Introduction

One of the most remarkable financial crises of 2008–10 has been the one that unfolded in Latvia. The country was already the most overheated economy in the European Union when the crisis hit. Then it suffered a near complete liquidity squeeze, which shaved off no less than one-quarter of its GDP.

Contrary to popular expectation at the time, Latvia did not crumble and social calm prevailed. Its democratic, parliamentary system of government proved perfectly able to handle and resolve the crisis. After two years of output contraction, Latvia's economy began to expand again in 2010 on the back of strong export growth.

The economic policy that helped Latvia recover from the crisis is striking. A broad majority opposed devaluation of the Latvian currency, the lat, and the country has maintained its fixed exchange rate to the euro. Instead Latvia carried out an "internal devaluation" with large cuts in wages and public expenditures as well as strategic reforms in public services. The country benefited from one of the largest international financing packages and became an experiment of cooperation between the International Monetary Fund (IMF) and the European Union.

Motivation

Why write a book about a brief financial crisis in a small country such as Latvia with a population of only 2.2 million? There are many reasons why this topic is worth a book.

Measured as decline in GDP from peak to nadir—25 percent—Latvia experienced the most severe financial crisis in the world during the crisis years of 2008–10. Unemployment, as measured by labor force surveys, peaked in the first quarter of 2010 at 20.7 percent of the active labor force—the worst in the European Union. Yet, in spite of the severity of the crisis, the Latvian economy recovered reasonably quickly and soundly after nine quarters of declining GDP in annualized terms. Latvia stands out as an example of how such a financial crisis can be resolved.

The financial crisis in Latvia, as well as in its Baltic neighbors Estonia and Lithuania, provoked a charged international policy debate. Numerous international economists argued that devaluation was not only necessary but also inevitable. By the end of 2009, however, it became clear that they were wrong.

Instead, all three Baltic countries have pursued "internal devaluations"—cutting public expenditures, wages, and other costs, while carrying out profound structural reforms. When a country needs to address underlying structural inefficiencies in the economy, internal devaluation is preferable to exchange rate devaluation, which offers only temporary relief from cost pressures while avoiding long overdue reforms.

An intriguing aspect of the crisis has been the political economy of Latvia's financial stabilization, which was carried out by a coalition government of some four parties, sometimes with a minority in the parliament, with one government collapsing in the middle of the crisis. Even so, the Latvian government succeeded in overcoming the crisis, and the Latvian people offered strong support to the government's policy. Social unrest was minimal, and extremism nearly absent. Most remarkably, the incumbent government that shepherded the nation through the hardship won the parliamentary elections in October 2010, while traditional populism lost out and ethnic tensions were reduced.

The Latvian stabilization program was accompanied by a large international financing package of €7.5 billion ($10.5 billion), 37 percent of Latvia's GDP. Soon, several larger packages were formed for other countries in crisis, but Latvia's was the pioneer. The country has used only 58 percent of the financing available and is already out of the crisis with a reasonable public debt of 42 percent of GDP at the end of 2010, suggesting that the large-scale rescue package was successful.

The international support package for Latvia was composed in a new way. The IMF contributed less than one-quarter of the total, while the European Union offered more than one-third and European neighbors most of the balance, creating a new form of cooperation between the IMF and the European Commission.

Because of the severity of the crisis, the Latvian government had no choice but to undertake large and swift reductions in public expenditures. The total fiscal adjustment has been estimated at 11 percent of GDP in 2009 alone, and most of it involved cuts in public outlays. These large cuts made long-delayed structural reforms in the public sector necessary, notably in public administration, health care, and education. These reforms are likely to generate positive supply effects that will contribute to greater growth in the future.

Key Lessons

Latvia has done what many said could not be done. We emphasize nine lessons on the economics of financial crisis and its political economy.

A key lesson from Latvia's financial crisis resolution is that devaluation is neither a panacea nor a necessity that many economists make it out to be. Latvia suffered from financial overheating. The country's competitiveness needed to improve, which was better done by reducing the bloated salaries and costs. The cure to overheating was to stop excessive short-term capital inflows, which did not require devaluation. The financial crisis erupted because of a sudden stop of international liquidity, and Latvia had to quickly mobilize more liquidity to deal with the crisis. In addition, the steady exchange rate parity forced Latvia to undertake long-overdue structural reforms. The alleged risk of a vicious, deflationary cycle was never real. For a small and open economy such as Latvia, prices are largely determined by the surrounding markets. As the pass through of inflation would have been great, devaluation would not have been effective in restoring competitiveness.

Second, the Latvian people were motivated by their desire for full European integration with early adoption of the euro, which led them to focus on two nominal anchors: a fixed exchange rate and a budget deficit below 3 percent of GDP, so that Latvia could accede to the Economic and Monetary Union as early as possible.

Third, Latvia's experience with fiscal adjustment shows the advantages of carrying out as much of the adjustment as possible early on. Hardship is best concentrated to a short period, when people are ready for sacrifice.

Fourth, more than three-quarters of the fiscal adjustment came from cuts in public expenditures, suggesting that they are economically and politically better than tax hikes. The most popular budget adjustments were cuts of salaries and benefits of senior civil servants and state enterprise managers as well as the reduction in public service positions. Latvians have remained strongly committed to their flat income taxes.

Fifth, the large and frontloaded international rescue effort was appropriate and has been successful. Today, it is difficult to understand that the size of the Latvian package could be controversial. Much larger emergency credits in relation to GDP than before were needed because of greater globalization, and the Latvian crisis was primarily caused by the dearth of international liquidity. It was not a solidity crisis.

Sixth, a strange myth has evolved that affluent democracies are politically unable to undertake large cuts in public expenditures. Latvia, as well as its Baltic neighbors, showed that these vibrant democracies were perfectly capable of reducing their public expenditures by about one-tenth of GDP in one year.

Seventh, the benefits of stable government have been greatly exaggerated. It is more important that a government be adequate than stable, and a precrisis government is rarely a suitable anticrisis government. Latvia benefited from being able to switch government quickly during the crisis. This was possible because of unstable coalition governments, which arise from a parliamentary system with proportional elections. Thus, parliamentary systems with many parties, leading to coalition governments and frequent government changes, may be beneficial for the resolution of macroeconomic crises.

Eighth, the bottom line is that populism is not very popular in a serious crisis when the population understands the severity of the crisis and wants a sensible and resolute government that can handle the crisis as forcefully as is necessary. Thus, the Latvian anticrisis government was able to win the parliamentary elections on October 2, 2010. The big losers in the 2010 elections were oligarchs who tried to exploit populism.

Finally, the international macroeconomic discussion was not useful but even harmful. Whenever a crisis erupts anywhere in the world, a choir of famous international economists proclaim that it is "exactly" like some other recent crisis—the worse the crisis, the more popular the parallel. Soon, prominent economists led by *New York Times* columnist Paul Krugman claimed that "Latvia is the new Argentina." A fundamental problem is their reliance on a brief list of "stylized facts," never bothering to find out the facts.

Structure of the Book

The structure of this book is chronological-thematic. Chapter 1 offers a brief background on Latvia's history and postcommunist transition to market economics and democracy. Chapter 2 discusses the boom of 2004–07 and the causes of the ensuing financial crisis. Chapter 3 presents the policies the government had to choose from in the fourth quarter of 2008 after the crisis had erupted, the initial government program, as well as the international assistance package. Chapter 4 focuses on the key intellectual debate and the biggest choice that the country faced: to devalue or not. Chapter 5 recounts the crisis resolution and the economic and political drama in 2009. Chapter 6 describes the early signs of recovery in 2010, when the financial crisis finally abated. Chapter 7 presents our conclusions, an important one of which is that Latvia is committed to adopting the euro as soon as possible, a goal that the government kept in mind when formulating its crisis resolution strategy.

In most regards, developments in the three Baltic countries took place in parallel during the financial crisis. However, we focus solely on Latvia as a case study of the global financial crisis of 2008–10 and largely avoid too many references to Estonia and Lithuania.

We have used a large volume of official government material in Latvian as sources and for readers' convenience have translated as accurately as possible all quotes and document titles into English. News reports we cite from two Latvian news agencies, LETA and DELFI, have also been suitably translated.