ECONOMIC RECOVERY: ELABARATION OF MEASURES TO BE TAKEN FOR THE REVIVAL OF THE NATIONAL ECONOMY OF THE REPUBLIC OF LATVIA

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Abstract

Economic and financial crisis that has hit the Republic of Latvia is of unprecedented strength. Moreover, socio-economic systems are changing worldwide so that measures for reviving of national economy that were working previously, might not work anymore. Hence, wise and timely action needs to be taken to improve the development prospects of Latvia and contain the damage to the national economy, which will be caused if decisive action to strengthen the economic revival of Latvia is not taken. This needs to be done bearing in mind the changing global environment and understanding trends that will affect it in the foreseeable future. Authors offer a new approach of structuring the tasks for economic recovery: efficiency of use of state budget resources, increasing of state budget revenues, and improving the political system. Authors also take a look at similar crises that have taken place in the world previously and point out to similarities and differences, as well as derive suggestions for policymakers.

Aim: the aim of the research is to elaborate measures to be taken for economic revival of the national economy of Latvia as well as provide the policy makers of Latvia with and inform the society of the said measures to be taken to bring back the development of Latvia on a sustainable footing.

Materials and methods: literature analysis, focus group method, expert method.

Main results and conclusions: the research finds that there are many possibilities to increase efficiency of state budget as well as increasing revenues in state budget. The main tasks lie with reforming of the public administration and streamlining its functions as well as with improving of the existing political system. Current crisis in Latvia is only partly similar to past crises in the region, but some lessons from the past crises can be derived.

Key words: *state budget expenditure efficiency; political system; crises; crisis remedies*

Introduction

Financial and economic crises in the world and in some particular national economies tend to be cyclical and hence repeat over time. Crises also can be local, regional or global. The global financial crisis officially starting in 2008 and the domestic situation in Latvia has made Latvia one of the most adversely hit countries in the recent global and local financial and economic crisis. Since crises have occurred in the world many times before the current crisis, it is educational and worthwhile looking at the historic crises and how they have been handled. This paper gives account of some past crises as well as compares two similar crises that have taken place in the region with the one in Latvia to see the similarities and differences and to derive conclusions and suggestions for Latvia.

By having looked at the past crises, the current global and local financial and economic crisis, and having seen the performance of countries during the crisis, the paper provides a framework for trying to solve the existing problems in Latvia.

Methods employed for writing of this paper are as follows. Analysis of existing literature and analysis of experience of other countries in overcoming economic crises has been performed. Moreover, proposals for the revival of the national economy of Latvia have been discussed in a focus group comprised of high level experts and managers at the Riga International School of Economics and Business Administration. The aforementioned proposals have also been discussed with a number of high level managers both in public and private sector. This approach gives possibility to analyse the situation in Latvia from the business point of view too.

This paper is organized as follows. Next section looks at the definition of crisis as well as some past crises. The third section looks at the impact of the recent financial and economic crisis on Latvia. The fourth section compares crisis in Latvia with similar crises from the past. The fifth section provides a framework for thinking of how to put the national economy back on track. The final section concludes and provides suggestions for further research.

Crisis and some examples of past economic and financial crises

The term "crisis" has a number of definitions, just as do other commonly met terms that have their application on a wide scale all over the world. WordNet (a lexical database for English at the Princeton University) defines the term crisis as "an unstable situation of extreme danger or difficulty". There are many other definitions to the term, and most of them contain the most important characteristics of the term – instability and unpredictability of the situation, danger and risks that the situation can turn into, and difficulties of getting out of the situation. Crises, however, can take place in various domains, inter alia in economics and finance.

Many economic and financial crises have taken place in different places all over the world during last decades as well as earlier. The Bank of Latvia (Latvijas Banka, 2010) provides some overview of the crises that have taken place before the current financial and economic crisis, i.e. between years 1994 and 2005. Information on these crises is briefly contained below.

Crisis in Mexico (1994-1995) was a typical currency crisis, which was spurred by the overvalued national currency (peso), which was pegged to the U.S. dollar. Drying up foreign reserves and significant current account deficit caused substantial devaluation of the national currency. Loan rates rose sharply, which lead to many insolvencies and even closures of banks. Consequently, floating exchange regime was introduced, activities for stabilising of the macroeconomic policy were instituted, and bank system was reformed. Mexico had to take significant international loans to stabilise the situation. Pace of reforms, however, was criticised for being slow and ineffective.

Southeast Asia crisis (1997-1998) struck a whole region. In a short period of time, the region lost investor confidence and capital started leaving it. A number of countries saw their currencies devalue and loan rates rise. Consequently, share prices in stock exchanges started falling, spreading the crisis to Latin America, the U.S., and Europe. Countries affected directly had to take loans for stabilisation of the situation.

Russian crisis (1998) was largely caused by decreasing international investor confidence in carrying out reforms in the Russian Federation, and was complemented by falling oil prices, caused significant outflows of capital. International debt of the Russian Federation soared, and the attempts to keep the pegged currency regime proved to be unsuccessful. Consequently, controlled floating exchange regime was introduced together with some capital controls. Rising oil prices helped Russian Federation to recover.

Crisis in Brazil (1998-1999) was accelerated by the crisis in the Russian Federation, which made investors cautious. Overvalued exchange rate, huge external debt, and inadequate macroeconomic policy were the main drivers of the crisis. Brazil received significant international loan and banks agreed to restructure the loans.

Turkey crisis (2000-2001) was spurred by acute liquidity crisis, caused by weak banking sector. Consequently, floating exchange rate was introduced, and the national currency devalued by one half.

Crisis in Argentina (2000-2002) was a combination of currency and banking crisis. Fixed exchange mechanism against the U.S. dollar and overvalued national currency was largely responsible for causing of the crisis. Lack of fiscal discipline in combination with rising external debt had weakened the national economy of Argentina. Consequently, currency peg was abandoned and capital controls and freeze of bank deposits was instituted. The country received significant international loans for stabilisation of the situation. The crisis has not been completely averted even by nowadays.

From the aforementioned, it can be seen that there are some common characteristics of the crises described above – overvalued national currency, fixed currency regime, which due to foreign reserve tensions is abandoned in favour of floating currency regime, and increased international borrowing (often – inter alia from the International Monetary Fund) for stabilisation of the situation and putting the national economy back on track.

Crisis of year 2008 and its impact on Latvia

September 2008 and the breaking news of the well-known investment bank Lehman Brothers filing for Chapter 11 bankruptcy protection formally started the recent and still ongoing economic and finance crisis. The crisis and its causes had been building and aggravating over time, and the aforementioned event just started breaking out of loss of investor and consumer confidence all over the world, leading to drop in global output, loss of confidence, closure of banks, fiscal stimulus packages of governments, international lending to countries suffering the most etc.

All of the aforementioned factors and many more caused the world economy to weaken significantly already in 2008 and even more so – in 2009 with modest recovery foreseen for the coming years. According to the World Bank publication (World Bank, 2010), the real GDP over the last years has been changing as follows:

Table 1: Real GDP growth in the world, high-income countries, and developing countries.

	World	High-income countries	Developing countries	Developing countries excl. China and India
2007	3.9%	2.6%	8.1%	6.2%
2008	1.7%	0.4%	5.6%	4.3%
2009 (estimate)	-2.2%	-3.3%	1.2%	-2.2%
2010 (forecast)	2.7%	1.8%	5.2%	3.3%
2011 (forecast)	3.2%	2.3%	5.8%	4.0%

Source: the World Bank.

As can be seen from the table 1, the world GDP decreased slightly above 2% in 2009 with high-income countries leading the decrease. Although the real GDP in the world is expected to raise both in 2010 and 2011, the numbers are still projected lower than they were in year 2007. The same applies also to countries if assessed in the three groups shown in table 1.

Latvia was struck particularly hard by the global and domestic economic and financial crisis. During the years of economic expansion Latvia was building twin deficits – the government budget deficit as well as the current account deficit. Negative real interest rates and excess availability of cheap credit resources lead to excessive crediting, especially in the real estate sector. This, inevitably, lead to increase in asset prices, driven by increase in real estate prices. Latvia also witnessed double digit inflation over the boom years. The Government of Latvia already in 2007 introduced the so-called Inflation Combating Plan, which foresaw that banks could give out loans only when the income of the loan taker has been verified with the State Revenue Service. This already introduced some slowing down in the crediting market. The Lehmann Brothers filing for bankruptcy in 2008 and the resulting consequences of liquidity shortage, global mistrust etc. hit Latvia adversely. Loans suddenly became non-available, investment flows almost ceased and in some quarters even reversed. Hence, economy of Latvia experienced significant liquidity shortage, insolvencies, deleveraging etc. The Government also had to bail out the biggest domestically-owned commercial bank, which ran into serious liquidity shortage in the end of 2008. To bail out the said bank and to ensure the activities of the public administration, the Government of Latvia was forced to ask for financial and technical assistance from the International Monetary Fund, the European Commission, the World Bank, the European Bank for Reconstruction and Development, and a number of bilateral donors. These efforts resulted in a EUR 7.5 billion external assistance (loan) package assigned to Latvia to cover the financing gap that had emerged in the wake of the crisis for the coming years. In return for that, the Government had to introduce strict austerity for the coming years. It was agreed that the austerity package as well as other activities for the recovery of the economic activity will be centred around the fixed exchange rate of the national currency (LVL) against the euro (EUR). As a result of the crisis, Latvia witnessed its GDP falling both in 2008 and in 2009, when the GDP fall reached 18% year on year. The Government debt rose sharply, the inflation went down, the unemployment rose sharply, the domestic demand went down, the current account went into surplus etc. However, additional austerity measures are still going to be introduced to put the economy of Latvia back on track at least for the year 2011.

Similar crises to that of Latvia

When looking at the brief description of previous crises in the world as well as the situation in Latvia over the past years, the question arises as to if there have been any crises similar to those of Latvia and if there are any lessons that can be learned from them. There have been at least two crises similar to that of Latvia, which have not been described above. One of them took place in Sweden, the other one – in Finland.

According to Lars Jonung (Jonung, 2009), the crisis in Sweden started in late 1980s with the financial deregulation that took place in Sweden. This financial deregulation set good grounds for financial innovation, which drove credit boom, which in turn fuelled the rise in asset prices, especially housing prices. At the same time, the monetary policy pursued foresaw fixed exchange rate. Furthermore, this was supported by lax financial and monetary policies, which all in all resulted in private individuals as well as business entities being heavily over indebted. Financial supervision has also been blamed for adding to the severity of the crisis. As a result of the crisis, credit became virtually unavailable, asset prices fell, deleveraging took place, and distress of the financial system threatened the existence of a number of big financial institutions. The financial crisis spurred deep recession. However, as opposed to today's crisis, Swedish crisis was local, not global.

Jonung et al (2008) state that situation in macroeconomic development of Finland in the 1980s was almost identical to that of Sweden described above. Financial liberalisation took place also in Finland, resulting in cheap and readily available financial resources despite pegged national currency. This inevitably increased lending to all sectors of the national economy, but especially driving up prices in the real estate sector and on the stock exchange. Both countries faced increase in real interest rates, which set in the fall of value of assets, unavailability of credit resources, decreasing domestic consumption etc. Both countries could not stand their pegged currency rates and were forced to float the currencies together with significant depreciations in 1992. According to Jonung et al, "the process demonstrates the difficulties inherent in a policy of pegged exchange rates in a world of free capital markets during a debt deflation process. Falling asset prices, financial instability, widespread bankruptcies and banking crises can not be countered successfully as long as the defence of the pegged exchange rate requires high domestic interest rates". During recovery, both countries had to let their currencies depreciate, had to adopt fiscal austerity measures to contain the budget deficit and government debt, some public benefits were decreased, restructuring of industries took place etc.

Table below summarizes the common and different characteristics of the crisis in Sweden, Finland, and Latvia. For Latvia – situation is depicted according to authors' own assessment.

Table 2: Comparison of crises in Sweden, Finland, and Latvia.

	Sweden	Finland	Latvia
Major deregulation of the financial system	Yes	Yes	Yes
Foreign currency borrowing due to deregulation	Yes	Yes	Yes
Low/ negative real interest rates during boom	Yes	Yes	Yes
Soaring inflation during boom	Yes	Yes	Yes
Peg as monetary policy anchor	Yes	Yes	Yes
Countering policies too late	Yes	Yes	Yes
Austerity package instituted by the government for saving the situation	Yes	Yes	Yes
Austerity package and other government actions saved the peg	No	No	Yes – up to now
Restructuring of businesses to increase competitiveness	Yes	Yes	Yes – but not very evident
Political unity for countering crisis	Yes – very strong	Yes	No
Local crisis as a part of a global crisis	No	No	Yes

Source: various sources, authors' composition.

As can be seen from the table above, the difference arises in how the austerity packages have worked in the three countries. In Sweden and Finland they did work together with the restructuring of the business sector. Although this did not save the monetary policy anchor – the peg – it helped the economies of Sweden and Finland to recover in the course of time. In Latvia, austerity package has been put in place since the end of 2008; however, additional austerity activities need to be put in place for the coming years as well to reduce the budget deficit and decrease government borrowing. The business sector is also restructuring in Latvia, although there are many cases when companies cannot restructure and go insolvent – especially in the real estate and trade sectors.

One very significant difference between situation in Sweden and Finland and that of Latvia is that in the case of the former the crisis was mainly of regional character. Hence, part of recovery after the crisis took place with increased exports of the involved countries. At the same time, other activities for recovery from the crises were also available. In the situation of Latvia, the local crisis has occurred almost simultaneously with the crisis in the world. This means that it is way more difficult to find solutions out of the crisis, since export markets have decreased, there is liquidity and financing strains in the rest of the world, the confidence of buyers is falling worldwide, thereby not giving too much chance of quick recovery etc. For Latvia as for a small open economy global recovery is significant precondition for local recovery, since the domestic demand is low and is barely recovering and the impact of global financial flows is high on the country. Although the world economy has been predicted to rebound to growth already in 2010 (as can be seen in table 1), the question still remains what will be the most important global drivers of growth and what type of recovery will the world enjoy in the years to come. Although there are signs of economic recovery in the world and in Latvia, many economists still worry about the W-type economic development, which foresees another drop in economic situation after the initial and fragile signs of world economy recovering.

The last remarkable difference between the situation in Sweden and Finland and that of Latvia is that in the case of the former, the political decision makers made their best effort to agree on the way forward and on the activities to be taken to find a resolution of the crisis. In the case of Latvia, though the crisis is as severe, but the global conditions are far worse, the political parties cannot agree on the way forward beyond words. The nonexistent political agreement on the crisis solutions even caused the dismissal of the government in the first quarter of 2009 when the situation was particularly tense and the political unity was very necessary. Foxley (2009) in his paper, however, states that austerity packages that should at least partly put the overheated economies back on track would be difficult to justify for the politicians where “politicians must face frequent elections and where poverty and income inequalities are still hard facts of life”. As of writing this paper, the Parliamentary elections of the Republic of Latvia of the year 2010 are just some months distant in the future. Yet, there is no political party or union of political parties that has proposed a clear plan (with tasks to be done, their economic impact, and their financial and fiscal impact calculations) of how to put the economy of Latvia back on sustainable footing.

Actions to be taken to put the national economy back on track

In the light of the existing economic and financial situation in Latvia, a working group (focus group) comprised of high level experts and managers at the Riga International School of Economics and Business Administration convened a number of times over the first half of 2010 to discuss the existing situation and the possible remedies to counter it. The group discussed a number of possibilities on: (1) how to raise the efficiency and effectiveness of state budget expenditures, (2) how to increase the state budget income, and (3) how to reform the political system that governs the economy. Additionaly in focus group was analised situation in some important (with high expert potential) branches for instance wood processing, transit, etc.

The authors of this publication then derived a framework for reviving of the national economy of Latvia. This framework is centred on the growth revival of the national economy, which is located in the centre of the framework. Then there are two domestic aspects that determine the revival of growth of the national economy. On one hand, economic recovery is grounded in the adequacy of state expenditure, efficiency of state expenditure, and pre-conditions for rising of state income. This presumes state as an actor in the national economy and prescribes both regulatory and economic role to the state. On the other hand, economic recovery is significantly dependent on the changes in the political system. These changes are of pivotal importance for any targeted activities to be undertaken by those in power for putting the national economy back on track. Please see graphical depiction of the proposed framework in picture 1 below.

This framework deliberately focuses on the domestic factors, since the authors argue that domestic policies and environment needs to be put in order at the outset. The authors, however, do not aim to diminish the importance of development of the global economy on the national economy of Latvia.

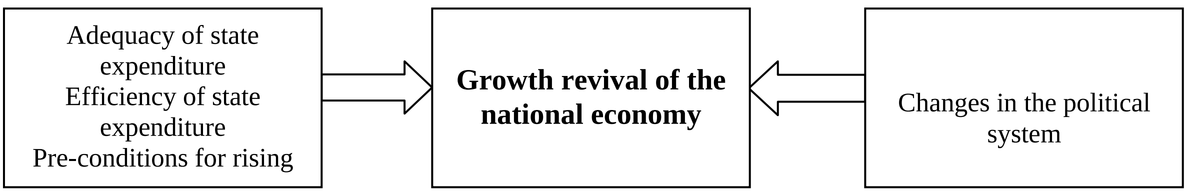

Figure 1: National economy growth revival framework. Source: authors' proposition.

At the outset, one needs to take a look at the public administration to understand the left-hand side of the framework. The existing situation in the public administration can be described by the fact that currently there are more than 300 policy planning documents in Latvia that are organised in a hierarchical system. However, there is no single document that lays out the following about the policy planning and how the national economy is supposed to develop: (1) what results are to be attained and when, (2) what activities are being planned and with what resource endowment, (3) how results are to be attained and how will the inter-sector coordination work, and (4) what will be the impact of the aforementioned on the society and individual members of the society. The current public administration system does not assess deliverables against the funds spent, although some marginal activities in this regard are being undertaken, which, however, do not allow seeing the whole picture with the state budget expenditure.

If one looks at the efficiency of the state budget spending, it is straightforward that due to lack of performance indicators in the public administration, it is also difficult to assess the efficiency of the administration, since there is no plan against which to assess the performance. To provide some proof of that, reports of the State Audit Office can be used. One of the reports (State Audit Office, 2009a) reveals that the cost for bringing back one unemployed person to the job market costs the state around LVL 22,636 (EUR 32,208), while one budget place for one student costs just LVL 1,303 (EUR 1,854) per annum. In addition to that, LVL 1 million (EUR 1.42 million) from LVL 13 million (EUR 18.5 million) or 7.7% has been spent without reason. Moreover, three ministries are involved in requalification of unemployed – Ministry of Welfare, Ministry of Education and Science, and Ministry of Economics, which implies unnecessary coordination activities and bureaucracy.

Another report (State Audit Office, 2009b) states that only administrative expenses in 4 healthcare institutions were used inefficiently in the amount of LVL 2.8 million (EUR 3.98 million). Yet another report (State Audit Office, 2009c) suggests that some benchmarks for setting a cap on administrative expenses when calculating tariffs for utilities need to be set, as central heating tariffs include administrative component ranging from 4.1% to 22.5% of the end-user tariff in different municipalities, which is a significant variation. There are also many other striking cases of how state budget income could be increased by reforming the system of how state enterprises pay dividends to the state, how the state uses and oversees its immovable property, which it has a lot of, assessing of lease and rent agreements before their signing etc. Instead of that, the tax base is being broadened and tax rates are being raised, which does not contribute positively to the revival of the national economy.

On the right-hand side, which is the political system, as already described earlier, there is no political party or union of political parties that has proposed a clear plan of how to revive the national economy. Nor there is any policy document that clearly spells out the activities to be taken to bring the economy back on track as well as their fiscal and financial impact. To the contrary, additional fiscal austerity packages to correct the economic imbalances are being instituted within the annual budget cycle.

Authors propose that any reform that is supposed to help the country in the revival of its national economy should: (1) have pre-defined results to be achieved within the budgetary framework, (2) include assessment of various options on how results can be achieved, both involving the public and the private sector in doing that, and (3) have measurable goals so that the impact of any reform can be understood. These steps are in essence based on the classic scheme of planning, executing, and reporting and correcting/ following up. Bearing in mind the aforementioned, there are activities that need to be instituted in the shortest possible period of time. For the left-hand side of the framework, the public administration has to have well-defined goals, has to follow attainment of those goals, and has to control the situation and correct for errors, if any occur, as well as strive for continuous improvement. For the right-hand side of the framework, influence of corporate ties needs to be diminished in the policy making as well as normative base needs to improved to account for the results achieved. Moreover, sector development strategies and goals need to be integrated in a broader framework of development of the national economy.

Conclusions and suggestions for further research

This paper has taken a look at the global financial and economic crisis that broke out in 2008, at the concurrent crisis in Latvia, as well as at some past crises that have some resemblance with the current crisis in Latvia. The paper concludes that there are many similarities between the current crisis in Latvia and the crisis that took place in 1990s in Sweden and Finland. The common characterising aspects of these crisis is major deregulation of the financial system, foreign currency borrowing due to deregulation, low/ negative real interest rates and soaring inflation in the run-up to the crisis, peg as monetary policy anchor, countering policies being introduced too late, and austerity packages being introduced by the governments to try to put the national economies back on track. The differences, however, are also remarkable. Neither Sweden, nor Finland managed to save the currency peg. However, crisis of Sweden and Finland was a part of regional, not global crisis. Sweden and Finland had a positive example of political unity when countering the crisis, which is not the case of Latvia. Political unity and sound economy revival package remains the main challenge of the national economy of Latvia.

To counter the economic difficulties of Latvia, authors propose a framework for economic growth revival of Latvia. This framework foresees improving the public administration sector as well as the political system. The framework deliberately excludes the impact of global factors on the national economy of Latvia, since the authors argue that dealing with domestic factors is important at the outset. Nevertheless, authors do not disregard the very strong impact of global economic developments on the national economy of Latvia.

There are numerous institutions and publications that assess performance of countries over time in terms of competitiveness, doing business etc. Inter alia, some of them are Doing Business by the World Bank[5], the Global Competitiveness Report by the World Economic Forum[6], and World Competitiveness Yearbook by IMD[7] etc. Information provided in these reports if compared with actual economic performance of countries does not necessarily correlate positively. Hence, suggestion for further research is made in the form that it could be analysed whether the quality and efficiency of public administrations has any impact on the actual economic performance of countries assessed and whether it has positively or negatively affected the performance of the said countries at the times of crisis. This could be done by using the proportion of public administration in the total GDP of the country so as to take account of the size of the public administration. In this regard, public administration could be analysed to test if it has created the crisis, contributed to deepening of crisis, both or neither of the aforementioned.

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