Ilmārs Rimšēvičs: Structural reforms to pave the way to prosperity in the future

Speech by Mr Ilmārs Rimšēvičs, Governor of the Bank of Latvia, at the Baltic Economic Forum 2010, Riga, 23 September 2010.

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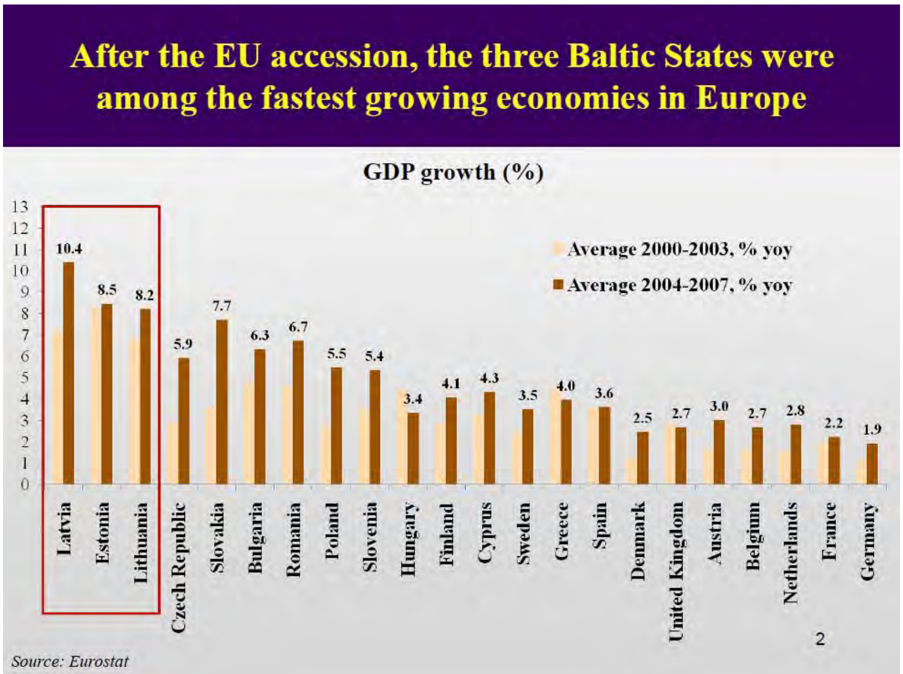
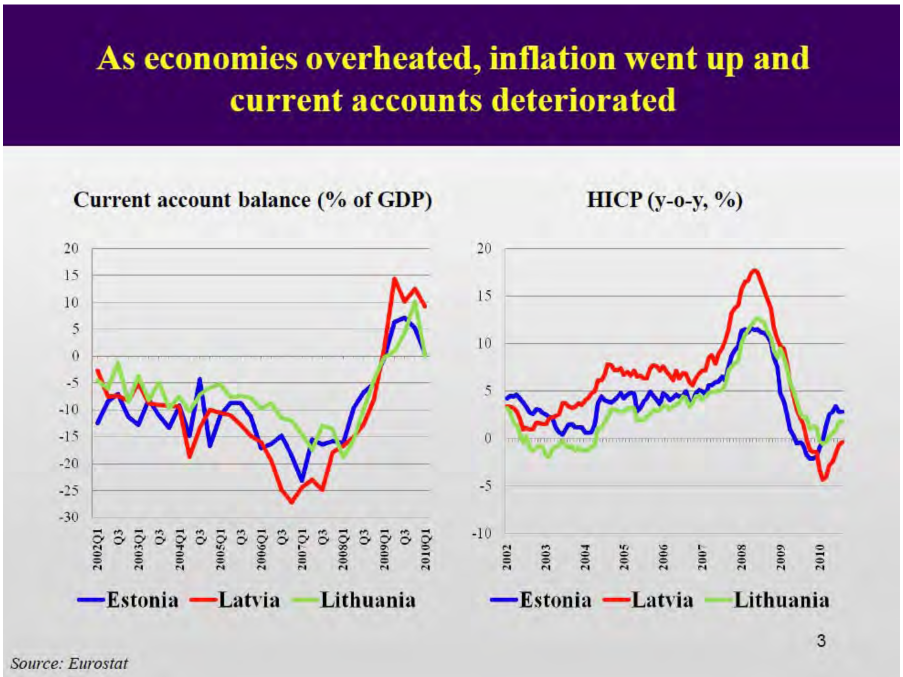
Ladies and gentlemen!

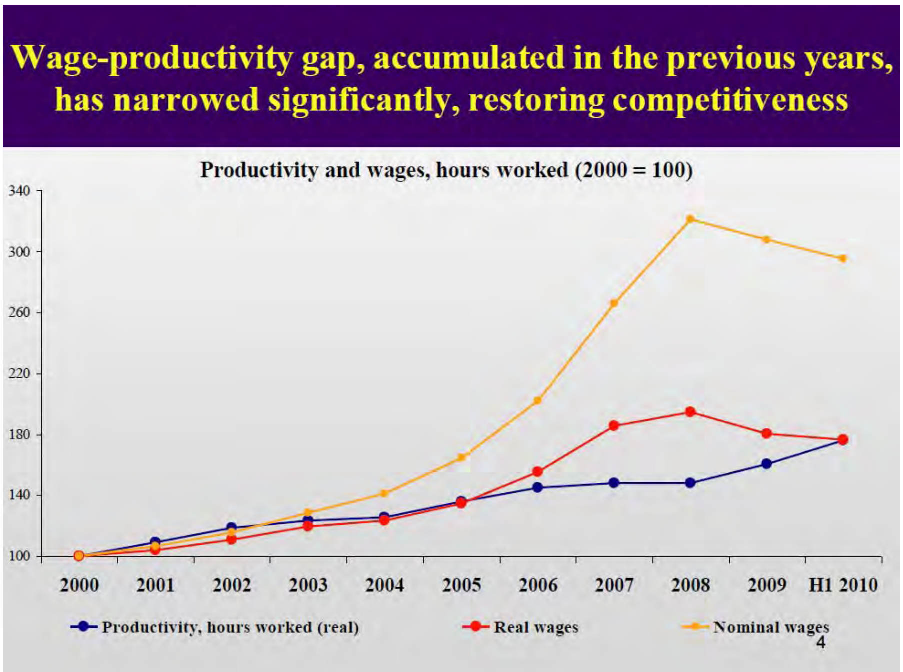
I think only very few would have missed out that the Baltics have attracted a lot of international attention during the recent years. I would even venture to say that the three small countries located by the Baltic Sea – and Latvia above all – have stretched out their boundaries considerably to occupy an increasingly large part of the globe: they have suddenly become more noticeable than ever before. Obviously there must be something unique about these countries that has made them stand out during the recent crisis.

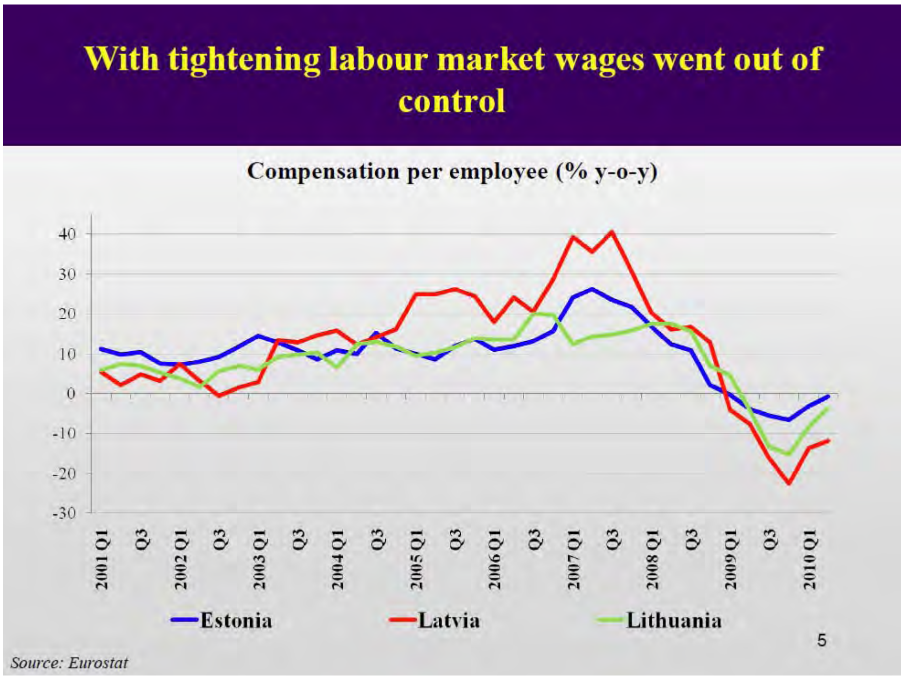
It might be ***the flexibility of the Baltic tigers***: they have shown themselves capable of making great leaps in both directions – forward and backward. The real uniqueness obviously lies in the way the economies have adjusted to the crisis and the magnitude of the economic swings they have experienced. Just a few short years ago we were amongst ***the strongest performers*** in the entire world and clearly the fastest growing economies within the EU. With Latvia leading the race, its GDP grew in the double digits on average for four consecutive years after the EU accession. Other Baltic neighbours followed suite. Blown up by the massive inflows of foreign funds and breathtaking lending growth, by the expansionary fiscal policy and remittances or repatriated wages – domestic demand ballooned bringing along an accelerating inflation and a widening current account deficit. Latvia was unique in recording a current account deficit as high as 27% of GDP during the peak quarters, and stunned the world by sustaining it above 20% for two years in a row. Inflation peaked at 18%, and real estate prices more than doubled in just a few years. Similar, but somewhat less extreme developments were observed in Lithuania and Estonia, with both inflation and current account deficits staying in the double digits during the boom years.



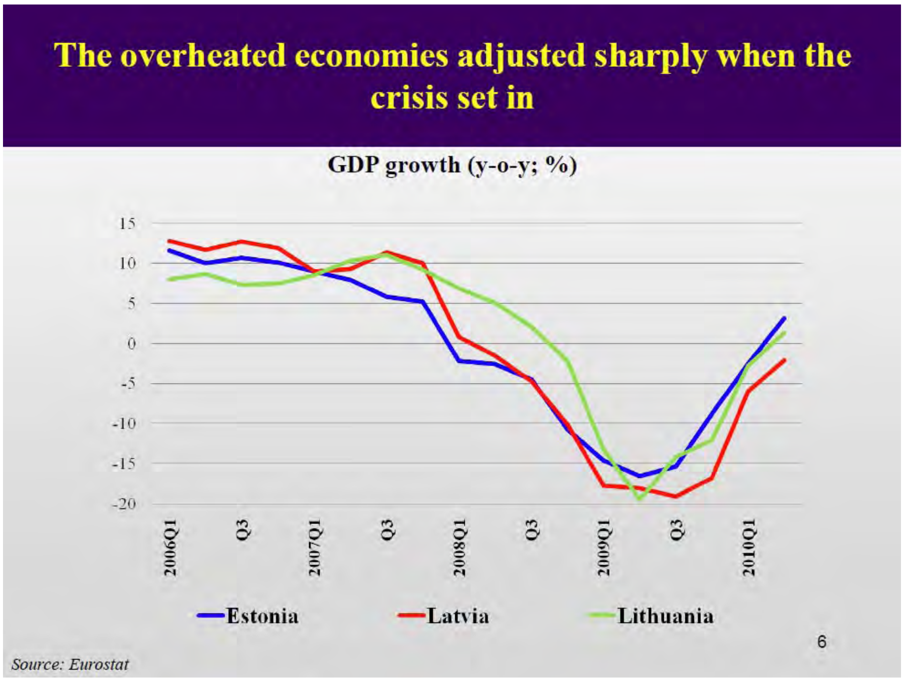


The booming economies rewarded their citizens with generous income flows. Labour markets soon became caught in a vice between massive demand pressures and limited supply of workers that was significantly constrained by labour outflows after the EU accession. This gave the rise to uncontrolled wage developments that by far outstripped productivity. Conventional wisdom told us this was leading to dead end. However, ***the temptation to reach the prosperity of Western Europe overnight prevailed***, and the vicious circle of wages and prices kept tightening. Economies kept going and wage increases of 20–30% a year became a fact of life. In Latvia, salaries more than doubled between 2004 and 2008 opening a wide wage-productivity gap. Similar developments were recorded in Estonia, and somewhat less pronounced but still significant departure of wages from productivity was observed in Lithuania. Consequently all three countries suffered from ***a significant deterioration of cost competitiveness***.





All these developments weakened the economies and made them ***extremely vulnerable*** to sudden changes in investor sentiment and global woes. Initially it seemed that the Baltic countries were easing into a soft landing. This was supported by banks cutting lending in a controlled way at the outset of the global financial crisis. However, the collapse of Lehman Brothers uncovered the real weaknesses – flushing away most of the wealth created in an unsustainable way. Throughout 2009, GDP fell by close to 14% in Estonia and Lithuania, and by an even more shattering 18% in Latvia.



Many suggested devaluation as the best solution to support economy and to solve old problems. However, that was clearly not an option for the Baltic countries given their openness, flexibility, large foreign-currency-denominated debt and long history of fixed exchange rate regimes serving as an anchor for macroeconomic stability for the Baltic States, and also Bulgaria. Already now Baltic performance has reassured many sceptics that ***the internal adjustment strategy simply works***, making ***a good case for other countries*** to move forward with fiscal consolidation and much needed reforms. I mentioned the internal adjustment strategy – there was actually such strategy: the State Treasury was running out of funds and there is simply no other alternative.

The reform agenda in the Baltics has been ***ambitious***. To ensure fiscal sustainability, the adjustment burden undertaken ranged from an estimated 9–10% of GDP in Lithuania and Estonia to 14% of GDP in Latvia throughout 2009–2010 – something that the world had not seen before. And yet ***we did not get stuck in a protracted recession*** as sceptics predicted. We have already reached a significant progress in regaining cost competitiveness, have made our economies structurally more resilient and are moving towards sustainable growth.

Sizeable fiscal consolidation packages have already been implemented in all Baltic States

Fiscal consolidation measures (% of GDP)

Country	Year	Total consolidation	Revenue measures	Current expenditure measures	Capital expenditure measures
Latvia	2009	9.9	1.8	5.7	2.4
	2010	4.2	2.2	1.6	0.4
Lithuania	2009	3.5	0.2	1.3	1.9
	2010	5.6	0.5	3.9	1.2
Estonia	2009	7.7	2.8	4.2	0.7
	2010	2.3	2.3	0.0	0.0

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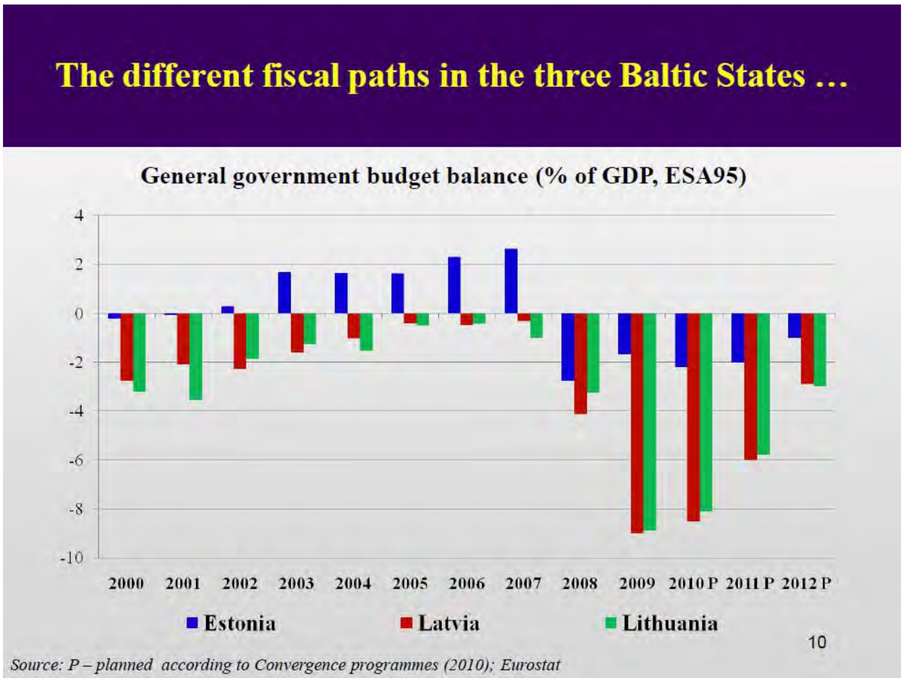
Source: Convergence programmes; Bank of Latvia

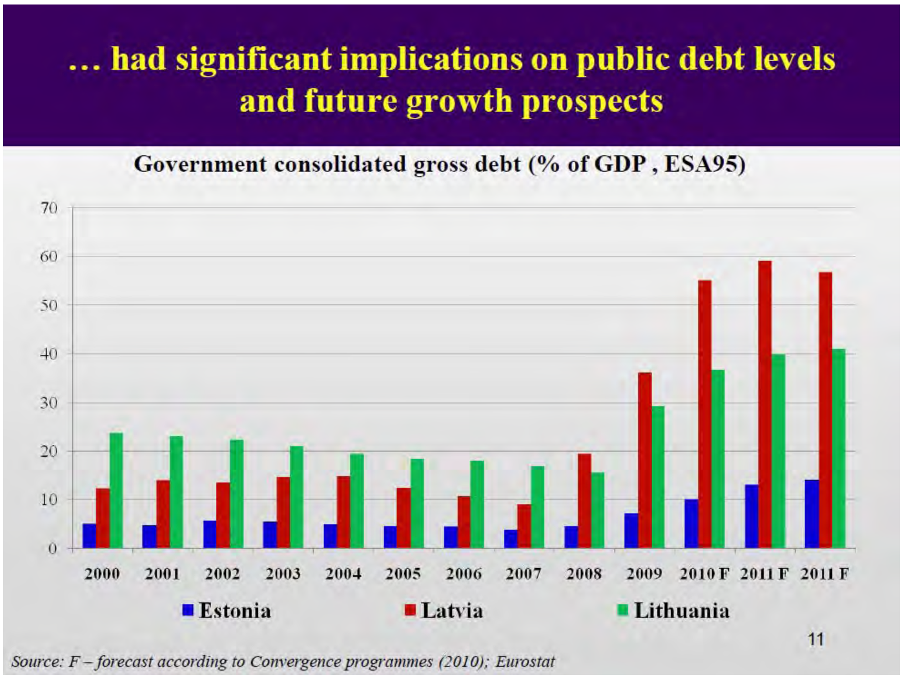
So far I have addressed the Baltics as a region rather than the individual economies that they are and therefore it might seem that developments there were rather similar. Despite the many similarities, however, there were also ***significant differences*** that are extremely important if one is to draw lessons from the recent crisis. One may also say that while all three being tigers – a metaphor commonly used to describe the past exceptionally strong expansion of the Baltic economies – each of the three had and still has its own – unique – character.

One of the obvious differences among the Baltic countries was their policy stance in the run-up to crisis. ***Fiscal discipline differed considerably*** among the three countries throughout the boom years that largely shaped their performance during the crisis.



Latvia was clearly the most quick-tempered one on the fiscal front. Experiencing the fastest economic expansion and extremely strong cyclical upturn in tax revenue, we still managed to spend more than we earned and recorded a budget deficit every single year during the boom. While being rather moderate in nominal terms, the deficits were extremely large when cyclically adjusted – amounting to 7–8% of GDP, in turn adding extra fuel to the already severely overheated economy. Budgetary discipline was extremely weak. Every single year when revenue performance turned out better than expected, budget laws were amended to further boost expenditure. Between 2004 and 2008, expenditure picked up 2½ times, and most of that was of a structural nature. As many of you know – there was really one industry which was overheating – namely construction and nothing was done to prevent it. This meant ***an accumulation of an enormous fiscal gap*** – over 20% of GDP – that was temporarily obscured by the economic boom but became obvious with the burst of the bubble. As authorities rapidly ran out of available liquidity and no investors were ready to finance the massive fiscal needs, Latvia had to turn for international support, becoming a program country under the IMF Stand-By Arrangement and European Commission support.

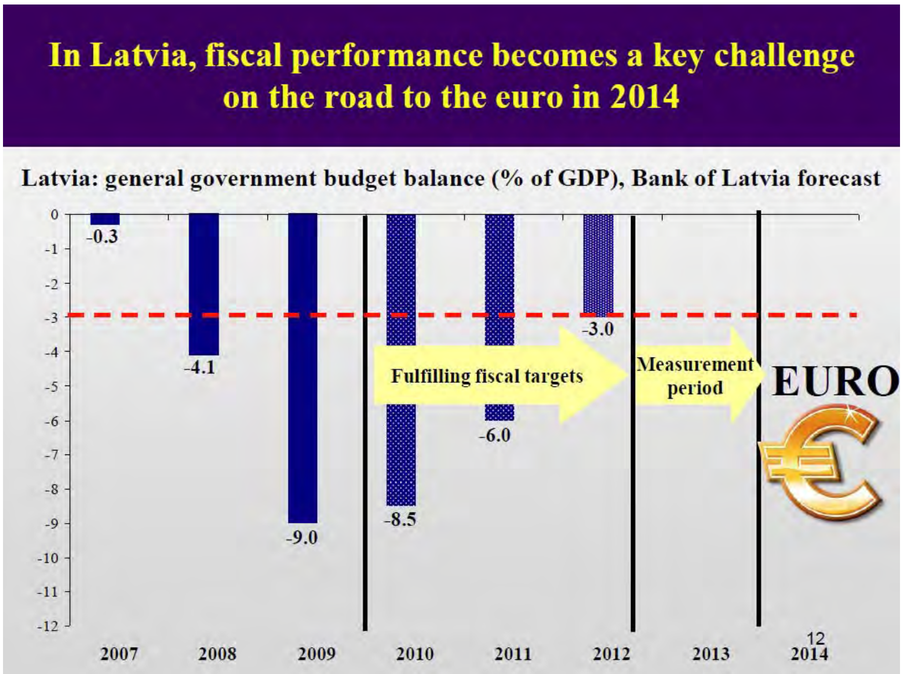
Lithuania was not materially better in terms of fiscal management, but was lucky to lag behind in terms of the economic cycle, which resulted in a less overheated economy before the crisis took off. ***Estonia, however, showed much more prudence*** in pursuing counter-cyclical policies accumulating considerable liquidity cushion to support economy during the downturn. Every single year since 2002 Estonia ran budget surpluses that increased over time as the economy accelerated. This made a significant difference in the way economies adjusted during the crisis with strong implications to their future growth prospects. While Latvia and Lithuania ended up with skyrocketing public debts, ***Estonia's debt remained contained***, allowing for a greater fiscal space and stronger growth potential in future. Already now Estonia has a faster GDP growth and its future looks much brighter. In other words – it is the combination of prudent fiscal and monetary policies which is behind the most notable difference with the other Baltic States. A by-product of Estonia's persistent prudent policies or – should we say – a prize for its very top stands during last 10 years, that is also going to be its membership of the Euro area as early as 2011.



The euro is not a solution to all problems and it does not mean a automatic welfare gains for converging economies like ours, but ***if policies are kept on track, the euro helps*** boosting growth potential ***and provides vast opportunities*** for future development. While we have been struggling to simply stay afloat, Estonia has strategically moved towards its aim of joining the euro. I can only express a friendly envy regarding their ***pragmatism, strategic mindset and ability to move in unison*** to make use of synergies and reach common targets. "Yes We Can!" sounds like Estonia, and I would like to wish every success to the Estonian authorities in their future endeavours of making their country a better place to live and advance.

What can we learn from Estonia? Our northern neighbour is a good example that ***any target*** can be reached, but this ***requires strategy and ambition***. Latvia has shown that it can brace up and make hard but necessary steps forward when cornered. However, all determination tends to fade away with the situation becoming less pressing. ***When afloat we start drifting downstream instead of heading towards the river bank*.** I am afraid, as we hear, that Latvia has done a good job, that we are leaving the crisis behind us, there could be less motivation to continue the adjustment.

Hopefully, this has been changed by the recent crisis. Latvia is gradually heeling its economic wounds and, hopefully, has learned the lesson that a county cannot live beyond its means without endangering its future prospects. To create a stable economy, which generates more prosperity, is clearly the target for the undertaken reform agenda in this country. In any case, we need ***another round of fiscal consolidation and structural reforms*** to bring public finance on a sustainable footing and economy back on a sustainable growth track. At the moment, unsustainable public finance is significantly hampering lending activity, investment, economic activity and new jobs, reduction of the state debt. In other words – deficit can hamper future growth should this problem remain unsolved.



While the economic and financial situation in Latvia has improved significantly since the onset of the recent crisis, ***we are not out of the woods yet***. According to our estimates another 400 million in expenditure cuts backed by ***structural reforms that make them permanent are needed*** to bring the recently high budget deficit towards a more comfortable level in 2011. The resulting budget deficit of 6% is not a magic number, though! Circumstances permitting, the deficit could be even smaller, provided Latvia with higher rating, lower interest rates, new investments and new jobs. This would also bring us much closer to the euro introduction in 2014 as an exit from the international support program. I am perfectly aware that this is not an easy task; however, it is realistic should we have a strategic mindset and enough ambition.

In conclusion let me quote the Estonian president Toomas Hendrik Ilvess from what he said back in April 2009 during a meeting with his Latvian counterpart Valdis Zatlers:

"In Estonia we know that tax revenue is lower than expected and additional steps are required. (..) ***At times when money runs out, there are no simple or pleasant solutions left*** – expenditures have to be cut. It is an illusion to think that we will be able to spend money, which we actually do not have. That is impossible – for individuals and states alike.

Therefore – if one does not have the money to spend, expenditures have to be cut. The question then naturally is – where to cut. ***I believe that both Estonia and Latvia are clearly aware that it is fiscally responsible to make these complicated choices now and not dump these complicated choices on the future generations.***

Thank you for your attention!