LATVIJAS BANKA

EIROSISTĒMA

Crisis and recovery in Latvia. What are the lessons learnt?

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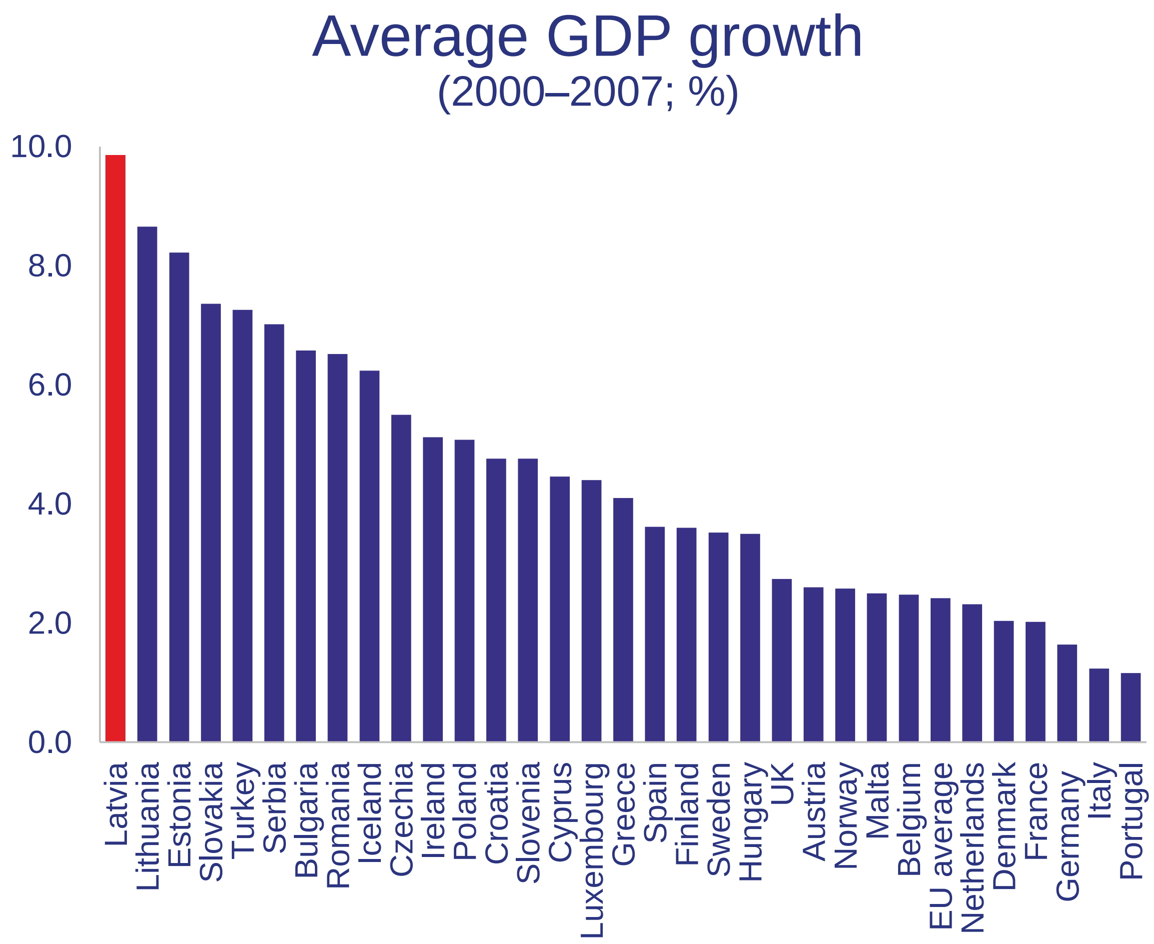
12.07.2019.

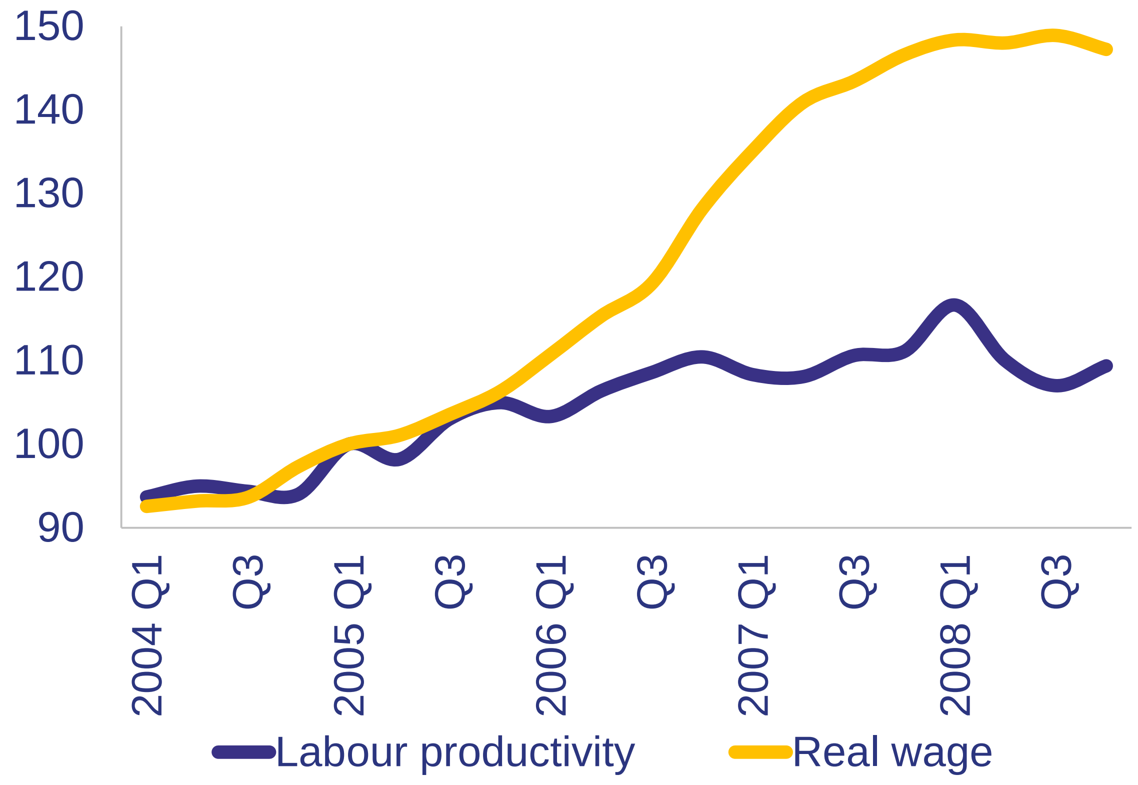
Latvia was an absolute champion in terms of growth during the early 2000s



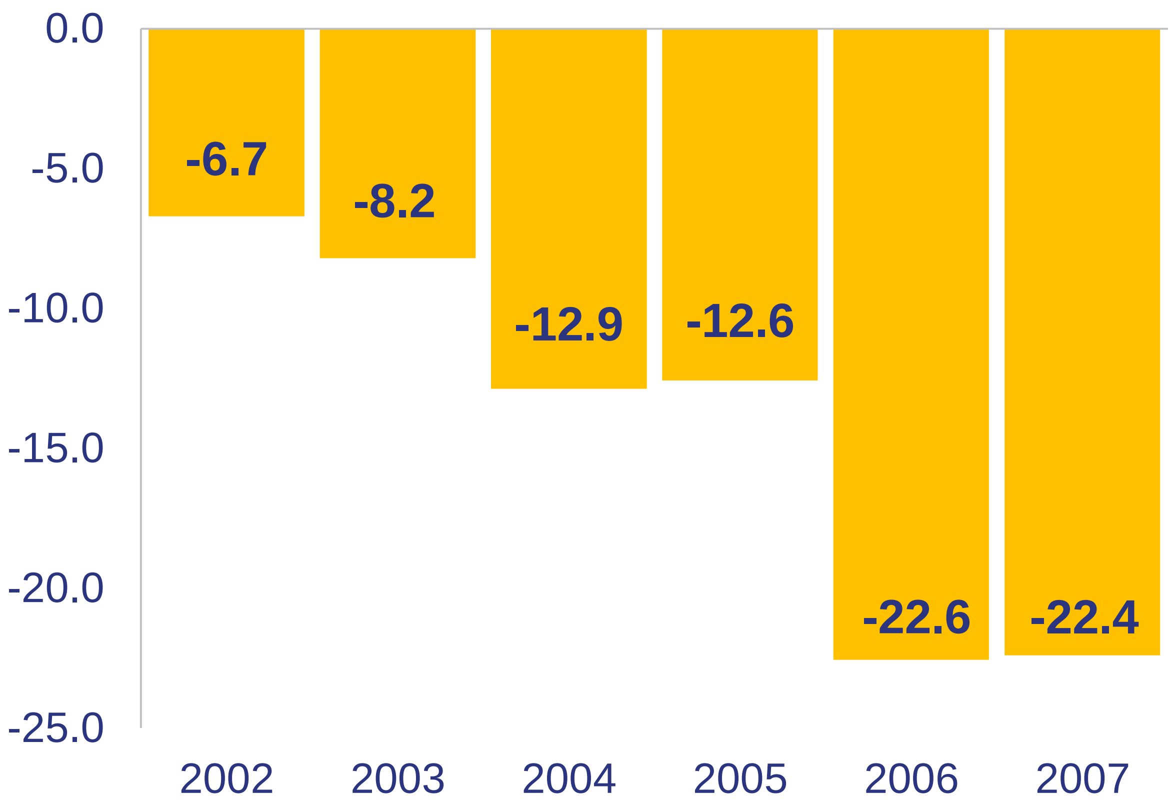
Source: Eurostat.

But rapid growth came at a price of deteriorating competitiveness. Such developments were clearly not sustainable.

Real hourly wage and labour productivity per hour
(s.a.; 2005 Q1 = 100)



Current account deficit
(% of GDP)



Source: CSB, Bank of Latvia staff calculations.

Latvia at the outset of the recent crisis

Many suggested devaluation as a way out of the crisis.

Why devaluation was not an appropriate solution?

One size does not fit all!

- **Small** vs **large** economy
- **Open** vs **closed** economy
- **Resource rich** vs **resource importing** economy
- **Euroized** vs **domestic currency** dominated economy

Devaluation was not a solution for Latvia

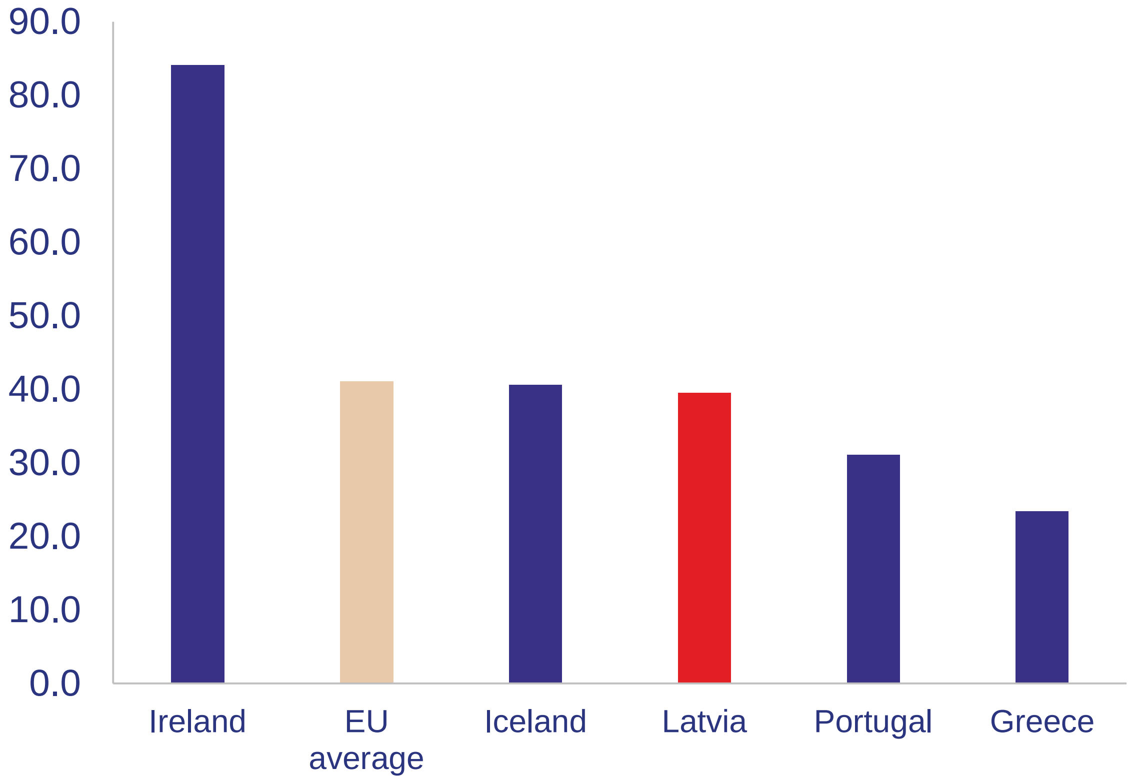
- **High import content** in exports and domestic production, competitive gains reduced by surge in input costs
- **High share of FX liabilities:** many corporates would face negative equity immediately, making large part of the banking sector insolvent
- **Loss of credibility** and likely run on banks
- **Court system unable to cope** with sharp increase in insolvency cases, inefficient insolvency procedure
- **No** motivation to improve **efficiency and productivity**

The internal adjustment was the only path to follow

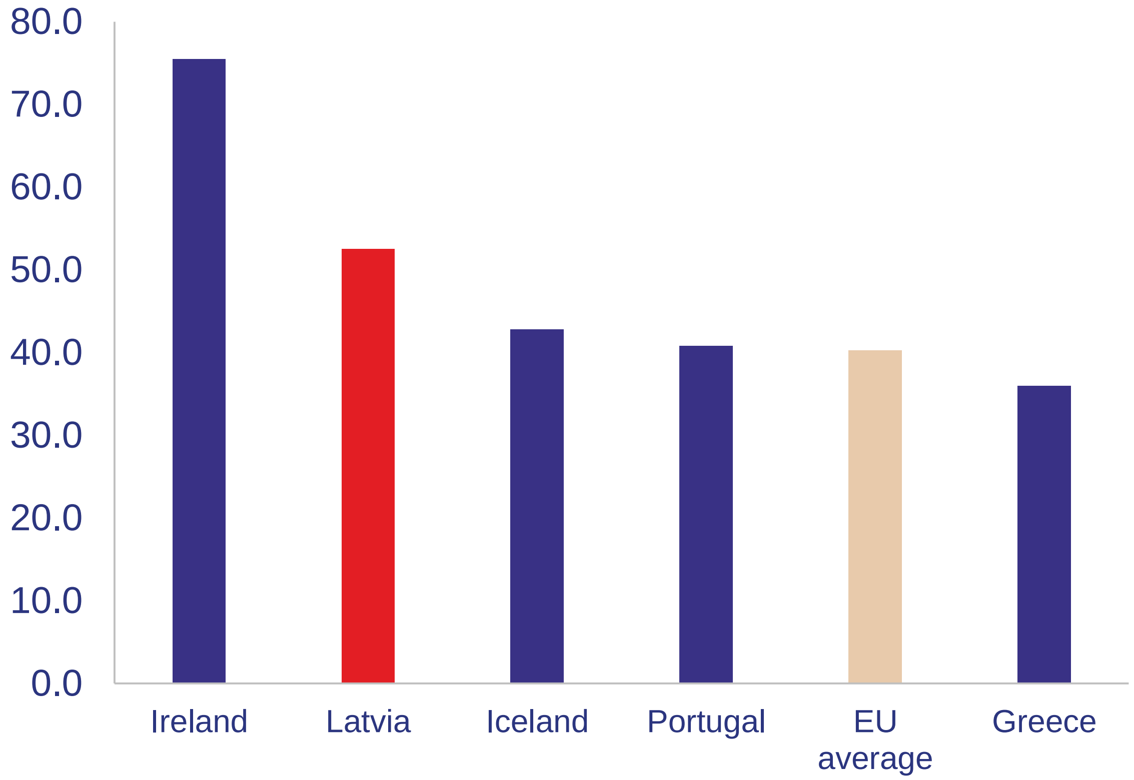
- **Time bought for structural reforms** that smoothen adjustment
- Improvement of **public sector efficiency**
- **Less corporate bankruptcies** reduce costs for the economy
- More gradual adjustment motivates businesses for **productive improvements**
- Latvia's **economy is reasonably flexible** to adjust
- **Society** understands the root causes of crisis and **supports necessary austerity and reforms**

For small and open economies, exports have large import component making devaluation a double-edged sword

Imports of goods and services
(% of GDP; 2007)

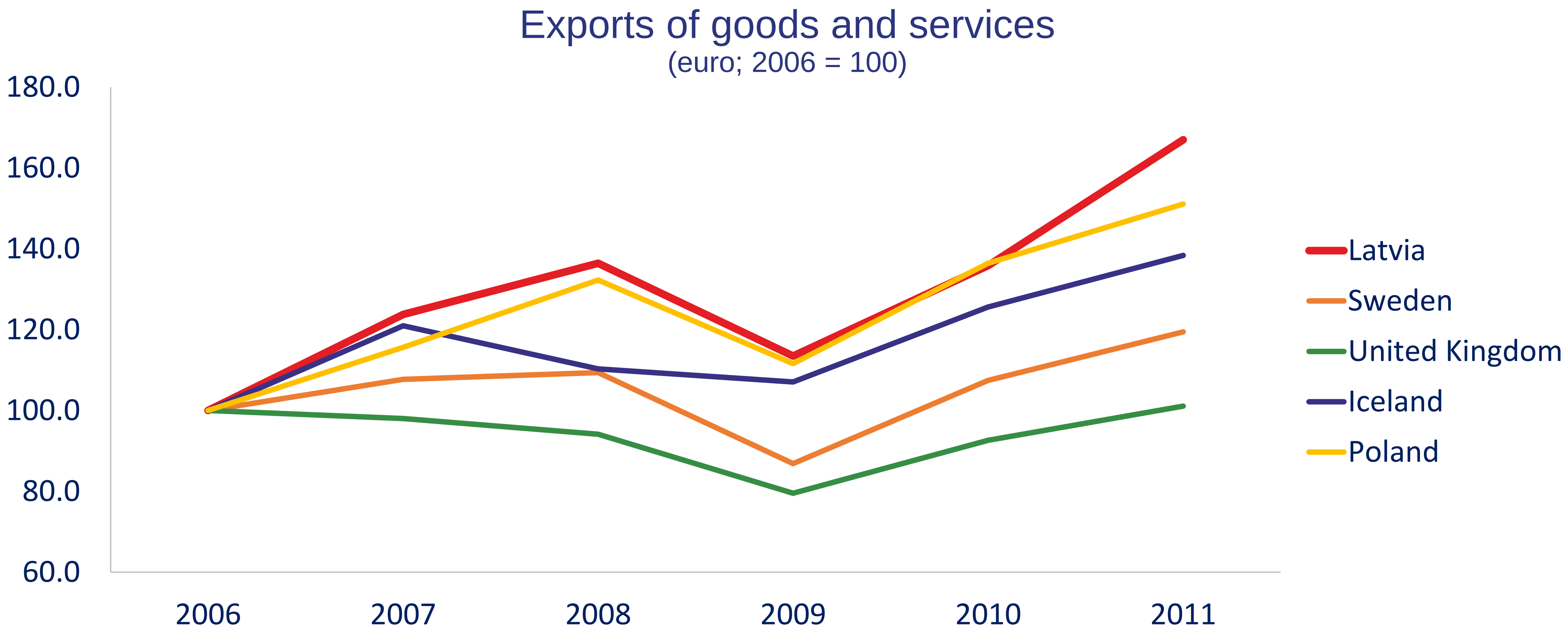


Exports of goods and services
(% of GDP; 2007)



Source: Eurostat.

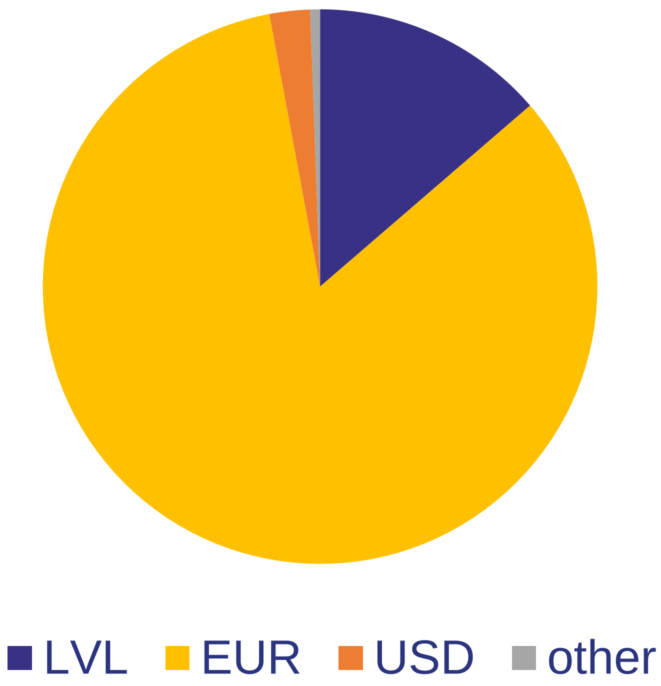
Despite the lack of exchange rate adjustment, exports recovered even stronger than in some countries with flexible exchange rates



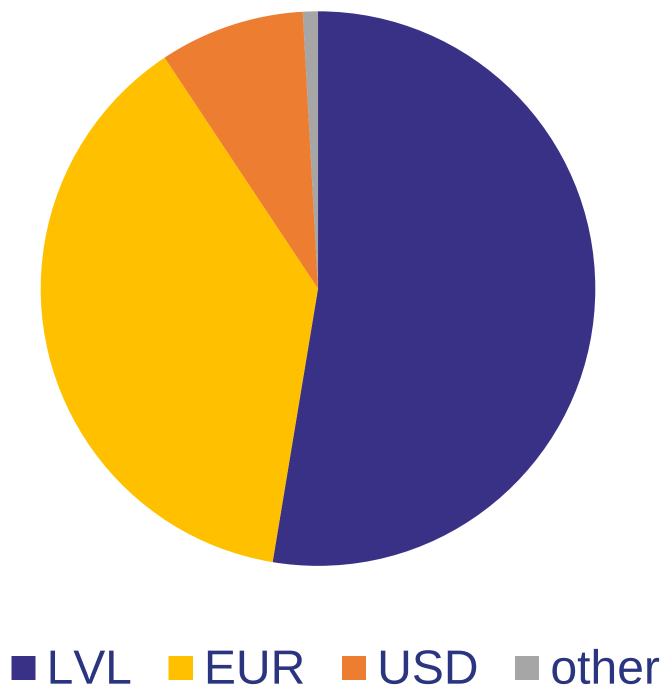
Source: Eurostat.

Foreign currencies widely used in domestic financial transactions

Currency structure of **loans** to residents in 2007 (%)

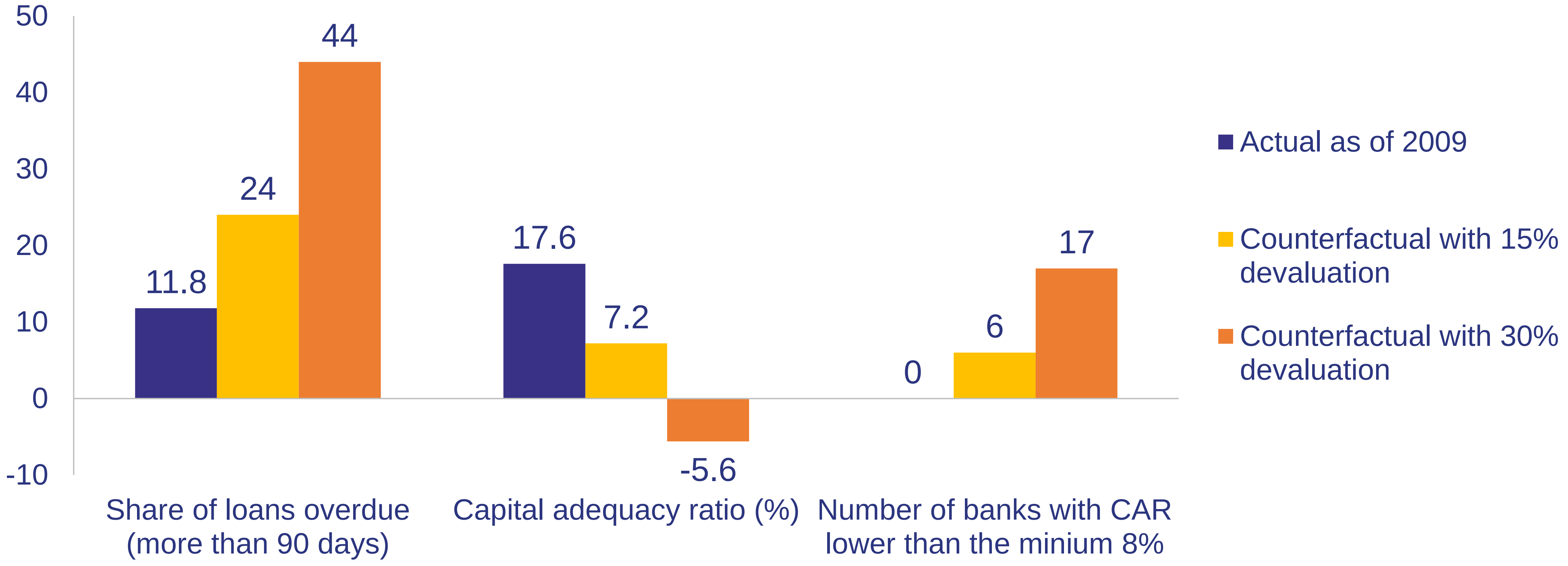


Currency structure of resident **deposits** in 2007 (%)



Source: Bank of Latvia.

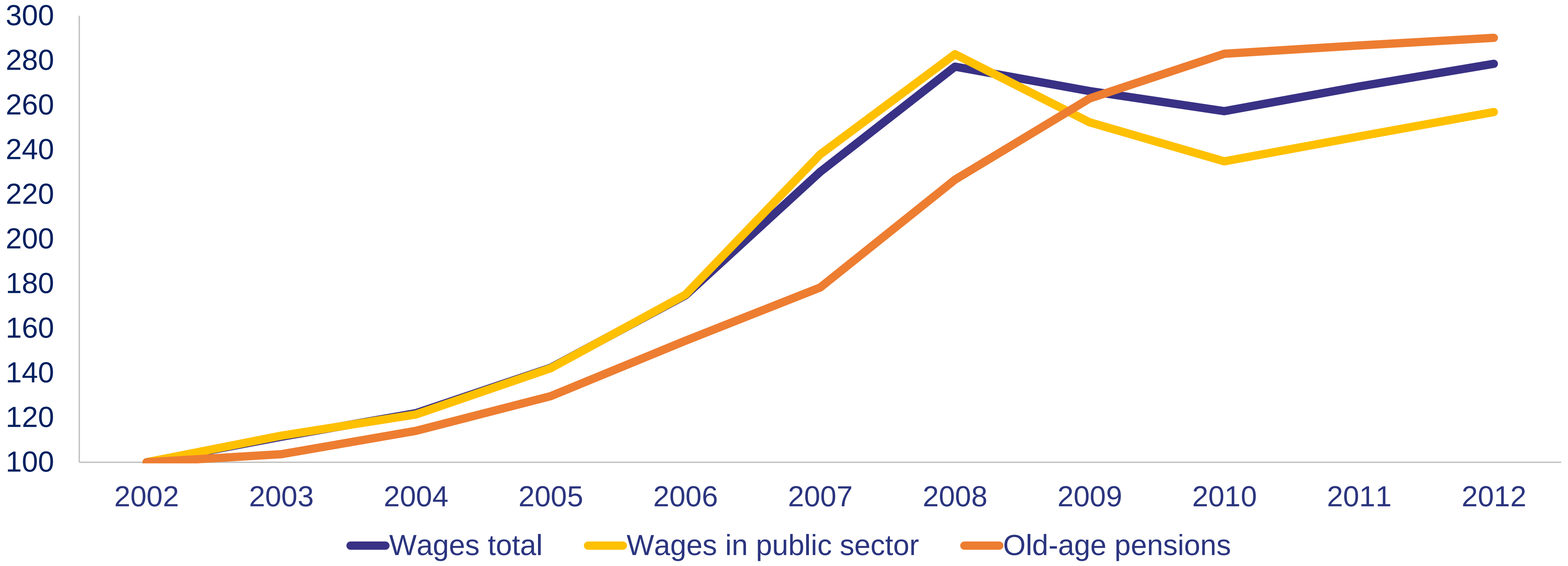
Devaluation would make large part of the banking system insolvent overnight



Source: FCMC, Bank of Latvia calculations.

Nominal wage adjustment solved problems where they had arisen (wage-productivity mismatch).
Devaluation would have made every citizen worse off.

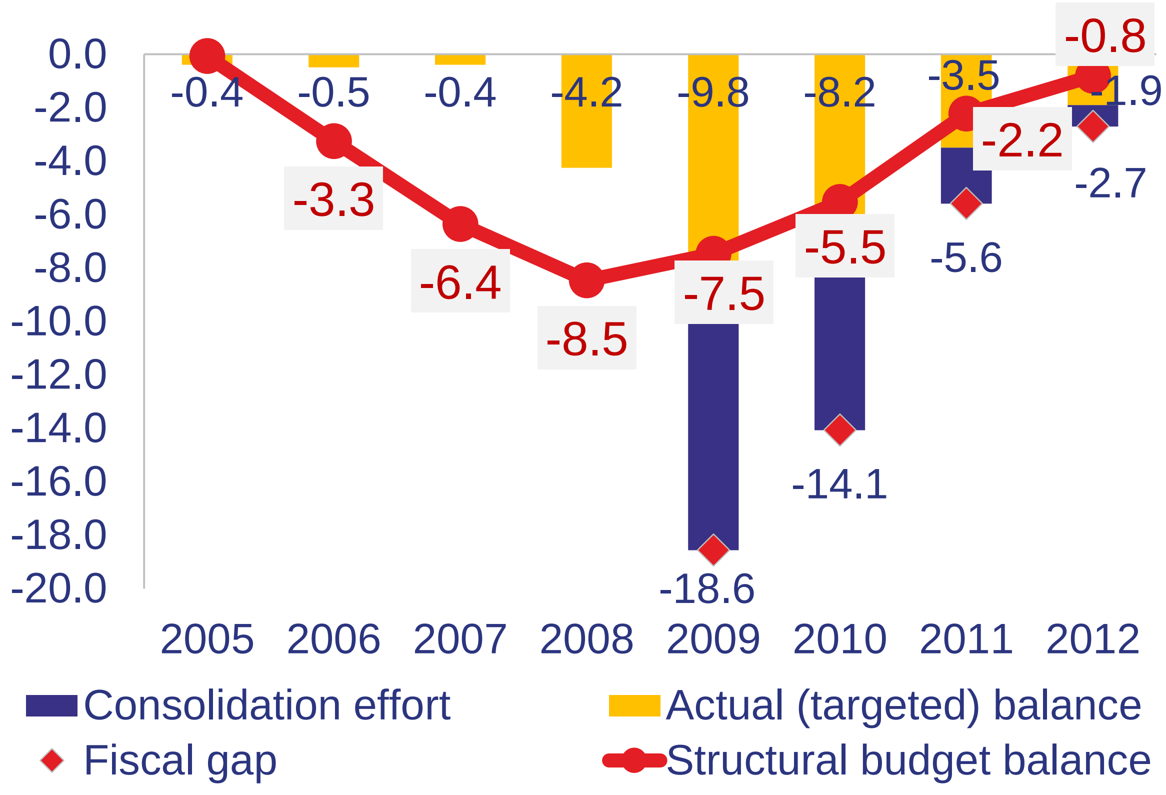
Average wages and old-age pensions in Latvia (2002 = 100)



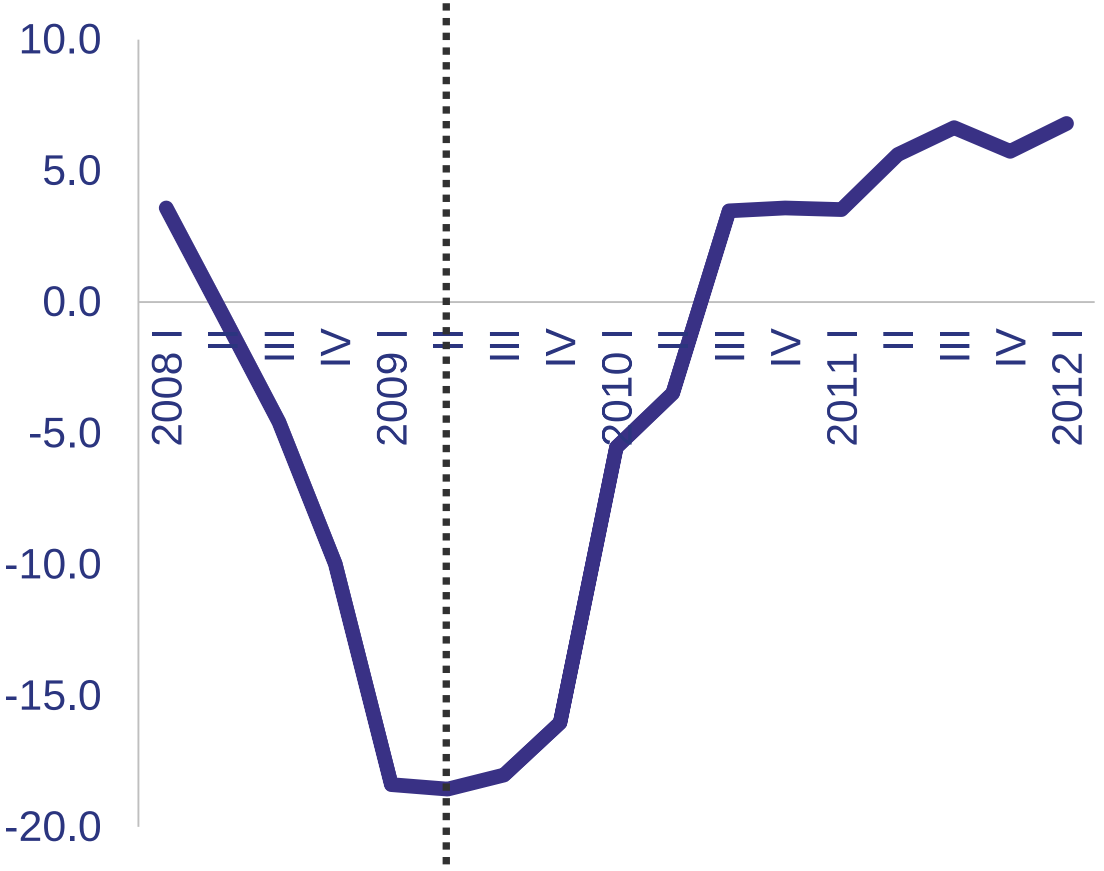
Source: CSB.

Both fiscal consolidation and GDP growth patterns show a clear V-shaped pattern

General Government budget balance
(ESA'95; % of GDP)



Real GDP growth (%; y-o-y)



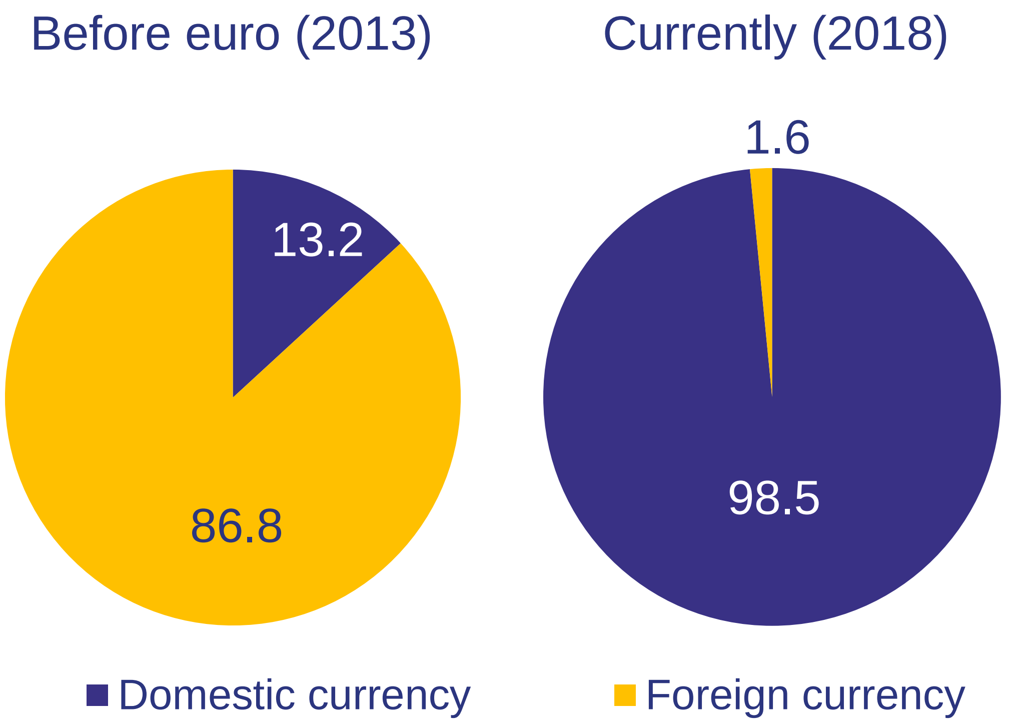
Source: Eurostat.

Why internal adjustment worked: Latvia's recipe

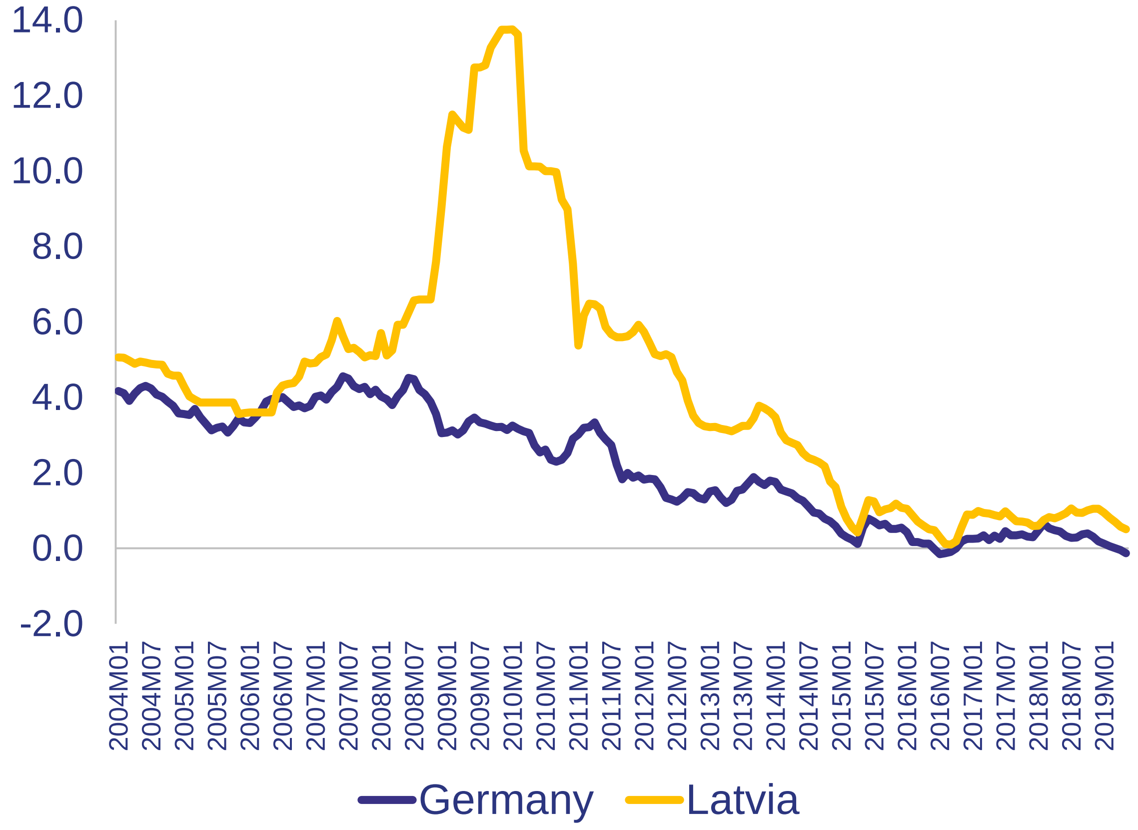
- Speed
- Ownership
- Commitment
- Solidarity

But Latvia also had a unique exit strategy – euro adoption that contributed to reduction of risks

Structure of resident loans (%)



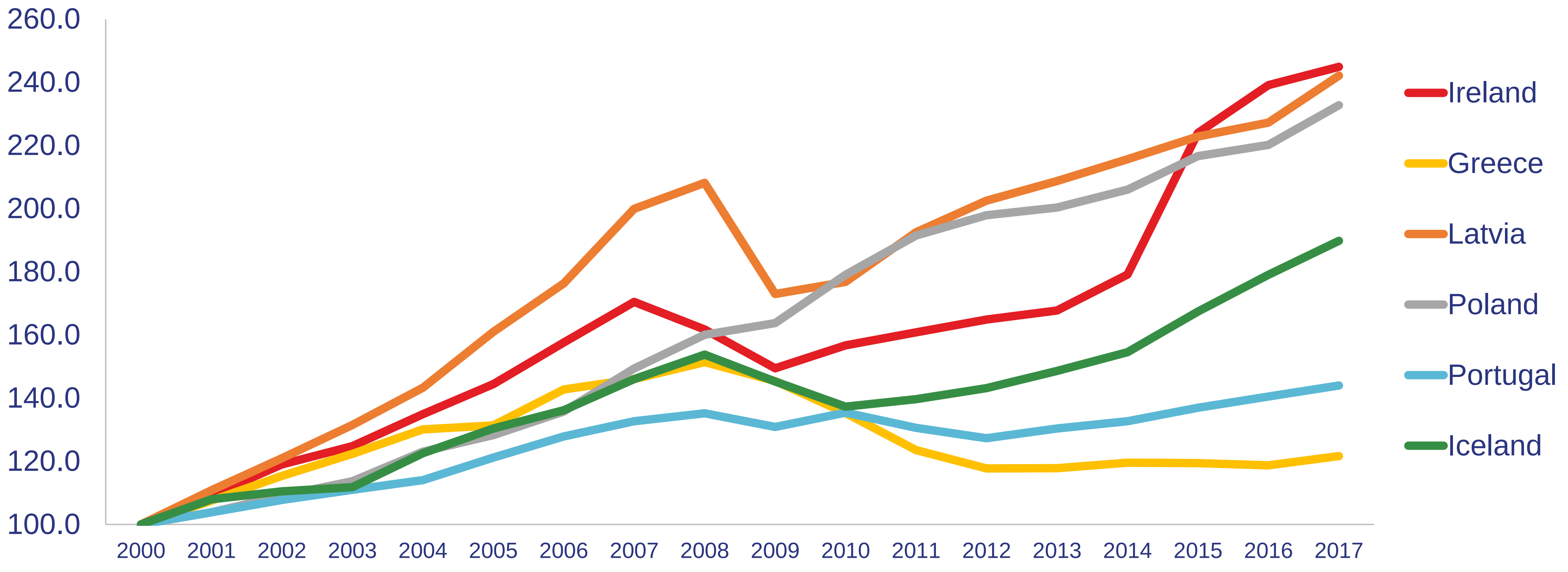
Long-term government bond yields (%)



Source: BoL, Eurostat.

Pre-cricis level of GDP has been reached within a few years, solid growth continues but with sound fundamentals

GDP (purchasing power standard (PPS); 2000 = 100)



Source: Eurostat.

This crisis has shown that

MORE is LESS and LESS is MORE