Dombrovskis, Valdis

Article

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Panel 2

Managing the Crisis

Keynote Address by

Valdis Dombrovskis
Prime Minister of Latvia

The topic of this panel – Managing the Crisis – has been the leitmotiv of my term as Prime Minister of Latvia. In my remarks I will look back at the roots of the crisis in Latvia and highlight the features specific to our situation. I will also explain how we are emerging from the crisis, and what lessons can be drawn.

After joining the EU in 2004, until 2007, Latvia enjoyed a period of strong double digit economic growth. Cheap credit was available on international financial markets, which most of our commercial banks used to fund a generous crediting policy. Easily available credits fuelled domestic demand, which led to the economic boom. The Latvian government during those years adopted loose fiscal policies, despite repeated strong warning signals about overheating from the European Commission and the IMF. Nevertheless, Latvia neglected these warnings.

As a result, during the boom years Latvia built up large economic imbalances. Capital inflows in the non-tradable sector caused the real estate bubble to balloon and accelerated inflation. Meanwhile, strong wage growth undermined the competitiveness of Latvian producers and stalled export growth. As a result, the current account reached a record deficit of 22.5 percent in 2007. Regrettably, no thought was given to building up reserves during the boom years.

And then the crisis hit. The global financial crisis at the end of 2008 amplified Latvia's domestic imbalances, causing sharp economic contraction. GDP fell by 4.6 percent in 2008, after 10 percent growth in the previous year. GDP in 2009 was 22 percent down from 2007. Employment in 2009 was 12 percent down from the previous year.

In late autumn of 2008, Latvia had no choice but to request international financial aid. A sum of 7.5 billion euros was provided by the EU, the IMF and our regional neighbours. In order to bring the economy back on a sound and sustainable footing, it was crucial to implement a national programme, first, to withstand short-term liquidity pressures, second, to improve competitiveness, and third, to support an orderly correction of imbalances in the medium term. Latvia has now taken all necessary consolidation measures, predefined in the programme, by carrying out structural reforms and stabilising the situation in the financial sector.

As a small, open economy, Latvia was badly hit by a combination of three factors: first, the global financial crisis, second, irresponsible fiscal and macroeconomic policies, and third, a run on PAREX Bank. Latvia plunged into the deepest recession ever experienced by an EU member.

The international bail-out package came with strong conditionality, asking the Latvian government to commit itself to decisive structural reforms. As the saying goes, reforms begin where the money ends. My government took office in March 2009 after the failure of the previous government to make the necessary amendments to the state budget. From the beginning, we have been committed to major economic and social reforms.

Regaining national competitiveness was set as the over-arching priority. Here, we had a double objective. Short-term competeveness meant improving ratings by the largest international rating agencies as soon as possible. In parallel, we had to restructure from an inward looking economy, based on real estate and local services, towards an export-oriented economy able to compete on the European and global stage. To boost national competitiveness, we have chosen structural reforms based on three pillars – economy, social system and public sector.

Economic reform is happening mainly through EU Structural Funds, as no other financing was available for stimulating growth. The aim of our activities is to support enterprises in increasing the value added of their production, as well as their ability to export. To achieve this objective, we have put in place programs promoting innovative products and services as well as the export credit guarantee schemes. On a more macroeconomic policy level, although the margin of manoeuvre is rather limited due to our commitments towards international lenders, we are looking at reshaping our tax system in the medium term.

One of the features of the Latvian social system was poor accessibility and inefficient targeting of social benefits. My government has put in place an emergency safety net, keeping a focus on active labour market programs and reviewing the benefit system. In 2009 and 2010 we consolidated the budget by 1 billion *lats* or over 10 percent of GDP. The challenge is to make the right decisions on social sector reforms to increase efficiency, but not jeopardize the economic growth prospects in the medium and longer term.

I have a large collection of news headlines from last year predicting total economic and financial collapse for Latvia. Also there were large speculations against the *lats* and I am glad to say that those predictions were wrong, and Latvia not only survived, but is recovering well. As the Wall Street Journal noted on 10 April this year, “the case of Latvia shows that with enough political will, it is possible to slash a fiscal deficit even when an economy is collapsing”. The case of Latvia also shows that it is very difficult to apply a ‘one size fits all’ approach to economic problems, due to local conditions and culture. There is no magic remedy.