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# **Macroeconomic policy regimes in emerging market candidates for a currency union: the case of Latvia**

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## **Abstract**

This paper has the goal to explore the functionality of the economic development in emerging countries, which are on their way of joining a currency union based on the concept of macroeconomic policy regimes (MPRs). Functional MPRs are considered those that deliver sustainable economic growth, employment and more equitable income distribution. A macroeconomic policy regime consists of policies (foreign economic policy, industrial policy, wage policy, monetary policy and fiscal policy), the financial system, and the institutional frameworks in which the economies are embedded. The MPRs of emerging countries, candidates for a currency union, applied to the case of Latvia will be analysed using a Post Keynesian approach. It will be argued that the institutional changes in Latvia have paved the way for a dysfunctional policy mix, such that led to high current account deficits, capital flow volatility, large employment losses and instable economic development. This paper suggests that to reduce the current account deficits and achieve a more sustainable growth, foreign economic policy and the industrial policy should be given high priority.

**Keywords:** Macroeconomic regime, open economy policies and institutions, emerging countries, industrial policy, Latvia

**JEL classification:** E02, E58, E61, E65, F41, F43

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## 1. Introduction

This paper has the goal to explore the functionality of the economic development in emerging countries, which are on their way of joining a currency union, based on the concept of macroeconomic policy regimes (MPRs). Functional MPRs are considered those that bring sustainable economic growth in the long run, employment and more equitable income distribution. A macroeconomic policy regime stands for the recognition that economic policies, their interaction and institutions play an important role in explaining the economic development of a country. MPR is a set of macroeconomic and structural policies and the institutional frameworks in which the economies are embedded.

The focus in this paper will be put on Central Eastern European countries (CEECs)<sup>1</sup>, in particular Latvia as an emerging country, candidate for entry in the European Monetary Union (EMU). Latvia is chosen for the reason that it is a small, open, and net debtor country. Latvia furthermore experienced a strong boom period, for which it was called 'Baltic tiger', supported by high capital inflows especially in the real estate and financial sector from the mid 1990s until 2007, and a bust phase in 2008 with high losses in output, employment and capital outflow.

The functionality of the economic development in Latvia will be assessed on the basis of a normative model of a functional MPR from a Post Keynesian perspective. For this purpose, specific indicators for the evaluation of the functionality of the separate elements of MPR will be used. There are limitations to conducting a plausible econometric analysis of a macroeconomic policy regime in Latvia because of the unavailability of continuous data with long time period coverage. The concept of MPR is furthermore of a qualitative nature, and therefore, the methodology applied will consist of review of primary literature dealing with macroeconomic policies in open, emerging economies in Post Keynesian fashion, statistical data analysis and descriptive analysis of the relevant macroeconomic policies and institutions which are part of the MPR.

In a nutshell, I will argue that the macroeconomic and structural policies within the deregulated financial, labour and goods markets in the emerging countries in the European Union - in this paper represented by Latvia - can cause unsustainable growth, low employment and unequal income distribution and hence, are dysfunctional.

In section 2 the contours of a macroeconomic policy regime will be set. Moreover, all the elements of the latter will be addressed in detail. What follows is a sketch of a functional

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<sup>1</sup> The group of Central Eastern European countries includes: Hungary, Poland, Czech Republic, Latvia, Lithuania, Bulgaria and Romania.

macroeconomic policy regime. In section 3 the focus will be put on the Latvian economy and the assessment of its MPR on the basis of the normative model of a MPR drafted in the second section. In the last section conclusions will be presented.

## **2. Model of a functional macroeconomic policy regime**

There is a lack of coherent body of literature dealing with and defining MPRs. An important contribution towards developing macroeconomic regimes in industrial countries was made by Heine et al. 2006:18, author's translation) where "an economic regime is characterised by the interaction of the particularly important macroeconomic areas: monetary policy, fiscal policy and the wage development. Here the external sector embeddedness of one country should be added".

On the basis of Heine/Herr/Kaiser (2006), Herr/Kazandziska (2011b) developed a definition of MPR introducing the financial sector as a part of a regime. According to them,

"MPR (is) the interaction between monetary policy, fiscal policy, wage policy and foreign economic policy within a framework of both, macroeconomic institutions which can be actively changed by policy-makers and become part of economic policy, and institutions which are beyond the control of policy-makers...(The) financial system is an important part of a macroeconomic policy regime."

This paper will provide one solution for a functional MPR for emerging countries, candidates for a currency union. Emerging economies inevitably show different characteristics of their policy and institutional framework compared to industrial countries, which are mainly the focus of attention in the debate about MPRs. Many emerging economies which are candidates for a currency union tend to be small<sup>2</sup>, open economies and in many ways, dependent on the growth of and changes in the world market.<sup>3</sup> Furthermore, most of the emerging countries, similar to most developing countries, are net debtor countries with especially high debts in a foreign currency which makes them vulnerable to exchange rate fluctuations and increases the likelihood of financial and/or currency crises (Priewe 2008:35). For this reason, parts of the development literature will be included as well. Within the latter, Priewe/Herr (2005:44) analysed macroeconomic regimes of developing countries and formulated the former as "a set

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<sup>2</sup> Measured in terms of the size of GDP.

<sup>3</sup> The focus in this paper will be put on the Central Eastern European countries (CEECs) as candidates for entry in the European Monetary Union (EMU).

of conditions and their interaction including economic institutions which create growth or not“.

Applying the concept of MPR to emerging countries is one of the new contributions to both the literature dealing with MPR and the development literature. We can define a macroeconomic policy regime of emerging countries, candidates for a currency union as a set of policies (foreign economic policy, industrial policy, wage policy, monetary policy and fiscal policy), the financial system, and the institutional frameworks in which the economies are embedded. Institutions pave the way the policy instruments can be applied, and only when certain institutions are in place, certain types of policies are possible. Institutional changes can be induced by the decisions of the national governments, but they can also happen as a result of actions which are out of governments' reach.<sup>4</sup>

In this model the foreign economic policy and industrial policy will play a very important role. Introducing industrial policy as a part of MPR is the second novelty of this paper. The foreign economic policy is given the tasks of reducing the current account deficits and achieving a balanced current account, managing the capital in- and outflows and hence, preventing currency mismatches in the balance sheets of the economic actors. Industrial policy would complement foreign economic policy by supporting investments in R&D, production and exports of high value-added products and thus improving the terms of trade. The financial system should support both the industrial and foreign economic policy by providing sufficient finance for the manufacturing sector and securing stability in the financial sector. Wage policy based on high wage coordination<sup>5</sup> should provide a stable anchor for prices (and the real exchange rate, when the nominal exchange rate is fixed); it should also aim at stabilising a certain functional income distribution, and provide a minimum (decent) income for the poorest households. Monetary policy should contribute to stability in the financial sector, provide low- cost finance, and prevent panics in the financial system. Fiscal policy's tasks will be to stabilize aggregate demand in the short and in the long run, support high employment and reduction in income inequality. For these policies to achieve most optimal results (in terms of sustainable long-run economic growth, low income inequality and high employment), coordination and interaction of the former is necessary.

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<sup>4</sup> E.g. institutional changes in the economic/political union to which the respective country belongs can cause a change in its institutional framework as well.

<sup>5</sup> Through extension of collective agreements, automatic membership of employers in employers' associations or centralised wage bargaining.

Table 2.1 Solution for a functional macroeconomic policy regime

	Objectives	Instruments	Institution in charge	Strategy
Foreign economic policy	<ul style="list-style-type: none"> <li>- Reduction of the current account deficit and achieving balanced current account</li> <li>- Capital flow management</li> <li>- Preventing currency mismatch</li> </ul>	<ul style="list-style-type: none"> <li>- Foreign exchange intervention</li> <li>- Capital controls</li> <li>- Regulations to restrict the foreign currency exposure</li> </ul>	Central bank Government	<ul style="list-style-type: none"> <li>- Supporting exports and reduction of income elasticity of imports</li> <li>- Providing exchange rate anchor</li> <li>- Stimulating FDI in manufacturing</li> </ul>
Industrial policy	<ul style="list-style-type: none"> <li>- Reviving manufacturing</li> <li>- Increasing competitiveness</li> <li>- Increasing innovation capacity</li> <li>- Improving terms of trade and the current account</li> </ul>	<ul style="list-style-type: none"> <li>- Subsidies</li> <li>- Policy loans</li> <li>- Conditional provision of foreign currencies</li> <li>- Regulations of entry/exit and capacity expansion in specific markets</li> </ul>	Government development banks	<ul style="list-style-type: none"> <li>- Targeting specific sectors/companies</li> <li>- Provision of public infrastructure for private investment</li> </ul>
Financial system	<ul style="list-style-type: none"> <li>- Provision of low-cost finance for the private sector (manufacturing)</li> <li>- Securing stability in the financial system</li> </ul>	<ul style="list-style-type: none"> <li>- Regulations of financial instruments</li> <li>- Regulation and supervision of the financial actors</li> </ul>	Central bank Government	<ul style="list-style-type: none"> <li>- Involvement of the central bank in the credit allocation of the banks</li> </ul>
Wage policy	<ul style="list-style-type: none"> <li>- Preventing inflation/deflation</li> <li>- Stabilizing real exchange rates<sup>1</sup></li> <li>- Maintaining a constant functional income distribution</li> <li>- Securing a minimum income for the poorest</li> </ul>	<ul style="list-style-type: none"> <li>- Wage negotiations at macroeconomic level</li> <li>- Extension of collective agreements</li> <li>- Minimum wages</li> </ul>	Social partners Government	<ul style="list-style-type: none"> <li>- Wage norm</li> <li>- Government support of higher trade union involvement in wage bargaining</li> <li>- Wage coordination</li> </ul>
Monetary policy	<ul style="list-style-type: none"> <li>- Provision of stability in the financial system</li> <li>- Prevention of panics in the financial system</li> <li>- Provision of low-cost financing</li> </ul>	<ul style="list-style-type: none"> <li>- Interest rate</li> <li>- Regulation measures for providing stability and finance in the financial system</li> </ul>	Central bank	<ul style="list-style-type: none"> <li>- Maintaining low real interest rate</li> </ul>
Fiscal policy	<ul style="list-style-type: none"> <li>- Stabilizing aggregate demand</li> <li>- Reducing income inequality</li> <li>- Supporting full employment</li> </ul>	<ul style="list-style-type: none"> <li>- Public investment</li> <li>- Public spending (in a wider sense)</li> <li>- Taxation (progressive taxation, etc.)</li> <li>- Comprehensive welfare system</li> </ul>	Government	<ul style="list-style-type: none"> <li>- Functional finance</li> <li>- Anticyclical fiscal policy</li> <li>- Automatic stabilizers</li> </ul>



From the above said, this paper can be expected to raise the importance of both policies and institutions which on a macroeconomic level pave the way for the economic development of the emerging countries that aspire to be a part of a currency union. Yet, due to space limitations, this paper will not go further to elaborate on the benefits and costs of being a member in a currency union.

One solution for a functional MPR is illustrated in Table 2.1. However, other solutions are also possible. What follows is a separate analysis of the elements of a MPR.

### **2.1. Foreign economic policy**

In the context of the economic growth of open economies in the long run, the impact of external factors needs to be examined. Countries can generally improve their current account position by increasing exports or restricting imports. They can gain competitiveness through real devaluation or through unit labour cost development below the one of their partners. However, countries which are on their way of joining a currency union (specifically the Euro area) and also have a high level of dollarization/euroization do not have the option of nominal exchange rate devaluation. Moreover, the use of import restrictions is also highly limited. Hence, to gain competitiveness these countries can keep nominal wage increases below productivity or change the export structure. However, only under some conditions is a wage restraint policy possible.<sup>6</sup> Thus, increasing exports especially of high value-added products seems to be the most plausible argument for the long-run growth of small, open economies. The balance-of-payments-constrained-growth model (BPCG) put forward by Thirlwall (1979) supports the latter argument as well. The BPCG model originally shows that the countries' growth is constrained in the long run by the balance of payments, i.e. countries cannot sustain their trade deficits and still maintain their high growth rates in the long run. This is because with increased growth and aggregate demand, imports rise which deteriorates the balance-of-payments position even further and puts a constraint on the economic growth, provided that the rise in exports is not able to compensate for the increase in imports. Current account deficits in the long run have to be financed by capital flows, which increase the net foreign debt-GDP ratio. The latter can put the domestic currency under a pressure to depreciate and cause an inflationary development (McCombie 2002). The balance-of-payments growth rate is determined by two main factors: export growth and income elasticity of demand for

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<sup>6</sup> E.g. there should exist a wage coordination between sectors.

imports.<sup>7</sup> Through stimulating exports to achieve a higher growth rate, but not endangering the balance of payments Thirlwall (1979) provides a rationale to support policies for export-led growth based on technological progress and higher productivity increase in the long run. Thus, the first indicator that will be used to assess the functionality of foreign economic policy is the current account balance-GDP ratio.

Imports of capital and intermediate goods are needed for production, but they can be translated into exports only partially. Even more importantly, they have proven to be a source of disruption causing the domestic currency to appreciate and current account deficits to soar. It is often the case that the capital inflow is used for imports of consumption goods which only worsens the current account and does not provide any prospects for improving the economic development in the future (Mencinger 2007:117). Capital inflows can also cause speculation activities to increase when the former are directed towards the stock or real estate markets (Becker/Jäger 2010:8).<sup>8</sup> Capital flows can also cause the level of external debt to rise (like in the case of portfolio debt flows and credit flows). There is a broad consensus among Post Keynesian economists that under certain conditions out of all the different types, FDI is the most desirable type of financial flow that does not automatically create an external liability (Herr/Kazandziska 2011b:50). If it is directed towards sectors/firms with many horizontal and vertical links to other sectors and/or subsectors, involves technology transfer and contributes to an increase in exports, it can stimulate economic growth (Priewe/Herr 2005:95). Foreign economic policy, hence, has another important task: to manage the capital flows. Capital flow management will help combat dollarization/euroization, will stabilize the exchange rate, will enable a more autonomous monetary policy and protect the weak financial sector (Priewe 2008). We will therefore look at the external debt-GDP ratio to get an idea about the level of external indebtedness created through capital inflows.

As previously elaborated, emerging countries-candidates for a currency union and especially those that have a high dollarization/euroization need a stable anchor for the exchange rate. To defend its exchange rate peg and maintain its competitiveness, a country would need a sufficient amount of foreign exchange reserves. The foreign exchange reserves-external debt ratio will show us if the reserves available are sufficient to cover for the external debt.

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<sup>7</sup> The formula describing this relationship is:  $y = \frac{x}{\pi}$ , where  $y$  is balance-of-payments growth rate,  $x$  stands for export growth and  $\pi$  for income elasticity of demand for imports (Thirlwall 1979:49).

<sup>8</sup> The current account can be negatively affected as well when the capital invested from abroad is repatriated (and in some cases the profit repatriation rates can be significantly high). For illustration, on average the rate of profit repatriation out of foreign direct investment has been 70% in the CEECs (Hunya 2009).

## **2.2. Industrial policy**

Against the background of rising economic growth and sectoral shift of production and employment from the manufacturing towards the service sector, especially in the emerging countries where the industrial capacity is not yet exhausted, industrial policy is intended to support particular industries and firms in the manufacturing sector that could increase the economic welfare of the whole country. The negative effects of the deindustrialization process (declining share of the manufacturing output in total output and declining share of employment in manufacturing in total employment) can be seen in the increasing current account deficits, as many services are non-tradable (child and elderly care, education, government services and legal services) (Chang 1994:57-58). Sole reliance on the service sector for economic growth seems to be a very dangerous growth strategy, for the productivity cannot rise at as high rate as the productivity in the manufacturing sector (Chang 1994:58).

Productivity in the manufacturing sector can be improved by investment in R&D, especially in the infant industries, in know-how and technology. Thus the government's support of new and diversified knowledge in high value-added industries, which will improve the terms of trade, reduce the current account deficits and increase economic growth, is of high importance (Chang 1994:67-68). It will be important to look at the public spending on R&D in order to assess the government's involvement in improving the productivity in the economy. In the emerging countries, the government needs to undertake large public investments in order to contribute to the increase of productivity and economic growth. Thus, public investment through providing infrastructure for private investment is significant for increasing labour productivity and also extends the capacity to export. Hence, the development of the public investment-GDP ratio will be used to assess the public investment.

All in all, we can say that the industrial policy will be given the tasks of supporting foreign economic policy, providing infrastructure for private investment, increasing productivity in the manufacturing sector, improving its competitiveness, terms of trade and net exports, and thus, creating conditions for more sustainable economic growth.

## **2.3. Financial system**

That a positive development and size of the financial system has an important role to play for economic growth in a country was highly stressed by the Post Keynesian school (Priewe/Herr 2005:124). A so-called credit-investment-production-income-savings process needs to be put in motion for the economy to function properly (Priewe/Herr 2005:151-152). Firms need initial capital for the start of the production process, before the sales take place. If banks are

willing and able to give loans to firms, the latter then can use these loans to make an investment and increase employment, which will stimulate the creation of output, income and savings (Davidson 2011:141, Priewe/Herr 2005:150). However, for a functional credit-investment-income process to take place, it is important that the domestic money does not lose its functions as medium of exchange, unit of account and store of value; otherwise the credit expansion will at least partially be exchanged to a foreign currency and the level of dollarization/euroization will rise. In the emerging countries the quality of the currency and the level of dollarization/euroization are particularly important. High preference for a foreign currency as a store of value initially, and as unit of account and medium of exchange at a later stage, signifies that dollarization/euroization is under way (Priewe/Herr 2005:160-161). It is especially dangerous when there is a high presence of a foreign currency in the balance sheets of the government, the non-exporting firms and the household sector as their revenues are mostly in a domestic currency. Currency mismatch can be furthermore supplemented by maturity mismatch (when assets have a different maturity than liabilities). Hence, it will be useful to look at the rate of growth of dollarization/euroization measured as foreign currency loans-total loans ratio and foreign currency deposits-total deposits ratio.

High credit expansion towards the real estate and the household sector (in some countries, predominantly in foreign currency) characterises the development of a bubble also in emerging countries. In order to prevent the creation of bubbles and to increase productivity in the long run, it is particularly important that the central bank is involved in the process of credit allocation. For instance, the central bank through determining different reserve requirements for different asset classes can foster higher credit allocation towards the manufacturing sector and away from the speculative activities. In this way, the financial system activities will be geared towards supporting industrial policy. Through ceilings on loans directed towards the real estate sector and regulation of non-banks, the central bank can prevent speculative activities and financial crisis.

Following the discussion in this section, the ratio loans to manufacturing sector relative to the loans given to the private sector will be used for assessing the dynamics of the manufacturing sector, which using Kaldor's argument is the precondition for economic growth (Kaldor 1967). We will also argue that high loans to the latter speak of a more stable credit allocation, as opposed to loans predominantly to the real estate and financial sectors.

## 2.4. Wage development/policy

Wages can potentially have negative effects on the price development if they are flexible. Flexible nominal wages cause volatility in unit labour costs which, at least in a closed economy, are the most important determinant of prices (Herr/Kazandziska 2007:132-133). Too high nominal wage increases (over productivity development) can *ceteris paribus* potentially cause price increases, while nominal wage increases below productivity can cause a deflationary development. In small, open economies, nominal wage increases can cause changes in income distribution or can have price effects which will reduce the net exports.<sup>9</sup> Therefore, the Post Keynesian school recommends a certain rigidity of nominal wages.<sup>10</sup> Assuming constant distribution claims, the nominal wage policy would ideally take into account productivity development and the inflation target for the economy (Hein/Stockhammer 2011:130).<sup>11</sup> This means that unit labour costs should grow in line with the inflation target, which will prevent deflation and a change in the income shares, provided that mark up of the firms remains unchanged.<sup>12</sup> This norm functions if there are no persistent oil price increases and/or currency devaluations which will erode real wages and will put the whole burden on workers.

In order to encompass the analysis of functional wage policy, we also need to take a look at the connection between exchange rates and wages. In countries with pegged exchange rate regime the nominal exchange rate is fixed, hence the changes in prices and wages will automatically cause changes in the level of competitiveness relative to its trading partners (through the real exchange rate), which *ceteris paribus* will have a reflection on its current account position (Logeay/Rietzler/Stephan/Zwiener 2006:118). Therefore, a wage anchor will help to keep the real exchange rate stable as well. A necessary condition for a functional wage policy is high wage coordination which necessitates strong labour market institutions and high collective bargaining coverage which can be also achieved through extension of collective agreements by the government. In countries where collective bargaining is weak and the extension of collective agreements is possible only under very limited conditions and is rare, minimum wages can be used to provide an anchor for the wage structure and to contribute to the implementation of the wage norm (Herr/Kazandziska 2011a). To prevent widening of the

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<sup>9</sup> Blecker (2011:215-239) provides an excellent discussion about distribution in open economies.

<sup>10</sup> Both the parking-it and the horizontalist stream within the Post Keynesian school accept this formulation of a wage policy.

<sup>11</sup> Wages (as part of unit labour costs) are one of the most important factors determining the price level in a closed economy (Keynes 1930).

<sup>12</sup> Under inflation target I do not necessarily mean that the central bank follows a strategy of inflation targeting. It is commonplace that every central bank calculates a specific 'desired' level of inflation.

wage structure, the minimum wage should increase in accordance with the wage norm described previously, provided that wages follow this model as well.

The deviation of nominal wages from the wage norm will show us if the wages have created an additional impulse for inflationary/deflationary development. Medium to long-run growth of unit labour costs will be used as an indicator for international competitiveness. The wage share is the indicator which will be used to analyse the changes in the functional income distribution.

## **2.5. Monetary policy**

Generally, there are two different streams within the Post Keynesian school regarding the use and transmission mechanism of monetary policy on the economy: the ‘activist’ and the ‘parking-it’ approach (Rochon/Setterfield 2007). What they have in common is that they both consider the credit supply to be determined by credit demand. There is no external limit that the central bank sets, but rather the banks decide on the credit allocation according to the credit demand and their perception about the creditworthiness of their clients (Rochon/Setterfield 2007). Yet, the difference lies in the way the monetary policy, i.e. the interest rate policy, should be used. According to the ‘activist’ approach the central bank should use active interest rate policy to bring the actual inflation rate close to the inflation target. Due to the fact that monetary policy becomes less effective in times of recession and deflation, proponents of the ‘activist’ approach suggest that the central bank applies very expansionary monetary policy in recessions and more careful increases in interest rates in boom phases.

The ‘parking-it’ approach stands for a rather inactive role for monetary policy because of the reason that it has asymmetric effects on the economy and because interest rate changes can have long-run distributional effects which might undermine the short-run effect on inflation (Hein/Stockhammer 2011). These economists share the opinion that the central bank ‘parks’ the interest rate at a certain level and leaves the wage/incomes policy the role of combating inflation.

Since this paper focuses on emerging countries, a more general recommendation for central banks would be to target low but positive long run real interest rates, applying low, but positive nominal interest rates, at a given inflation rate maintained by the wage policy, so as to stabilize expectations, to promote investment and prevent the occurrence of high and speculative flows (Priewe/Herr 2005:52).

Thus, the ratio real long-term interest rates minus productivity growth, together with the ratios real short-term and real long-term interest rates minus GDP growth will be used to assess the functionality of monetary policy. Keeping real long-term interest rates below productivity growth is important for high real investment and growth (Hein 2012). Real interest rates higher than GDP growth point towards an ex-post restrictive stance of monetary policy and vice versa.

## 2.6. Fiscal policy

Fiscal policy has an important role to play in the economy. Post Keynesian authors argue that fiscal policy should be assigned the role of securing full employment, real stabilisation in the economy and more equal income distribution (Arestis/Sawyer 2004, Hein/Truger/van Treeck 2012). In these studies, and following the theory of functional ‘finance’ the authors propose that fiscal policy compensate for the excess of saving over investment at stable inflation levels of employment and assuming a roughly balanced current account.<sup>13</sup> Furthermore, automatic stabilizers together with anticyclical fiscal policy should be used to combat demand shocks (Hein/Truger/van Treeck 2012:28). The structural budget balance – GDP ratio in relation to output gap will be used as indicator for assessing the cyclicity of fiscal policies.

The government also needs to provide social programs to reduce poverty and income inequality. Progressive taxation or extensive welfare systems including unemployment benefit schemes, social aid, and public health care are just a few examples of government’s active involvement in this. To assess the redistribution effects of taxes and social policies, the Gini coefficient before and after tax will be used. Public investment (providing public employment, education and infrastructure) is also a very important part of fiscal policy.<sup>14</sup>

However, we should bear in mind that due to the low currency premium and currency quality in the emerging countries, particularly the ones with current account deficits, especially in times of financial and economic crisis, even a small increase in budget deficits can increase the costs for the borrowing of the government and capital flight. Consequently, we can argue that the level of public debt in emerging countries should be kept at a lower level than in developed countries, especially when the debt is in a foreign currency (Priewe/Herr 2005:56).

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<sup>13</sup> The functional finance view states that when the private sector is in surplus/deficit, and assuming a balanced current account, the public budget should be in deficit/surplus because there is no automatic force that brings investment and saving in equilibrium (Lerner 1943, Arestis/Sawyer 2004).

<sup>14</sup> To avoid unnecessary repetition, the indicator public investment-GDP to evaluate the level of public investment will not be used here as it is already used as an indicator for assessing the functionality of industrial policy.

### **3. Macroeconomic policy regime in the Baltic region – the case study of Latvia**

In what follows the MPR of Latvia representing small, open, net debtor emerging economies which are candidates for entry in a currency union will be examined. The focus will be put on two periods: the pre-crisis, or boom phase 1995-2007, and the crisis, or bust phase 2008-2011. Firstly, the economic development and the contributions of elements of aggregate demand to growth will be analysed. Afterwards, I will provide examination and assessment of all the elements of MPRs applied to Latvia separately.

#### **3.1. Economic development**

After the early transition phase in the early 1990s (when Latvian experienced large losses of output, high inflation and increases in unemployment), the economy in 1995 started showing the first signs of stabilisation and recovery. During the phase that followed (1995-2007) the Latvian economy experienced uninterrupted growth of 6.7% per year (European Commission 2012c). Due to the deregulation of financial markets, as well as the entry in the European Union, Latvia attracted high capital flows which supported a creation of ever higher current account deficits. Mostly the inflows of capital were channelled in the form of credits to the service sector (specifically the real estate, financial and construction sector). The number of loans to households increased continuously after 2002 (Table 3.3). This boosted consumption which was the main driver for growth in the economy (Figure 3.1).

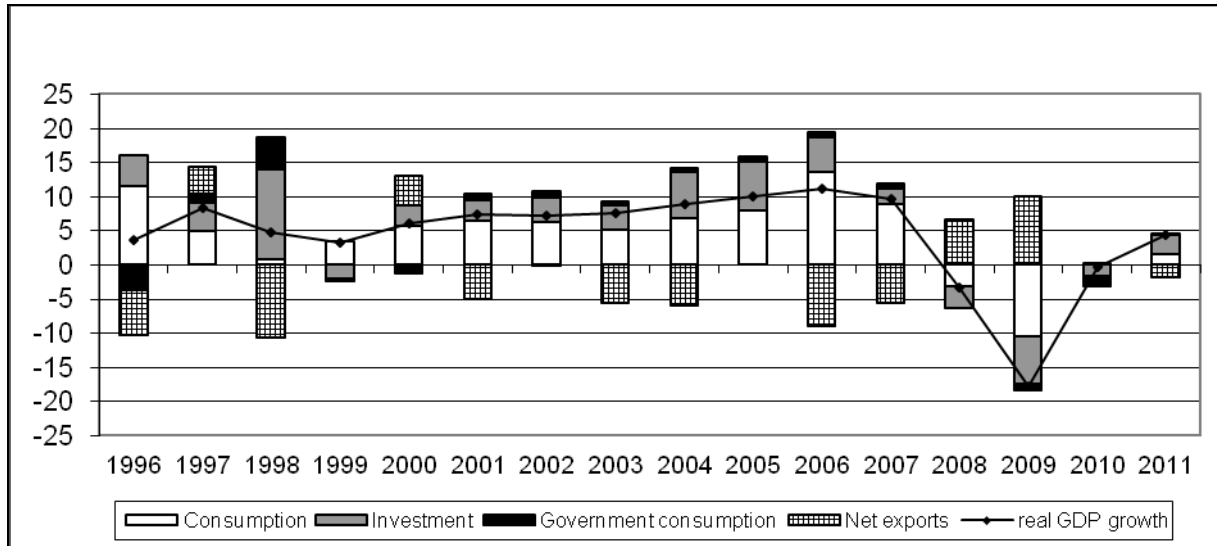
However, the relatively high economic growth was not supported by employment creation. In fact employment increased only at a rate of 0.35% on average for the respective period. It is because of the strong and prolonged increase in GDP and not in employment that we can observe big increases in productivity indices starting from 1996 onwards. Therefore, we can speak of a jobless growth in Latvia.

In 2008 the Latvian economy slid into recession which lasted until 2011. It was among the European countries, which were the hardest hit by the financial and economic crisis. Both private consumption and investment fell sharply in 2008. In 2009 The EU Council decided that Latvia had excessive public deficits and had to undergo an excessive deficit procedure, with cuts in government spending, which coupled with very large declines in private consumption and investment was a very important cause for reduction in GDP growth of around 18% in 2009. The positive contributions of net exports to GDP growth were registered only in 2008 and 2009, when Latvia also managed to achieve surpluses in the current account. These were not due to the improvement in the export performance, but were rather a



consequence of the collapse of imports in the face of the severe cuts in wages, unemployment increases and the loss in purchasing power.

Figure 3.1 Contributions of components of aggregate demand to GDP growth, 1996-2011



Source: author's calculation based on European Commission 2012c.

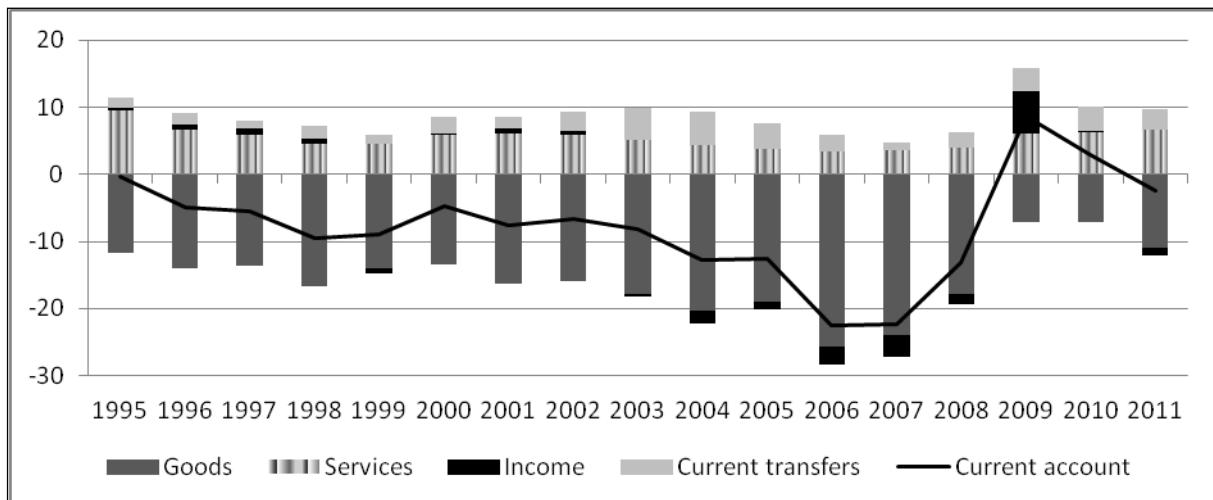
### 3.2. Foreign economic policy

Latvia introduced a new currency already in 1992, the Latvian ruble, which was a step in the direction of gaining independence from Russia and the whole Soviet Union. In 1994 the currency was pegged to special drawing rights (SDR), including the US dollar, the German mark (later the Euro), the pound sterling and the Japanese yen, at a rate of 0.7997 Latvian Lats (LVL) for 1 SDR. In January 2005 the Lat was pegged to the Euro and a few months later the Lat entered the Exchange Rate Mechanism II, in order to fulfil the Maastricht criteria for accession to the EMU. In spite of the option to allow for 15% fluctuation around the arranged exchange rate parity, the Latvian government decided to keep the exchange rate within  $\pm 1\%$  fluctuation margins.

To assess the functionality of the foreign economic policy as a part of MPR, we will firstly look at current account balance-GDP ratio. The financial market deregulation in the mid 1990s caused the first wave of high capital inflow. The second wave of an increase in capital inflows that started in 2004 and lasted until 2007 was caused by the entry of Latvia in the EU and the positive expectations created therewith. This large capital inflow caused a dramatic increase in the current account deficit, especially since 2000 (Figure 3.2). This development was mainly a consequence of the erosion of the balance of trade in goods. As the capital

inflows increased, the income part of the current account was also put under pressure.<sup>15</sup> The increase in imports was financed mainly by capital inflows in the form of interbank loans, and secondly, intercompany loans as a part of other investment flows (Figure 3.3).<sup>16</sup> Credits create an external liability and thus, increase external debt. The former increased very strongly, especially after 2004. In 2007, the amount of the external debt stock amounted to 136% of GDP (Table 3.1). The high amount of external liabilities created through the capital inflows led to an increased vulnerability of the financial system (see also section 3.4). The second important source of finance is FDI; though, it remained low in comparison to other CEECs. During the growth phase, the latter has mainly been directed towards the real estate sector, financial sector, trade, energy and transport and communication sector. FDI inflows in the manufacturing sector even in the peak years (2006 and 2007) remained very low (about 0.5% of GDP), while solely the financial sector attracted FDI which amounted to 3% of GDP (Swedbank 2012). FDI inflows also have some negative sides, which can be also confirmed in the Latvian case. FDI flew mainly towards services, which are to a large extent non-tradable. According to Mencinger (2007), the influx of FDI caused a deterioration of the current account by stimulating more imports than exports and by increasing the deficit in the income account.

Figure 3.2 Contributions to the current account balance (% of GDP), 1995-2011

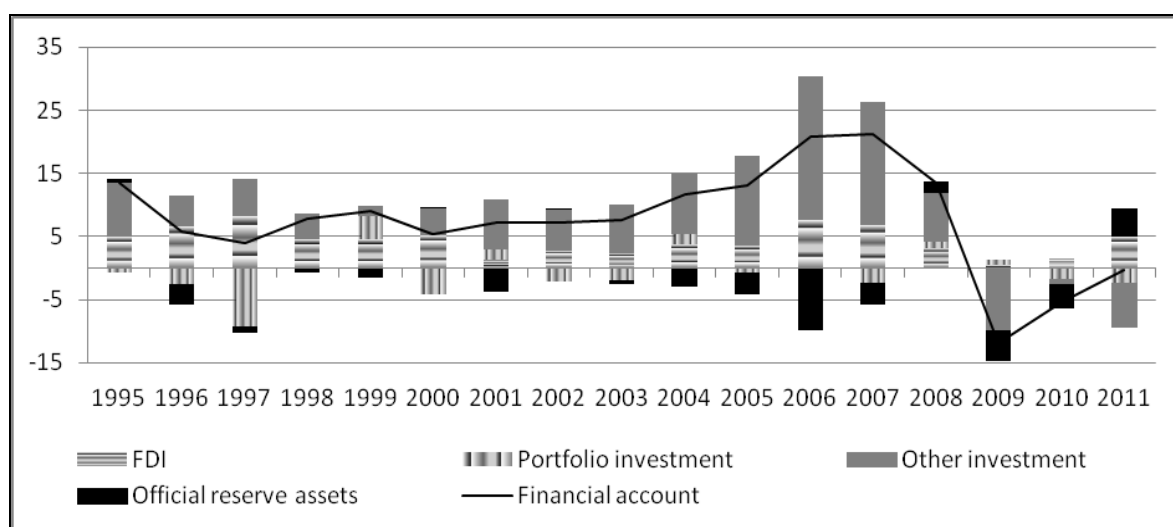


Source: author's calculation, Bank of Latvia 2012

<sup>15</sup> Starting from 2003, cumulative interest payments, as well as profit repatriation led the balance of the income account to turn negative.

<sup>16</sup> Own calculation based on Bank of Latvia – balance of payments data tables (2012).

Figure 3.3 Capital flows, net (% of GDP), 1995-2011



Source: author's calculation, Bank of Latvia 2012

Table 3.1: External vulnerability indicators for Latvia, 1995-2010

	REER index, (1999=100) Latvia	REER index, (1999=100) EMU-16	Current account balance / GDP (%)	External debt / GDP	Foreign exchange reserves / external debt
1995	69.8	121.0	-0.3	8.8	109.3
1996	79.5	117.7	-5.0	22.1	53.1
1997	91.3	104.1	-5.6	45.0	27.6
1998	94.38	101.1	-9.8	47.1	25.7
1999	100.0	100.0	-9.0	55.7	21.5
2000	112.4	94.4	-4.7	62.0	17.5
2001	112.2	96.5	-7.5	63.7	21.7
2002	108.0	97.2	-6.7	73.1	18.2
2003	99.0	104.4	-8.2	78.7	16.3
2004	99.3	103.7	-12.8	90.1	15.4
2005	99.5	102.8	-12.4	88.8	15.7
2006	104.0	102.0	-22.7	112.8	19.4
2007	111.4	100.8	-22.3	135.7	14.2
2008	123.8	106.8	-13.3	124.3	12.0
2009	126.6	116.3	8.8	161.6	15.9
2010	122.8	109.4	3.0	164.7	18.3
1995-07	98.5	103.5	-9.8	68.0	28.9
2008-10	124.4	110.8	-0.5	150.2	15.4

Notes: REER stands for real effective exchange rate. Increase means appreciation.

Source: author's calculation based on World Bank 2012.

In the aftermath of the financial crisis with the drop in output, the increase in unemployment and wage cuts in the crisis period, imports declined, which caused an improvement in the current account. A second reason is a surplus in the income account caused by the financial losses of the foreign investors due to the financial crisis.

In 2008 Latvia had to suffer reserve losses in attempt to prevent a devaluation of the Lat amidst the high increase in external debt (especially of the government). What also contributed to a decline in the quality and credibility of the Lat was the withdrawal of capital by foreign banks from their subsidiaries or other unaffiliated banks (Onaran 2011:224). The depreciation pressure became so pronounced that the Latvian government was forced to ask for financial aid from the International Monetary Fund (IMF) and the ECB to keep the exchange rate stable (Onaran 2011:225).<sup>17</sup> The reserves to external debt ratio has throughout the years dramatically declined, which speaks of the potential inability of the central bank to defend the fixed exchange rate regime (Table 3.1).

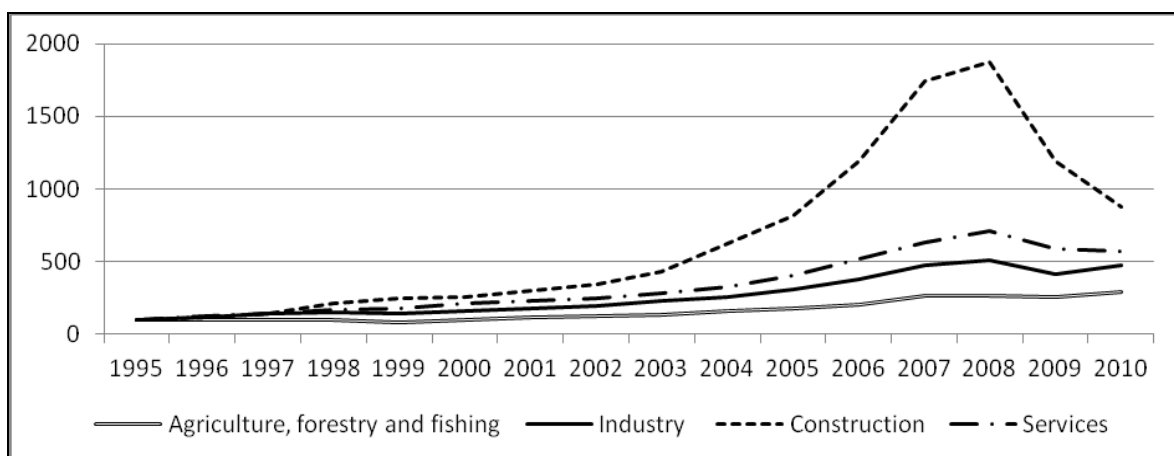
From the above said, we can speak of dysfunctional foreign economic policy, which led to ever-increasing current account deficits, overvalued currency, currency mismatch in the balance sheets of the households, the non-exporting companies and the government.

### 3.3. Industrial policy

Out of the three different sectors (agriculture, industry and services), the growth of the Latvian economy after the mid 1990s was predominantly driven by the rise in the output in the service sector. In comparison with the service sector, the output and employment in the industrial sector increased at a much lower rate (Figure 3.4).

At the same time, we can observe an increase in value added in the service sector, especially in the real estate, wholesale, retail trade, transport and accommodation sector. However, also in these sectors there has been only a moderate increase in employment.

Figure 3.4: Sectoral composition of output, 1995-2010 (index, 1995=100)



Source: own calculation based on Eurostat 2012.

<sup>17</sup> The response of the EU in 2009 to provide financial assistance to Latvia was rather belated because the country had already fallen into recession in 2008.

Table 3.2 provides the indicators for assessing the functionality of industrial policy. We can clearly observe while that the government spending on R&D relative to GDP has been lower than the EU average for the whole period for which we have available data (2004-2010), the public investment-GDP ratio although it was lower than the EU average until 2003, after 2004 it showed significant improvement. Yet, after 2004 and to a large extent supported by the EU, the amount of public investment as a share of GDP was higher than the average of EU (Table 3.2).<sup>18</sup> All in all, we can argue that on the positive side, the government after 2004 increased its investment on building infrastructure. However, its spending on R&D relative to GDP has remained relatively low. Moreover, there does not seem to exist a clear strategy for industrial policy, but rather sporadic interventions.

Table 3.2: Industrial policy indicators, 1995-2010

	Public investment / GDP		government spending on R&D / GDP	
	Latvia	EU-27	Latvia	EU-27
1995	1.91	2.58	...	...
1996	2.31	2.47	...	...
1997	1.22	2.28	...	...
1998	1.34	2.31	...	...
1999	1.45	2.35	...	...
2000	1.34	2.31	...	...
2001	1.12	2.39	...	...
2002	1.28	2.34	...	...
2003	2.38	2.45	...	...
2004	3.11	2.41	0.18	0.72
2005	3.11	2.26	0.20	0.71
2006	4.63	2.50	0.27	0.69
2007	5.69	2.59	0.30	0.68
2008	4.86	2.73	0.29	0.72
2009	4.29	2.93	0.21	0.77
2010	3.72	2.70	0.16	0.76
1995-07	2.38	2.51	0.24	0.70
2008-10	4.29	2.40	0.22	0.75

Source: Eurostat 2012, author's calculation.

### 3.4. Financial system

The process of deregulation in the financial system has started already in the early 1990s when most barriers to entry for banks or other financial institutions were lifted. Until the mid 1990s, the credit ceilings, credit controls and restrictions on international capital flows were

<sup>18</sup> This improvement can to a large extent be connected to the entry in the EU. For illustration, through the Structural Funds and the Cohesion Fund of the EU, it is decided that Latvia receives 1.7 billion euro to improve transport infrastructure and 1 billion euro for R&D for the period 2007-2013 (European Commission 2009).

eliminated (IMF 2008:769-776). As the stock market grew, firms could increasingly obtain finance in the capital markets, which also stimulated a rise in the stock prices. The particularly high increase of stock prices in the second half of 2003 which indicates a bubble in the stock market can be connected to the entry of the Central Eastern European countries in the EU (see Figure A1 in the appendix). Despite the growth in the stock markets after 2000, the main source of funding came from the banks.<sup>19</sup> We can observe an entry of foreign capital in the banking sector. The share of foreign-owned banks in total banks increased from 9% in 1995 to 62% in 2009 (Claessens/van Horen 2012:30).

In Latvia the financial system has shown an impressive growth which can be confirmed by the growth of loans. As it can be seen from Table 3.3 high credit expansion can be particularly spotted beginning from 2005 onwards, which is the time when the bubble in the real estate and stock market evolved. The biggest share of loans used to be directed towards the financial corporations and the business sector. However, a very small share of these loans went to the manufacturing sector (Table 3.3). Loans granted to households (especially mortgage loans) gained importance.<sup>20</sup>

In the period 2002-2007 we can observe a galloping presence of foreign currency loans (mainly Euros) in the balance sheets of the private and the public sector (Table 3.3). The high presence of foreign currency in the balance sheets of the economic actors (especially the households, the government and the non-exporting companies) points towards high dollarization/euroization and a currency mismatch. During the bust phase the foreign currency deposits-total deposits ratio has increased to over 50% which speaks of a loss of confidence in the domestic currency and capital flight. Even more dangerous was the fact that during this phase the loans were also predominantly granted in a foreign currency both to the company and the household sector.

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<sup>19</sup> In the period 2005-2008, 92% of total assets belonged to the banks and the rest 8% to the non-banks (EBRD 2009:13).

<sup>20</sup> In 2007 the mortgage loans to the households amounted to 34% of GDP. In the report of the European Bank of Reconstruction and Development (EBRD) it is also emphasized that in 2009 even one third of the total mortgage lending was in a foreign currency (EBRD 2009:128).

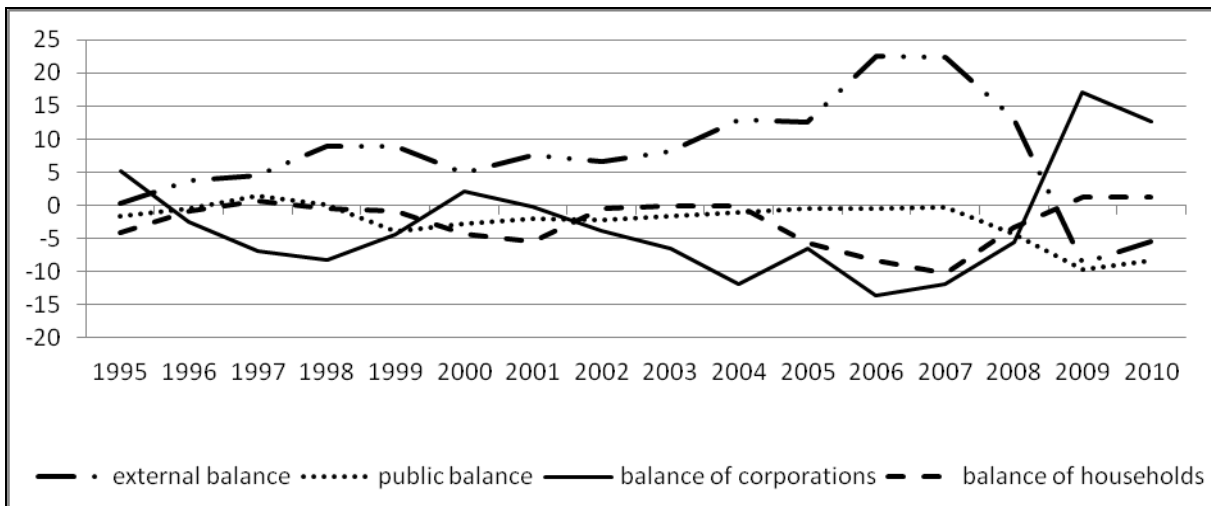
Table 3.3: Domestic loans and deposits of the different actors, 2002-2011

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-07	2008-11
Total loans (index, 2002=100)	100.0	138.2	193.6	289.4	474.6	750.8	941.4	1001.9	921.6	841.8	324.4	926.7
out of which in foreign currency (% of total loans)	57.6	54.2	55.8	65.1	70.7	77.4	87.7	89.2	92.2	91.7	63.5	90.2
Loans to households (% of total loans)	18.8	24.4	31.0	36.1	40.5	45.1	45.8	44.1	45.5	46.5	32.6	45.5
out of which in foreign currency (% of household loans)	49.1	55.9	59.9	68.3	70.5	78.1	86.7	88.0	90.2	90.4	63.6	88.8
Loans to private financial and non-financial companies (% of total loans)	75.4	70.4	66.0	61.3	57.8	53.8	52.2	53.3	51.5	49.6	64.1	51.6
out of which in foreign currency (% of corporate loans)	59.5	54.5	54.1	63.8	70.8	76.6	88.4	89.9	93.7	92.4	63.2	91.1
Loans to the manufacturing sector (% of loans to the company sector)	...	16.8	14.7	14.2	13.2	13.3	14.0	6.5	5.9	5.5	14.4	8.0
Non-performing loans (% of total loans)	2.0	1.4	1.1	0.7	0.5	0.8	3.6	16.4	19.0	18.4	0.9	13.0
Total deposits in foreign currency (% of total deposits)	46.4	41.2	36.5	38.3	42.1	42.6	47.7	53.3	53.3	52.2	41.2	51.6

Source: author's calculation based on Macroeconomic Development Reports of the Bank of Latvia of various years.

As it can be seen from Figure 3.5 the main imbalances during the boom phase have been created in the current account from the capital inflows, which supported private sector investment over saving. The spending of the government on the other hand was slightly higher than tax revenues, approaching zero right before the start of the financial crisis.

Figure 3.5: Financial balances of the different sectors (% of GDP) (1995-2010)



Source: author's calculation based on Eurostat 2012.

As a result of the burst of the bubble in 2008, the balances of the private sector turned positive and the current account deficits were reduced. Higher government spending was needed to absorb the excess of saving over investment. However, as explained in section 3.7, already in 2009 the government resorted to budget consolidation policies.

All in all, we can say that the open capital account has allowed for a high inflow of capital in a form of loans, which mainly denominated in euros, created a situation of currency mismatch for all economic actors. Furthermore, while the loans to the real estate and financial sector increased, the number of loans granted to the manufacturing sector has had a continuous decline. Therefore, we can undoubtedly argue that the development of the financial system was overall dysfunctional.

### 3.5. Wage development/policy

Latvia's wage bargaining system, similarly to the Lithuanian and Estonian, shows characteristics of predominantly high decentralization, i.e. the wage negotiations take place mainly at the company level (Eurofond 2011).

Although a positive development can be seen in the increase in the employer organization density (from 20% in 2002 to 35% in 2008), the collective bargaining coverage remained low



compared to the EU average (Visser 2011).<sup>21</sup> Furthermore, the union membership is low and wages are often set individually by the employer.<sup>22</sup> Very rarely do wage negotiations take part at industry level. Collective agreements on a sectoral level can be almost automatically extended, if the employers that sign the agreements employ at least 50% of the workers or produce 60% of the output in the whole sector (CesIfo 2012). However, looking at the low collective bargaining coverage it is straightforward to argue that this instrument has not brought a high success. The area in which trade unions and employers' organizations have an important contribution is setting the minimum wage within the framework of the Minimum Wage Law. For this purpose, the National Tripartite Commission was formed to support an open discussion about the minimum wage (Eurofond 2009). On a national level, though, we can argue that this is the only attempt to get the engagement of the social partners on a wage-related matter. This is because on a sectoral level, the agreements are mainly so-called framework agreements setting the basic conditions, but the wage-related issues are dealt with in the individual companies.

As previously elaborated, unit labour costs are an important factor that influences price development and affects the international competitiveness. In Latvia on average for the period 1995-2007 we can see a higher growth of unit labour costs than in the EU, and thus, a loss of competitiveness on the side of Latvia (Table 3.4).

In 2008 the government was forced to implement wage cuts in the public sector as a part of the austerity measures imposed by the EU Commission and the EU governments in order to reduce the budget deficit (Onaran 2011). The proposal was that Latvia would turn to internal devaluation, as external devaluation was not considered to be possible taking the commitment of the Latvian government to maintain the fixed exchange rate. The wage cuts in the public administration led to a decline of wages in the private sector as well. Hence, the average wage declined by almost 13% in 2009 and 6% in 2010, which put the pressure on prices to fall. Due to the lack of long-run data we cannot make a definite conclusion about the wage share, but if we compare it with the wage share in the EU, we can see that during the bust period the wage share in Latvia has had a more stabilizing effect on consumption and thus on the economy, as it shows a higher increase relative to the EU (Table 3.4).

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<sup>21</sup> In 2008 the collective bargaining coverage in Latvia was 25%, while in the EU it was around 60% on average for the 27 member countries (author's calculation based on Visser 2011).

<sup>22</sup> After the breakdown of the Soviet Union, trade unions also had to go through a period of transformation from unions "close to the state" to independent social partners. Due to these changes, trade union density declined from 28% in 1995 to 16% in 2007 (Visser 2011).

Table 3.4: Labour market indicators, 1995-2011

	ULC growth (%) Latvia	ULC growth (%) EU-27	nominal wage growth (%)	productivity growth (%)	inflation rate (%)	AWS (% of GDP) <sup>3</sup> Latvia	AWS (% of GDP) EU-27
1995	-1.9	n.a.	8.8	10.6	25.0	51.7	59.6
1996	21.7	2.5	27.3	5.6	17.6	54.0	59.3
1997	9.2	2.6	13.0	3.8	8.1	54.8	58.8
1998	1.1	1.5	6.2	5.1	4.3	53.1	58.5
1999	2.4	1.6	7.5	5.1	2.1	52.2	58.5
2000	-2.2	1.9	7.4	9.6	2.6	49.1	58.8
2001	-1.8	2.8	4.3	6.1	2.5	47.4	58.9
2002	-1.4	2.2	2.8	4.2	1.9	45.3	58.6
2003	5.5	2.2	11.0	5.6	2.9	46.0	58.4
2004	6.9	1.0	14.5	7.6	6.2	45.7	57.8
2005	16.6	1.6	25.1	8.4	6.9	47.9	57.4
2006	17.3	1.2	23.3	6.0	6.6	50.1	56.9
2007	29.3	1.9	35.1	5.8	10.1	53.0	56.5
2008	19.9	4.1	15.7	-4.2	15.2	56.6	57.1
2009	-7.5	4.2	-12.7	-5.3	3.3	52.8	58.9
2010	-9.5	-0.4	-6.0	3.5	-1.2	48.7	58.0
2011	2.2	1.3	4.4	2.2	4.2	51.7	57.6
1995-07	7.9	1.9	14.3	6.4	7.4	50.0	58.3
2008-11	1.3	2.3	0.4	-0.9	5.4	51.3	57.9

Notes: ULC stands for unit labour costs.

Source: author's calculation based on European Commission 2012c.

Table 3.5: Wage norm indicators, 1995-2011

	Inflation target (%)	Medium term productivity growth (%)	Nominal wage growth (%)	Wage norm (%) <sup>1)</sup>	Deviation of the wage norm (%) <sup>2)</sup>
1995	25.0	4.7	8.8	29.7	-20.9
1996	17.6	4.7	27.3	22.3	5.0
1997	8.1	4.7	13.0	12.8	0.2
1998	4.3	4.7	6.2	9.0	-2.8
1999	2.1	4.7	7.5	6.8	0.7
2000	2.0	4.7	7.4	6.7	0.7
2001	2.0	4.7	4.3	6.7	-2.4
2002	2.0	4.7	2.8	6.7	-3.9
2003	2.0	4.7	11.0	6.7	4.3
2004	2.0	4.7	14.5	6.7	7.8
2005	2.0	4.7	25.1	6.7	18.4
2006	2.0	4.7	23.2	6.7	16.5
2007	2.0	4.7	35.1	6.7	28.4
2008	2.0	4.7	15.7	6.7	9.0
2009	2.0	4.7	-12.7	6.7	-19.4
2010	2.0	4.7	-6.0	6.7	-12.7
2011	2.0	4.7	4.4	6.7	-2.3
1995-07	5.6	4.7	14.3	10.3	4.0
2008-11	2.0	4.7	0.3	6.7	-6.3

Notes: <sup>1)</sup> Wage norm is calculated as the sum between the productivity increase and the inflation target.

<sup>2)</sup> Deviation of the wage norm shows the difference between the actual wage development and the wage norm in percentage points. <sup>3)</sup> AWS stands for adjusted wage share. It is calculated by dividing compensation per employee by GDP at factor cost per person employed.

Source: author's calculation, European Commission 2012c.

The wage norm for stability-oriented wage policy (that wage increases move in line with the productivity development in the medium run plus the inflation target) is a criterion for checking the functionality of the wage development. Being that the Latvian central bank does not explicitly have an inflation target, the ECB's target of 2% inflation rate is taken as the inflation target the Bank of Latvia aims at. Hence, after 2000 when Latvia reached 2%, the ECB's 2% inflation rate target is taken as an implicit target for the Bank of Latvia.<sup>23</sup> From Table 3.5, we can conclude that the wage increases have been above the proposed wage norm for the period 1995-2007, which put additional pressure on inflation. In the period of economic crisis, the former has developed below the wage norm, which contributed to a

<sup>23</sup> For the period 1995-1999, the actual inflation rate is taken.

deflationary development. For this reason and for the reason that Latvia has lost competitiveness, we can talk about dysfunctional wage policy.

### 3.6. Monetary policy

One crucial institutional change with respect to monetary policy was the creation of a two-tier system in 1988 when conditions for establishment of the first private commercial banks were set (Barisitz 2002:85). The Bank of Latvia was established in 1990 and already by July 1992 interest rates were liberalised (EBRD 2003:164). Very similar to the ECB, the Bank of Latvia set maintenance of price stability as the main objective of monetary policy.<sup>24</sup> It is not clear, though, what price stability actually means, as the central bank does not explicitly set nor publishes inflation targets. The intermediate target towards achieving its main objective is the exchange rate peg to the Euro, which the central bank defends through foreign exchange intervention.<sup>25</sup> Hence, we can argue that the monetary policy of the central bank is very much restricted by the attempts to keep the exchange rate within the  $\pm 1\%$  margins.

Table 3.6: Monetary policy indicators, 1997-2011

	Inflation rate (CPI)	Nominal refinancing interest rate	Convergence to the Euro area <sup>1)</sup>	RRIR <sup>2)</sup>	RRIR minus GDP growth	RLIR minus GDP growth <sup>3)</sup>	RLIR minus productivity growth
1997	8.1	4.0	...	-4.1	-12.4	...	...
1998	4.3	4.0	...	-0.3	-5.1	...	...
1999	2.1	4.0	1.0	1.9	-1.4	...	...
2000	2.6	3.5	-1.2	0.9	-5.3	...	...
2001	2.5	3.5	0.2	1.0	-6.4	-1.5	-0.3
2002	2	3.0	0.2	1.0	-6.2	-3.5	-0.5
2003	2.9	3.0	1.0	0.1	-7.5	-6.9	-4.9
2004	6.2	4.0	2.0	-2.2	-11.1	-11.4	-10.2
2005	6.9	4.0	1.7	-2.9	-13.0	-14.7	-13.0
2006	6.6	5.0	1.5	-1.6	-12.7	-12.8	-7.7
2007	10.1	6.0	2.0	-4.1	-13.7	-13.8	-10.0
2008	15.3	6.0	3.5	-9.2	-6.0	-5.1	-4.2
2009	3.3	4.0	3.0	0.7	18.5	26.6	14.1
2010	-1.2	3.5	2.5	4.7	5.1	11.2	7.3
2011	4.2	3.5	2.5	-0.7	-5.2	...	...
1997-07	7.5	4.0	0.9	-0.9	-8.6	-9.2	-6.7
2008-11	5.4	4.2	2.9	-1.1	3.1	10.9	5.7

<sup>24</sup> See the website of the Bank of Latvia for more information.

<sup>25</sup> See the website of Bank of Latvia about the objectives and targets of monetary policy.

Notes: <sup>1)</sup> Convergence to the Euro area is calculated as the difference between the refinancing interest rate of the Bank of Latvia and the one of the ECB. <sup>2)</sup> RRIR stands for real refinancing interest rate. <sup>3)</sup> RLIR stands for real long-term interest rate.

Source: author's calculation based on European Commission 2012c, Eurostat 2012.

In Table 3.6 we can see the development related to the monetary policy in Latvia. The nominal interest rate development until 2002 was closely connected to the interest rates of the ECB. In the years that followed the central bank increased the refinancing interest rate to fight the ever increasing inflation. Yet, higher interest rates supported higher capital inflow and a deepening of the asset price bubble. On average, the real short- and long-term interest rates were negative during the boom period which furthermore fuelled up investment and credit-driven consumption. The former have had a development below the increase in productivity, which stimulated a rise in real investment too.

In the bust period the real interest rates grew above GDP and productivity, which suffocated growth and real investment. In 2009 and 2010 as a result of the decreasing inflation rate in 2009 and deflation in 2010, real interest rates turned positive, which shows the limited ability of the central bank to use interest rates for improving investment and economic growth in times of deflation. For the reason that the monetary policy was too expansionary in the boom period and too restrictive in the bust episode we can argue that monetary policy was dysfunctional.

### **3.7. Fiscal policy**

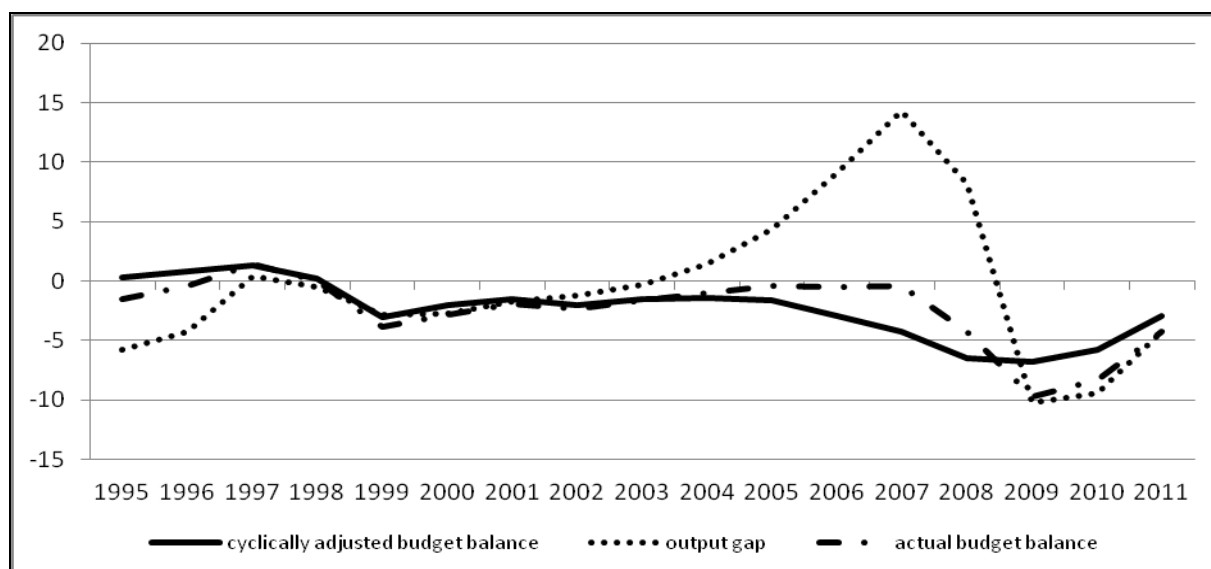
Except of 1999, the year when the financial system and the whole economy was affected by the Russian financial crisis, Latvia fulfilled the Maastricht criteria of keeping its budget deficit to GDP under the 3% limit and the public debt/GDP below the 60% target. However, the financial crisis of 2007/2008 caused a sharp decline in output and thus an increase in budget deficits of 4% in 2008 and 9% in 2009 (Eurostat 2012). In the Memorandum of Understanding (2009) one of the conditions for the financial assistance to Latvia set by the European Community is fiscal consolidation. Furthermore, by signing the Euro Plus Pact in 2011, Latvia committed to incorporating the objectives of the EU, particularly related to 'sound finances' in its national law or constitution.<sup>26</sup> Therefore, in spite of the recession, the government implemented six austerity packages between 2009 and 2012. A series of cuts in public spending followed including reduction in public sector wages. The VAT has been

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<sup>26</sup> The conclusions of the meeting in 2011 drew the objectives of Euro Plus Pact which include fostering competitiveness, employment, keeping sound finances (e.g. in the form of a debt brake), and financial stability (European Council 2011).

increased from 18% to 22% in 2012 (Ministry of Finance of the Republic of Latvia, MoF 2012). The reduced VAT was increased from 5% to 12%. In 2010 a capital gains tax of 15%, a capital income tax of 10% and a financial stability duty of 0.036%<sup>27</sup> were introduced (MoF 2012). The personal income tax rate was increased from 23% to 26% in 2010. In 2011 it has been reduced to 25%. The spending of the government on social security benefits has remained to be the lowest in the European Union in spite of the increase in the unemployment rate from 7.5% in 2008 to 18.7% in 2010. The cyclicity of fiscal policy can be judged by looking at the development of the structural budget balance-GDP and the output gap-GDP ratio (Figure 3.6). We can observe that while the fiscal policy in the 1990s was mainly anticyclical, in the last three years before the crisis it turned procyclical.

Figure 3.6: Structural budget balance and output gap, 1995-2011



Source: European Commission 2012c.

The government also stated that:

“These fiscal targets<sup>28</sup> clearly show that Latvia is strongly committed to ensure the budget deficit in structural terms of not more than 0.5% of GDP in coming years – starting already with 2015 the budget deficit in structural terms will be lower than the medium-term budget target for Latvia set by the EC. The realization of this kind of fiscal policy is an essential prerequisite for Latvia to

<sup>27</sup> This is to be paid by the Latvian banks, Latvian branches of foreign banks and foreign branches of Latvian banks (European Commission 2012a:9)

<sup>28</sup> The targets are that the budget deficit does not exceed 1.4% of GDP in 2013, 0.8% of GDP in 2014 and 0.3% of GDP in 2015 (ibid. p.4).

implement its strategic goal – to adopt the euro as of January 1, 2014.” (The Government of Latvia 2012:4)

Hence, it is very evident that fiscal policy will be kept restrictive, which could have negative effects on the economy in recession when higher structural deficits might be needed. However, looking at the financial balances of different sectors, it is obvious that the imbalances were created by the private sector and huge capital inflows which created high current account deficits, and not by the deficit spending of the government (Figure 3.5).

In terms of redistribution policies, we cannot make a definite judgement due to the lack of data. Namely, according to the European Commission (2012b) data for Gini-before and after taxes are available only for 2007 for Latvia (0.44 and 0.35 respectively). However, one important fact is that there is a flat tax rate of 25% on personal income, which on the one hand does not speak in favour of redistribution policies in favour of more equal income distribution and on the other hand causes a weakening of the automatic stabilizers, especially important in times of crisis.

#### **4. Conclusions**

In this paper a normative model of a functional macroeconomic policy regime for emerging countries, candidates for a currency union was presented. This model served as a benchmark for assessing the functionality of the MPR in emerging countries, which are at the doorstep of a currency union. The findings can be summarized as follows:

Institutional changes as a result of the deregulation of financial, goods and labour markets set limits to the macroeconomic policy mix used in the emerging countries on their way towards a currency union. Taking the example of Latvia, the deregulation of the financial markets led to high dollarization/euroization, currency mismatch in the balance sheets of the economic actors and ever-increasing current account deficits when the exports cannot keep up with the growth in imports. Current account deficits which increase mainly in the boom phase, in a situation of fixed exchange rate regime or high dollarization/euroization can be reduced by a fall in income and imports in the bust phase, which is a very painful process. Deregulated labour markets in the case of decentralised wage bargaining and low wage coordination can put an additional pressure to inflation and can cause deterioration of the competitiveness of the domestic firms.

These institutional changes paved the way for a macroeconomic policy mix, which in the case of Latvia was dysfunctional. Firstly, the foreign economic policy contributed to the expansion of current account deficits and made the financial system prone to capital flow volatility.

Secondly, the loans in the financial system (predominantly in a foreign currency) were directed mostly to the real estate and financial sector, which contributed to the widening of the asset bubble and to an increase in the currency mismatch in the balance sheets of all economic actors. Thirdly, monetary policy was constrained in the objective of keeping the exchange rate peg to the euro stable by the open capital account and the high currency mismatch in the balance sheets of all economic actors. During the boom, the low interest rate policy was too expansionary, deepening the asset bubble, while during the recession the real interest rates turned positive, which hurt investment. Fourthly, fiscal policy has been dysfunctional because for several years it showed a procyclical development and because it did not significantly contribute to improving income equality. Therefore, we can speak of dysfunctional development of the MPR, which created conditions for unstable growth, low employment and unequal income distribution.

This paper provided an alternative model of a functional MPR based on Post Keynesian economics. It shows that sacrificing external balance for higher economic growth is not a sustainable strategy in the long term. The first recommendation is that a bigger focus is put on foreign economic policy, which can help rebuild the competitiveness of the exporting sector and contribute to a reduction of the current account deficits. Reliance on capital inflows to cover for the latter is not a sustainable option, as they tend to be procyclical. International capital flow management (e.g. through setting different reserve requirements for different assets) can be used to reduce the foreign currency exposure of the financial system. Industrial policy through providing infrastructure for private investment and targeting of specific sectors/companies can contribute to a revival of the manufacturing sector and increase in the exporting capacity of domestic firms. The financial system is required to provide sufficient finance especially to the manufacturing sector and provide stability in the financial system. The case of Latvia also clearly shows that a very important factor determining prices is the wage development. Thus, providing a stable wage anchor would help preventing inflation/deflation, as well as an increase in income inequality, and it would *ceteris paribus* keep the real exchange rate stable. Monetary policy should be given a task of preventing panics in the banking sector, providing low-cost finance and stability in the financial system. Fiscal policy should care for the real stabilisation in the economy, full employment and more equal income distribution. Hopefully, the analysis of the macroeconomic policy regime in Latvia presented in this paper can stimulate research of the MPRs of other small emerging countries that are approaching a currency union.



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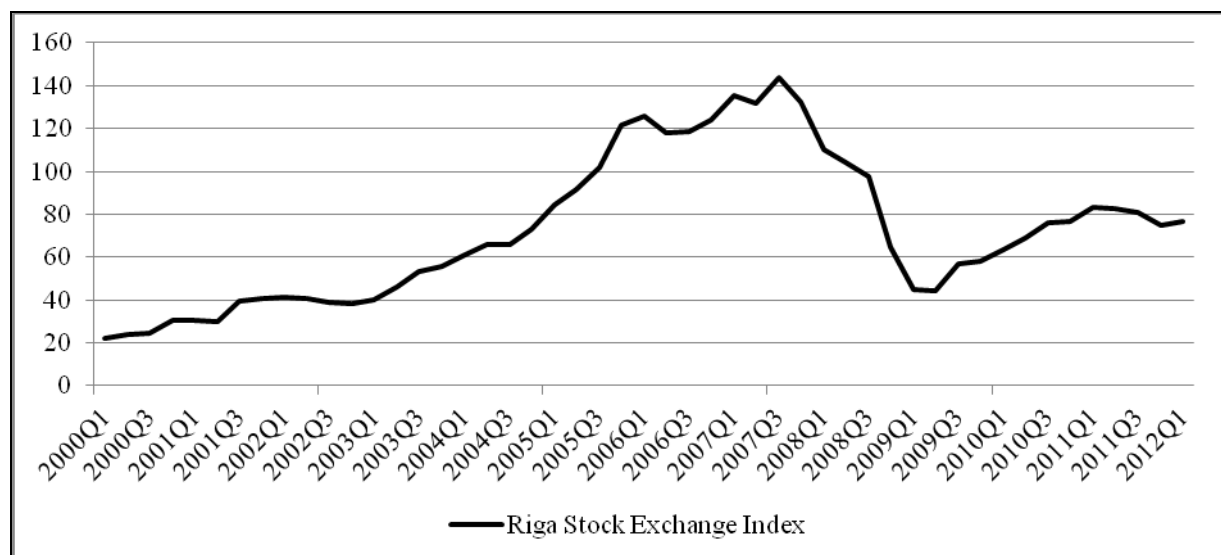
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## Appendix

Figure A1: Stock price development, 2000-2012



Source: Eurostat 2012





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