvia)

Source: IMF
Development of main demand components since the GDP peak: Competitiveness does not seem to be a problem - but everything else is.....
Paul Krugman
One of the dissenting voices

Latvia is the new Argentina

Riga Mortis
Meanwhile things could be worse.
And in Latvia they are.
• http://krugman.blogs.nytimes.com/2010/02/10/riga-mortis/

They have made a desert
And called it successful adjustment.
• http://krugman.blogs.nytimes.com/2010/05/14/they-have-made-a-desert/
Latvian peculiarities:
Why not an external devaluation?

- December 2011: Rumours on Twitter create a run on Swedbank’s ATMs

Opening Pandora’s Box....

1. Russia 1998 (or Belarus 2011....)
2. “In developing countries there are no small devaluations…”
3. Disorderly devaluation
4. Contagion
5. Euro adoption as a goal
6. Euro adoption as a disciplinary device
7. Never the right time
8. Strong belief in a nominal anchor
9. Too euroized already
10. Lack of public debate
GDP growth

Latvia and Greece

(Lack of?) lessons from Latvia:

- Extreme flexibility:
  - Labour markets
  - Inflation
  - Current account
- Extreme austerity
- Lack of trade unions
- Remembering a much worse past
- Discussions in the kitchen, not on the street
- If austerity, then immediately while it enjoys some support/understanding
Latvian Prime Minister
Valdis Dombrovskis

Reelected in 2010 and 2011

- where else would that happen?*

- *except in Estonia*...
Lending in Latvia by currency - severe currency mismatch

Latvia and EMU
Exit strategy, IMF-EU programme: Join EZ 2014

- Because Estonia is in the eurozone!
- Because Latvia is highly “euroized” already
- Because Latvia is committed to adopt the euro
- Because it has been a policy signal at least since 21 September 2003
- Because LVL is less credible than EUR
- Because the eurozone will overcome its current trouble (…)

![Chart showing lending in Latvia by currency]
Thank you for your attention!
Questions and comments are welcome

Stockholm School of Economics in Riga

Founded 1994