
# Latvia's Internal Devaluation: A Success Story?

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## Acknowledgments

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# Executive Summary

Advocates of an economic strategy of "internal devaluation" have recently pointed to Latvia as an example of successful macroeconomic policy. The Latvian economy is projected to grow by four percent in 2011. They argue that the Latvian government, along with the European authorities (including the International Monetary Fund – IMF), pursued the correct macroeconomic policies by maintaining Latvia's fixed exchange rate and implementing pro-cyclical fiscal policies (that shrunk the economy further) and sometimes pro-cyclical monetary policies. They argue that these were the best policies –as opposed to counter-cyclical, expansionary fiscal and monetary policies, accompanied by devaluation– designed to promote a rapid economic recovery.

In 2008 and 2009, as many countries fell into recession due to the global financial crisis and world recession, Latvia experienced the worst loss of output in the world. From late 2007 to late 2009, the country lost about 24 percent of its GDP. Official unemployment rose from 5.3 percent in late 2007 to 20.5 percent in early 2010.

Any argument that the "internal devaluation" strategy was an economic success would therefore have to be based on the counterfactual that a devaluation with expansionary macroeconomic policy would have been worse.

Table 1 below shows the loss of GDP following other large, crisis-driven devaluations, for a number of countries in the past two decades. Argentina, which defaulted on a record $95 billion of sovereign debt and suffered a financial collapse, lost 4.9 percent of GDP, after its devaluation, before it started growing again. The average loss for countries with devaluations in crisis situations was 4.5 percent of GDP. This compares to a loss of 24.1 percent of GDP for Latvia during its recession, while it kept its exchange rate fixed.

More importantly, we can also look at where each of these countries GDP was three years after these large, crisis-driven devaluations. Most of the countries are considerably above their pre-devaluation level of GDP three years later. The average economy is up by 6.5 percent over their pre-devaluation level of GDP. Latvia, by contrast, is down 21.3 percent of GDP, three years after the crisis began.

In addition to the loss of national income, there have been other social and economic costs of the Latvian government's strategy of internal devaluation. The official unemployment rate rose from 5.3 percent at the end of 2007 to 20.1 percent at peak in early 2010. Even after more than a year of recovery, the unemployment rate remains devastatingly high at 14.4 percent. That is mainly because the recovery has been relatively weak, especially given the depth of the severe economic contraction. But the official unemployment rate does not measure the full cost of this recession and weak recovery to Latvia's labor force. If we take into account those who are involuntarily working part-time and those who have given up looking for work, we get peak unemployment/under-employment of 30.1 percent in 2010, declining to 21.1 percent in the third quarter of 2011.

It also does not include all the people who have left the country in search of employment since the crisis began. It is estimated that the net loss of population in 2009-2011 amounts to as many as 120,000 people, or 10 percent of the labor force. If not for this migration, the broader measure of unemployment could be as high as 29 percent in the third quarter of 2011, instead of 21.1 percent.

Another way to evaluate the impact of the crisis and economic policy on the labor market is to look at employment. Employment dropped about 20.3 percent from its peak in the fourth quarter of 2007 to the bottom in the first quarter of 2010. Since the economy began recovering, it has recovered just 6.0 percentage points of this loss, leaving Latvia with 14.3 percent fewer working-age people employed as compared to pre-crisis employment.

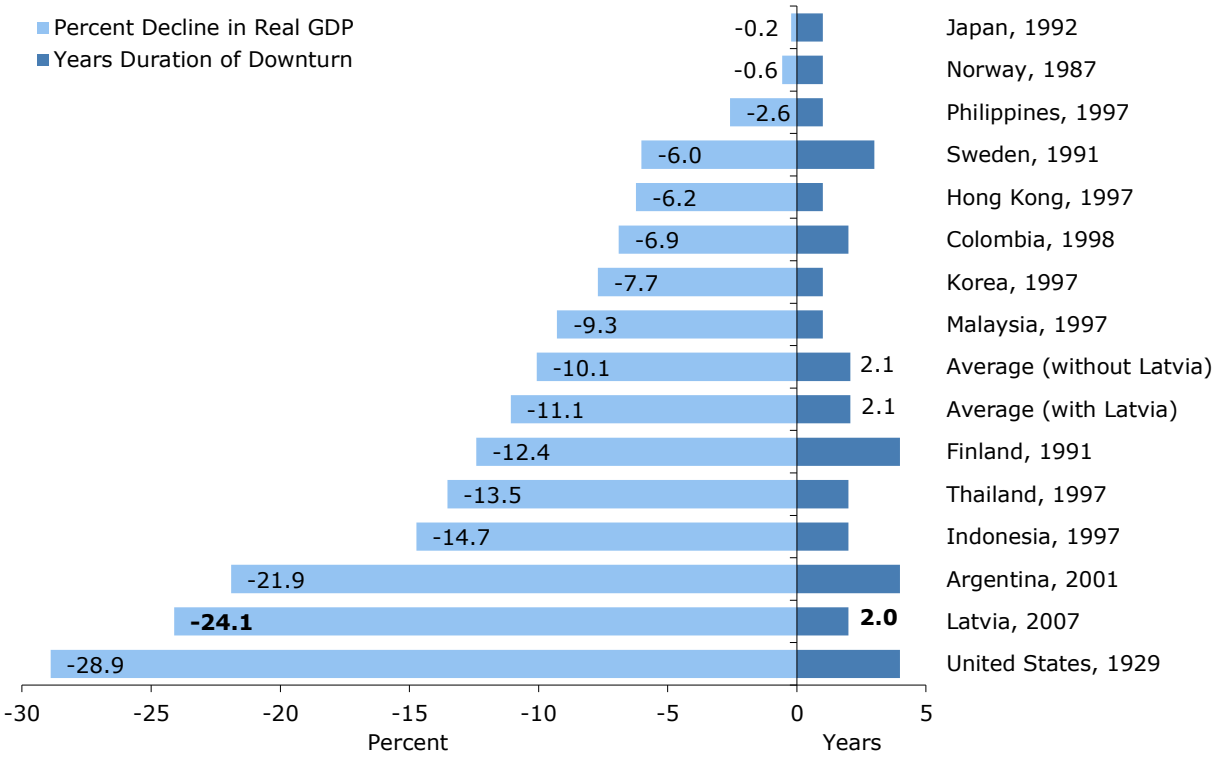
In addition, Latvia's net exports contributed little or nothing to the recovery that the economy has experienced over the past year and a half. Therefore, it cannot be said that "internal devaluation" has brought about Latvia's economic recovery. Rather, it appears that the recovery resulted from the government not adopting the fiscal tightening for 2010 that was prescribed by the IMF, as well as an expansionary monetary policy caused by rising inflation. The data contradict the notion that Latvia's experience provides an example of successful internal devaluation.

This has implications for the current debate over the crisis in the eurozone, since pro-cyclical policies are being implemented in a number of countries. If Latvia had provided a successful example of recovery through internal devaluation, it might be relevant to the weaker eurozone economies that have locked themselves into pro-cyclical fiscal policies and are to varying degrees relying on the prospect of internal devaluation to eventually boost their economies through next exports. The Latvian case provides further evidence that this can be a very costly strategy and one that does not work. The risks in the eurozone are even greater because of the financial crisis that has resulted from these pro-cyclical policies.

# Introduction

In 2008 and 2009, as many countries fell into recession due to the global financial crisis and world recession, Latvia experienced the worst loss of output in the world. From late 2007 to late 2009, the country lost about 24 percent of its GDP. Official unemployment rose from 5.3 percent in late 2007 to 20.5 percent in early 2010. **Figure 1** shows Latvia's loss of GDP as compared with other recessions and depressions over the past century. Latvia's loss of output is the worst over a two-year period or less.

**FIGURE 1**
**Latvia: Comparison with Similar Downturns**




Source: IMF (2011a), Reinhart and Rogoff (2009) and authors' calculations.

In the fourth quarter of 2009, the economy began to recover, and while year-over-year growth for 2010 was still negative (falling 0.3 percent), it is projected to be positive 4.0 percent for 2011. On this basis, advocates of "internal devaluation" have now pronounced Latvia to be an example of successful macroeconomic policy. They argue that the Latvian government, along with the European authorities (including the International Monetary Fund – IMF), pursued the correct macroeconomic policies by maintaining Latvia's fixed exchange rate and implementing pro-cyclical fiscal policies (that shrunk the economy further) and sometimes pro-cyclical monetary policies. They argue that these were the best policies –as opposed to counter-cyclical, expansionary fiscal and monetary policies, accompanied by devaluation– designed to promote a rapid economic recovery.

"Latvia stands out as an example of how such a financial crisis can be resolved," write Anders Aslund and Valdis Dombrovskis in a 2011 book published by the Peterson Institute for International Economics. "When a country needs to address underlying structural inefficiencies in the economy, internal devaluation is preferable to exchange rate devaluation . . ." [1]

This argument could be relevant to a policy debate that is an important part of the current crisis in Europe. The weaker eurozone economies (Greece, Ireland, Portugal, Spain, and Italy) are currently carrying out a similar "internal devaluation" strategy. The idea is that they can regain competitiveness, and eventually resume normal growth and employment levels, by pushing down labor costs through high unemployment and downward pressure on wages. Fiscal consolidation – budget tightening – is also seen as necessary, even if it worsens the economy in the short run, for additional reasons: to reduce the public debt and public payroll. The weaker eurozone economies are under heavy pressure to "stay the course," and continue with the painful process (although in the case of Greece there is finally recognition that some debt cancellation will be necessary). The Latvian "success story" is being used as evidence that there is light at the end of the tunnel. It is the best-developed argument for "internal devaluation," based on a country study that has been put forward.

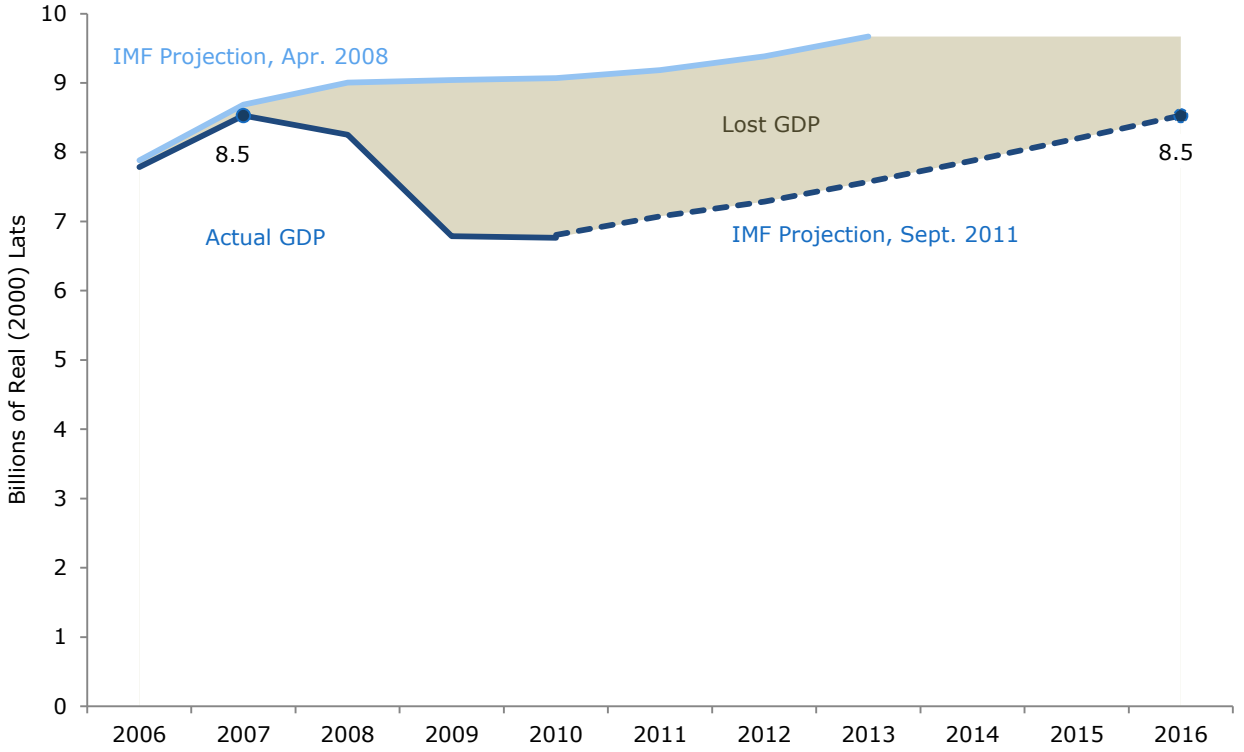
# The Costs of Devaluation- Internal versus External

As noted above, Latvia's loss of output from peak to bottom was 24 percent, over two years – an enormous loss by any international or historical comparison. **Figure 2** shows the path of real GDP (in 2000 lats, the domestic currency) since the country's pre-recession peak, with IMF projections for the years 2011-2016. As can be seen from the graph, Latvia is not projected to reach its pre-crisis peak until 2016, nine years later.

Figure 2 also shows a comparison with the IMF's projections in 2008, before the "internal devaluation" strategy – in which the government engaged in fiscal tightening of 7 percent of GDP in 2009– was embarked upon. As can be seen from the graph, even with the IMF's modest projections for post-2008 growth (about two percent annually), Latvia's recovery is far from trend growth. At current projected growth rates, it would take until 2028 to reach its trend GDP as projected in 2008.

1 Aslund and Dombrovskis (2011), page 2.

**FIGURE 2**
**Latvia: Real GDP, Actual and Projected**



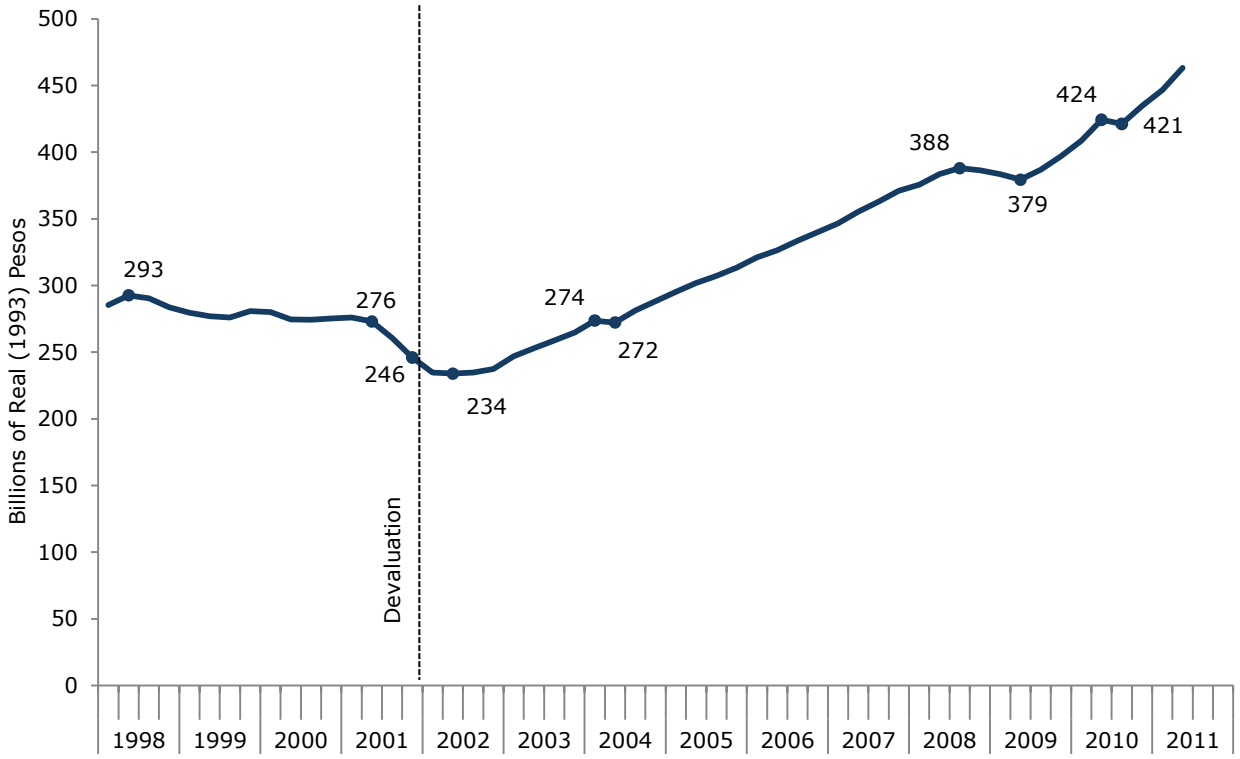

Source: IMF (2008) and (2011c), and authors' calculations.

Any argument that the "internal devaluation" strategy was an economic success would therefore have to be based on the counterfactual that a devaluation with expansionary macroeconomic policy would have been worse. It is therefore worth comparing Latvia's experience with that of other countries that had large devaluations in times of crisis. **Figure 3** shows the case of Argentina, which devalued at the beginning of 2002, during a severe financial crisis and recession. Just as Latvia's currency was (and remains) pegged to the euro and its economy and loans highly "euro-ized," the Argentine peso was pegged to the dollar and the financial system highly dollarized. This is relevant because it means that there are large "balance sheet effects" associated with a devaluation – households and firms whose income is in domestic currency but debts are in the foreign currency suffer large losses and, depending on government policy, bankruptcies. The Argentine banking system suffered a collapse after the devaluation, and the government defaulted on $95 billion of sovereign debt. So the consequences of devaluation were severe.

As can be seen in Figure 3, with the havoc wreaked on the banking system, Argentina's loss of GDP was about 4.9 percent following the devaluation. Almost all of this was in one quarter, the first quarter of 2002. The economy then began to expand, growing more than 90 percent over the next nine years (including the 2009 recession). Within three years Argentina passed up its pre-recession peak (1998) GDP, and within six years it passed 20-year trend GDP.

It is sometimes stated that Argentina's growth was a "commodities boom," driven by agricultural exports. But exports accounted for a small proportion of Argentina's growth during this period, and agricultural exports even less.[2]

**FIGURE 3**
**Argentina: Real, Seasonally Adjusted GDP**




Source: IMF (2011a).

**Table 1** shows the loss of GDP following other large, crisis-driven devaluations, for a number of countries in the past two decades. As noted above, Argentina lost 4.9 percent of GDP, after its devaluation, before it started growing again. Indonesia and Thailand came in worst with loss of 13.4 and 14.2 percent of GDP, respectively. The average loss was 5.9 percent of GDP. This compares to a loss of 24.1 percent of GDP for Latvia during its recession, while it kept its exchange rate fixed.

2 See Weisbrot et al (2011) for details.

**TABLE 1**
**Major Recent Devaluations and Ensuing GDP Loss**

| | Devaluation | | | | | GDP Decline | | |
|---|---|---|---|---|---|---|---|---|
| | Date | Mos. until Trough | National Currency per US Dollar | | Size of Devaluation | Quarters until Trough | Loss of GDP | Change in GDP 3 Years After Devaluation |
| | | | Before | Trough | | | | |
| Argentina | Jan-01 | 5 | 1.0 | 3.6 | -72.2% | 2 | -4.9% | +17.2% |
| Finland | Sep-92 | 11 | 4.4 | 5.8 | -23.9% | 4 | -2.4% | +6.8% |
| Georgia | Dec-98 | 2 | 1.5 | 2.3 | -36.8% | 1 | -1.6% | +6.5% |
| Iceland | Oct-08 | 1 | 91.2 | 135.3 | -32.6% | 6 | -10.4% | -5.7%[1] |
| Indonesia | Jul-97 | 12 | 2,446.6 | 13,962.5 | -82.5% | 5 | -13.4% | -7.9% |
| Iran | Mar-93 | 2 | 67.3 | 1,635.7 | -95.9% | 4 | -1.6% | +10.6% |
| Italy | Aug-92 | 12 | 1,102.6 | 1,605.1 | -31.3% | 2 | -1.7% | +6.0% |
| Malaysia | Sep-97 | 4 | 2.7 | 4.4 | -37.8% | 5 | -8.5% | +6.7% |
| Mexico | Dec-94 | 3 | 3.4 | 6.7 | -48.6% | 4 | -8.0% | +5.9% |
| South Korea | Dec-97 | 1 | 1,025.6 | 1,701.5 | -39.7% | 2 | -9.1% | +14.0% |
| Sweden | Nov-92 | 9 | 6.2 | 8.1 | -22.8% | 2 | -0.4% | +8.9% |
| Thailand | Jul-97 | 6 | 25.8 | 53.8 | -52.1% | 5 | -14.2% | -4.7% |
| UK | Aug-92 | 12 | 0.5 | 0.7 | -23.1% | 0 | 0.0% | +9.7% |
| | | | | | | | | |
| *Latvia* | *2007Q4* | *24* | *0.49* | *0.48* | *2.1%* | *8* | *-24.1%* | *-21.3%* |

[1] Not enough time has elapsed to measure Iceland's GDP three years after devaluation. Shown here is the most recent data: 2.75 years after devaluation.

Source: IMF (2011a).

More importantly, Table 1 also shows where each country's GDP was three years after these large, crisis-driven devaluations. Once again Indonesia and Thailand come in at the bottom, down 7.9 and 4.7 percent from pre-devaluation GDP. Iceland, which had one of the worst financial crises in all of Europe during 2008-2009, is down 5.7 percent, but this is after only 2.75 years. Most of the countries are considerably above their pre-devaluation level of GDP three years later. The average economy is up by 5.7 percent over their pre-devaluation level of GDP. Latvia, by contrast, is down 21.3 percent of GDP, three years after the crisis began.

Of course it is impossible to know exactly what the counterfactual would look like had the Latvian government tried another, more expansionary, rather than contractionary and stated[4] pro-cyclical strategy. There is certainly a potential that any economic strategy could have been badly managed. But many of the countries shown in Table 1 had severe banking crises and collapses during or after their devaluations. Some of them had much worse corruption, as well as much weaker institutional and governing capacity than exists in Latvia. Yet none of them suffered the scale of losses that Latvia has suffered under its "internal devaluation" strategy, and all of them recovered much more quickly.

4 See Weisbrot (2010).

Latvia received 7.5 billion euros ($10.2 billion), or about 75 percent of its annual GDP, in aid commitments for 2008-2011 from Europe and the IMF, and it is also unknown how much of the European and IMF aid would have been provided if Latvia had pursued a different economic strategy. The IMF, in its public documents, insisted that the decision to keep the pegged exchange rate was a decision of the Latvian government, and even indicated that it did not necessarily agree with that decision.[5] But Swedish and other European banks would have lost many billions of euros from a devaluation, since many of their loans to Latvia would have been unpaid or restructured. And the banks' influence on the decision-making of the European authorities and governments who provided aid commitments was very strong, to say the least.

However, it is important to note that if it is the case that the European authorities and governments threatened to withhold aid unless Latvia maintained its fixed exchange rate and suffered through a costly internal devaluation, that is not necessarily an argument that this was the best policy for Latvia. That is an argument that Latvia was pressured to adopt bad policy, and it would shift some of the blame for the results to these parties (including the foreign banks that influenced these decisions).

In any case there is no obvious reason to believe that if Latvia had responded to the crisis with devaluation, combined with fiscal and monetary stimulus, it would have resulted in a loss of output so vastly greater than that of these past devaluations in times of crisis. The real income losses in Latvia have been truly staggering, and it is difficult to imagine that a devaluation with expansionary macroeconomic policy would have produced a worse outcome than what actually happened.

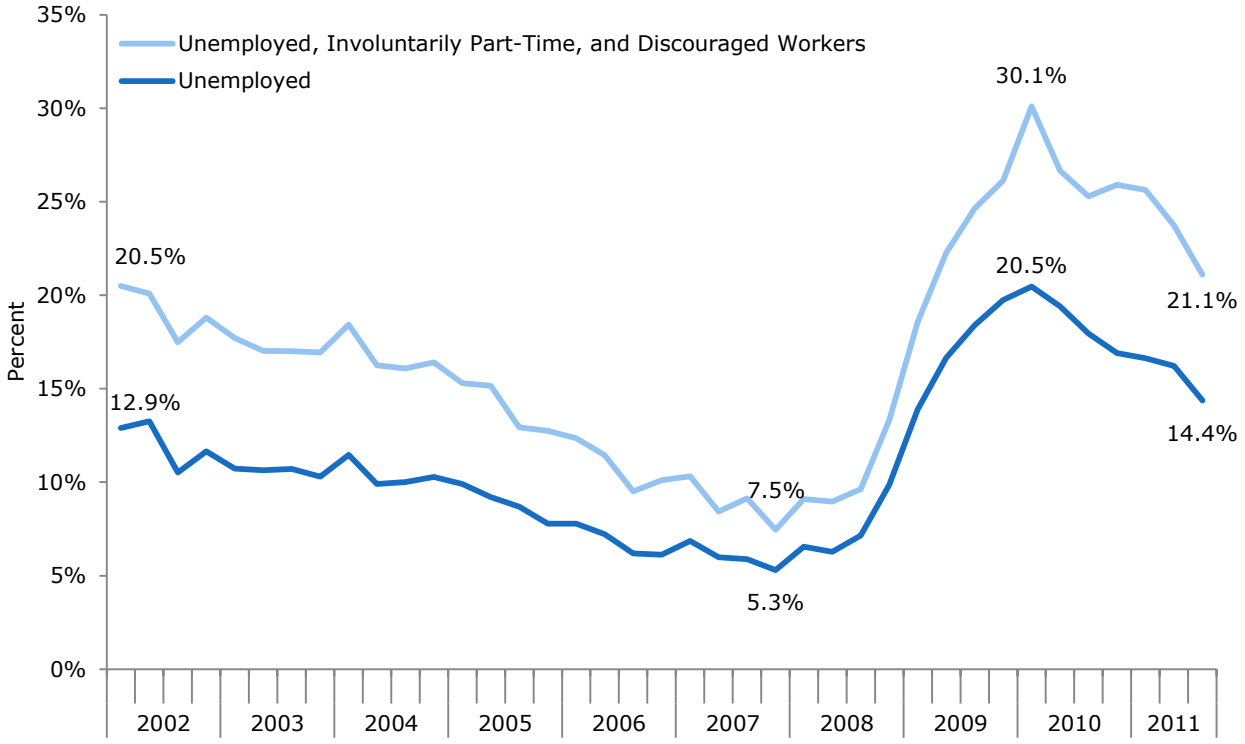
## Social Costs of Latvia's Internal Devaluation

In addition to the loss of national income, there have been other social and economic costs of the Latvian government's strategy of internal devaluation. **Figure 4** shows the official unemployment rate, which rose from 5.3 percent at the end of 2007 to 20.1 percent at peak in early 2010. Even after more than a year of recovery, the unemployment rate remains devastatingly high at 14.4 percent. That is mainly because the recovery has been relatively weak, especially given the depth of the severe contraction.

The official unemployment rate does not measure the full cost of this recession and weak recovery to Latvia's labor force. If we take into account those who are involuntarily working part-time (because they could not find full-time work, or other economic reasons) and those who have given up looking for work, we get peak unemployment/under-employment of 30.1 percent in 2010, declining to 21.1 percent in the third quarter of 2011.

5 The IMF's Stand-By Arrangement with Latvia cites the Latvian government's "unequivocal commitment to the exchange rate peg" and recognizes that the peg "brings difficult consequences, including the need for fiscal tightening and the possibility that recession could be protracted, perhaps more so than if an alternative strategy had been adopted." (IMF, 2009a, p. 9).

**FIGURE 4**
**Latvia: Unemployment**



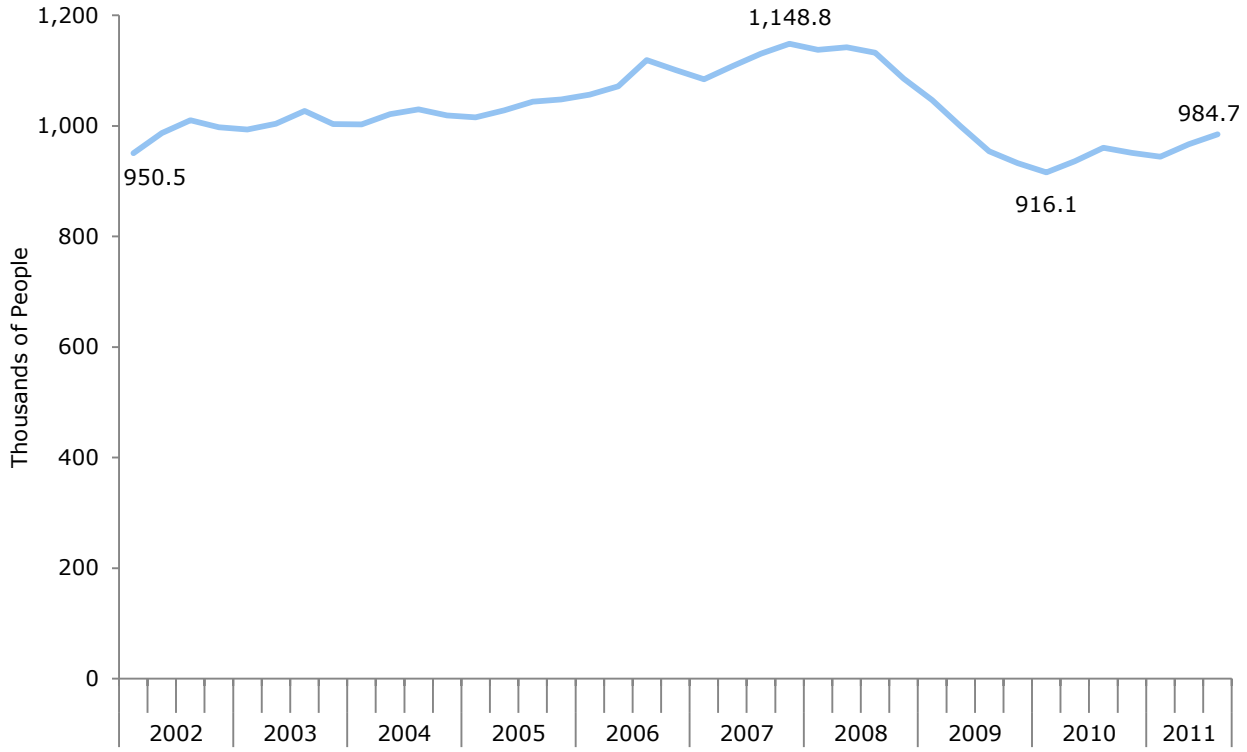

Note: Unemployment is measured as a percent of the active labor force. Unemployed, involuntarily part-time, and discouraged workers are measured as a percent of the active labor force plus discouraged workers.
Source: Latvijas Statistika (2011) and authors' calculations.

It also does not include all the people who have left the country in search of employment since the crisis began. It is estimated that the net loss of population in 2009-2011 amounts to as many as 120,000 people, or 10 percent of the labor force.[6] If not for this migration, the broader measure of unemployment could be as high as 29 percent in the third quarter of 2011, instead of 21.1 percent.

Another way to evaluate the impact of the crisis and economic policy on the labor market is to look at employment. This is shown in **Figure 6**. Employment dropped about 20.3 percent from its peak in the fourth quarter of 2007 to the bottom in the first quarter of 2010. Since the economy began recovering, it has recovered just 6.0 percentage points of this loss, leaving Latvia with 14.3 percent fewer working-age people employed as compared to pre-crisis employment.

6 Official data shows a much lower flow, but this data does not capture most of the people who emigrate. Studies using data on Latvian migrants in the countries where they emigrate to have yielded the much higher and more realistic figures cited above. In fact, Hazans cites data showing that emigration, which he puts at 80,000 between 2009 and 2010, actually accelerated in 2011; thus, 120,000 over three years can be seen as a conservative estimate. For more on Latvian emigration, see Hazans (2011a), 2011b, Hazans and Philips (2011), and Holland et al. (2011).

**FIGURE 6**
**Latvia: Employment, age 15-74**




Source: Latvijas Statistika (2011).

It is too early for up-to-date numbers that could measure the impact of this episode on income distribution. However, given the data on unemployment, employment, and wages – as well as the cuts in government social spending, it is almost certain that income inequality has increased significantly as a result of the internal devaluation strategy.

It is important to keep in mind that the enormous social costs as measured by employment, unemployment, and inequality are not a negative side effect of the internal devaluation but constitute an integral part of this economic strategy. Since the nominal exchange rate is fixed, the strategy calls for lowering the real exchange rate by lowering unit labor costs. This is done primarily through lowering wages. Increasing unemployment is the main means by which wages are lowered. The pro-cyclical policies, by lowering aggregate demand and deepening the recession, are also intended to lower prices; this also contributes to lowering the real exchange rate.

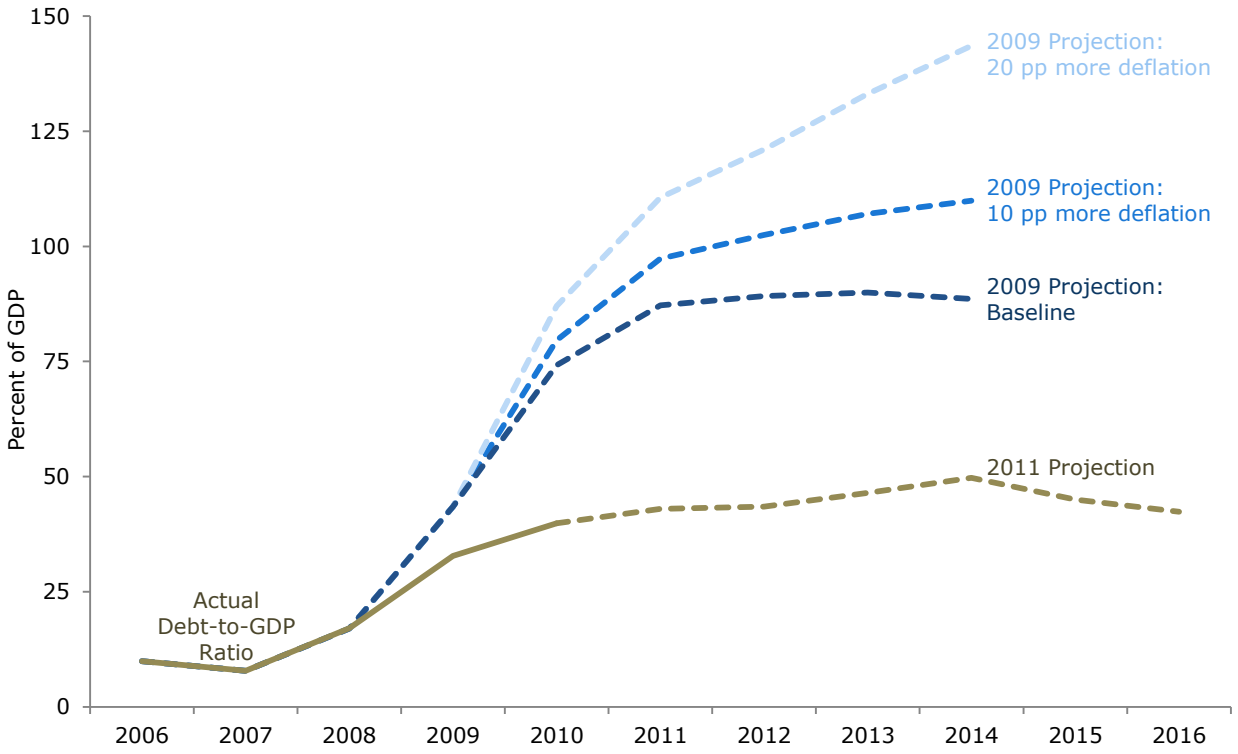
# How Latvia Came Out of its Recession: It Wasn't Internal Devaluation

In the fourth quarter of 2009, the prognosis for Latvia was very bleak. Latvia had already seen a loss of about 24 percent of GDP, and the IMF was projecting another 4 percent drop for 2010, and a total loss of output from peak to bottom of 30 percent of GDP.

Prices were falling and the IMF was expecting "significant deflationary pressures for the next year or two." Latvia also faced a rapidly growing debt burden, another cause of concern for the IMF. As shown in **Figure 7**, the IMF's baseline projection was that Latvia's debt would reach 74.2 percent of GDP in 2010 and 87.2 percent of GDP in 2011. The Fund also projected two worse possible scenarios of soaring debt-to-GDP ratios that did not stabilize, based on deflation being worse. These are also shown in Figure 7. But in fact, the public debt now projected for 2011 is just 43 percent of GDP (also shown in Figure 7).

But because there was still no light at the end of the tunnel at the end of 2009, and because the current IMF program at that time called for a fiscal tightening of about 6.5 percent of GDP for 2010, some analysts questioned whether Latvia was trapped in a downward spiral whose end could not be forecast.

**FIGURE 7**
**Latvia: General Government Gross Debt, Actual and Projected By the IMF in 2009**



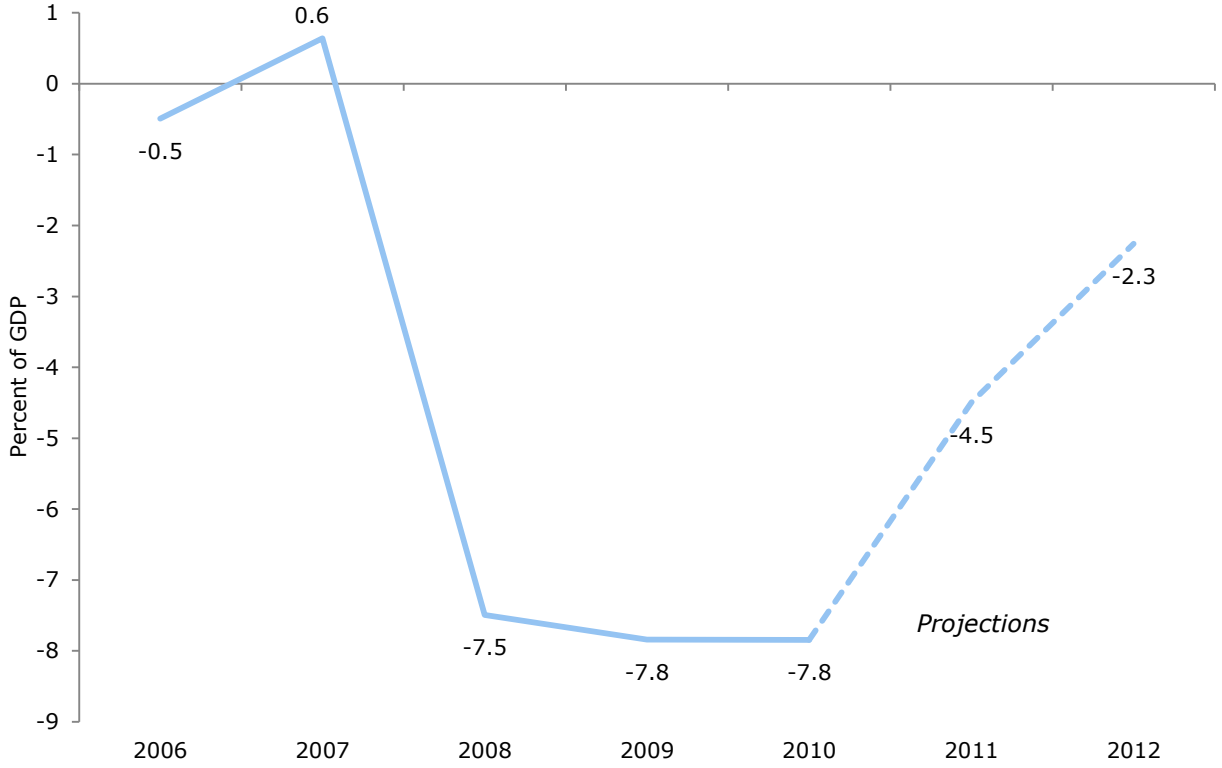

Source: IMF (2009b) and (2011c).

As it turned out, the economy began slowly to recover shortly thereafter, and all of these projections turned out to be overly pessimistic – some more than others. First, the decline of GDP came to a halt at about 24 percent, not 30 percent. Why did this happen?

Most importantly, the government did not implement the fiscal tightening that it had pledged, which would almost certainly have caused further serious economic damage. As shown in **Figure 8**, the

fiscal deficit in 2010 was the same as for 2009 at 7.8 percent of GDP. As such, there was almost no fiscal tightening at all. [7]

**FIGURE 8**
**Latvia: General Government Balance, Actual and Projected**



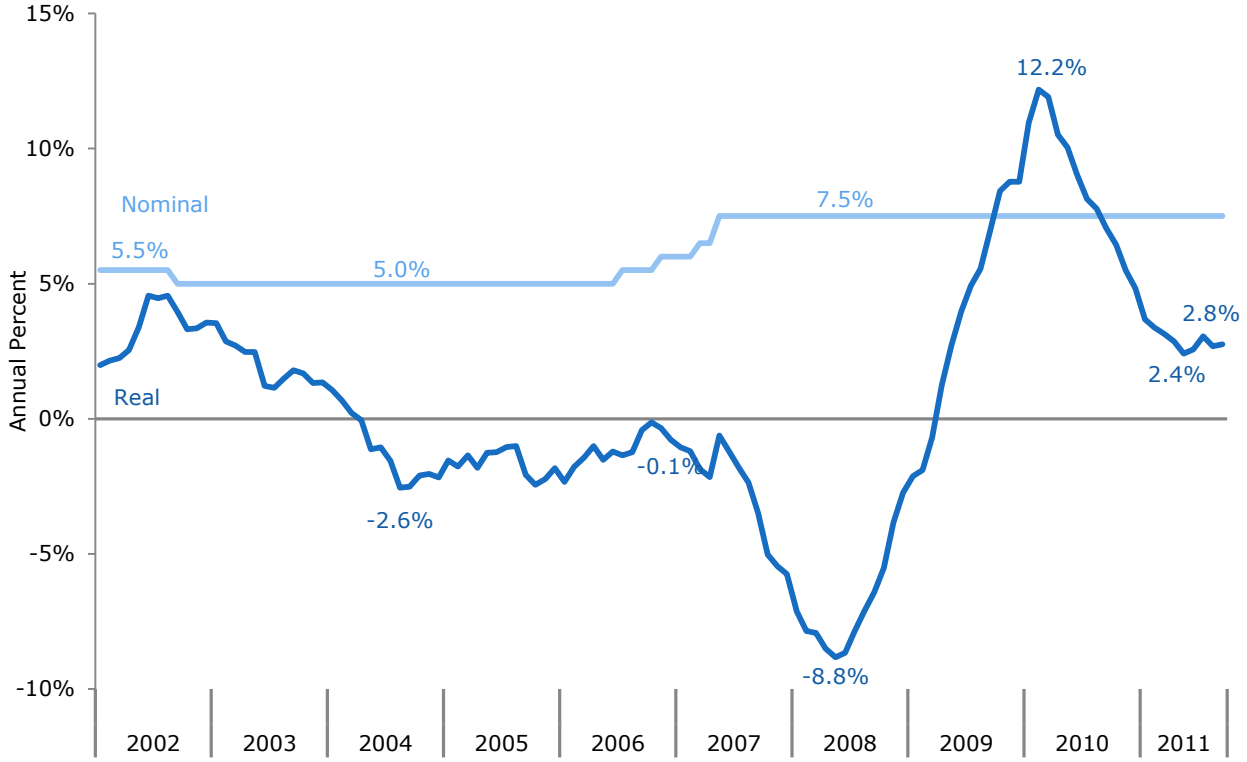

Source: IMF 2011c.

Another vitally important change helped spur the recovery: there was a turnaround in inflation. Monthly year-over-year inflation was negative in the fourth quarter of 2009, and had fallen to -4.2 percent by the first quarter of 2010. It then shifted and rose to a positive 5 percent by mid-2011.

This lowered real interest rates significantly, as shown in **Figure 9**. As can be seen, these fell from 12.2 percent in early 2010 to 2.4 percent in mid-2011. Nominal long-term interest rates on Latvia's government bonds also fell sharply from 13.8 percent in late 2009 and early 2010 to 5.6 percent in August 2011.

7 On a year-over-year basis, nominal GDP fell by 2.7 percent from 2009 to 2010 (IMF, WEO). With the fiscal deficit constant at 7.8 percent of GDP, this implies a fiscal tightening of just 0.2 percent of GDP.

**FIGURE 9**
**Latvia: Policy Interest Rates (Lending, Nominal and Real)**




Source: European Commission (2011), Latvijas Statistika (2011), and authors' calculations.

The result of these changes is that Latvia's recovery was spurred by macroeconomic policies that went against the strategy of "internal devaluation." In other words, the government of Latvia adopted an "internal devaluation" strategy that included massive fiscal tightening, rising real interest rates, depression-level unemployment rates, and deflation. The economy suffered the worst collapse in the world for 2008-2009. Then policy was reversed: fiscal policy was neutral for 2010; monetary policy became expansionary, because external shocks raised the inflation rate. The inflation also lowered the country's debt burden, as noted above. This increased investor and consumer confidence (including confidence that the peg would hold, which facilitated the maintenance of more expansionary monetary policy). It is important to remember that the inflation also went against the government's policy of internal devaluation, which relies on lowering inflation, or even deflation as occurred in 2009, to lower the real exchange rate. But this burst of inflation was very important to the recovery.

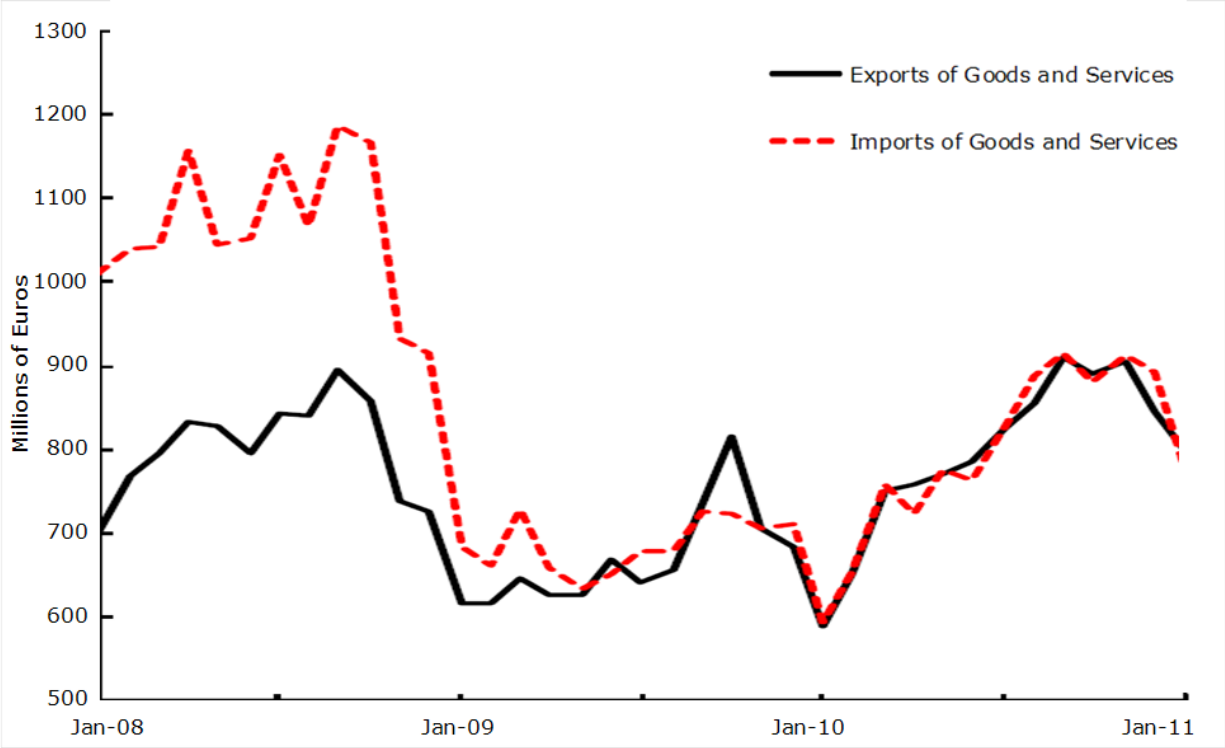
Because these macroeconomic policies and the inflationary shock were much more expansionary than the program that the government was committed to, the economy was able to get out of the downward spiral that had caused the IMF to project such a pessimistic forecast at the end of 2009.

It is true that there was some internal devaluation; according to the IMF, the real effective exchange rate, based on unit labor costs, depreciated by about 21 percent from its peak at the beginning of 2009, to the third quarter of 2010. On a CPI (consumer price index) basis, the depreciation was about nine percent from a peak in March 2009 to March 2011. Although exports increased from

January 2010 onward, imports increased commensurately; so there has so far been little or no contribution to the recovery from net exports following the internal devaluation. This can be seen in **Figure 10**.

This must be emphasized because the end goal of the internal devaluation strategy is to boost the economy through an increase in net exports. As can be seen in Figure 10, *there is almost no increase in net exports since the economy began to expand at the beginning of 2010*. Furthermore – and again this must be emphasized, the plunge in imports – which eliminated the trade deficit – took place *before there was any real depreciation of the exchange rate*. The real exchange rate did not begin to depreciate until the first quarter of 2009 (by the Unit Labor Cost Measure), or even later (2nd quarter 2009) by the CPI measure. As can be seen from Figure 10, the collapse of imports occurs before the first quarter of 2009, mainly due to the collapse of aggregate demand as a result of the deep recession.

**FIGURE 10**
**Latvia: Exports and Imports of Goods and Services**




Source: Reprinted from IMF (2011b).

# Conclusion

The Latvian government adopted an aggressive strategy of internal devaluation in response to the 2008-2009 crisis, adopting pro-cyclical macroeconomic policies in order to increase unemployment and lower unit labor costs. As reviewed above, this strategy had huge economic and social costs, including a record loss of 24 percent of GDP in two years, soaring unemployment, and massive emigration. These costs are considerably higher than the worst crisis-devaluation experiences of other countries over the last 20 years, and the Latvian recovery has been much slower. The recovery that the economy has experienced over the past year and a half owes nothing to net exports, so it cannot be said that the internal devaluation is responsible for this recovery. Rather, it appears that the recovery resulted from the government not adopting the fiscal tightening for 2010 that was prescribed by the IMF, as well as expansionary monetary policy caused by rising inflation. The data contradict the notion that Latvia's experience provides an example of successful internal devaluation.

This has implications for the current debate over crisis in the eurozone, since pro-cyclical policies are being implemented in a number of countries. If Latvia had provided a successful example of recovery through internal devaluation, it might be relevant to the weaker eurozone economies that have locked themselves into pro-cyclical fiscal policies and are to varying degrees relying on the prospect of internal devaluation to eventually boost their economies through net exports. The Latvian case provides further evidence that this can be a very costly strategy and one that does not work. The risks in the eurozone are even greater because of the financial crisis that has resulted from these pro-cyclical policies.

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