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Latvia:
Between Scylla and Eurybdis, ready for taking a dive

Latvia is joining the euro area in 2014 at a time when the euro project itself is in deep trouble, the reason being that the country's ruling elites deem it a safer haven compared to the present hard peg regime. The short-lived 'success story' of internal devaluation is souring again, given the lack of investments, ongoing austerity policies and the impossibility of running an 'export-driven' beggar-thy-neighbour growth model in a phase marked by an EU-wide economic and social crisis. However, wage increases exceeding those of productivity may well bolster economic growth, at least temporarily.

In June the European Commission, in its 2013 Convergence Report on Latvia, confirmed that the country fulfils all Maastricht criteria by a wide margin and proposed to the Council that Latvia shall adopt the euro on 1 January 2014. The analysis presented by the EC in order to assert if a 'high level of sustainable economic convergence' has been achieved however does not prove the latter, but demonstrates the problematic measurement and supply side-oriented interpretation of economic stability and flexibility by the Commission. At the same time, the most recent opinion polls show that the support of the Latvian population for euro adoption could only be raised to 38% – although the Latvian government campaigned broadly for the project. As the analyses of the IMF shortly after the outbreak of the economic bust in the Baltics and the experience of Iceland have shown, the Latvian government would have had much better alternatives than the one chosen, i.e. maintaining the euro peg, implementing harsh austerity measures named 'internal devaluation' and joining the euro area thereafter.

Latvian exporters improved their competitive position during the crisis period by reducing employment and cutting wages, which led to an increase of their shares in the international markets and in general to a rebound of exports in the period up to the end of 2012. Although Latvia still reports positive growth in nominal trade figures, the increase dropped substantially towards the end of the first quarter of 2013. At the same time industrial production plummeted by 4% compared to the first quarter of 2012. Not only did external demand of most of the EU countries decline, but also a remarkable slowdown of Latvian exports to its Baltic neighbours and Russia has occurred recently. However, reduced growth in investments and restocking resulted in imports evolving less swiftly alike. Thus the current account deficit even declined compared to the first quarter of last year.

As expected, growth in gross fixed capital formation, which was particularly volatile last year, dropped substantially in the first quarter of 2013 and is likely to rebound towards the end of this year only if export and growth prospects change to be better. Although capacity utilisation in the manufacturing sector rose remarkably again after the economic bust, it is still below the pre-crisis level at slightly above 70%. In the run-up to the euro area the government has not taken advantage of the good progress of revenues to increase investments in the public infrastructure. The upcoming elections at the national level in 2014, as well as Riga becoming European Capital of Culture in 2014 however might be drivers of some additional public expenditure.

The economic rebound of the past two years effected employment to grow up to the end of 2012, most prominently in the non-tradable sectors, but also in manufacturing. However, due to the massive layoffs during the crisis and substantial emigration total employment is still more than 15% below the level five years ago, and close to 20% of those aged 15 to 34 years are not in employment or education. Overall job creation already slowed down substantially in the first quarter of 2013 (while employment started to decline in manufacturing) and will continue to do so throughout the year but shall still reach about 2% per annum on average. The unemployment rate is likely to amount to about 13% of the active population in 2013 on average. However, economic growth in 2013 is likely to be too low to bring about further fast improvements on the Latvian labour market.

Latvian employees profit from a renewed upswing in gross wages especially in the service sectors, low inflation rates and the reduction of the income tax rate by 1 percentage point to 24% which took place in January 2013. Altogether this led to an increase in net wages by 4.8% in real terms in the first quarter of 2013. This trend is most likely to hold on throughout this year, given the fall in consumer price inflation. Thus consumption of private households will act as the main driver of economic growth in 2013. However, retail figures of the most recent months indicate that the impetus shall be lower compared to last year.

The lively economic activity of 2012 resulted in increased tax revenues of the government. At the same time public expenditures were kept almost unchanged compared to 2011 in real terms. Thus the budget deficit declined to 1.2% of GDP while at the same time the share of public expenditures in GDP was reduced to 36.5% last year. The reason for following this austerity-oriented fiscal policy stance has been not only the envisaged goal of euro adoption but also the outspoken aim of Prime Minister Valdis Dombrovskis to employ supply-side policies in order to return to a minimum state as soon as possible after the bust. He states that: 'These large cuts made long-delayed structural reforms in the public sector necessary, notably in public administration, health care, and education. These reforms are likely to generate positive supply effects that will contribute to greater growth in the future.' [1] In 2012 the share of the health sector in total employment amounted to 5.8%, while the average of the EU-27 ranges at 10.4%.

Similar to last year's outcome the budget for 2013 also foresees a deficit of 1.2% of GDP. The regressive changes to the income tax law, approved together with the 2013 budget, foresee a further reduction of the personal income tax rate to 22% in 2014 and 20% in 2015. This will reduce the income base of the government, hindering the necessary upgrading of public infrastructure in various fields, but especially in the health sector and the social sphere in general. Moreover, the implemented fiscal policies will further fuel boom-bust cycles, increase the high levels of income inequality and perpetuate the deep scars that the policy of 'internal devaluation' has inflicted on Latvian society.

Looking at the other side of the 'success story' we can see that 26% of the Latvian population are severely materially deprived according to Eurostat statistics in 2012. This share was exceeded in the EU only by Romania (29% in 2011) and Bulgaria (43% in 2011), another currency board country pursuing a minimal state ideology, while the EU-27 average amounted to 8.8% in 2011. Thus it is not surprising that emigration especially of the younger generation, which attained an unprecedented large scale during the phase of 'internal devaluation', is going on according to the Latvian Statistical Office.

The reduction of the VAT rate in 2012 brought the development in prices of consumer goods close to deflation in the first half of 2013. This effect will cease from July this year onwards, however, the fall of import prices should keep inflation at 1% per annum.

The reasons for the European Commission to praise Latvia so loudly as the 'success story' of internal devaluation are manifold and questionable at the same time. First of all, the EC defends its support of the Latvian internal devaluation path, a choice which was substantially and rightly criticised by a number of reputed economists and by the IMF during the design of the rescue package implemented after the bust. The considerably higher economic costs of this choice and the resulting social harm are obvious. However, the EC also defends the Latvian experiment of internal devaluation against the headwinds

[1] Anders Aslund and Valdis Dombrovskis (2011), How Latvia came through the financial crisis, Peterson Institute for International Economics.

of international commentators who reason about 'Why the Baltic states are no model'[2], since it is replicating the same procedure on a larger scale in the southern core of the European Union with the same and maybe even more disastrous outcomes. Again the EC is telling us recently that rebalancing (which is effected by crushing domestic demand inter alia via cuts in public expenditures) is showing first signs of success, while EU unemployment levels are at unprecedented levels and escalating further.

Given the stagnant economic development in the euro area and the austerity stance of fiscal policies of the government, GDP growth shall decline substantially also in Latvia, from 5.4% last year to 2.8% in 2013. However, this rather favourable outcome for a period when the EU in general is in recession is driven by household consumption, a demand effect that is still backing overall economic activity. The further outlook is based on the assumption of a slight improvement of economic activity in Europe in 2014, wage growth in the Latvian service sectors above productivity, while on the negative side it is expected that the Dombrovskis government will follow its procyclical fiscal policy track-record. Depending on euro area and also Russian external demand, Latvian producers may develop some optimistic animal spirits and invest in the coming year in order to exploit their export possibilities and expand their capacities. Thus we expect GDP growth to revive to 3.1% in 2014 and 3.5% in 2015.

[2] Comment by Martin Wolf, *Financial Times*, 30 April 2013, http://www.ft.com/cms/s/0/090bd38e-b0c7-11e2-80f9-00144feabdc0.html. Others having pointed to the fact that the Latvian and Baltic experience proves once and again that internal devaluation is one of the costliest alternatives in terms of economic loss and social problems in order to rebalance; to name but a few: Zsolt Darvas, Heiner Flassbeck, Jeffrey Sommers and of course Paul Krugman.

Table LV

Latvia: Selected Economic Indicators

	2009	2010	2011	2012 [1]	2012	2013	2013	2014	2015
					1st quarter			Forecast	
Population, th pers., average [2]	2254.8	2239.0	2058.2	2034.9	2038.7	2024.9	2023	2013	2003
Gross domestic product, LVL mn, nom.	13070	12784	14275	15521	3403	3540	16100	16800	17700
annual change in % (real)	-17.7	-0.9	5.5	5.6	7.0	3.6	2.8	3.1	3.5
GDP/capita (EUR at exchange rate)	8600	8600	9800	10900	.	.	.	.	.
GDP/capita (EUR at PPP)	12700	13200	14700	16100	.	.	.	.	.
Consumption of households, LVL mn, nom.	7889	7947	8725	9496	2186	.	.	.	.
annual change in % (real)	-22.8	2.5	4.7	5.5	5.5	4.7	4.5	4.0	4.5
Gross fixed capital form., LVL mn, nom.	2820	2330	3045	3644	692	.	.	.	.
annual change in % (real)	-37.4	-18.1	27.9	12.3	39.0	-10.6	-3.0	8.0	9.0
Gross industrial production [3]									
annual change in % (real)	-18.1	14.9	9.0	6.1	9.7	-4.0	-2.5	5.0	6.0
Gross agricultural production (EAA)									
annual change in % (real)	-0.7	-2.4	2.8	14.9	.	.	.	.	.
Construction industry									
annual change in % (real)	-34.9	-23.4	12.5	13.5	28.5	9.5	.	.	.
Employed persons, LFS, th, average [4]	983.1	940.9	970.5	885.6	857.6	898.3	905	915	925
annual change in % [4]	-12.6	-4.3	3.1	2.8	2.6	4.7	2.2	1.1	1.1
Unemployed persons, LFS, th, average [4]	203.2	216.1	176.4	155.5	166.7	131.9	140	130	120
Unemployment rate, LFS, in %, average [4]	17.1	18.7	15.4	14.9	16.3	12.8	13.2	12.5	11.5
Reg. unemployment rate, in %, end of period [4]	16.0	14.3	11.5	10.5	11.7	10.8	.	.	.
Average gross monthly wages, LVL	461	445	464	481	466	486	.	.	.
annual change in % (real, net)	-5.6	-6.5	0.3	1.6	0.3	4.8	.	.	.
Consumer prices (HICP), % p.a.	3.3	-1.2	4.2	2.3	3.3	0.4	1.0	1.5	2.0
Producer prices in industry, % p.a.	-3.1	2.4	7.7	4.1	7.3	2.0	.	.	.
General governm.budget, EU-def., % of GDP									
Revenues	34.0	35.3	34.9	35.2	.	.	34.6	35.0	34.5
Expenditures	43.7	43.4	38.4	36.5	.	.	36.0	34.2	34.5
Net lending (+) / net borrowing (-)	-9.7	-8.1	-3.6	-1.2	.	.	-1.4	-0.8	0.0
Public debt, EU-def., % of GDP	36.9	44.4	41.9	40.7	41.6	.	43.0	40.5	39.0
Central bank policy rate, % p.a., end of period [5]	4.0	3.5	3.5	2.5	3.5	2.5	.	.	.
Current account, EUR mn	1598	532	-434	-371	-149	-71	-650	-900	-1100
Current account, % of GDP	8.6	2.9	-2.1	-1.7	-3.1	-1.4	-2.9	-3.8	-4.4
Exports of goods, BOP, EUR mn	5253	6813	8578	9921	2186	2341	10800	12000	13500
annual change in %	-19.6	29.7	25.9	15.7	14.5	7.7	8.9	11.1	12.5
Imports of goods, BOP, EUR mn	6575	8084	10765	12107	2772	2891	13400	15000	16800
annual change in %	-38.0	23.0	33.2	12.5	20.8	5.0	10.7	11.9	12.0
Exports of services, BOP, EUR mn	2747	2754	3181	3547	805	845	3750	4200	4750
annual change in %	-11.0	0.3	15.5	11.5	21.4	5.6	5.7	12.0	13.1
Imports of services, BOP, EUR mn	1625	1647	1868	2032	442	451	2150	2400	2700
annual change in %	-25.1	1.4	13.4	8.8	15.1	2.4	5.8	11.6	12.5
FDI inflow, EUR mn	68	284	1039	777	259	136	600	.	.
FDI outflow, EUR mn	-44	14	44	148	31	65	100	.	.
Gross reserves of NB excl. gold, EUR mn	4572	5472	4666	5412	5067	5468	.	.	.
Gross external debt, EUR mn	29097	29978	29459	30078	30023	30980	.	.	.
Gross external debt, % of GDP	157.1	166.2	145.8	135.1	142.6	136.4	.	.	.
Average exchange rate LVL/EUR	0.7057	0.7087	0.7063	0.6973	0.6985	0.6997	0.7087	0.7087	0.7087
Purchasing power parity LVL/EUR	0.4812	0.4632	0.4726	0.4726	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) From 2011 according to census March 2011. - 3) Enterprises with 20 and more employees. - 4) From 2012 according to census March 2011. - 5) Refinancing rate of National Bank.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.