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ECONOMIC CRISIS IN THE BALTIC STATES: FOCUSING ON LATVIA

ABSTRACT: *This paper examines the causes of the economic crisis in new EU member states in Central and Eastern Europe, focusing on the Baltic States, especially Latvia. Thanks to the Single Market of the EU, workers in this country became able to migrate to advanced EU countries, especially the UK, decreasing the unemployment rate and at the same time causing a sharp increase in wages due to a tightened labour market. Banks from Nordic countries came to operate in Latvia and competed for market shares, stirring a consumption boom. In a situation in which people can easily get loans denominated in a foreign currency the monetary policies of the central bank are weakened. The Latvian economy already showed signs of overheating in 2005. However in the spring of 2007 the government turned to restrictive policies, causing a depression at the end of 2007. The Lehman shock dealt the Latvian economy its final blow. Latvia set up the introduction of the Euro in 2013 as an exit strategy. Latvia is in a dilemma: if the country does not devalue its national currency and tries to satisfy the Maastricht criteria soon, it will be obliged to adopt pro-cyclical policies, causing economic stagnation.*

KEY WORDS: *Global financial crisis, EU-Phoria, Central and Eastern Europe, Baltic States, Latvia*

JEL CLASSIFICATION: O19, O52, P26, P52

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1. INTRODUCTION

More than twenty years have passed since the system changed in Central and East European countries (Central Europe + South Eastern Europe + Baltic States). These countries have undergone remarkable development since the mid-1990s and between 2004 and 2007 realized a long-cherished desire, i.e. membership of the European Union (EU). The new EU member states (NMS) seemed to continue their economic development in a relatively satisfactory way, even after dark clouds began to hang over the world economy in 2007 due to the subprime loan problem in the USA. However the global financial crisis arising from the collapse of Lehman Brothers in September 2008 caused NMS to take a direct hit, and since then the NMS have been more or less in economic crisis. The economic crisis has been very serious in Hungary and the Baltic states. Some analysts have speculated that the crisis in NMS might shake advanced EU member states, due to the huge amount of credit that banks in the latter countries have given[1].

This paper tries to grasp the general picture of the economic crisis in the NMS, mainly based on studies by a research group at the Vienna Institute for International Economic Studies (WIIW). Focusing on the Baltic States, Latvia in particular, which has supposedly been in a most serious situation, reasons for why the crisis has become so serious are explored. Next, factors that influenced the economic crisis in the Baltic States are examined, i.e. the effectiveness of the prescription from the EU and the IMF, as well as a scenario in which the financial crisis in Latvia might effect the EU economy via the threat to Swedish banks. Finally the paper reaches some conclusions.

2. ECONOMIC CRISIS IN NMS: VARIOUS SCENES

Among NMS we can find various economic crisis scenarios, ranging from countries with very serious crises to countries with rather milder crises. These countries can be classified into several groups. When we look at the extent of the fall in GDP growth rates in Q1 of 2009 compared with Q2 of 2008 (Table 1), six countries have experienced double-digit falls in GDP growth rates, starting with Lithuania at -18.8% to Bulgaria at -10.6%. It is in Lithuania, Latvia, and Estonia that GDP growth rates continued to make double-digit falls in 2009. These three countries belong to the group that is hardest hit by the crisis.

1 For example, a news item that reported on "Latvia's crisis" causing unrest in Europe. *Nihon Keizai Shimbun*, June 10, 2009.

Although there are certain influences from the global financial crisis, the depression is milder in the Czech Republic and Poland compared with the Baltic states. In the other countries the magnitude of the impact is in the mid-level range.

Table 1. Extent of the Growth Reversal

	Change in quarterly GDP growth rates, 1Q2009 compared to 2Q2008, percentage points	GDP growth rates real change in % against preceding year		
		2008 2Q	2009 1Q	2009 Forecast
Lithuania	-18.8	5.2	-13.6	-16
Latvia	-16.1	-1.9	-18.0	-20
Romania	-15.5	9.3	-6.2	-6
Estonia	-14.0	-1.1	-15.1	-16
Slovenia	-14.0	5.5	-8.5	-4
Slovakia	-13.5	7.9	-5.6	-5
Bulgaria	-10.6	7.1	-3.5	-3
Hungary	-8.8	2.1	-6.7	-6.5
Czech Republic	-8.2	4.9	-3.3	-1.5
Poland	-5.1	5.9	0.8	0.8

Source: Richter, et al (2009), p.3.

Table 2. Changes in the Unemployment Rate

									Forecast		
	1991	1995	2000	2004	2005	2006	2007	2008	2009	2010	2011
Czech Republic	4.1	4.0	8.8	8.3	7.9	7.1	5.3	4.4	7	7	6.5
Hungary	7.4	10.3	6.4	6.1	7.2	7.5	7.4	7.8	10.5	11	10
Poland	11.8	13.3	16.1	19.0	17.8	13.8	9.6	7.1	9	10	9
Slovakia	n.a.	13.1	18.6	18.1	16.2	13.4	11.1	9.5	13	14	14
Slovenia	8.2	7.4	7.0	6.3	6.6	6.0	4.8	4.4	7	7.5	7
Bulgaria	11.1	16.5	16.9	12.0	10.1	9.0	6.9	5.6	9	9	8
Romania	3.0	n.a.	6.9	8.0	7.2	7.3	6.4	5.8	9	9	8
Estonia	n.a.	9.7	13.6	9.6	7.9	5.9	4.7	5.5	15	18	18
Latvia	n.a.	18.9	14.5	10.4	8.7	6.8	6.0	7.5	18	22	20
Lithuania	0.3	17.5	16.4	11.4	8.3	5.6	4.3	5.8	15	19	18

Source: Richter, et al. (2009), p.19; *wiiw Handbook of Statistics 2007*, p.19; For 1991, EBRD (1998), *Transition Report 1998*.

A point which surprises many outside observers when looking at statistics on loans in Central and Eastern Europe is the fact that households and companies have had a very high share of total loans in foreign currency (Table 3). The share of total loans that is denominated in foreign currency has been very high in the Baltic States, especially in Latvia and Estonia, where it ranged from the 80% mark to nearly 90%, and in Latvia where it exceeded 90% in 2009. In Lithuania, Hungary, and Romania foreign currency loans account for about two-thirds of total loans. In Bulgaria the foreign currency share has been fluctuating around the 50% mark. In Poland it increased from a quarter to one-third of total loans during the period April 2008 through April 2009. It is noteworthy that in three countries, the Czech Republic, Slovakia, and Slovenia, it has been very low[2].

Table 3. Share of Loans in Foreign Currency in% of Total Loans, End of period

	2008									2009			
	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Czech Re.	12.9	13	12.4	12.6	13.1	13.1	13.2	13.6	14.1	14.4	14.4	13.8	13.4
Hungary	53.8	56.6	56.3	55.7	56.9	58.7	63.7	63	64.6	67.3	67.4	68.2	66.3
Poland	24.3	24.1	24.6	24.2	25.8	27	30.1	30	33.1	34.8	35.8	35.5	33.9
Slovakia 1)			17.7			17.3			17.6			3.9	
Slovenia 2)	6.8	6.6	6.5	6.4	6.6	6.7	7	6.8	6.7	6.6	6.4	6.1	6
Bulgaria	52.7	53.3	54.2	54.7	55.8	55.7	56.3	56.6	57.1	57.4	57.7	57.6	57.7
Romania	62.4	62.5	62.8	62.7	63	63.4	63.5	63.6	63.9	64.2	64.1	64.1	63.9
Estonia	82.5	82.9	83.6	84.3	84.6	84.7	84.9	85.1	85.3	85.7	86	86.4	86.7
Latvia	85.8	83.9	87.7	89.8	88.2	87.4	88.9	88.6	89.8	91.6	91.9	92.1	91
Lithuania	61.2	61.7	62.3	62.3	62.7	62.8	62.8	63.4	64	64.9	65.7	66.2	66.9

Note: 1) From 2008 non-euro currencies only; 2) Non-euro currencies only.

Source: Richter, et al (2009), p.11.

Among countries relying on foreign capital, the Czech Republic has not suffered such serious damage. In this country the share of total loans denominated in foreign currency is low. The exposure of the Czech banks to sub-prime securities is negligible. Despite quite vigorous GDP growth the domestic credit expansion has been rather sluggish when compared with other NMS. The deposit/loans ratio exceeds 1 by a large margin and the net external position of Czech banks is positive (unique among the NMS). Moreover, unlike the situation in other NMS,

2 In contrast to those countries, short-term foreign debt as a percentage of foreign reserves has been very high in the Baltic States. In Latvia this share was 277.8% in Q1 2007, and it increased to 302.7% in Q4 2007, and then decreased, but was still as high as 250.7% in Q1 2009. Similarly in Estonia this share has been high, fluctuating around 250%. In Lithuania this share is lower, fluctuating between 100% and 150% (Richter, et al, 2009, p. 23).

loans denominated in foreign currencies were not attractive since Czech interest rates have tended to be lower than foreign interest rates (Richter, et al. 2009, p.13).

Among the NMS of Central and Eastern Europe, only Poland managed to maintain positive GDP growth in 2009 . One of the reasons is that a depreciation of domestic currency enhanced competitiveness and absorbed the shock to a certain extent. This point is shared with some other NMS.

Table 4. Exchange Rate Regime and Prospect for Introduction of Euro

Country	Exchange Rate Regime	Target Date for Introduction of Euro
Estonia	Currency Board	Currently ERMII. 2011
Latvia	Pegged to Euro	Currently ERMII. Changed from 2008 to 2013.
Lithuania	Pegged to Euro	Currently ERMII. Unfixed.
Slovenia	Euro (since January 1, 2007)	
Slovakia	Euro (since January 1, 2009)	
Poland	Floating Exchange Rate	2013, but will be prolonged.
Hungary	Floating Exchange Rate	After 2012
Czech Re.	Floating Exchange Rate	Changed from 2010 to 2012.
Bulgaria	Currency Board	Unfixed.
Romania	Floating Exchange Rate	Plans to join ERM II in 2012, Euro in 2014.

Source: Drawn by the author, based on information from *CEE Quarterly* and newspapers.

The general picture of the economic crisis can be summarized as follows: first, countries with fixed exchange rates (countries adopting the Euro, or with a national currency pegged to the Euro or currency board regime) could not mitigate the shock through depreciation of their national currency, and suffered severely. Among them, however, countries with fiscal room (Bulgaria and Slovenia) were able to increase their budget expenditure to stimulate their domestic demand, and therefore were able to somewhat mitigate the shock.

Second, in countries with floating exchange rates, and where the share denominated in foreign currency of total loans was relatively small (the Czech Republic and Poland), the shock was also relatively small. In addition, the Czech Republic was able to adopt anti-cyclical policies by increasing budget expenditure. In contrast, however, countries where the share denominated in foreign currency of total loans was higher (Romania and Hungary), the shock was relatively large.

Third, one country with a floating exchange rate, a higher share of total loans denominated in foreign currency, and in addition a higher share of public debt compared with GDP (Hungary) was not able to afford to undertake deficit spending, and in consequence its economic policies have become pro-cyclical, resulting in a more serious situation.

Fourth, since the Baltic States have had not only fixed exchange rates (currency board regime in Estonia and Lithuania, and Euro-peg in Latvia), but also a huge current account deficit, relatively large external debts, a very high share of loans denominated in foreign currency in the total debt, etc. their economies have been very vulnerable to external shocks.

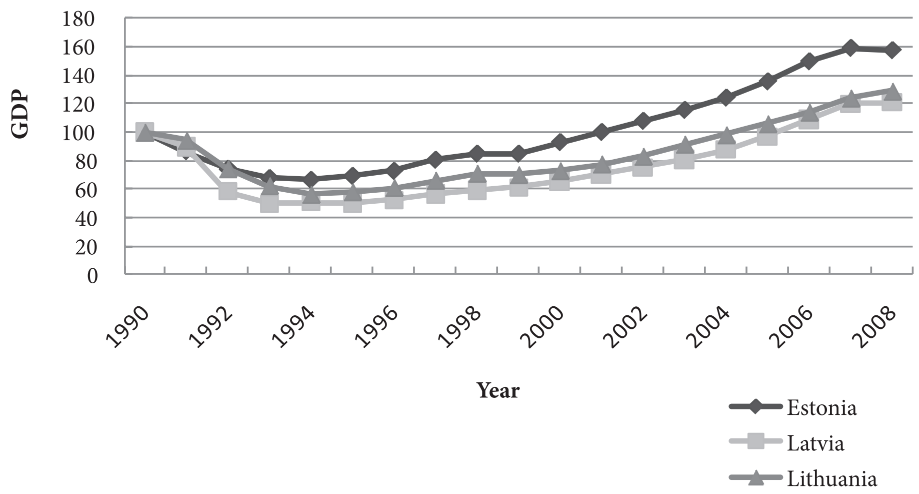
3. GENERAL VIEW OF THE BALTIC STATES

The Baltic States are all small countries, with the population of Estonia, Latvia and Lithuania being 1.35 million, 2.3 million, and 3.4 million respectively. These three states were forcibly incorporated into the Soviet Union in 1940. They shared their destiny with the Soviet Union for almost half a century, but they gained independence in September 1991. In 2003 the rural population in these countries ranged between 31% and 33%. Since the 19th century the Baltic States have been agricultural countries. Full-fledged industrialization began after incorporation into the Soviet Union. The impact on the Baltic States of the collapse of the Soviet Union and their secession from the COMECON block was enormous (Yoshino, 2004, pp.30-31). In the transition to a market economy all of them experienced 'transformational recession'.

In the meantime they became beneficiaries of the PHARE programme in September 1991. In June 1995 they concluded the European Agreement with the European Union, and in December of the same year together they made applications for full membership of the EU. Finally in May 2004 they accomplished their long-cherished desire, i.e. full membership of the EU. Thanks to this the Baltic States joined the single market in the EU, enabling them to enjoy four freedoms: free movement of goods, free movement of services, free movement of capital, and free movement of labour. The extensive economic area of the EU in fact consists of five regional groupings, like the five-ring Olympic emblem, in which relatively independent activities based on the specific characteristics of the regions are allowed. Among them a 'microcosm of Europe', the 'Baltic Sea economic area', has formed, with Sweden playing an outstanding role.

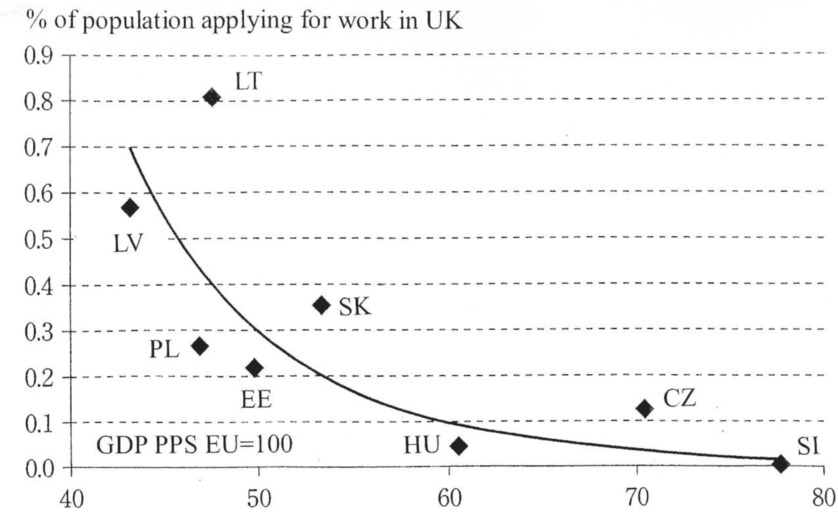
The economies of the Baltic States turned upward around 1995. Although their economies stagnated in 1999 under the influence of the Russian financial crisis of August 1998 (GDP growth rates declined in Latvia, Estonia, and Lithuania to 3.3%, -0.1% and -1.5% respectively), from 2000 they began to have high economic growth (see Figure 1). Latvia in particular accomplished double-digit economic growth for three consecutive years from 2005 and Estonia for two consecutive years from 2005. Such high economic growth can be partly ascribed to their active measures to attract foreign capital (reduction in corporate income tax, etc.). The amount of FDI inflow was already very large before their accession to the EU. Although it decreased at the turn of the 21st century it increased again around 2004 when the Baltic States were admitted to the EU. In Estonia the amount of FDI inflow as a percentage of GDP reached as high as 20.5% and it recorded double-digits until 2007. Both Latvia and Lithuania attracted a huge amount of FDI, although the amount was not as much as in Estonia.

Figure 1. Changes in GDP in the Baltic States



During this period the unemployment rate rapidly decreased in these countries. In 2001 the percentage of unemployed was in the double-digits : 12.9% in Latvia, 11.9% in Estonia and 17.4% in Lithuania, but from this date the unemployment rate gradually decreased. After EU accession in 2004 the higher wage levels in the EU-15 resulted in labour migration from the Baltic States, particularly to the UK (Figure 2), and the unemployment rate decreased more rapidly, to around 5% in 2007. In parallel with this process domestic labour markets became tight, and consequently gross wages began to surge around 2004. The inflation rate was gradually increasing and in 2007 it rose suddenly to critical levels (14.1% in Latvia, 9.6% in Estonia, and 8.1% in Lithuania). Around 2005 the economies of the Baltic States began to overheat. Imports increased, reflecting domestic consumption booms. Although there had been significant amounts of transfer from overseas, the countries' current account deficits expanded, reaching unsustainable levels (current account deficit as a percentage of GDP in Latvia, Estonia, and Lithuania was -22.8%, -17.4% and -13.7% respectively).

Figure 2. Job Applications in UK by People from EU-8 Countries



Source: World Bank (2005), p.11.

4. ECONOMIC SITUATION IN LATVIA

The Latvian industrial structure can be outlined as follows: about 5% of the GDP is produced by agriculture, forestry, and fishery and about 25% by manufacturing. The main items of export are products of so-called low technology and middle - high technology, including wood products such as timber and furniture and cast iron and steel (see Table 5). Nearly 70% of the GDP comes from the service sector, which includes the wholesale and retail trade, transport, shipping, storage, real estate, and information technology, etc. (Docalavich, 2006, pp.32-33).

Since the mid-1990s Latvia has made remarkable strides and accomplished rapid convergence in income, with its income per capita at purchasing power parity increasing by 16 percentage points compared to the average of EU15. It was among the fastest growing of the eight NMS in Central and Eastern Europe (IMF, 2006b). Seemingly for several years in the mid-2000s both government and people in Latvia indulged themselves in EU-Phoria[3]. The economy continued to grow at a double-digit rate for three consecutive years from 2005. Apparently the country was doing well, but around 2005 the economy began to show signs of overheating as illustrated by increasing inflation, rising wages, and a widening current account deficit. In an interview in May 2009 a staff-member of the IMF said, "As far back as 2005, we warned publicly that this economy was in danger of overheating"[4] (IMF, 2009b). In a similar way *Emerging Europe Monitor,* published by Business Monitor International, and *CEE Quarterly,* published by Unicredit group, often pointed out in 2007 the necessity for soft landing to moderate economic growth.

Table 5. Ten Most Important Product Groups in Merchandise Exports to the EU-27 in 2008, SITC Classification (Ranking and Share in Exports)

	Latvia		Estonia		Lithuania	
	Product label		Product label		Product label	
1	Cork & wood	12.3	Electrical machinery	8.4	Petroleum & petro.prod.	26.4
2	Iron and steel	10.3	Road vehicles	6.6	Fertilizers	6.3
3	Cork & wood manu.	7.0	Telecom.apparatus	6.5	Furniture & parts	4.9
4	Road vehicles	6.5	Manufactures of metal	5.6	Plastics in primary forms	4.3
5	Telecom.apparatus	3.7	Cork and wood	5.2	Apparel & clothing	3.8
6	Apparel & clothing	3.6	Furniture & parts	4.9	Miscellan.manu.articles	3.4
7	Manufactures of metal	3.5	Miscellan.manu.articles	4.9	Road vehicles	3.4
8	Miscellan.manu.articles.	3.0	Petroleum & petro.prod.	4.6	Diary products	2.5
9	Cereals	3.0	Cork & wood manu.	4.3	Electrical machinery	2.5
10	Metal.ores & scrap	2.8	Iron & steel	3.6	Manufactures of metal	2.3

Source: Gligorov, Vladimir, Josef Poeschl, Sandor Richter, et al. (2009), pp. 146-147.

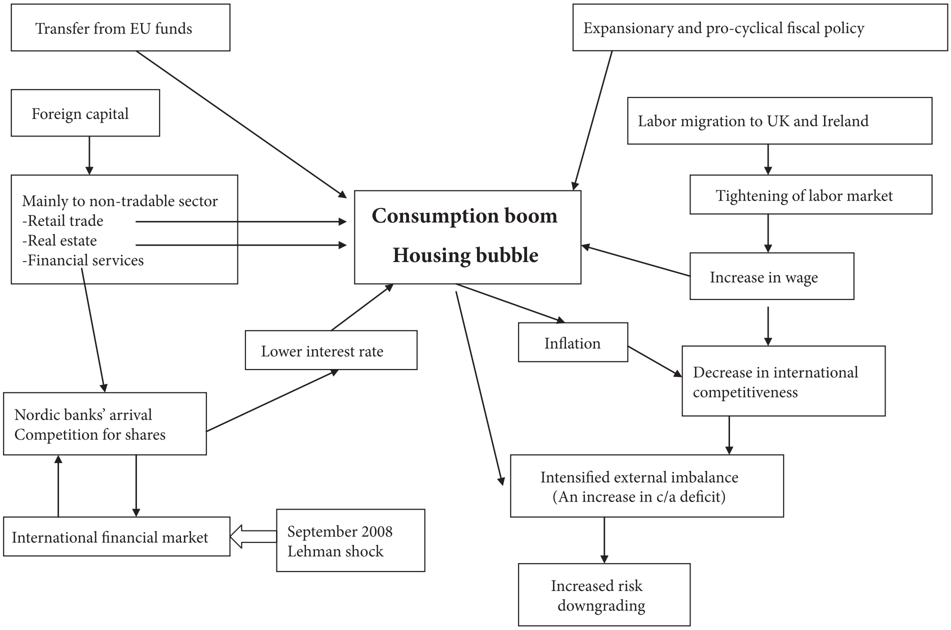
The mechanism of the overheating of the Latvian economy (Figure 3) can be explained as follows: foreign capital, which had flowed into the Latvian economy since the mid-1990s, greatly contributed to economic development. Inward FDI stock amounted to €7.261 billion as of 2007. As for investor countries, investment from Estonia, a neighbouring country in the Baltics, had rapidly increased in recent years. In terms of inward FDI stock Estonia exceeded Sweden in 2006, occupying first place. In 2007 Estonia occupied first place with its stock being

3 This expression is taken from the title of Rahman (2008).

4 Finish economist Jari Jumpponen (2005) pointed out signs of overheating in the Latvian economy in early 2005. p.50.

€1,044.8 million (14.5%), followed by Sweden (13.9%), Denmark (8.9%), Germany (8.9%), Finland (6.2%), the Netherlands (5.8%), USA (4.8%) and Russia (4.7%). It appears a little strange that the UK, which is the second largest importer to Latvia, is in 12th place (3.1%) in inward FDI stock. Possibly UK companies were investing in Latvia via their subsidiaries in Estonia.

Figure 3. Overheating of the Latvian Economy, 2004-2007



Source: Extrapolated by the author based on information from a variety of sources (*Emerging Europe Monitor*, *CEE Quarterly*, IMF, etc.)

The largest share of FDI has been in financial intermediation, (28.3%), followed by real estate, renting & business activities (18.3%), other activities not elsewhere classified (13.1%), wholesale, retail trade, repair of vehicles, etc. (12.4%), manufacturing (8.8%), transport, storage and communication (7.9%), and electricity, gas and water supply (5.3%). It can be seen that the manufacturing share is very small (Hunya, 2008, pp.85-87). In recent years FDI inflow has concentrated mainly in the non-tradable sector such as the retail trade, real estate, and financial services.

After EU accession the unemployed, low-skilled workers, and construction workers migrated to EU member countries, mainly the UK and Ireland, on a massive scale. (It is officially estimated at 5% of the total labour force). For two years until early 2006 the unemployment rate decreased by 2.5% to 7.75%, and the labour market became tight. As a result, combined with *de facto* wage indexation, nominal incomes increased in an accelerative way for two years and recorded an increase of more than 19% y-o-y in Q1 2006 (IMF, 2006a, pp. 9-11). This increase substantially surpassed the growth in productivity.

Table 6. Latvia - Main Economic Indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009*
GDP (y-o-y % -growth, const. prices)	8	6.5	7.2	8.5	10.6	12.2	10.3	-10.3	-19.6
Industrial production (y-o-y-growth)	6.9	5.8	6.5	6	5.6	4.8	0.5	-6.7	-18.5
Inflation (CPI, end period)	3.2	1.4	3.6	7.3	7	6.8	14.1	15.4	2.5
Gen.gov. budget balance (% of GDP)	-2.1	-2.3	-1.6	-1	-0.4	-0.2	0	-4	n.a.
Gross wage (period average, EUR)	282	297	298	314	350	430	683	678	670
Unemployment (% end of period)	12.9	11.6	10.3	10.3	8.7	6.8	5.4	9.9	16.7
Exports (€ million, current prices)	2232	2416	2559	3204	4085	4594	5727	6202	2327
Imports (€ million, current prices)	3910	4284	4634	5671	6879	8828	10986	10534	3241
Export/Import ratio	57.1	56.4	55.2	56.5	59.4	52	52.1	58.9	68.5
FDI inflow (€ million, current prices)	n.a.	223	248	489	568	1324	1797	909	50
FDI inflow as % of GDP **	n.a.	n.a.	n.a.	4.4	4.4	8.3	7.8	4	n.a.
Current account (% of GDP)	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-22.8	-12.6	1.1

* As for 2009, for GDP and unemployment data as of Q2, for gross wage and current account data as of Q1, for exports and imports data as of January - June, for FDI inflow data as of January - March, for industrial production data as of June, for inflation

Source: *Baltic Rim Economies*, No.4, 2009,p. 2.

Owing to the liberalization of financial services, banks from the Nordic region, Sweden in particular, came to operate in Latvia and competed for market shares. As mentioned above, the amount of FDI inflow was relatively large, but it was substantially surpassed by the current account deficit every year (Table 6). How was the gap covered? The table of international payment (Bank of Latvia, 2009) indicates that the amount of portfolio investment inflow was small (it often recorded negatives and consistently recorded negatives from Q4 2008 through Q4 2009). As a matter of fact 'other investment' (overwhelmingly borrowing by foreign-owned banks from parent banks) in the financial account exceeded the amount of FDI inflow and covered most of the current account deficit every year until the end of 2007 (Banincova, 2009). However in recent years major European banks increasingly finance themselves on wholesale markets and depend to a lesser extent on deposits by general customers (Hoshino, 2009). Swedish banks obtained Euros in exchange for Swedish Krona on the international financial market (for example, in London) and gave customers in Latvia (through subsidiaries in Latvia) loans denominated in Euros[5]. Thus households and enterprises in Latvia were able to enjoy lower interest rates. Credit to private sector residents increased by nearly 65% in 2005, and the loan to GDP ratio reached 70%, which was three times higher than the level in 2000, the highest among the EU8. Collateral loans to households increasingly became Euro nominated (IMF, 2006a, p. 11). The real estate sector came to occupy nearly half of all total loans[6]. Economists at UniCredit group described the Latvians' behaviour as a 'spree of high consumption' (*CEE Quarterly*, 03/2007). The IMF mission that visited Latvia in April 2007 warned the government that the mindset of 'buy now and pay later' had taken root, increasing systemic risk.

The fiscal policy was expansionary. In addition there was an inflow of EU grants amounting to 3-4% of the GDP every year. Programmes such as the Common Agricultural Policy (CAP) provided households with direct income support. EU money from Structural Funds and Cohesion Funds flowed into Latvia through public infrastructure projects and employment policies. Private companies were able to use EU funds to upgrade equipment (Allard, 2008). At the same time the fiscal policy was pro-cyclical. The budget revenue recorded natural increases due to a boom at that time, and it became the normal pattern that money resulting from over-performance of the budget was not saved, but instead was consumed through additional expenditures on a supplementary budget towards the end of the year. At the Article IV Consultation[7] with the government of Latvia in 2006 IMF staff advised avoiding a pro-cyclical fiscal policy. Finance ministry officials were mindful of the advisability of avoiding the pro-cyclical fiscal policy, but they said that it would be infeasible to leave a budget surplus that year, in view of pre-election spending measures and large public sector wage increases. Rather, taking into consideration the over-performance of the budget revenue, the government was planning a phased 10 percentage point reduction in the personal income tax rate to 15% beginning in 2007, in order to bring it into line with the corporate

5 Christoph Roseberg, Senior IMF Regional Representative for Central Europe and the Baltics, says "Banks refinance themselves abroad and then pass on the currency risk to their clients", Rosenberg (2008).

6 According to IMF country report, banks in Latvia offer mortgage loans very easily, and "some banks are actually offering mortgages with LTV (loan to value) ratios above 100%". IMF (2006c), Chapter III, Box 1.

7 The IMF consults with governments of its member states once a year on the basis of Article IV of the Agreement.

income tax rate and to encourage legalization of the shadow economy. However, responding to criticism by IMF staff, this plan was not implemented (IMF, 2006a pp.13-14 and p.23).

The growth rate was as high as 12.2% in 2006. Economists at the UniCredit Group viewed it as consumption-led economic growth[8], saying “On the demand side, overheating domestic demand, in particular private consumption and capital formation, remained the main engine of growth, while on the supply side, sectors serving consumption needs, i.e. trade, finance, commercial services, hotels and restaurants, and construction were the ones to fuel growth. The manufacturing industry, however, grew at a below average rate. At the same time, external imbalances became more pronounced, with imports growing twice as fast as exports (*CEE Quarterly*, 01/2007).

The inflation rate increased, reflecting the consumption boom and housing bubble. It fluctuated between 1.4% and 3.6% until 2003 but jumped to 7.3% in 2004 and recorded 7.0% and 6.8% in 2005 and 2006 respectively. In November 2006 the central bank raised the refinancing rate by 50 bps to 5%, which was still lower than the inflation rate – which meant the interest rate was practically negative – and proved quite insufficient to dampen the overheating economy (*CEE Quarterly*, 01/2007). Since its EU accession in 2004 Latvia’s goal had been to adopt the Euro in 2008 and so it was difficult for it to have an interest rate quite different from that of the European Central Bank. In addition when Latvians could easily get loans in foreign currency it was no use for banks to increase the borrowing rate in Lats[9]. In 2006 Latvia satisfied all the criteria of Maastricht except the inflation criterion, and the country had to give up its plan to adopt the Euro in 2008.

Increasing wages that surpassed productivity and inflation gradually eroded Latvia’s export competitiveness. Every year the country recorded a huge amount of trade deficit that was partly covered by FDI inflow, but it had still a large current account deficit. In 2005 the current account deficit accounted for 12.7% of the GDP, which was already an alarming amount, and it rapidly increased to 21.2% of GDP in 2006. At the Article IV Consultation in Autumn 2006 the IMF mission expressed the view that measures were urgently needed to moderate domestic demand in order to decrease imbalances, preserve external competitiveness, bring forward compliance with the Maastricht criteria, and limit vulnerabilities ahead

8 The IMF staff made a similar remark. IMF (2006b), Public Information Notice, No.113.
9 National currency of Latvia: Latvian Lat (LVL); 1 Euro=0.71197 Latvian Lats on Nov. 9, 2010.

of Euro adoption. However the government officials did not share the perception that the economy was overheated and were more sanguine in their assessment of economic developments; accordingly they were not planning significant changes in fiscal or other policies. Rather Finance Ministry officials welcomed Latvia's dynamic growth as essential for delivering income catch-up within a reasonable time horizon. They attributed the rise in inflation mainly to convergence in wage and price levels, rather than to overheating. On the other hand the central bank officials were less sanguine, and saw overheating as a concern that was unlikely to subside in the near future (IMF, 2006a, pp. 14-16).

5. SWITCHOVER TO RESTRAINED POLICIES

Even if the government was sanguine, foreign observers were very much concerned with about the Latvian economy. As the government produced a current account deficit with an external debt that exceeded 100 % of the GDP in spite of the receding prospect of introducing the Euro, the grading company S&P degraded Latvia from stable to negative in February 2007. From the end of February through early March of the same year the Lat came under pressure of depreciation on the foreign exchange market and the central bank was forced to intervene in the market for the first time in several years (*EEM*, May 2007). The government of Latvia finally switched its policy to manage aggregate demand more actively and launched a package of measures geared to delivering a durable reduction in inflation, as follows: i) The government promised to balance the budget in 2007-2008 by restraining spending growth; ii) Capital gains tax would be levied on real estate held for less than three years and state tax on registration of mortgages would be hiked; iii) Loans would be assessed on the basis of the legally declared income of prospective borrowers; iv) A maximum loan to value ratio would be established. At the same time the central bank hiked the key refinancing rate from 5.0 percent% to 5.5 percent% and reiterated its commitment to the current exchange rate regime (*EEM*, May 2007). In April of the same year the inflation rate increased to 8.9 %. The central bank hiked interest rates by 50bps to 6 % in May to support disinflationary measures. Accordingly interest rates on mortgage loans in Euros and Lats have risen by about 100bps since 2005 to 5.7 percent% and 7 percent% respectively (*EEM*, July, 2007).

The package of measures had no immediate impact on the economy, and the consumption-led boom continued through Q3 of 2007. As the anti-inflation measures proposed by the government required time for discussion in the Parliament that they were approved and translated into action in July. Real GDP increased by a faster-than-expected 11.3% y-o-y in Q2 2007 (slightly up from 11.2% in Q1). Manufacturing output declined by 0.2% from 2.4% in Q1 to 2.2% in Q2 owing to downturns in the wood processing, furniture, radio, television, and communication equipment sectors (*EEM*, October 2007). Real GDP increased to a still high 11.9% y-o-y, although at a somewhat slower pace in Q3 2007.

The government measures introduced in July began to have an effect in the autumn. Property prices started to decline and by October were around 12% lower than at the start of 2007. The number of housing sales in the secondary market also started to fall, adding to the negative wealth effect (*EEM*, January 2008). The BNP Pariba shock, which happened in August 2007, increased financing costs on interbank markets, making credit activities more cautious (Tanaka, 2009). Among 'other investments' in the Latvian balance of payments, the borrowing of funds by subsidiaries from parent banks had showed positive to date, but turned negative in Q1 2008, which meant a backward flow of funds. Parent banks withdrew funds from their subsidiaries (although this item recorded positive in Q2 and Q3 2008, it recorded negatives for the consecutive five quarters from Q4 2008 through Q4 2009 (Bank of Latvia, 2009)). Thus both companies and households experienced a money shortage. Real GDP growth eased to 9.6% y-o-y in Q4 2007 and the overheated economy began to lose its momentum. Retail sales growth dropped to a six-year low of 1.7% y-o-y in December, and industrial production contracted for the third consecutive month (*EEM*, April 2008).

The Latvian economy made a hard landing. The Latvian housing market bubble burst. The number of transactions in the property market dropped by almost 18% in 2007, with prices for apartments in the capital city Riga falling by a similar amount, after having peaked in April at over €1,700 (*CEE Quarterly*, 02/2008). In Riga apartment prices fell by around 25% during the year to June 2008 (*CEE Quarterly*, 03/2008). In turn the slowdown of the real estate sector negatively influenced consumption via a wealth effect and investment.

Consumers had become more cautious in the face of the rising debt burden (household debt rose from 9% of the GDP to approximately 55% at the end of 2007) and increased uncertainty about the outlook for jobs and income, while persistently high inflation (17.5% in April 2008) started to damage household purchasing power. Inflation-adjusted retail trade turnover fell by 1.1% y-o-y in Q1 2008, while the number of newly registered cars was down 49% y-o-y in March 2008. Negative wealth effects associated with the steady decline in property prices dampened private consumption by 7% y-o-y in Q4 2007. The construction industry also slowed down (*EEM*, July 2008). The economic growth rate rapidly decelerated from 12.2% in 2006 to 10.3% in 2007 and -1.9% in Q2 2008. In contrast the inflation rate increased to 15.5% on average in 2008. It was stagflation.

The Latvian economy fell into depression in December 2007. The Lehman shock in September 2008 dealt the Latvian economy its final blow. In October of the same year Parex Bank[10], the second largest bank in Latvia, was exposed to a sudden outflow of non-resident deposits and faced serious liquidity constraints. In the top ten banks in Latvia there are four domestic banks with a total market share of 29.5% (Table 7). The remaining share (70.5%) is occupied by six subsidiaries of foreign banks, of which three are Swedish banks. By contrast in Estonia and Lithuania subsidiaries of foreign banks are overwhelmingly in the majority: in 2007 their share was 98.7% and 85.3% respectively (Banincova, 2009). Thanks to this both Estonia and Lithuania were able to find their way out of the financial crisis. In Latvia, however, Parex Bank was an indigenous bank, which rapidly grew by collecting deposits from non-residents (people in Russia and CIS) and had no parent bank behind it, and therefore could not find a way out of the financial crisis. In early November the government nationalized this bank in order to prevent bankruptcy.

The nationalization of Parex Bank aggravated the Latvian economic situation. A huge number of deposits were removed from other Latvian banks and placed in Estonian banks because they were perceived to be the safest due to their well-capitalized Scandinavian parent banks. Meanwhile the central bank of Latvia had to intervene in the foreign exchange market to defend the fixed exchanged rate, resulting in a significant decrease in its official reserves (Banincova, 2009). In mid-December the central banks of Sweden and Denmark hurried to rescue Latvia and concluded swap agreements with the central bank of Latvia. These arrangements enabled the central bank of Latvia to use a maximum €500 million (of which €375 million came from Sweden) in exchange for Lats. These arrangements served as bridging loans until the IMF programme for Latvia was finalized. Soon the rescue package for Latvia was decided as follows: the IMF provided Latvia with about €1.7 billion ($2.4 billion), supplemented with loans from the EU, the World Bank, and Nordic and Central European countries. Specifically, the EU provided €3.1 billion ($4.3 billion), Nordic countries €1.8 billion ($2.5 billion), the World Bank €0.4 billion ($0.5576 billion), the Czech Republic €0.2 billion

10 According to Professor Sonoko Shima, Parex Bank was founded about 15 years ago by a Latvian of Russian descent, who started his business from an exchange house after the transition to the market economy. She presented this information at the annual conference of the Japan Association of Russian and East European Studies, held on November 17, 2009 at Akita University.

($0.2788 billion), and EBRD, Estonia and Poland €0.1 billion ($0.1394 billion) each (according to IMF, Press Release No.08/332, December 19, 2008). The total amount was €7.5 billion ($10.5 billion), equivalent to a third of the Latvian GDP in 2008. The credit was to be released in several tranches from the end of 2008 until mid-2011. About half of the money was envisaged for covering the budget deficits, a third for financing the government debt, and the rest for further bank recapitalization and loans to enterprises (Leitner, 2009, p.59).

Table 7. Top Ten Banks in Latvia

Banks	Market share	Parent banks
Hansabanka	21.70%	Swedbank (Sweden)
Parex banka	14.60%	A private bank, taken over by the government on November 8, 2008. On December 5, 2008 State Collateral and Land Bank of Latvia became a majority owner. On February 24, 2009 shares owned by the government were transferred to the Privatization Agency.
SEB Unibanka	14.10%	SEB (Sweden)
DnB Nord	8.30%	DnB Nord: Joint Venture of DnB (Norway) and Nord/LB (Germany)
Nordea	7.90%	Nordea Group (Sweden)
Rietumu banka	5.60%	Majority private capital
Aizkraukies banka	5.10%	Private local capital
Latvijas Hipoteku un zemes banka	4.20%	State
UniCredit	3.40%	UniCredit Group (Italy)
Latvijas Krajbanka	3.10%	Snoras (Lithuania)

Source: CEE Banking – Still the right bet, UniCredit Group, July 2008.

With this external help the financial market in Latvia managed to hold on, but Latvia was regarded as a highly risky country and had difficulty in getting loans from the international credit market. Citizens' complaints against the government increased, leading to riots in the streets of Riga in mid-January 2009, the first riots of this kind since Latvia's independence in 1991. In February the coalition government led by Prime Minister Ivars Godmanis dissolved, and in March a five-party coalition government led by Valdis Dombrovskis[11]was formed.

11 Mr. Dombrovskis was 36 years old when he was inaugurated Prime Minister. He is an economist with experience of working at the central bank of Latvia and has served as a member of the European Parliament. He formed a coalition government comprising the center-right New Era – his own party - , Civic Union, For the Fatherland and Freedom/ LNNK, the People's Party and the Union of Greens and Farmers (*EEM*, May 2009).

It should be noted that the rescue package from the EU and IMF was accompanied by strict conditions. The government of Latvia had to make a promise to cut its expenditure and reduce the budget deficit to 5% of the GDP. By April 2009 however it was proved that the fall in government revenues was more dramatic than expected. The Minister of Finance announced that the budget deficit was expected to amount to at least 9% of the GDP in 2009, even when taking into account the planned additional, drastic expenditure cuts (Leitner, 2009, p.60). The attitude of the EU and the IMF to the tight fiscal policy was very strict. They refused to release the second tranche of the rescue package, worth about €1.7 billion (when adding the contributions of the Nordic neighbours), which was planned for the end of May[12].

By the end of May the Bank of Latvia's forex reserves had dropped by almost 40% y-o-y and were dwindling day by day. In the first week of June the sovereign default of Latvia loomed when the authorities failed to sell any Treasury Bills in a public debt auction. In the following week the development of the overnight Rigibor - the interest rate of Riga's interbank market - escalating to more than 20% showed that interbank lending was drying up, and in forward markets the Latvian Lat was traded for 50% of its nominal value (Leitner, 2009, p.60).

At that time there was whispering about the possibility of devaluation of the Latvian national currency both outside and inside (even within the government) of Latvia. On the one hand the devaluation of the national currency would enhance the international competitiveness of Latvia's export products, but on the other it would bring a sudden rise in debt service obligation denominated in national currency for both companies and households.

In the end the government of Latvia abandoned the nominal depreciation and chose 'internal depreciation' (adjustment of the real economy), a way of decreasing domestic prices, primarily through cuts in wages and pensions etc., and enhancing competitiveness of exports. The government opted for further austerity amendments to the 2009 budget, fixing a cut in government expenditures by 40% compared to 2008 in nominal terms. The public wage bill was to be reduced by another 20% nominally, pensions by 10% for non-working pensioners, and for those working by 70%. Expenses for health and education

12 According to the IMF Survey Magazine, the EU's Economic and Monetary Affairs Commissioner Joaquin Almunia said on May 6 that the EU would like to see more progress on budget and structural reforms before it released the second tranche of its aid programme, worth about € 1 billion (IMF, 2009b).

were to be cut severely, and it was announced that two-thirds of the nation's 73 inpatient hospitals and dozens of schools were to be closed.

The non-taxable minimum for personal income tax was reduced by 60% and child benefits by 10%. Even Dominique Strauss-Kahn, Managing Director of the IMF, identified this as disputable due to the impact on the country's poor (Leitner, 2009, p. 60). The *EEM* voiced fears that an internal devaluation would lead to a painful debt-deflationary spiral, which would prove disastrous for social stability *(EEM*, August 2009).

Towards the end of July 2009 the IMF and the government of Latvia reached a staff-level agreement that would lead to the completion of the first review under the Stand-By Agreement. It was decided that Latvia would be given access to about €195 million ($278.3 million) in new financing after the staff-level agreement, which was endorsed by the IMF's Management, if it gained approval by the Executive Board in early September. The point that the IMF staff stressed was that across-the-board cuts provide a "quick fix" in the short term, but they disproportionately hurt the poor and also have a negative influence in the longer run on the quality of government services. The IMF staff recommended a comprehensive strategy to improve the social safety net which included guaranteed minimum income payments covering health co-payments for the most vulnerable, increasing funds for emergency housing support, protecting schooling for six-year-olds, and promoting job creation through active labour market policies. In addition the staff recommended improvements in tax administration and broadening of real estate and personal income tax, i.e. adopting progressive tax rates instead of a flat tax which had been adopted in 1997 (IMF Survey Magazine: Interview, July 28, 2009).

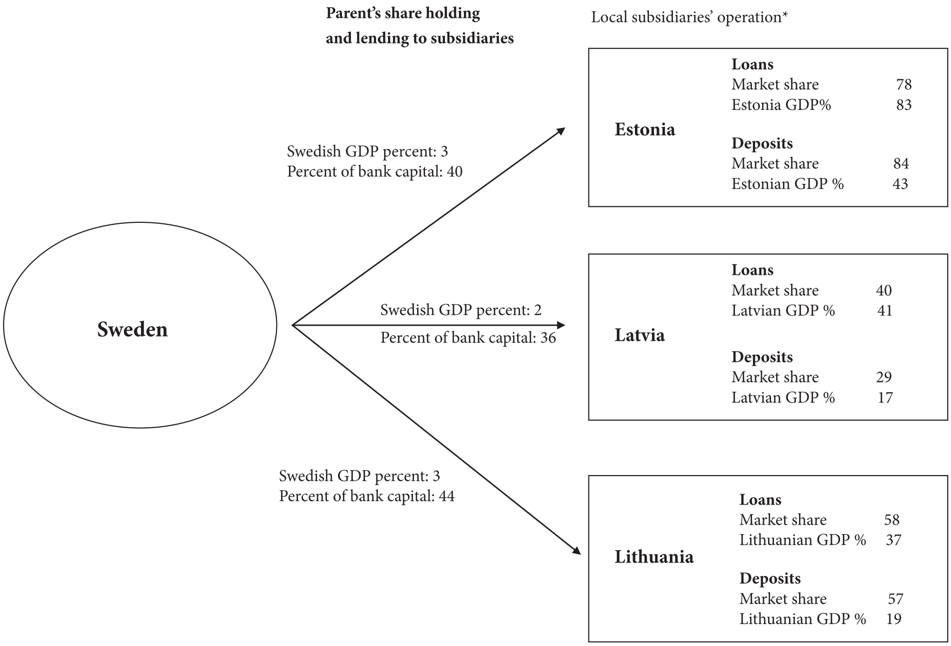
Of course such consideration for the most vulnerable people is necessary, but the conditions imposed by the EU and the IMF in return for financial support prevent the government of Latvia from adopting more active fiscal policies to boost the economy In spite of relentless cuts in expenditure and the increases in tax rates mentioned above, the budget deficit was expected to expand to 10% of the GDP in 2009 and 8.5% in 2010 (Leitner, 2009, p.61; IMF, 2009b). While the EU and the IMF allow such a substantial budget deficit for the time being, together with the government of Latvia they established the introduction of the Euro for 2013 as an exit strategy. In order to accomplish this Latvia is required to satisfy the Maastricht criteria of having a budget deficit of less than 3% of GDP, public debt of less than 60% of GDP, etc. In this way the government of Latvia is obliged to adopt pro-cyclical policies following the framework of the EU and the

IMF. As exemplified by cases in Latin America where neo-liberal prescriptions have often failed (Sano, 2009), the Latvian economy will stagnate for a long time in the future. In Latvia unemployment is increasing and wages and pensions are being cut, so the question is for how long these difficulties can be endured.

6. THE INVOLVEMENT OF SWEDISH BANKS IN LATVIA

SEB and Swedbank hold significant market shares in Baltic States (40-80% in loan markets and 30-85% in deposit markets), and the financial authorities remain engaged with these activities (see Figure 4). Swedish banks' equity and loan claims on their Baltic subsidiaries at the end of 2008 represented 8% of Swedish GDP, while loans to their subsidiaries amounts to 35-45% of bank capital. In addition Swedish banks' reliance on operating profits from Baltic operations is extensive (25% for Swedbank and nearly 10% for SEB) (IMF, 2009b, p.29).

Figure 4. SEB and Swedbank: Exposures to Baltic Countries (As of End-2008)



Source: IMF (2009a), Sweden: Staff Report for the 2009 Article IV Consultation, p.29.

Original: Banks' annual reports; the authorities' websites; and IMF staff estimates based on publicly–available information.

*Deposits exclude non-residential deposits.

Banks' profitability fell sharply during 2008-09 despite negligible exposure to US subprime – or other structured – assets. Two of the largest banks (SEB and Swedbank), both increasingly funded on wholesale markets and exposed to Baltic states, saw sharp increases in loan losses with their rating marked down accordingly (IMF, 2009b, p.14). It is also reported that share prices of banks such as SEB and Swedbank, which have huge loan balances in Latvia, dropped by more than 10% in June 2009 (*Nihon Keizai Shimbun*, June 10, 2009).

Riksbanken (the central bank of Sweden) and Finansinspektionen (Finance Inspection Agency of Sweden) independently conducted stress tests for the largest banks (Nordea, SHB, Swedbank and SEB). According to a memorandum published by Finansinspektionen, this stress test presupposed the following scenarios:

1. Conservative base scenario
2. Extreme stress in Eastern Europe
3. Scenario 2 + a prolonged recession in Western Europe

In the base scenario all of the banks meet the minimum regulatory capital requirements by a solid margin and none of the banks fall below a 9% Tier 1 capital ratio. In scenario 2, in two banks, Swedbank and SEB, credit losses exceed profits during the above-mentioned three years. SEB and Swedbank reach significantly lower Tier 1 capital ratios[13] at the end of 2011, 8.2% and 6.0% respectively. In scenario 3, for three banks not including SHB, credit losses exceed profit. For all four banks Tier 1 capital ratios decrease at the end of 2011, but all of them fulfil the minimum regulatory requirements by a solid margin.

Scenarios 2 and 3 assume very high credit loss levels. Finansinspektionen considers these scenarios to be improbable but not impossible. It calls for the banks' attention, saying that the future continues to be highly uncertain and the banks must be in a good state of preparedness, even for improbable scenarios (Finansinspektionen, 2009).

According to economists at the central bank of Sweden, in contrast to US and British economies banks play a very important role in the Swedish economy, because both companies and households are heavily dependent upon loans from banks and other credit institutions. Bank loans account for over half of corporate debt financing. The portion of debt financed via the securities markets plays a

13 Tier 1 refers to bank-owned capital in the narrow sense.

significantly smaller role in these companies. Corporate bonds and commercial papers comprise only 9% and 2% of companies' total borrowing respectively. The remaining loans mainly consist of loans raised within the corporate group (including cross-border loans). In 2008 a number of companies encountered difficulties in finding buyers for their bonds overseas. Although inflow via bond issues in foreign currencies increased in Q1 of 2009, repayments exceeded inflow of funds from the second half of 2007 through November 2008. The central bank of Sweden estimates that the shortfall in financing for major companies during 2008 has partly been replaced by foreign bank loans and partly by bank loans in Sweden (Ekici, Guibourg and Asberg-Sommer, 2009).

During the global financial crisis the central bank of Sweden did everything in its power to protect the banking system. The banks have become unwilling to assume counterparty risk by lending money without collateral to other banks, especially at longer maturities. Banks that have surplus liquidity now prefer instead to deposit this money in the central bank even though the interest rate on such deposits may be lower. At the same time an increasing number of banks choose to borrow from the central bank against collateral instead of on the interbank market. During the crisis, alongside its normal operation, the central bank has taken other more unconventional measures: i) providing loans to commercial banks at longer maturities; 2) providing loans in US dollars; 3) approving a wider range of securities as collateral for loans; and 4) increasing the circle of monetary policy counterparties (Sellin, 2009). The central bank economists say that although there was a decline due to cyclical factors there are no signs of any credit crunch, thanks to such unconventional measures (Ekici, Guibourg and Asberg-Sommer, 2009).

In addition, central banks in Nordic countries and the Baltic states have kept up a network of close cooperation (Ingves, 2008). It seems the least probable scenario that the financial crisis in Latvia will cause disorder in the EU economy via the collapse of Swedish bank(s).

7. CONCLUSIONS

Taking all of the above into consideration, we can conclude as follows.

First, in Latvia there was a continuing boom in the mid-2000s and the economy already showed signs of overheating in 2005, but the government responded to it too late. Only in spring 2007 did the government turn to restrictive policies, causing depression at the end of 2007. In addition the Lehman shock dealt the Latvian economy a final blow. EU membership has both positive and negative aspects. Thanks to the EU single market workers were able to migrate to advanced EU countries, especially the UK, decreasing the unemployment rate and at the same time causing a sharp increase in wages due to a tightened labour market. Owing to the liberalization of financial services, banks from the Nordic region, Sweden in particular, came to operate in Latvia and competed for market shares, stirring the consumption boom. In a situation in which people could easily get loans denominated in foreign currency the financial policies of the central bank of Latvia were weakened. Within the framework of the EU, monetary authorities in Sweden are responsible for supervision of Swedish bank subsidiaries operating in Latvia but have not regulated these financial institutions.

Second, Baltic states have had a common weakness in terms of their development relying heavily on foreign capital. However the fact that foreign-owned banks overwhelmingly dominate the banking sector has benefited Estonia and Lithuania, as the parent banks dealt with the difficulties and thus both countries were able to avoid the worst of the crisis.

Third, Latvia, which is reconstructing its economy with support from the EU and the IMF, set the introduction of the Euro in 2013 as an exit strategy. Latvia is in a dilemma: if the country does not devalue its national currency and tries to satisfy the Maastricht criteria soon (especially that of having a budget deficit less than 3% of GDP), it will be obliged to adopt pro-cyclical policies, causing economic stagnation. It is a noteworthy opinion that the IMF should offer credit lines to governments rather than to the central banks of developing countries, so that they can afford to have expansionary budgetary programmes (Frenkel & Rapetti, 2009).

Fourth, financial authorities in Sweden have been responding properly to the difficulties the domestic banking system has been facing. The least probable scenario seems to be that the financial crisis in Latvia will cause disorder in the EU economy due to the collapse of Swedish bank(s).

Fifth, new EU member states are required to satisfy the strict criteria mentioned above in order to adopt the Euro. Nevertheless, since they have experienced the global financial crisis they will make greater efforts towards the introduction of Euro, echoing a Japanese proverb saying “Look for a big tree when you seek shelter”.

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