Jörg Asmussen: Lessons from Latvia and the Baltics

Introductory remarks by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, to the panel "Lessons from Latvia and the Baltics" at the High-level conference on Latvia, Riga, 5 June 2012.

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Dear ladies and gentlemen,

It is my pleasure to be here today in Riga to discuss the lessons from the Baltic recovery. In the Hanseatic League, to which Riga and other Baltic cities belonged, commerce and politics went hand in hand. And history is never far away from the headlines of the day. The ongoing financial and sovereign debt crisis illustrates yet again how closely economics and politics interact – for good or for bad.

I would like to structure my intervention around the following three main questions:

- What makes the Latvian experience so special in the context of the current crisis?
- What can euro area countries learn from the Baltic recovery?
- What can Latvia itself learn from its adjustment?

I. When good economics coincides with good politics

It is said that "good economics is often bad politics" and vice versa. The experience of Latvia and more generally the Baltics is worth exploring *precisely because* it defied this conventional wisdom – both economically and politically.

First, it disproved the frequently made claim that an internal devaluation strategy cannot work. From 2008, Latvia was faced with the deepest recession in the world. The cumulative output decline was 24%; unemployment peaked at 20%. Compared with this economic collapse, even some of the euro area peripheral countries were faring relatively better. Keeping the euro peg was considered by many as a "mission impossible". External devaluation was presented as the only way forward. But Latvia did not choose the easy "quick fix". It embarked on a courageous fiscal consolidation path and structural reforms.

Two years later, the speed of the economic rebound is as extraordinary as the depth of the recession. Against all the odds, Latvia recorded a real GDP growth rate of 5.5% in 2011. While domestic demand was the main driver of growth last year, exports have also recovered very strongly. Evidently, Latvia's competitiveness has improved, even though many challenges still lie ahead. The economic dynamics behind this swift stabilisation and recovery merit close examination.

Equally interesting is the political economy of the Baltic adjustment. Jean-Claude Juncker once said: "we all know what to do but we don't know how to get re-elected afterwards". This saying, often referred to as "Juncker's curse", unfortunately seems to be confirmed by the crisis in vast segments of the euro area. Italy, Greece, Ireland, Portugal: in all of these countries the government fell directly as a result of its handling of the economic crisis. Latvia seems to be the exception to the rule. Despite harsh austerity measures the Prime Minister managed to get re-elected twice. Many ruling politicians in Europe these days may look upon this with incredulous admiration.

Why was the internal devaluation strategy effective in Latvia and the Baltics, while other countries are still struggling with a deep economic and political crisis?

It is worth drawing lessons from the Baltic experience for euro area member countries.

II. Lessons for euro area member countries

Let me start with ***fiscal consolidation***. The Baltic experience shows clearly that speed is of the essence. In all three Baltic countries, the government reacted swiftly to the deterioration of public finances and frontloaded fiscal adjustment. With a budget consolidation of around 9% of GDP in 2009 alone, Latvia's effort is unparalleled in Europe.

Undertaking the necessary austerity measures at an early stage had a triple beneficial effect. First, it allowed the Baltics to benefit from positive confidence effects. Second, it allowed Latvia to return to the financial markets well ahead of schedule. Third, it allowed growth to bounce back after exceptionally severe output contractions. In 2011 the Baltic countries were the three best performers in the EU in terms of GDP growth. At a time when all euro area policy-makers urgently seek ways to relaunch growth, this is a remarkable achievement. The concept of "expansionary contraction" has been used and criticised in the ongoing debate about growth and austerity. The Baltic experience provides an indication that this need not be an oxymoron: even if fiscal consolidation weighs on the growth prospects in the short term, it has sizeable positive effects in the medium to long term.

But this frontloading approach also proved effective from a political perspective. By acting with speed and determination, the Latvian government was able to capture the sense of urgency prevailing among the population and mobilise it to support adjustment. This way, most of the required painful budgetary decisions could be passed before the so-called "adjustment fatigue" kicked in.

The bottom line is this: when adjustment is inevitable, it is better to take the medicine right away than to let the fever rise for months. This is undoubtedly an important factor that explains the different trajectories of the Baltics and certain southern European countries. But fiscal consolidation alone would not have allowed the Baltics to exit the crisis so swiftly. The ECB has long argued that the potential trade-off between fiscal discipline and growth can be mitigated if consolidation is accompanied by growth-enhancing ***structural reforms***. The case of the Baltics confirms this.

From a political economy perspective, the Latvian experience also shows that a critical mass of structural reforms is helpful to overcome vested interests. Education, health care, central administration: hardly any public sector category was spared by the reforms. Combined with targeted social safety net measures, this comprehensive approach helped the government to foster public acceptance of change.

At the same time, the quality and long-term sustainability of the reforms may – at least initially – have suffered from this approach. Structural reforms are not just about across-the-board cuts but are much more complex and multifaceted. Their overarching objective should be to create a favourable policy environment for growth and wealth creation. But they should also bear in mind equity considerations. In that regard, the IMF, the European Commission and the World Bank provided valuable advice and support to Latvia.

I am convinced that we Europeans can and should also step up our technical assistance to countries in need. The Fiscal Compact and the two-pack can provide a good basis for that. To be effective, they should be implemented in a spirit of mutual trust by the Member States and the European Commission.

Last but not least, an important lesson from the Baltics relates to the existence of a broad ***consensus in society***. In my view, beyond economic specificities, the key difference between, say, Latvia and Greece lies in the degree of national ownership of the adjustment programme – not only by national policy-makers but also by the population itself. I cannot but emphasise this again: national ownership and public support for the adjustment programme – these are key lessons from the Latvian experience which are of the utmost relevance to the current situation in Greece.

In that regard, the communication policy of the government plays a crucial role. This is what a responsible government ought to do:

- to state that the adjustment is for the country's own good, and not just to please international lenders;
- to tell the hard truth;
- to explain what needs to be done;
- to be clear what the consequences of non-action or of alternative policy choices would be.

All this is conducive to public acceptance of the programme and, therefore, its success. And this is also in the enlightened self-interest of the government, as the electoral reward of the Latvian Prime Minister demonstrates.

Beyond economic considerations, the adjustment programme has to be put into a broader context. Political factors can also be key justifications for undertaking difficult economic measures. In the case of the Baltics, the ultimate objective of adopting the euro also has a geostrategic dimension, namely completing their firm anchoring in a Union based on freedom, democracy and human rights.

In fact, sharing a currency is more than just drawing economic benefits; it means being part of a community with a shared destiny. This project of political integration justifies making short-term sacrifices to join – or stay within – the euro area.

To sum up, a speedy fiscal adjustment, a critical mass of structural reforms and a strong national ownership: these were, in my view, the key ingredients of the Baltic recipe for a quick economic rebound. There is, of course, no silver bullet that could be applied universally to all countries. Nevertheless, euro area policy-makers should look closely at the recent experience of the Baltic countries and draw the appropriate lessons.

I see at least one encouraging take-home message: if properly designed and effectively communicated, if fully supported by international lenders, economic adjustment does not necessarily imply political suicide.

III. Lessons for Latvia

Being here in Riga, let me conclude with a few observations about the lessons for Latvia itself. The end of the programme should not mean the end of the adjustment efforts. Key challenges remain also for this country to ensure the sustainability of the fiscal adjustment, to strengthen the fundamental drivers of sustainable and balanced growth and to prevent macroeconomic imbalances from building up again.

As regards euro adoption, the challenges that some euro area countries are currently facing illustrate clearly the importance of sustainable convergence. Very careful preparation is required to make sure that convergence continues also after euro adoption. Measures to reduce inflation temporarily or easily reversible measures to lower the fiscal deficit do not represent sustainable convergence. The decision to adopt the euro is a very fundamental one and should not be taken lightly.

The ECB published its Convergence Report 2012 last week and we came to the conclusion that Latvia does not yet fulfil all convergence requirements. So there is still a way to go for Latvia and the euro will not come for free. But let me state very clearly that the euro area is not a closed club. It is open to any EU Member State that fulfils the convergence criteria on a sustainable basis.

IV. Conclusion

The Baltic experience demonstrates that euro membership is not just about economics. The economics alone make only for a partial analysis of the failure or success of an adjustment

programme. The political motivations – such as the determination to join the euro area or to safeguard the political capital invested in EMU – have often been underestimated by markets during the crisis. I firmly believe that both economic and political arguments will ultimately also prevail in countries currently in the middle of an adjustment process that is similarly painful to Latvia's experience.

Thank you very much for your attention.