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# *THE EU'S ECONOMIC CRISIS AND ITS SOLUTIONS : LAVTIAN CRISIS AND RECOVER, IS IT AN AUSTERITY VICTORY?*

**Abstract.** *In EU there are many the debates opened about the current crisis, first of all because what the EU is living during the last 7 can be defined as the longest and the most bundersome economical crisis of the last 100 years.*
*All the debates are focused on solutions without any critical analysis on the factors that had provocated such event; in such scenario we find first and foremost a clear division in two schools of thought, ascetics and critics of austerity.*
*By this paper we would analize critically the case of Latvia which is a particular case of post crisis recovering due to the adoption of policies such as fiscal consolidation and internal devaluation that according the mainstream economic lecterature represent a great pattern of recovering by austerity. But studing more deeply such case we could easily say that the effectiveness of the "success story" seems far from obvious.*

**Key words:** *Latvia; EU's crisis ; austrity ; devaluation ; fiscal consolidation ; post--soviet economy ; market economy ; euro ; wage ; productivity ; growth .*

## Introduction

During the last months – or to better say years – in Europe have been opened an alight debate on the financial crisis that is hitting the *Old Continent* since 2007/2008 and the multiple methods for a fast recover, proposed by different economists and politicians that sistematically follow divergent ideological paths.
One of the main argument - that became definitively a battleground – is that regarding the *austerity*, which represents the only one solution according someone or a generator of additional problems according someone else.
One of the example that the austerity's ascetics use to defend all the harsh policies is that of Latvia and its recover.
Between 2004 and 2007 the Latvian growth rate (GDP) had been amog the highest around the World; such result can be related firstly with the wide flux of foreign capitals attracted by the high profit guaranteed by real estate sector.

The situation changed completely with the arise of the international financial crisis which suddenly interrupted the as called *"Latvian Miracle"* and constrapted the Baltic Country to ask the support of the IFM – under the form of money borrowing – aid which was tied up with an harsh austerity plan - *see the Greece case* - in order to rectify many imbalances within the Country, first of all commercial and financial whose caracterized the *boom* age.
By the end of 2009 Latvia registered a slight growth that almost all mainstream economic lecterature connect with two main factors : ***fiscal consolidation and internal devaluation,*** but studing in deep this case we will figure out that the austerity's success story is far from obvious.

**Historical Framework.**

The Republic of Latvia became independent from USSR in 1991, since that moment Latvia has been considered by many experts one of those countries that would had experimented a fast process of convengence torward the European's economic and social standards.
The transiction phase from the command economy to a model of market economy has been conducted mainly by a wide and deep plan of privatisations, the adoption of a national currency (lat) completely independent from the Russian Ruble[1] and the progressive adoption of a set of European Community – now Union – rules.
According a part of the economic leterature [2], the low GDP per capita, an efficient burocratic/administrative apparatus and the proximity with the Western Europe are the main factors that might explain that extraordinary process of convergence that Latvia experimeted from 2000's.
Between 2000 and 2005 the GDP's growth rate per capita exceeded the expectations. Such gap between the forecasted data and those effectively registrated are due to the extreme increse of the private investements instead of private savings.[3]
From 2004 to 2007 – period of economic boom – Latvian GDP grew at an eleveted pace, if we consider the European average, (+ 11% compared to the European 3-4% ), the unemployment rate decrease from 14% in 2000 to 6% in 2007, the inflaition rate based on CPI registered was of 17,5% and the REER has deprecieted its value over 15%. Furthermore, the progressive loss of foreign competitiveness generated a gradual expanction of trade balance gap.[4]
The internal boom had been generated first and foremost by the exchange rate fixation with the Euro and from the important flux of foreign capital, atracted by the high profit margin in the construction industry. [5] However in the end of 2006 it was already clear that the speculative bubble in Latvia was ready to explode and that the extraordinary growth of those years didn't find the support of permantent improvements in term of productivity.
The international financial crisis and the immediate contagion in the global financial makert in 2008 aggravated the situation due to the explosion of the speculative bubble

[1] The Lat has been anchored from 1994 to 2005 the IMF's SDR, after that period it is anchored to the Euro).
[2] Blanchard, O., Griffiths, M., & Gruss, B. (2013, September 19th). "Boom, Bust, Recovery. Forensics of the Latvia Crisis". Economic Studies at Brookings .
[3] Ibidem.
[4] from 2000 to 2007 the export/GDP rate stayed costant at 45% and the import/GPD passed from 50% to 70%.
[5] Frenkel, R., & Rapetti, M. (s.d.). "A developing country view of the current global crisis: what should not be forgotten and what should be done". Cambridge Journal of Economics, 5/2009.

that over the fisiological decelaration in the economy added in our case a systemical shock.
The combination of the sudden arrest of capital flux and the credit crunch led the Parex Banka – first Latvian Bank with over the 20% of market share – before to the bankruptcy and then toward the unavoidable nationalization.
Despite that efford to save the system, in the end of 2008 the governament required the Troika's finanancial support.
At that time many authoritative economists– such as Krugman, Rubini et al. – advised to the Latvian government to leave the peg with the Euro and to devaluete the Lat in order to avoid the risk of deflationary spiral of prices and wages.
Nevertheless the foreign creditors, the Latvian Central Bank and the European Commission have expressed immediately their opposite opinion due the Latvian will to enter into the EMU.[6]
Being on that time predominant into the government the second thesis, on December 11th 2008 , Godmanis had stipulated with the Troika and other European creditors an aid plan of 7,5 bil. Euro – equal to the 39% of country's GDP – in order to avoid the risk of default. As usual in the practice of the as called Troika - or even in the case of IMF - the delivery of all the credit tranche had been subordinated to an harsh plan of fiscal austerity that between 2008-2010 was accounted in about 17% of Country's GDP. Two-thirds of such welfare haircut included sector such as Health and Education and the remaing part was determinated by an increase of the tax wedge.
Among the first quarter 2008 and the third quarter 2009 the internal demanda s well as the import has registered a significant decrease in terms of GDP (-43% and – 26%). Even consumption and investments have followed the same trend (-21,7% and -51,1%).
At the same time the public debt reached a record level at 40% of GDP – considering that before the crisis and the explosion of speculative bubble it was just 8%.
One of the main peculiarity of the answer of Latvians to the crisis – as well as one of the major critical issue - is represented by the migration phenomena of a large part of high educated citizens (mostly young graduates). Already before the crisis such phenomena was wide into the Country but after the occurred events of 2008 such trend got stronger. Between 2009 and 2011 about 120.000 Latvians – 10% of the labour force – had left the Country. In Absence of such migration flux many authors [7] report that the unemployment rate would have been more widely ( + 8 - 9%).
Considerig even other indicators we saw that the Gini's index passed from 35,4% to 37,5% in two years (2007-2009) data widely higher than the European average (30%), meanwhile the percentage of people facing with the poverty passed from 19% (2004) to 26% (2008).
Since the end of 2009 the Country showed some positive signals of recovering, but on the effects of the mesures that have led toward such achievement is far to be concordant.

**The Debate on internal devaluation.**

[6] According the Maastricht Treaty, in order to be admitted into the EMU it is necessary to abide several macro-parameters/rules for a minimum determinated period of time. Among these rules one of the most important is that one that regulated the as known competitive devaluations.
[7] Ray, R., & Weisbrot, M. "Latvia's Internal Devaluation: A Success Story?". Center for Economic and Policy Research (CEPR), December 2011.

The debate around the effectiveness of the expansive austerity goes around the effects of the *fiscal consolidation, wage deflation, foreign competitiveness and reduction of the trade deficit.*

Many authors and institutions - the European Commissiona at first – have sided in favour of the as called *success story* . [8]

According this group, the fiscal consolidation would had favored the growth within the Country by the increasing of market confidence that had been demostrated by a decreasing in term of interest rate of the State debt.

The public sector wage reduction and the restraint on the private one would had also smoothed the competitivenes gap with the foreign competitors accumulated during the economical boom time. The recovering agaist the competitors would allowed Latvia to begin a pattern of growth based on the export.

A less optimistic comment have been made by many authors – with Krugman as first exponent [9]. According their opinion the resorption of the trade deficit would be achieved by a stronger import reduction then the export and not as the ascetics claim by an abatement of the *labour cost for unit of product* (LCUP).

Furthermore this growth trend would have concided with a partial disapplication of the measures agreed in the begining of 2010 with the creditors.

The Levy Economics Institute, analizing at disaggregated level all the sector that led the recover, found out that the most active companies during that time had been all those enterprises controlled by foreign holding and that have not relevant connections with local providers. Such factor, according the institute could contribute to polarize the industrial power in the hands of few enterprises.

Partially different is the contribution given about it by Blanchard that connect the recovering of Latvian trade balance to an inaspected productivity increase and not to the wages reduction. Other authors claim also that the true Latvian *success story* is more related with the competitiveness improvements established since 2009 in factors such as product placement and marketing.[10]

## Quantitative Analysis : an aggregate and sectorial examination.

In this secon part of this paper we would like to provide our opinion about the Latvian trade performance.

Our analysis had been conducted at macroeconomic by the estimate of an econometric model as regards the export and at microeconomic by the quantitative analysis of the data regading wages, productivity and sectorial export. In such way we aim to understand what factors would explain better the process of reabsorpion of the trade deficit and if there are margins of adataption of the *Latvian paradigm* in those economies that are different in terms of structure and size.

As regarding the aggregate analysis we followed the theoretical relation of the Mundell-Fleming's model and the methodological formulation of Rao and Singh.[11]

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[8] Åslund, A., & Dombrovskis, V. "How Latvia came through the Financial Crisi". Washington, DC: Peterson Institute For International Economics.(2011)

[9] See Krugman (2013).

[10] Benkovskis, K. (2012) "Competitiveness of Latvia's exporters". Bank of Lavtia Working Paper. 3/2012. http://biceps.org/assets/docs/bje/Benkovskis_0.pdf.

Vanags, A. (2013)."Latvia's exports: the real 'success story''. Baltic International Centre for Economic Policy Studies. http://biceps.org/assets/docs/izpetes-zinojumi/Latvias_exports

[11] Ray, R., & Weisbrot, M. (12/2011). "Latvia's Internal Devaluation: A Success Story?". Center for Economic and Policy Research (CEPR).

The empirical estimation had been conducted by the technical of the multiple regressions on the time series. The estimated model is:

$$\Delta \log(export)_t = \beta_0 + \beta_1 \Delta \log(\varepsilon_t Rich) + \beta_2 \Delta \log(\varepsilon_t Poor) + \beta_3 \Delta \log(Y_t^* Rich) + \beta_4 \Delta \log(Y_t^* Poor) + u_t$$

In the model above we see that the export depends from the multilateral real exchange rate based on the LCUP and from the foreign demand approximated on the Importers' GDP. Considered the high rate of concentration of the Latvian Export against only six Countries (Germany, Russia, Sweden, Lithuania, Estonia and UK), we have considered only the amount of export designated to this group of importers. [12]
As we see from the model above, the sample of Countries has been divided in two groups: *Rich and Poor*. Within the first group we find all the Countries with a GDP per capita for year more than 30.000$, (Germany, UK and Sweden), while under the denomination "Poor" we find those Countries in which that threshold is not achieved (Russia, Lithuania and Estonia).
The result of the estimation can be summarize as following: from 2000:1 to 2013:4 Latvia became progressively more competitive against that group of Countries that we have enclosed under the category *"Poor",* while the driving demand for its export had been that from the "Rich" Countries. Speaking in absolute terms we see that the foreign demand had a key role in the recovering Latvian process and not as a part of the letterature affirms because of improvments in the competitivenss against the foreign competitors. This result let us to recognize that the Latvian export is extremely polarizated in those sectors that represents its economy backbone.
Such results are remarked cleanly also in the sectorial analysis from which emerges also that: the recovering driving sectors are that manufacturing, agriculture and tourism. Furthermore, we find another interesting fact, it is true that the LCUP decreased in all the sectors but its decrease is due to an increase of the productivity and not to a wages concentration. Conversely the nominal wages, initially collapsed by the arise on the crisis, are currently at a higher level compared to those of 2007 (with the exception for the Public Administration sector that obviously has a negligible effect on export). Considered such premises we believe that the current model of *export-led growth* cannot ensure a stable and long-term process of growth because is based on those sectors that are exposed to the international competition (prices). Moreover, even if the improvement in terms of State balance are traced to the foreign demand and in the sectorials productivity improvements, we believe that there is no a direct causal relation between fiscal consolidation, competitiveness improvement and export growth.
As regard the extension of the Latvian example in those economies that differs in terms of dimension and structure, we agree with those which believe that it is not possible derive unique political economy implications from Latvian case.
The main reason lies in the size of the country's economic and social structure: Latvia did not generate any negative externalities in term of trade to its partners or any other EU's member. We believe that if we consider the event occurred in the Latvian case (-25% of GDP in two years), would be happened in any middle-big Country (in term of GDP) in EU it would have created a recession domino's effect into the economy of its partners.

[12] it is useful to remark that this group of Countries covered itself 50% of all Latvian export. (2000-2013).

At last, we believe that the Latvian case could not be considered an example so easy to be replied due to the particular social structure of the Country. Lavtians instead to remonstrate as other people around Europe have done, they preferred to emigrate that is according to us a different perception of democracy which represent the current problem for the European policy makers, 28 Countries represents nearly 28 different patterns of common policies.

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