Einar Repse: Macroeconomic stability - a crucial precondition for a successful development

Speech by Mr Einar Repse, Governor of the Bank of Latvia, at the Baltic Business Conference, held in Riga, on 19 May 2000.

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Ladies and gentlemen!

Today we are living in a world where global economic developments affect individual countries much more than they did a decade ago. Along with the unprecedented degree of economic integration within the European Union (EU), we see growth also in international trade and financial transactions in other parts of the world, all of which provides visible evidence of an ever-expanding globalisation.

Latvia joined in this process after regaining independence in 1991. The sad experience of fifty years as a part of a closed albeit large economy has convincingly shown Latvia that separation from the rest of the world through strict economic boundaries is counter-productive and cannot ensure sustainable economic growth. For historical reasons, Latvia and other countries in Central and Eastern Europe had to start their integration in the global economy from a disadvantageous position. Becoming actively involved in international economic affairs is probably the only means by which these countries can catch up with economically advanced countries in Europe in the coming decades.

When economic borders no longer exist and economic developments in one particular region directly affect other regions, it is of vital importance that the economic policies of small countries like Latvia are aimed at securing long-term stability. Being a small, open economy, Latvia cannot entirely avoid external influences, but sound economic policies help to mitigate the negative economic impact of external shocks.

From this perspective, Latvia’s integration into the EU allows for the simultaneous achievement both of greater integration in the global economy and sound economic policies. On the one hand, prior to actual EU membership Latvia has concluded the Europe Agreement with the EU, thus greatly liberalising its foreign trade regime and completely abandoning any restrictions on international capital flows. Hence, efforts to become an EU member have enhanced Latvia’s progress towards integration into the world economy.

On the other hand, membership in the EU requires a well-functioning market economy, one which is able to cope with competitive pressures and market forces within the union, as well as the capacity to undertake the obligations of membership. Thus, pursuit of EU membership incontestably encourages the pursuit of economic policies aimed at long-term stability.

With respect to Latvian monetary policy it is fair to say that the principles guiding actions at the Bank of Latvia are already very close to those employed by the European Central Bank (ECB). The law singles out price stability as the main monetary policy objective of the Latvian central bank and in its operational practice, the Bank of Latvia enjoys full independence from the government. Direct government borrowing from the central bank is also explicitly banned by the law. In pursuing its monetary policy, the Bank of Latvia uses the same market-based instruments employed by the ECB.

Latvian experience confirms that an independent central bank and firm anti-inflationary policies produce the good results expected. Annual inflation in Latvia declined to 2.4% in 1999. The lats has proved its stability for over six years, providing a solid foundation for restructuring and growth in the Latvian economy. Even without participation in the EU Exchange Rate Mechanism, the lats has stayed within the +/- 15% band against the ECU and later the euro during this entire period.

Fiscal policy in Latvia has always been implemented with EU accession in mind, thereby, in accordance with the European Stability and Growth Pact provisions, avoiding unsustainable government expenditure. Despite the dynamic political environment in Latvia since independence, every government has declared EU membership its top priority. Therefore, the pursuit of strict fiscal policies has never been threatened.

Over the past few years, as prudent monetary and fiscal policies led to productive economic transformation, Latvia has become one of the most successful transition economies in Central and Eastern Europe. These policies were tested in 1997-1998 during the Southeast Asian and Russian crises, but the Latvian economy has recovered from these shocks at a relatively fast speed and is now on a growth path again.

At a time of external pressures, the credibility of national economic policies becomes crucial to economic performance, as was evident in Latvia over the previous year and a half. In 1998, the current account deficit in Latvia was financed mainly by long-term capital, as foreign direct investment and other long-term capital inflows amounted to 72% of all capital flows. As a result, Latvia did not suffer from a sharp reversal of short-term capital flows that could have damaged the economy. As time went by and the country's economic situation remained stable, the confidence of foreign investors rebounded quickly. In the second half of 1999, inflows of foreign direct investments increased by 27%, as compared with the first half of the year.

The confidence in the Latvian banking industry was also restored rather quickly among both foreign investors and the general public. Presence of foreign capital as a percentage of total bank capital strengthened and main banking indicators improved considerably. Bank lending increased, acting as the engine for economic growth. Total loans increased by 52% in 1998 and by 15.3% in 1999, and 95% of all loans have been directed at the private sector. Credit growth has been accompanied by a gradual shift from short-term trade finance to increased lending directed towards the productive sector of the economy. In February 2000, the share of loans with a maturity of more than 5 years amounted to 16.8%, while at the end of 1998 the respective figure was 13%. Increased public confidence in the banking sector is also indicated by a 6.3% growth in residents' deposits in 1999. Long-term deposits (over 12 months) grew by 82% in 1999, thus exceeding the pre-Russian crisis level.

Positive trends can be observed in other Latvian financial markets as well. After the share prices fell during the aftermath of the Russian crisis in 1998, the stock market has rebounded: in January 2000, the stock market index in Latvia exceeded the 100 mark for the first time since the Russian crisis. In the first three months of this year, the Dow Jones Riga Stock Exchange Index increased by 33%.

In 2000, the market for government securities has become both wider and deeper, as 3-year government bonds were successfully launched in the domestic market for the first time in January, followed by 5-year bonds in March. The share of government bonds with a maturity of 1 year or more amounts to 86.5% of all government securities. The development of yields on government bonds issued in international markets also shows increasing confidence in the economic policies of Latvian authorities. The spreads on 5-year Eurobonds in the secondary market narrowed from 330 basis points at the beginning of May last year to 148 basis points in February of this year.

A balanced central government budget for 1999 had been adopted originally. Strict fiscal policy enabled the government to use the budget as an automatic stabiliser in the aftermath of the Russian crisis and allow the budget deficit to grow up to 4% of GDP in 1999. However, it is important to stress that this is considered an extraordinary one-time measure. The government has expressed strong intentions to reduce the deficit to 2% of GDP in 2000, with a balanced budget remaining the target for 2001.

As a result of these policies, all of which received public support, the unemployment rate dropped from 10.1% in March 1998 to 9% in March this year, and real GDP development after a 3.6% growth in 1998 remained positive in 1999 as well.

Given the beneficial impact of sound economic policies on Latvia's integration into European markets, there is little doubt that these policies will be implemented in the future as well. In fact, the provisions of the European Stability and Growth Pact and requirements for the members of the monetary union laid down in the EU Treaty specify the direction of economic policy, a direction to which Latvia is committed. Although these criteria are not legally binding for the country prior to EU membership, in the opinion of Latvian authorities and the Bank of Latvia the Maastricht criteria are the proper principles of sound economic policies. Consequently, economic policy in Latvia will be implemented in a way that facilitates thoroughgoing compliance with these requirements in due course. We strongly believe that these policies will establish our country as a small but reliable player in world markets and hence ensure rapid and sustainable growth in Latvia.