ECONOMIC CRISIS IN NEW EU MEMBER STATES IN CENTRAL AND EASTERN EUROPE: FOCUSING ON BALTIC STATES

Yoji Koyama*

Abstract

After giving a general view of the economic crisis in new EU member states in Central and Eastern Europe, this paper examines the causes, focusing on 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 labor market. Banks from Nordic countries, Sweden in particular, 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 foreign currency, monetary policies of the central bank are of no use. The Latvian economy already showed a sign of overheating in 2005. However, in the spring of 2007, the government turned to restrictive policies, causing depression at the end of 2007. In addition, the Lehman shock dealt the Latvian economy its final blow.

Baltic States have shared a common weakness in terms of their development relying heavily on foreign capitals. In the case of Estonia and Lithuania, however, the circumstances in which foreign-owned banks have been overwhelmingly dominating the banking sector benefited these countries. As parent banks of foreign-owned banks coped with difficulties, both countries were able to avoid the worst case scenario.

Latvia, which is reconstructing its economy under support from the EU and the IMF, set up the introduction of the euro in 2013 as an exit strategy. Latvia is in dilemma: If the country does not devalue its national currency and tries to satisfy the Maastricht criteria (especially having a budget deficit of less than 3% of the GDP) soon, it will be obliged to adopt pro-cyclical policies, causing economic stagnation.

There is a scenario in which the financial crisis in Latvia might cause disorder in the EU economy via the possible collapse of Swedish bank(s), but the likelihood that this will come to pass seems very small.

Keywords: Global financial crisis, EU-Phoria, Central and Eastern Europe, Baltic States, Latvia

JEL Classification: E30, E44, F41.

* Yoji Koyama is Professor Emeritus at Niigata University, Japan. The author is greatly indebted to Professor Takayasu Itoh (Faculty of Economics, Niigata University) who kindly answered his questions on financial problems. The author would like to express gratitude to Associate Professor Carmen Hannah (Faculty of Education, Niigata University) for her linguistic assistance.
1. Introduction

More than twenty years have passed since the system change in Central and East European countries (Central Europe + South Eastern Europe + Baltic States). These countries have undergone remarkable development since the mid-1990s and have realized a long-cherished desire, i.e. membership of the European Union (EU) from 2004 through 2007. 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. The NMS have been more or less in economic crisis. The economic crisis has been very serious in Hungary and the Baltic states. Some newspapers reported that the crisis in NMS might shake advanced EU member states (for example, Austria, Sweden, etc.) due to a huge amount of credit which banks in the latter countries have given.

To begin with, this paper tries to grasp the general picture of the economic crisis in the NMS in Central and Eastern Europe, mainly based on studies by a research group at the Vienna Institute for International Economic Studies (wiiw). Then 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, questions which the economic crisis in the Baltic States raised are examined, that is, the effectiveness of the prescription from the EU and the IMF, as well as a scenario in which the financial crisis in Latvia might cause disorder in the EU economy via the possible collapse of Swedish bank(s). Finally the paper reaches some conclusions.

2. Economic Crisis in NMS: Various Scenes

Among NMS we can find various scenes of the economic crisis, ranging from countries with very serious crisis to countries with rather milder crisis. 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 a group which is hardest hit by the crisis.

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1 For example, a news item that reported on “Latvia’s crisis” causing unrest in Europe. *Nihon Keizai Shim bun*, June 10, 2009.
Table 1  Extent of the Growth Reversal

<table>
<thead>
<tr>
<th>Country</th>
<th>Change in quarterly GDP growth rates, Q1 2009 compared to Q2 2008, percentage points</th>
<th>GDP growth rates real change in % against preceding year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2008</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-18.8</td>
<td>5.2</td>
</tr>
<tr>
<td>Latvia</td>
<td>-16.1</td>
<td>-1.9</td>
</tr>
<tr>
<td>Romania</td>
<td>-15.5</td>
<td>9.3</td>
</tr>
<tr>
<td>Estonia</td>
<td>-14.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>Slovenia</td>
<td>-14.0</td>
<td>5.5</td>
</tr>
<tr>
<td>Slovakia</td>
<td>-13.5</td>
<td>7.9</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-10.6</td>
<td>7.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>-8.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>-8.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Poland</td>
<td>-5.1</td>
<td>5.9</td>
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</table>


Table 2  Changes in the Unemployment Rate

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
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<td>4.0</td>
<td>8.8</td>
<td>8.3</td>
<td>7.9</td>
<td>7.1</td>
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<td>4.4</td>
<td>7</td>
<td>7</td>
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</tr>
<tr>
<td>Hungary</td>
<td>7.4</td>
<td>10.3</td>
<td>6.4</td>
<td>6.1</td>
<td>7.2</td>
<td>7.5</td>
<td>7.4</td>
<td>7.8</td>
<td>10.5</td>
<td>11</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>11.8</td>
<td>13.3</td>
<td>16.1</td>
<td>19.0</td>
<td>17.8</td>
<td>13.8</td>
<td>9.6</td>
<td>7.1</td>
<td>9</td>
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<tr>
<td>Slovakia</td>
<td>n.a.</td>
<td>13.1</td>
<td>18.6</td>
<td>18.1</td>
<td>16.2</td>
<td>13.4</td>
<td>11.1</td>
<td>9.5</td>
<td>13</td>
<td>14</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td>8.2</td>
<td>7.4</td>
<td>7.0</td>
<td>6.3</td>
<td>6.6</td>
<td>6.0</td>
<td>4.8</td>
<td>4.4</td>
<td>7</td>
<td>7.5</td>
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</tr>
<tr>
<td>Bulgaria</td>
<td>11.1</td>
<td>16.5</td>
<td>16.9</td>
<td>12.0</td>
<td>10.1</td>
<td>9.0</td>
<td>6.9</td>
<td>5.6</td>
<td>9</td>
<td>9</td>
<td>8</td>
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</tr>
<tr>
<td>Romania</td>
<td>3.0</td>
<td>n.a.</td>
<td>6.9</td>
<td>8.0</td>
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<td>7.3</td>
<td>6.4</td>
<td>5.8</td>
<td>9</td>
<td>9</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>n.a.</td>
<td>9.7</td>
<td>13.6</td>
<td>9.6</td>
<td>7.9</td>
<td>5.9</td>
<td>4.7</td>
<td>5.5</td>
<td>15</td>
<td>18</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>n.a.</td>
<td>18.9</td>
<td>14.5</td>
<td>10.4</td>
<td>8.7</td>
<td>6.8</td>
<td>6.0</td>
<td>7.5</td>
<td>18</td>
<td>22</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.3</td>
<td>17.5</td>
<td>16.4</td>
<td>11.4</td>
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<td>5.8</td>
<td>15</td>
<td>19</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

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

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 loans in foreign currency of all total loans (Table 3). The share of loans denominated in foreign currency of all total loans has been very high in the Baltic States, especially in Latvia and Estonia, which ranged from the 80% mark to nearly 90%, and in Latvia it exceeded 90% in 2009. In Lithuania, Hungary and Romania it accounts for about two-thirds of total loans. In Bulgaria it has been fluctuating on 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, i.e. the Czech Republic, Slovakia and Slovenia it has been very low2.

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Apr</th>
<th>May</th>
<th>Jun</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>12.9</td>
<td>13.0</td>
<td>12.4</td>
<td>12.6</td>
<td>13.1</td>
<td>13.1</td>
<td>13.2</td>
<td>13.6</td>
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<td>14.4</td>
<td>14.4</td>
<td>13.8</td>
<td>13.4</td>
</tr>
<tr>
<td>Hungary</td>
<td>53.8</td>
<td>56.6</td>
<td>56.3</td>
<td>55.7</td>
<td>56.9</td>
<td>58.7</td>
<td>63.7</td>
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<td>64.6</td>
<td>67.3</td>
<td>67.4</td>
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<td>66.3</td>
</tr>
<tr>
<td>Poland</td>
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<td>24.1</td>
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<td>24.2</td>
<td>25.8</td>
<td>27.0</td>
<td>30.1</td>
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<td>34.8</td>
<td>35.8</td>
<td>35.5</td>
<td>33.9</td>
</tr>
<tr>
<td>Slovakia 1)</td>
<td>17.7</td>
<td>17.3</td>
<td>17.6</td>
<td>17.6</td>
<td>17.6</td>
<td>17.6</td>
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<td>17.6</td>
<td>17.6</td>
<td>17.6</td>
<td>17.6</td>
<td>17.6</td>
</tr>
<tr>
<td>Slovenia 2)</td>
<td>6.8</td>
<td>6.6</td>
<td>6.5</td>
<td>6.4</td>
<td>6.6</td>
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<td>7.0</td>
<td>6.8</td>
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<td>6.6</td>
<td>6.4</td>
<td>6.1</td>
<td>6.0</td>
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<tr>
<td>Bulgaria</td>
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<td>53.3</td>
<td>54.2</td>
<td>54.7</td>
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<td>55.7</td>
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<td>57.4</td>
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<tr>
<td>Romania</td>
<td>62.4</td>
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<td>64.4</td>
<td>64.1</td>
<td>63.9</td>
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<td>84.9</td>
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<td>85.3</td>
<td>85.7</td>
<td>86.0</td>
<td>86.4</td>
<td>86.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>85.8</td>
<td>83.9</td>
<td>87.7</td>
<td>89.8</td>
<td>88.2</td>
<td>87.4</td>
<td>88.9</td>
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<td>91.6</td>
<td>91.9</td>
<td>92.1</td>
<td>91.0</td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
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<td>62.3</td>
<td>62.3</td>
<td>62.7</td>
<td>62.8</td>
<td>62.8</td>
<td>63.4</td>
<td>64.0</td>
<td>64.9</td>
<td>65.7</td>
<td>66.2</td>
<td>66.9</td>
</tr>
</tbody>
</table>

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

Among countries relying on foreign capital, the Czech Republic has not suffered such serious damage. In this country the share of loans denominated in foreign currency of total loans is low. The exposure of the Czech banks to sub-prime securities is negligible. Despite quite vigorous GDP growth, the domestic credit

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

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange Rate Regime</th>
<th>Target Date for Introduction of Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>Currency Board</td>
<td>Currently ERMII. 2011</td>
</tr>
<tr>
<td>Latvia</td>
<td>Pegged to Euro</td>
<td>Currently ERMII. Changed from 2008 to 2013.</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Currency Board</td>
<td>Currently ERMII. Not fixed.</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Euro (since January 1, 2007)</td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
<td>Euro (since January 1, 2009)</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>Floating Exchange Rate</td>
<td>2013, but will be extended.</td>
</tr>
<tr>
<td>Hungary</td>
<td>Floating Exchange Rate</td>
<td>After 2012</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Floating Exchange Rate</td>
<td>Changed from 2010 to 2012.</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Currency Board</td>
<td>Not fixed.</td>
</tr>
<tr>
<td>Romania</td>
<td>Floating Exchange Rate</td>
<td>Plans to join ERM II in 2012, and Euro in 2014.</td>
</tr>
</tbody>
</table>

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

Among NMS in 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. What makes Poland different from the other NMS? Richter, et al. (2009) mention the following points: i) the country's size; ii) its relatively low levels of exports and imports; iii) a production structure more diversified than in other NMS; and iv) Poland’s domestic financial system appears to be in good shape with debt levels (of households, the government and corporate sectors) significantly lower than elsewhere. In addition to these points, we can add another factor: This country has had a relatively high share of people engaged in agriculture (19% of all employed people in 2004) and enjoyed higher prices of agricultural products after EU accession as well as support from the Common Agricultural Policy (CAP) of the EU. Therefore domestic demand has been kept in good shape.

3 However, Richter et al. (2009) say, “This fact is not a sign of an exceptionally forward-looking policy. Rather, it follows from the brevity of the preceding GDP growth speedup which started only in 2006 and did not have time to reach the unsound proportion which characterized many other NMS” (p.4).

4 Professor Witold Morawski (Kozminski University) and Professor Masahiro Taguchi (Okayama University) provided the author with useful opinions on this point.
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 of loans denominated in foreign currency of all 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 of loans denominated in foreign currency of all total loans was higher (Romania and Hungary), the shock was relatively large.

Third, one country with a floating exchange rate, a higher share of loans denominated in foreign currency of all total loans and, in addition, a higher share of public debt compared with the 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 amount of current account deficit, relatively large external debts, a very high share of loans denominated in foreign currency for total debts, etc. their economies have been very vulnerable to external shocks.

3. The Baltic States
3.1 General View

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 population of the rural areas in these countries ranged between 31% and 33%. Since the 19th century the Baltic States have been agricultural countries. It was after incorporation into the Soviet Union that full-fledged industrialization began. 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 program in September 1991. In June 1995 they concluded European Agreement with the European Union, and in December of the same year they together 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 enjoy four freedoms: free movement of goods, free movement of services, free movement of capitals and free movement of labor. 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’ such as ‘the Baltic Sea economic area’ has practically been formed with Sweden playing an outstanding role in the area.

The economies of the Baltic States turned upward around 1995. Although under the influence of the financial crisis in Russia in August 1998 their economies stagnated in 1999 (GDP growth rates declined in Latvia, Estonia and Lithuania to 3.3%, -0.1% and -1.5% respectively.), they began to have high economic growth from 2000 (see Figure 1). Latvia in particular accomplished double-digit economic growth for three consecutive years from 2005 and also 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 percent and it recorded double-digits until 2007. Both Latvia and Lithuania attracted a huge amount of FDI, although the amount was not as much compared with Estonia.
During this period the unemployment rate rapidly decreased in these countries. In 2001 the unemployment rate recorded a double-digit figure in these countries, 12.9 percent, 11.9 percent and 17.4 percent in Latvia, Estonia and Lithuania respectively. The unemployment rate was gradually decreasing. Being attracted by higher wage levels, labor migration to EU-15, especially the UK became popular after EU accession in 2004 (Figure 2), and the unemployment rate decreased more rapidly to around 5 percent in 2007. In parallel with this process domestic labor 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 percent in Latvia, 9.6% in Estonia and 8.1% in Lithuania). Around 2005 the economies of the Baltic States reached the situation of overheating. Imports increased reflecting domestic consumption booms. Although there have been significant amounts of transfer from overseas, their current account deficits expanded, reaching unsustainable levels (current account deficit as a percentage of GDP in Latvia, Estonia and Lithuania was -22.8 percent, -17.4 percent and -13.7 percent respectively).

Table 5  Ten Most Important Product Groups in Merchandise Exports to the EU-27 in 2008, SITC Classification

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Latvia</th>
<th>Estonia</th>
<th>Lithuania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product label</td>
<td>Share</td>
<td>Product label</td>
<td>Share</td>
</tr>
</tbody>
</table>

### Latvia

The industrial structure can be outlined as follows: About 5 percent of Latvia’s GDP is produced by agriculture, forestry and fishery and about 25 percent by manufacturing. The main items of export are products of so-called low-technology and middle-high technology including wood products such as wood and furniture, cast iron and steel (see Table 5). Nearly 70 percent of the GDP comes from the service sector, which includes the wholesale and retail trade, transport, shipping, and 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. 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” (IMF, 2009b). In a similar way, Emerging Europe Monitor published by Business Monitor International and

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5 This expression is taken from the title of Rahman (2008).
CEE Quarterly published by Unicredit group often pointed out in 2007 the necessity for soft landing to moderate economic growth.

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 the economic development. Inward FDI stock amounted to € 7.261 billion as of 2007. As for investor countries, investment from Estonia, a neighboring country in the Baltics, rapidly increased in recent years. In terms of inward FDI stock Estonia exceeded Sweden in 2006 occupying first place. In 2007 Estonia occupies first place with its stock being € 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 for Latvia is in 12th place (3.1%) in inward FDI stock. Possibly companies in the UK may have been investing in Latvia via their subsidiaries in Estonia. When we examine inward FDI stock considering economic activities, Financial intermediation takes up the biggest share (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%). In this way, the share for manufacturing is very small (Hunya, 2008, pp.85-87). In recent years FDI inflow concentrated mainly in the non-tradable sector such as the retail trade, real estate and financial services.

Table 6  Latvia - Main Economic Indicators

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

* 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 data as of July, and for budget balance an estimate for the whole year. ** Based on the author's own calculation.


After EU accession unemployed persons, 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 labor force). For two years until early 2006 the unemployment rate decreased by 2.5 percent to 7.75 percent, and the labor 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.

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 had been relatively large, but it has been substantially surpassed by the current account deficit every year (Table 6). How has the gap been covered? The table of international payment (Bank of Latvia, 2009)
indicates that the amount of inflow of portfolio investment has been small (it often recorded negatives and consecutively recorded negatives from Q4 2008 through Q4 2009). As a matter of fact, ‘other investment’ (it overwhelmingly has been borrowings by foreign-owned banks from parent banks) in the financial account has exceeded the amount of FDI inflow and covered most of the current account deficit every year until the end of 2007 (Banincova, 2009). Major banks in Europe depend to a lesser extent on deposits by general customers, however, as for financial resources in recent years they increasingly finance themselves on wholesale markets (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 euros7. Thus households and enterprises in Latvia became able to enjoy lower interest rates. Credit to private sector residents increased by nearly 65 percent in 2005, and the loan to GDP ratio reached 70 percent, 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 loans8. Economists at UniCredit group described Latvian people’s behavior as a ‘spree of high consumption’ (CEE Quarterly, 03/2007). The IMF mission which visited the country in April 2007 warned the government of Latvia that the mindset of ‘buy now and pay later’ had taken root, increasing systemic risk.

The fiscal policy was expansionary. In addition there has been inflow of EU grants amounting to 3-4 percent of the GDP every year. Programs such as the Common Agricultural Policy (CAP) provide households with direct income support. EU funds from Structural Funds and Cohesion Funds flowed into this country through public infrastructure projects and employment policies. Private companies were able to use EU funds in the form of upgrading of equipment (Allard, 2008). The fiscal policy was at the same time pro-cyclical. The budget revenue recorded natural increases due to a boom at that time, and it became a normal pattern that over-performance of the budget was not saved but instead consumed through additional expenditures on a supplementary budget towards the end of the year. At the Article IV Consultation9 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 this year in view of pre-election spending measures and large public sector wage increases. Rather taking into consideration the

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

8 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 percent”. IMF (2006c), Chapter III, Box 1.

9 The IMF is to make consultations with governments of its member states once a year on the basis of the Article IV of the Agreement.
over-performance of the budget revenue, the government was planning a phased 10
percentage point reduction in the personal income tax rate to 15 percent beginning in
2007 in order to bring it into line with the corporate 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 percent in 2006. Economists at the
UniCredit Group viewed it as consumption-led economic growth10, saying the
following: 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, sector 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).

Reflecting the consumption boom and the housing bubble, the inflation rate
increased. It fluctuated between 1.4 percent and 3.6 percent until 2003 but jumped to
7.3 percent in 2004 and recorded 7.0 percent and 6.8 percent in 2005 and 2006
respectively. In November 2006 the central bank raised the refinancing rate by 50
bps to 5 percent, 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 had had a goal of adopting the Euro in 2008, it was difficult for this country to
have an interest rate quite different from that of the European Central Bank. In
addition, when people can freely get loans in foreign currency it would be no use for
banks to increase the borrowing rate in Lats11. 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.

Increase in wages, surpassing a rise in productivity, as well as inflation gradually
eroded Latvia’s export competitiveness. Every year the country recorded a huge
amount of trade deficit, which was partly covered by FDI inflow, but it had still a
wide current account deficit. In 2005 the current account deficit accounted for 12.7
percent of the GDP, which was already an alarming amount, but rapidly increased to
21.2% of the GDP in 2006. At the Article IV Consultation in Autumn 2006 the IMF
mission expressed a 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 of
Euro adoption. However, government officials did not have such a perception that
the economy was overheated, and they were more sanguine in their assessment of
economic developments and, accordingly, were not planning a significant change in
the course of fiscal or other policies. Rather, Finance Ministry officials welcomed

10 The IMF staff made a similar remark. IMF (2006b), Public Information Notice, No.113.
11 National currency of Latvia. 1 Euro =0.7028 Lat.
Latvia’s dynamic growth as essential to deliver 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 term (IMF, 2006a, pp. 14-16).

### 3.3. Switchover to restrained policies

Even if the government was sanguine, foreign observers were very much concerned with the Latvian economy. Since the government left a huge amount of current account deficit with the external debt, exceeding 100 percent of the GDP, and in spite of the receding prospect of introducing the euro, S&P, a grading company, 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, 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 in the same year the inflation rate increased to 8.9 percent. The central bank hiked interest rates by 50bps to 6 percent 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).

Such a package of measures did not have any impact on the economy immediately, 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 it was in July that they were approved and translated into action. 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 wood processing, furniture, radio, television and communication equipment sectors (EEM, October 2007). Although at a somewhat lower pace in Q3 2007, real GDP increased to a still high 11.9% y-o-y.

The government measures introduced in July began to have an effect in 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 at interbank
markets, making credit activities more cautious (Tanaka, 2009). Among ‘other investments’ in the Latvia’s Balance of Payments (Table 7), the borrowing of funds by subsidiaries from parent banks showed positive so far, but turned negative in Q1 2008, which meant backward flow of funds. Namely, the withdrawal of funds by parent banks from their subsidiaries occurred (although subsequently this item recorded positive in Q2 and Q3 2008, it recorded negatives for a consecutive five quarters from Q4 2008 through Q4 2009) (Bank of Latvia, 2009). Thus both companies and households came to feel a shortage of money. 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).

In this way, 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 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 has risen from 9 percent of the GDP to approximately 55 percent at the end of 2007) and increased uncertainty about the outlook for jobs and income, while persistently high inflation (17.5 percent in April 2008) started to damage household purchasing power. Inflation-adjusted retail trade turnover fell by 1.1 percent y-o-y in Q1 2008 while the number of newly registered cars was down 49 percent y-o-y in March 2008. Private consumption was also being dampened by negative wealth effects associated with the steady decline in property prices, 7 percent y-o-y in Q4 2007. The construction industry was also slowing 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 unemployment rate increased to 15.5% on average in 2008. It was stagflation.

The Latvian economy fell into depression in December 2007. In addition to this, the Lehman shock in September 2008 dealt the Latvian economy a final blow. In October of the same year Parex Bank12, the second largest bank in Latvia, was greatly exposed to sudden outflow of non-resident deposits and faced serious liquidity constraints. In the ranking of the top ten banks in Latvia there are four domestic banks with their total market share being 29.5% (Table 8). A remaining share (70.5%) is occupied by six subsidiaries of foreign banks, of which three are Swedish banks. In

12 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.
contrast to this, subsidiaries of foreign banks occupy an overwhelming majority of the total share in Estonia and Lithuania with their share in the total asset in 2007 being 98.7% and 85.3% respectively (Banincova, 2009). Thanks to this, both countries, 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.

Table 8  Top Ten Banks in Latvia

<table>
<thead>
<tr>
<th>Banks</th>
<th>Market share</th>
<th>Parent banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hansabanka</td>
<td>21.7%</td>
<td>Swedbank (Sweden)</td>
</tr>
<tr>
<td>Parex banka</td>
<td>14.6%</td>
<td>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.</td>
</tr>
<tr>
<td>SEB Unibanka</td>
<td>14.1%</td>
<td>SEB (Sweden)</td>
</tr>
<tr>
<td>DnB Nord</td>
<td>8.3%</td>
<td>DnB Nord: Joint Venture of DnB (Norway) and Nord/LB (Germany)</td>
</tr>
<tr>
<td>Nordea</td>
<td>7.9%</td>
<td>Nordea Group (Sweden)</td>
</tr>
<tr>
<td>Rietumu banka</td>
<td>5.6%</td>
<td>Majority private capital</td>
</tr>
<tr>
<td>Aizkraukies banka</td>
<td>5.1%</td>
<td>Private local capital</td>
</tr>
<tr>
<td>Latvijas Hipoteku un zemes banka</td>
<td>4.2%</td>
<td>State</td>
</tr>
<tr>
<td>UniCredit</td>
<td>3.4%</td>
<td>UniCredit Group (Italy)</td>
</tr>
<tr>
<td>Latvijas Krajbanka</td>
<td>3.1%</td>
<td>Snoras (Lithuania)</td>
</tr>
</tbody>
</table>

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

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. In the meantime, the central bank of Latvia had to intervene in the foreign exchange market to defend the fixed exchange 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 program for Latvia was finalized. Soon the rescue package for Latvia was decided as follows: The IMF provides 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 provides € 3.1 billion ($ 4.3 billion), Nordic countries € 1.8 billion ($ 2.5 billion), the World Bank € 0.4 billion
The credit is to be released in several tranches from the end of 2008 until mid-2011. About half of the money is 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).

With this external help, the financial market in Latvia managed to hold on, but Latvia was regarded as a highly risky country and it had difficulty to get loans from the international credit market. People’s complaints against the government increased, leading to riots in the streets of Riga in mid-January 2009, which were the first riots of this kind since Latvia’s independence in 1991. In February the coalition government led by Prime Minister Ivars Godmanis dissolved. In March a five-party coalition government led by Valdis Dombrovskis\textsuperscript{13} was formed.

It should be noted that the rescue package by the EU and IMF was accompanied by strict conditions. The government of Latvia was obliged 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 was very strict in keeping to the tight fiscal policy. The EU and the IMF 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 envisaged for the end of May\textsuperscript{14}.

By the end of May, forex reserves of the Bank of Latvia 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 was looming, 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, a possibility of devaluation of the Latvian national currency was whispered about both outside and inside (even within the government) of Latvia.

\textsuperscript{13} 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 (\textit{EEM}, May 2009).

\textsuperscript{14} According to the IMF Survey Magazine, the EU’s Economic and Monetary Affairs Commissioner Joaquin Almunia said May 6 that the EU would like to see more progress on budget and structural reforms before it releases the second tranche of its aid program, worth about € 1 billion (IMF, 2009b).
However, the devaluation of the national currency would enhance the international competitiveness of Latvia’s export products on the one hand, but it would bring a sudden rise in the debt service obligation denominated in national currency for both companies and households on the other hand.

After all, the government of Latvia abandoned the nominal depreciation and chose ‘internal depreciation’ (adjustment of real economy), namely, 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 budget for 2009, fixing a cut in government expenditures by 40% in 2009 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 were to be cut severely, two-thirds of the nation’s 73 inpatient hospitals and dozens of schools were announced 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 could 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, they disproportionately hurt the poor and that they 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 includes guaranteed minimum income payments covering health copayments for the most vulnerable, increasing funds for emergency housing support, protecting schooling for six-year-olds, and promoting job creation through active labor 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 since 1997 (IMF Survey Magazine: Interview, July 28, 2009).

Of course such consideration for the most vulnerable people is necessary, but being bound by the conditionality for the financial support from the EU and the IMF the government of Latvia is not allowed to adopt more active fiscal policies to boost the economy. In spite of relentless cuts in expenditure and the increases in tax rates as 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 set the introduction of the Euro for 2013 as an exit strategy. In order to accomplish this, Latvia is required to satisfy the Maastricht criteria having a budget deficit of less than 3% of the GDP, public debt of less than 60% of the 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 which neoliberal prescriptions have often failed in Latin America (Sano, 2009), the Latvian economy will stagnate for a long time in the future. Latvian people are forced to practice austerities with increasing unemployment and cuts in wages and pensions, but I wonder until when they can endure such difficult lives.

4 Sweden

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 percent of the Swedish GDP, while their loans to their subsidiaries amounts to 35-45 percent of bank capital. In addition, Swedish banks’ reliance on operating profits from Baltic operations is extensive (25% for Swedbank and nearly 10 percent for SEB) (IMF, 2009b, p.29).

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 were exposed to Baltic states, and both 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 balances of loans in Latvia, dropped by more than 10 percent in June 2009 (Nikkei Shimbun, June 10, 2009).
Riksbanken (the central bank of Sweden) as well as Finansinspektionen (Finance Inspection Agency of Sweden) conducted stress tests for the largest banks (Nordea, SHB, Swedbank and SEB) independently. 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 nine percent Tier 1 capital ratio. In scenario 2, 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\(^\text{15}\) at the end of 2011, 8.2 percent and 6.0 percent respectively. In scenario 3, for three banks not including SHB credit losses exceed profit. For all of the four banks Tier 1 capital ratios decrease at the end of 2011, but all of them fulfill the minimum regulatory requirements by a solid margin.

Scenario 2 and 3 assume very high credit loss levels. Finansinspektionen views that these scenarios are improbable but not impossible. It calls banks’ attention,

\(^{15}\) Tier 1 refers to banks’ owned capital in the narrow sense.
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 in this country 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 significantly lesser role for companies. Corporate bonds and commercial papers comprise only 9 and 2 percent, respectively, of companies’ total borrowing. The remainder, other loans, mainly consists of loans raised within the corporate group (including cross-border loans). In 2008 a number companies encountered difficulties in finding buyers for their bonds overseas. Although inflow via issues of bonds 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 the shortfall in financing for major companies arising 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 in order 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 at 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 which are listed as follows: 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 economists at the central bank 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 possible collapse of Swedish bank(s).

5 Conclusion

Taking all of the above into consideration, we can conclude as follows: First, in Latvia a boom continued in the mid-2000s, and the economy showed a sign of overheating already in 2005 but the government responded to it too late. Only in the spring 2007 did the government turn to restrictive policies, causing depression in the
end of 2007. In addition to that, the Lehman shock dealt the Latvian economy a final blow. EU membership has both positive and negative aspects. Thanks to the Single Market in 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 labor 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 can easily get loans denominated in foreign currency the financial policies of the central bank of Latvia are of no use. Within the framework of the EU monetary authorities in Sweden, which is the home country of Swedish banks’ subsidiaries operating in Latvia, are responsible for supervision, but they have not regulated these financial institutions there.

Second, Baltic states have had a common weakness in terms of their development relying heavily on foreign capitals. In the case of Estonia and Lithuania, however, the circumstances in which foreign-owned banks have been overwhelmingly dominating the banking sector benefited these countries. Namely, as parent banks of foreign-owned banks coped with difficulties both countries were able to avoid the worst situations.

Third, Latvia, which is reconstructing its economy under 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 (especially having a budget deficit less than 3% of the GDP) soon, 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 the central banks of developing countries so that they can afford to have expansionary budgetary programs (Frenkel & Rapetti, 2009).

Fourth, financial authorities in Sweden have been properly responding to difficulties the domestic banking system has been facing. It seems the least probable scenario that the financial crisis in Latvia will cause disorder in the EU economy via the possible 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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