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Does austerity work after all? The case of Latvia

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Policy recommendations

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Latvia is used by the 'austerians' as a case showing that hard and painful austerity can get an economy out of recession. This policy brief argues the opposite and shows that what actually happened in Latvia is that policymakers decided not to continue but to break with the policy of austerity. This made it possible for Latvia to get out of a vicious spiral of austerity causing a depression and thereby leading to even more austerity.

The real lesson that European policymakers should learn from Latvia is that restoring growth dynamics needs to come first and that consolidation of public finances can only follow afterwards. In very practical terms, this means that Europe should urgently apply a moratorium on new fiscal austerity measures so as to avoid deepening the recession many of its member states are already suffering. Instead of sticking to blind and rigid rules, Europe needs to bear in mind the state of the economy when setting public deficits targets. Unless economic growth picks up strongly in the next few years (an unlikely prospect given high private sector debt loads in several member states), this means that achieving a 3 per cent deficit should be shifted from 2013 to the 2016/2017 time horizon.

Introduction

Austerity is not working. The facts across Europe are pretty clear on this: with governments stubbornly sticking to overambitious deficit targets that cannot be realistically attained in the relatively short period of time that has been defined, the Euro Area economies are facing another serious slowdown in growth or even sinking back into recession.¹

If policy decisions in Europe were evidence based, then this strategy of brutal fiscal austerity would be up for a major and urgent revision so as to prevent further damage from being inflicted. Unfortunately, however, this is not the case: the powers holding the key to finance, the ECB in the first place, continue to adhere to the misguided idea that fiscal cuts, squeezing public sectors and welfare states, are the best basis for ensuring growth. One of the consequences of this is that policymakers are desperately looking

for examples to back up their beliefs so as to divert attention from the real negative impact austerity is having on the economy.

With Latvia, those who defend austerity at any cost and at any time think they have found an example that shows that it works: back in 2009, Latvia had the dubious privilege of being one of the first guinea pigs in Europe to implement the troika's policy of 'competitive austerity'. Three years later, the Latvian economy finds itself back on the path of growth, unemployment seems to be falling and so have financial markets' risk premiums on sovereign debt. Christine Lagarde, head of the IMF, therefore recently hailed Latvian austerity as a success story but also as a

¹ The goal set by Europe in its EU2020 strategy and in its stability plans is to bring deficits below 3 per cent of GDP by 2013–2014. In terms of the European average, this implies a deficit reduction of more than 3 per cent of GDP over three to four years, from 2010 to 2013.

solution for the crisis of the Euro Area.² According to Christine Lagarde, Latvia shows that an immediate package of hard and painful austerity can get an economy out of a deep recession: crisis-ridden countries such as Greece should learn from this and embrace this approach.

In the coming weeks and months, with the crisis of the Euro Area intensifying, it could be expected that the Latvian case would be used to convince workers of the beneficial effects of austerity. This policy brief therefore looks in greater detail at what really happened in Latvia, in terms of both the policy that was actually implemented and the results it generated. We conclude that the Latvian case does not support but instead *contradicts* the conventional view of successful austerity policy.

Austerity that was called to a halt

The IMF entered Latvia at the end of 2008 with a programme aiming to contain external and fiscal imbalances and to keep the exchange rate peg with the euro. Latvia, at that moment, was indeed hard hit by the financial crisis: the economy had gone through a housing boom with households facing a heavy foreign debt load expressed in euros and was registering a high current account deficit of 13 per cent of GDP. Foreign lenders (mainly Scandinavian banks) were no longer willing to roll over loans, let alone to extend new credit to finance the recurring external deficit.

The IMF identified the enormous fiscal policy challenges from the start, stating in a press statement of 19 December 2008 that the 'programme requires substantial fiscal tightening and a headline deficit target of less than 5 per cent of GDP in 2009 compared to a deficit of 12 per cent if no additional measures were taken'.

The fiscal adjustment programme for Latvia was indeed brutal and highly front-loaded: whereas the total fiscal adjustment package is reported to have amounted to 15 per cent of GDP over a period of three years, between 8 and 9 per cent of GDP was already squeezed out of the economy in the first year of the adjustment programme (2009). Public sector wages in particular were hit very hard, with wage cuts ranging from between 16 to 26 per cent in administration, health and education.

In line with this huge fiscal squeeze, economic activity contracted in 2009 by close to one-fifth. However, this deep recession was followed the next year by a stabilisation of economic activity, with some measure of growth reappearing in 2011.

How should this consecutive chain of austerity, followed by recession, followed by growth be understood? Does it mean that Lagarde's claim that painful austerity is the road to economic recovery might be correct after all?

Here, the several Latvian programme reviews written by IMF staff over the course of this period provide a revealing answer.

The first review, written at the end of 2009, reads like a wake-up call. Over the course of that year, Latvia had been hit by a double blow: exports had fallen by 15 per cent and domestic demand, also because of the huge 9 per cent GDP fiscal cut, had collapsed as well. The IMF was therefore looking at an economy in total shambles: GDP had contracted by 18 per cent, employment by 8 per cent and unemployment had doubled to 15 per cent. Meanwhile, the public deficit had exploded from 3.3 per cent in 2008 to 13 per cent of GDP in 2009: fiscal cuts in the amount of 9 per cent of GDP had been implemented but had been more than offset by falling revenues and increasing public expenditure resulting from the collapse of economic activity. Fiscal cuts themselves were heavily responsible for dragging economic activity down.

On top of that, the IMF review at the end of 2009 estimated that the 2010 deficit would be even worse, increasing to a record high of 18 per cent (!) of GDP. The gap with the official deficit target of 8.5 per cent of GDP, as set by the ECOFIN council, was huge and implied another massive fiscal squeeze of 10 per cent of GDP or more.

At that moment, the IMF started to have serious doubts (point 28): 'The massive fiscal contraction required would put additional pressure on output, with significant risk of a downward spiral'. In view of this concern, the IMF actually relaxed the deficit target, allowing a 12 per cent deficit for 2010 instead of the European Commission's deficit target of 8.5 per cent of GDP.

This still represented an additional and huge fiscal cut of (more than) 6 per cent of GDP. In practice, however, the 2010 fiscal ambitions were further and drastically revised downwards. According to the second IMF programme review, published mid-2010, the Latvian government limited the 2010 fiscal cut to a net 2.5 per cent of GDP (also thanks to a Constitutional Court ruling invalidating previous pension cuts in the amount of 1.5 per cent of GDP). In the end, and according to the Commission's 2010 spring economic forecasts, the deficit hardly moved from 2009 to 2010. The IMF again allowed all of this loosening of the austerity strategy, calling the 2010 budget a 'strong' budget.

In other words, the story which the head of the IMF is now spreading around in the media is far from the truth. What happened in reality was exactly the opposite: instead of sticking to overambitious and rigid deficit targets, Latvian authorities *abandoned* this policy of austerity and substantially loosened the fiscal straightjacket. The consequence was that the economy ended its freefall and economic activity stabilised in the course of 2010.

What would have happened, on the other hand, if the authorities had pursued the initial IMF recommendation of a 6 per cent fiscal cut or, even worse, if they had tried to reach the ECOFIN deficit target by administering a lethal amputation of 10 per cent of GDP? In that case, the economy would surely have stayed in deep recession for the third year in a row. This would also have resulted in a higher deficit than the targeted one, possibly leading to further cuts and even lower economic activity. Latvia, thanks to a (rare) moment of lucidity on the part of the IMF allowing deficit target flexibility, was able to escape from the austerity trap.

2 See: <http://www.rte.ie/news/2012/0605/imfs-lagarde-hails-latvia-austerity-as-solution.html>

Competitive (net) export revival that never was

In the IMF's traditional script book for stabilising the financial side of the economy, fiscal austerity is to be accompanied by competitive austerity: cuts in public sector wages and jobs are to signal to private sector employers that private sector wage bills need to be squeezed as well, the latter improving the country's competitiveness and dragging the economy out of the slump via exports. If this 'signal' from public sector wage cuts is not enough, the IMF does not hesitate to go for structural reforms that weaken the private sector wage fixing machinery itself by, for example, advocating a cut in statutory minimum wages.

In the case of Latvia, it was indeed the explicit intention of the IMF/troika programme to also put private sector nominal wages on a downward path, thereby generating an export-led recovery.

Wages in Latvian manufacturing did react (although not to the same extent as the wage cuts in the public sector) and fell by a nominal 2 per cent over the three-year period 2009–2011. At the same time, however, productivity in this sector improved substantially, leading to a fall in the real effective exchange rate to 2 per cent below the level reached a decade ago (nominal effective exchange rate deflated by manufacturing unit wage costs) (see Bruegel 2011).

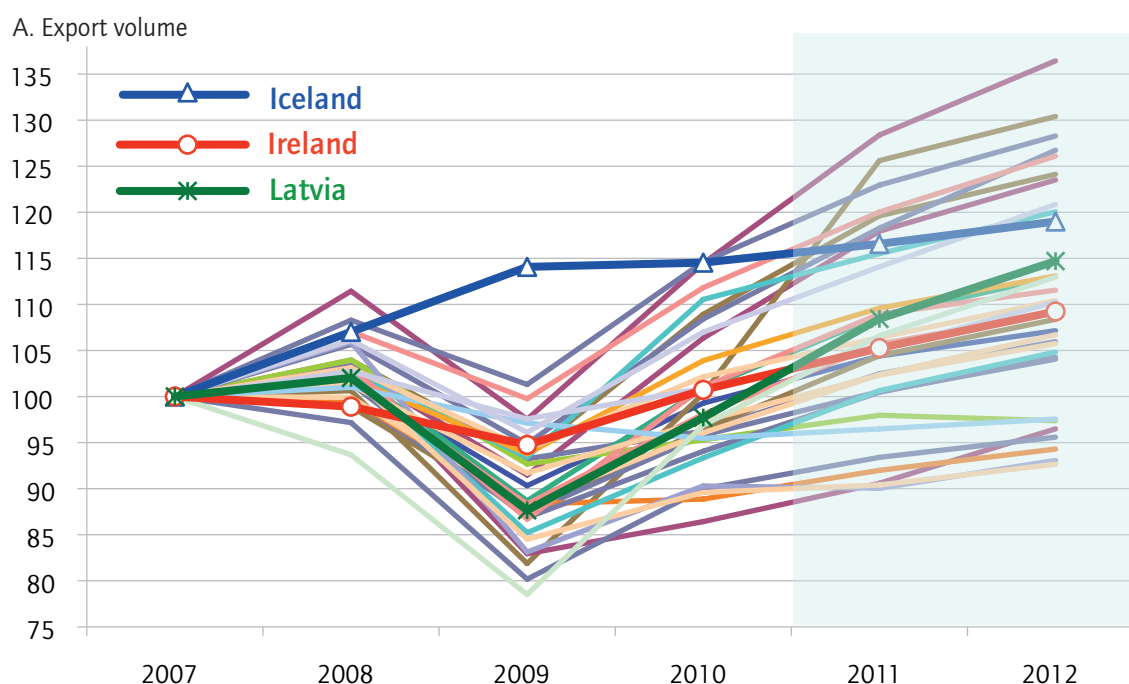
Although this represents a huge improvement in wage cost competitiveness, its impact on exports was mixed. Latvian exports did recover in 2010 and 2012, growing by 11–12 per cent. However,

with the recovery of world trade, export dynamics accelerated across the whole of Europe. Despite a spectacular fall in wage costs, Latvia did not really outperform others but simply situated itself in the middle range of the spectrum (see graph). Moreover, it needs to be taken into account that Latvia is geographically very close and its foreign trade deeply integrated with Poland and Scandinavia. Both of these regions either recovered quickly (Scandinavia) and/or did not experience much of a crisis at all (Poland). It obviously helps a lot for your exports if a country's export markets are doing quite well. From this point of view, Latvia's (gross) export performance was not really outstanding, despite a rather extreme wage cost adjustment turning the relative wage clock a decade back in time.

Moreover, in terms of *net* exports, there was no visible progress: both imports and exports grew by 11 per cent in 2010, thereby producing a *zero* contribution of external trade to economic recovery. In 2011, with imports rising faster than exports, the contribution of foreign trade was even negative. These figures also reflect the structural problem that economies such as Latvia are facing and that is the low embeddedness of (foreign owned) export firms importing assembly parts from all over Europe while adding only limited value in Latvia itself.³

In any case, these outcomes contradict the IMF's idea of an export-led recovery, being triggered by wage cuts. It was the rebound in domestic demand (with both consumption and investment playing a major role) that supported growth in Latvia from 2010 onwards, not the contribution of net exports to GDP growth. The latter has actually been negative over the entire recovery period (see graph).

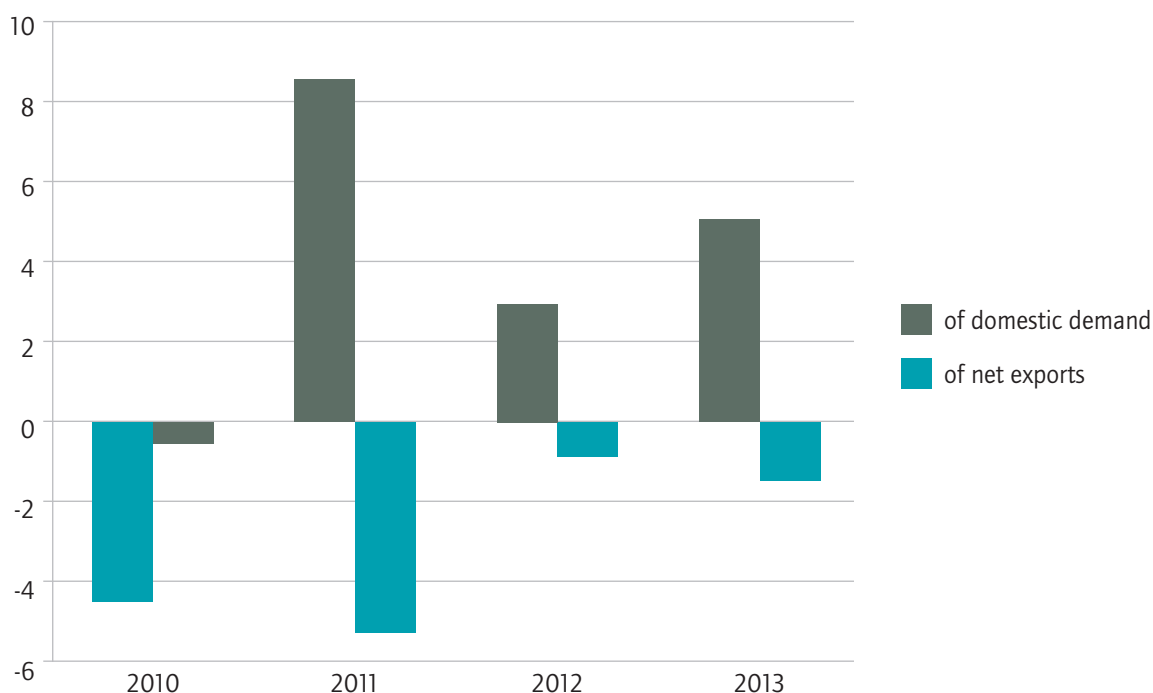
Figure 1: Exports of goods and services in 34 countries (at constant prices, 2007=100), 2007-2012



Source: Bruegel 2011

³ Kattel and Raudla (2012) mention the example of neighbouring Estonia where one Finnish-owned mobile manufacturing company uses around 200 suppliers for its production in Estonia, none of them based in Estonia itself. They also claim that such integration in a few European manufacturing networks has hardly anything to do with domestic policy actions but is a typical characteristic of the Baltic economies.

Figure 2: Contribution of domestic demand and net exports to growth



Source: EC

Exporting people: short-term relief, long-term pain

One element that is entirely being overlooked by the mainstream economic discussion on Latvia is the role played by emigration in stabilising the economy. Workers and unemployed leaving the country and looking for jobs abroad does not just improve the statistics of unemployment, it also implies that the financial burden on social safety nets and public deficits is alleviated. Moreover, if part of the income generated by workers abroad is transferred back as remittances to family members, it helps to preserve some sort of living standard, thereby injecting new domestic demand into the economy.

In Latvia, emigration has been dramatic. Weisbrot and Ray (2011) refer to a net loss of some 100,000 to 120,000 people (especially youngsters) or some 9 to 10 per cent of the workforce leaving Latvia in 2009–2011. Together with discouraged workers giving up on job search efforts and withdrawing from the labour market, this explains why unemployment rates have fallen substantially since 2010 despite the fact that the economy was actually losing jobs over this period: unemployment fell from 17 per cent in 2009 to 14.8 per cent in 2012, while the number of additional jobs created in 2011 and 2012 (3.4 per cent and 0.7 per cent respectively) was not even sufficient to offset the 4.8 per cent drop in employment from 2010.

While, as argued above, such emigration has contained the explosion in unemployment and poverty and has probably helped to stabilise economic activity, the fact remains that the loss of over 10 per cent of the workforce represents a serious threat to the economy's growth potential over the longer run. Moreover, it is

also educated and skilled workers that tend to leave the country, thereby undermining long-term growth in terms of both quantity (number of future jobs) and quality (productivity of future jobs).

Europe is not Latvia

In the end, Latvia has a poor record in terms of real economy performance to show for its initial policy of austerity and its five years of crisis and subsequent recovery: Latvia lost more than one-fifth of its initial (2007) level of economic activity in the recession years and will – by 2013 – only recover partially, leaving output 10 per cent below its pre-crisis peak. Unemployment has doubled from 7.5 per cent before the crisis (2008) to 14.8 per cent in 2012. Poverty rates, already high before the crisis, have also gone up and are peaking at 25 per cent. And all of this happened in a country that was already characterised by levels of inequality that are the highest across Europe (Gini coefficient of 36.9 compared to an average coefficient for the EU of 30.4). Moreover, it needs to be stressed that, if competitive austerity cannot be hailed as a success story for Latvia, it will certainly fail if applied to the whole (or important parts) of Europe. Indeed, Latvia shows several characteristics that can be thought of as facilitating austerity policy, characteristics which do not exist for Europe as a whole.

For instance, Latvia is a small open economy, making it more feasible for policymakers to act as a 'free rider' and count on demand dynamics in neighbouring countries and export markets while depressing domestic demand. Big European member states do not find themselves in a similar position. And if the deficit countries of the Euro Area were to pursue as a block the same

type of policy, this would only depress their mutual export markets while not much improving their (relative) competitive positions. Latvia also had a different starting point in terms of public debt: Even if public debt rose substantially from 10 per cent of GDP before the crisis, the ratio is still limited to 40 per cent, easing financial investors' fear about a sovereign debt default. Finally, the banking system is largely in the hands of foreign, mainly Scandinavian, banks. This had two advantages: not the Latvian public finances but the head offices of the banks abroad carried the main cost of recapitalising the Latvian banking system. In addition, the Scandinavian head offices, supported by a loan from the ECB, arranged to continue to extend credit lines to the Latvian branch. This contrasts with the situation many Euro Area governments are now facing in which they have to deal with a domestic banking system that is on the brink of collapse as well as a foreign banking system that is 'unfriendly' towards renewing existing, let alone extending new finance.

Conclusion

To conclude, the real lesson that Europe and the Euro Area should learn from Latvia is that deficit targets need to be handled in a flexible and realistic way. If the 'madmen in authority' are allowed to continue with their austerity policies, the recession will intensify and deficit targets will be missed and public debt rates will go up anyway.

Europe should indeed do what Latvia did in 2010 and abandon the catastrophic policy of austerity. To give growth a chance, Europe should apply a moratorium on new fiscal austerity measures and postpone the 3 per cent deficit target from 2013 to the 2016/2017 time horizon.

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