BALTIC ECONOMIES

Typical street scene in Santa Ana, El Salvador. (Photo: iStock)

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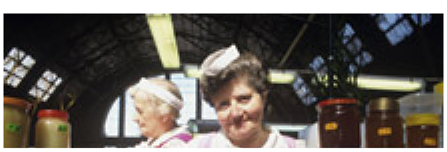
IMF Survey: After Severe Recession, Stabilization in Latvia

IMF Survey online

February 18, 2010

- Hope of a recovery late this year and into 2011
- €7.5 billion international support package has kept economy afloat
- Exports key to recovery

With a decline in GDP of about 18 percent in 2009 and unemployment hovering above 20 percent, Latvia has suffered one of the deepest recessions in the world.



Related Links

- Press release (/external/np/sec/pr/2010/pr1047.htm)

Market stall in Riga, Latvia, where international support allowed higher budget deficit to soften blow dealt by world recession (photo: Newscom)

- Video: Latvia set for recovery (/external/mmedia/view.asp?eventID=1734)
- 'Baltic Tiger' plots comeback (/external/pubs/ft/survey/so/2009/car121009a.htm)
- Reforms in EU's new members (/external/pubs/ft/survey/so/2009/car120409b.htm)
- Banks deal limits crisis (/external/pubs/ft/survey/so/2009/int102809a.htm)
- Latvia's downturn struggle (/external/pubs/ft/survey/so/2009/int080309a.htm)
- Latvia caught in downturn (/external/pubs/ft/survey/so/2009/car052809a.htm)

But a €7.5 billion support package from the international community has allowed the country to pull through the worst of the crisis, and the IMF is now predicting a recovery late in 2010. In this interview, Mark Griffiths, the IMF's mission chief for Latvia, looks at what's next for the Baltic state.

***IMF Survey online:* It's been a little more than a year since the IMF gave Latvia an emergency loan. What impact has the loan had?**

Griffiths: Together with the government's strong efforts, the €7.5 billion international support package that was agreed in 2008 has been crucial to stabilizing Latvia's economy. The IMF's part of the package amounts to €1.7 billion and was approved in December 2008 (/external/np/sec/pr/2008/pr08332.htm). At that time, around €600 million was disbursed, followed by another disbursement of €200 million (http://www.imfhttp:/www.imf.org/external/np/sec/pr/2009/pr09290.htmhttp:/www.imf.org/external/np/sec/pr/2009/pr09290.h in August 2009. On February 17, the IMF's Executive Board decided to make a further €200 million available (/external/np/sec/pr/2010/pr1047.htm) to the country.

The package, which also includes contributions from the European Union (€3.1 billion); the Nordic countries (€1.8 billion); the World Bank (€400 million); the Czech Republic (€200 million); and the European Bank for Reconstruction and Development, Estonia, and Poland (€100 million each), has ended the drain on international reserves. Latvia's foreign currency reserves stand at €4.8 billion today, up from €3.4 billion at the height of the crisis in November 2008. Pressures on the exchange rate have abated, and overnight interest rates have fallen from a peak of 33 percent last June to around 1.3 percent today. As a result of the package, financial market confidence has improved.

***IMF Survey online:* How has the money been used?**

Griffiths: Much of the €3.3 billion or so that has been disbursed so far from the €7.5 international support package has been used to finance Latvia's budget deficit, enabling the government to pay public sector wages and maintain essential public services. The government faced severe difficulty in borrowing from markets, and without international support, government spending would have simply collapsed. Instead, the loans enabled the government to run a budget deficit of around 7 percent of GDP in 2009. So even if it may not feel that way to all the people who have lost their jobs or have suffered from cuts in public services, the higher deficit did soften the blow dealt to the economy by the recession.

As an aside, the government had the option of increasing the deficit to 13 percent of GDP under the IMF-supported program but it chose not to do so because it wanted to make more rapid progress with fiscal consolidation and did not want to accumulate more debt.

As part of the international support package, Latvia also benefited from its participation (/external/np/country/2009/091409.htm) in the European Bank Coordination Initiative (/external/pubs/ft/survey/so/2009/int102809a.htm), which saw foreign banks commit publicly to support their subsidiaries in Latvia. These public guarantees have eased pressures on foreign currency reserves and have helped maintain confidence in the banking system.

***IMF Survey online:* What are the prospects for recovery?**

Griffiths: Latvia is suffering from an extremely severe economic contraction, but there is hope for a recovery late this year and into 2011.

When we discuss Latvia's future, it's important to understand its recent past. From 2000 to 2007, Latvia grew at annual rate of 9 percent, making it one of the fastest growing economies not only in Europe but in the world. Between 2005 and 2008, wages doubled. Much of the demand was channeled into property, causing a bubble in real estate prices. In 2006 and 2007, the current account deficit grew to more than 20 percent of GDP. This meant that Latvia was borrowing roughly 20 percent of its income from abroad. By end 2007, foreign debt, most of it private sector debt, had increased above 125 percent of GDP.

As we now know, none of this could last. Foreigners stopped lending more to Latvia, foreign depositors withdrew their funds, and in late 2008 Latvia faced a deep recession. With the world economic crisis superimposed on this, it became a severe economic crisis. Latvia's economy contracted by 4 percent in 2008 and by 18 percent in 2009. Much of this was a painful correction to the bubble that had inflated in the earlier part of the decade.

***IMF Survey online:* Where will growth and new jobs come from?**

Griffiths: Domestic demand will probably remain weak for some time. Retail sales are down 30 percent in the year to December 2009 because of the increase in unemployment and the decline in wages. And given high levels of indebtedness and the need for banks to correct for their past excessive lending, credit is much harder to come by.

This means exports will be key. Here, much will depend on the strength of the global economy and world trade, which seems to be bouncing back. Latvia's exports increased by 6 percent in the third quarter of 2009 and manufacturing output is up by almost 10 percent since February, led by a 30 percent increase in wood products. So there is hope.

The government can take further steps to improve the business environment and help exports. For instance, funds from the European Union can be used to spur investment and boost productivity, which will stimulate exports, recovery and the creation of new jobs.

***IMF Survey online:* Has competitiveness been restored?**

Griffiths: Competitiveness has definitely improved in the past few months because of wage and price deflation, but there is a long way to go.

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Since 2004, private wages in Latvia have increased by close to 140 percent, compared to around 75 percent in Lithuania and Estonia, and roughly 12 percent in Germany. During the same period, prices increased by more than 50 percent in Latvia, compared with 32 percent in Lithuania and Estonia, and 10 percent in Germany.

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Improving competitiveness is difficult. Because the government's strategy is to maintain the fixed exchange rate peg to the euro, improving price competitiveness requires lower wages and prices. Wage-based adjustment is already taking place. In the third quarter of 2009, wages were down 6 percent from one year earlier, and in December consumer prices were down by 1.4 percent compared with the previous year. Since March 2009, the consumer price index-based real effective exchange rate has depreciated around 7 percent.

Despite this progress, competitiveness is roughly where it was when the IMF-supported program was launched, because some of Latvia's main trading partners saw their exchange rates depreciate in late 2008 and early 2009.

The other way to improve competitiveness is through structural reform and productivity growth. There are signs of this taking place, but clearly there is a long way to go.

***IMF Survey online:* There are reports that emigration has increased dramatically, with skilled labor leaving for Britain and other countries. Will this trend threaten recovery?**

Griffiths: Latvia has a well educated labor force, and there are many cheap flights to the rest of the European Union. Emigration plays a key role in Latvia's economy, and it's one of the topics we intend to focus on in the IMF's next annual assessment of Latvia's economy.

Emigration is a safety valve that can help overcome Latvia's severe unemployment problem. But if entrepreneurs and the most skilled workers leave in big numbers, Latvia will lose the very people who could be creating new companies and jobs. And by reducing the labor force, emigration will also reduce output in Latvia. Unless it is offset by substantial remittances, emigration will reduce tax revenues and make it harder to finance government spending, such as pensions.

***IMF Survey online:* Have banks started lending again to small businesses and consumers?**

Griffiths: One of the key goals of the program is to strengthen the financial system so that banks can start lending again. There is anecdotal evidence that banks are starting to increase their loans to exporting firms.

But overall lending is clearly in decline. This decline in credit will dampen the recovery but it's an unavoidable consequence of the unsustainable boom that came before. Credit grew by 58 percent in 2006 and by 34 percent in 2007. This jump in lending volume caused real estate prices to increase by 75 percent from the start of 2006 to the peak in spring 2007. It also increased credit to almost 90 percent of GDP in 2007.

Most of these loans were financed by borrowing from abroad, not organically through local deposits. Relative to GDP, the size of Latvia's banking sector assets has been the highest not only compared with the three Baltic countries but also compared with all the new EU member states in eastern and central Europe.

Now that the boom is over, foreigners are no longer willing to lend freely to Latvian banks, which means that the funding base for domestically owned banks has shrunk. But the good news is that EU-based parents of foreign-owned banks have so far strongly supported their Latvian subsidiaries through continued funding and repeated recapitalizations.

The Financial and Capital Market Commission is strengthening its oversight of the financial system to make sure that banks are stronger and in a position to restart lending. And in the meantime, EU funds and loans from the Nordic Investment Bank and the European Bank for Reconstruction and Development can help provide some resources for Latvian firms and banks.

***IMF Survey online:* As part of efforts to balance the budget, there have been deep cuts to the social sector. What advice has the IMF offered to the government?**

Griffiths: Because of the severe recession, tax revenues fell by 26 percent in 2009. Even with billions of euros in loans to help finance this gaping hole, the collapse in revenues has left Latvia's government with no other option but to cut spending.

Working with the government and the World Bank, the IMF has done its best to find ways to protect social spending within the very tight budget envelope. Efforts have focused on strengthening the safety net for those most in need of help. Let me give some specific examples of measures the government has introduced under the IMF-supported program:

Health sector copayments for the poorest used to amount to 25 to 50 percent of the standard rate. These have now been completely eliminated.

Plans to abolish preschool education for 5–6-year-olds have been dropped.

The guaranteed minimum income was increased from L27 per month in 2008 to L37 from January 1, 2009, and then to L40 from October 1, 2009 with a new higher L45 rate for children.

Unemployment benefits were extended to 9 months, even for workers with short employment histories.

> "Even though adopting the euro will have many benefits compared with the current fixed exchange rate regime, it will not solve everything."

A new public works program was introduced for people that weren't eligible for unemployment insurance. Though the stipend is relatively low, at only L100 per month, which amounts to about 80 percent of the minimum wage, take-up has been impressive, with 19,500 people joining and many more applying.

In response to the crisis, we have made a special effort to build flexibility into the program, allowing the budget deficit targets to increase by up to 1 percent of GDP if the government wants to increase safety net spending.

***IMF Survey online:* Have efforts been made to help people pay their mortgages?**

Griffiths: Increased unemployment and wage cuts have increased the need to help people stay in their homes. The government approved a scheme in 2009 that guarantees loan repayments if banks agree to restructure mortgages. The scheme freezes part of the loan for a period of two years, reduces monthly mortgage payments, and writes off part of the principal.

The IMF has worked closely with the European Commission, the government, and others throughout 2009 to make the new scheme possible. To ensure that it targets those most in need, the government intends to limit the scheme's coverage to the primary residences of homeowners with mortgages up to L100,000.

Homeowners have also been helped by a drop in interest rates on euro-denominated loans. Most mortgages in Latvia are denominated in euros, so keeping the fixed exchange rate has also helped homeowners.

But there are trade-offs. Eventually, the government will have to decide whether this scheme is the most effective use of scarce resources.

***IMF Survey online:* Latvia's president says the government is now aiming for euro adoption by 2014. Is that a good strategy? Is it realistic?**

Griffiths: I agree 100 percent with President Zatlers that aiming for euro adoption by 2014 is a good strategy. By replacing the fixed exchange rate with the euro, speculation over the exchange rate would end once and for all, and interest rates would fall to levels in the euro area.

To adopt the euro by 2014, Latvia will need to meet the Maastricht criteria by 2012. The most difficult challenge will be to reduce the budget deficit to no more than 3 percent of GDP, and then keep it at or below that level in the future.

While the government has made a lot of progress, our best estimate right now is that another 800 to 900 million lats—about 7 percent of GDP—in tax increases or government spending cuts will still be needed during 2011–12. This is a very large number, especially for an economy battered by recession. But Latvia has already implemented about 10 percent of GDP of adjustment in 2009, including the recently approved budget for 2010. And the task will become a little easier once the economy starts growing again.

Even though adopting the euro will have many benefits compared with the current fixed exchange rate regime, it will not solve everything. If Latvia becomes a member of the eurozone, it will need continued budget discipline. It will also have to work hard to improve competitiveness.

IMF Survey online: **How much longer will the IMF stay involved in Latvia?**

Griffiths: We will stay involved in Latvia for as long as the government needs our help. We have already discussed this issue with the government and have agreed to extend the current program through the end of 2011. This will help us spread our financial support over a longer period. It also means that the program should still be in place when the government prepares its 2012 budget, which will be critical for meeting the Maastricht criteria for euro adoption.