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HOW GREAT IS LATVIA'S SUCCESS STORY?

The economic,
social and political consequences
of the recent financial crisis in Latvia

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Introduction

Latvia is a country of extreme contrasts. Twenty-two years of independence have brought periods of both high growth and deep slumps. The general trend of economic development has been positive since the early 1990s, more and more people have enjoyed enhanced well-being, while Latvia has become accepted as a fully-fledged member of the international society of sovereign states, including the club organizations of wealthy Western states like the North Atlantic Treaty Organization (NATO) and the European Union (EU). As of 1 January 2014, Latvia has become a member state of the eurozone. Latvia has also been invited to start accession talks for the Organization for Economic Development and Cooperation (OECD).

On the other hand, Latvia, like other Baltic countries, but in contrast to other Central and Eastern European states[1], has meticulously followed the path of neoliberal economic policy making since the 1990's. This neoliberalism implied the prioritization of business interests (very low taxes on capital) and small government (limited social welfare). As a consequence, this business oriented economy, in combination with political and administrative elite initially composed largely of members of the Soviet nomenclature, made possible the enrichment of a few, while leaving a considerable part of society without substantial improvement, even deterioration. Labor unions in Latvia remain weak and civic society, while being vivid and enjoying better treatment on the part of the political elite since the parliamentary elections of 2010, lacks financing for large scale activity.

Certainly, the globalized economy presents a great challenge to small nations, as states must compete not only for material resources and capital, but lately also for people. The rate of success depends on flexibility and resilience. However, as small countries have limited human capital, a high degree of social and political cohesion is of the utmost importance to them. The problem is that the high volatility of economic growth erodes this cohesion, and may make departure to more stable economies an attractive option for local people at some point in time. Indeed, one has to agree with Milan Kundera that "[f]or small nations, existence is not a self-evident certainty but always a question, a wager, a risk."[2]

The Latvian Government is full of optimism. According to the National Development Plan for 2014-2020, "[i]n 2020 Latvia will be a country that is Latvian in character and self-confident, secure and resident-friendly, green and well-tended, prosperous, effective and competitive – and a home to industrious,

[1] Cf., Jan Drahokoupil, "The Rise of the Comprador Service Sector: the Politics of State Transformation in Central and Eastern Europe," (Polish Sociological Review 2 (162), 2008).

[2] Quoted in Rainer Kattel et al., "Small States, Innovation and Administrative Capacity," in Victor Bekkers et al., ed. Innovation in the Public Sector. Linking Capacity and Leadership (Palgrave Macmillan, 2011), 61-81.

well-educated, creative, healthy and happy people."[3] Christine Lagarde, the Managing Director of the International Monetary Fund, has praised Latvia and the other Baltic countries for their determination in overcoming economic hardships in a decisive manner, for restoring competitiveness and market confidence through severe comprehensive austerity measures. According to Lagarde, Latvia has a bright future ahead.[4]

The optimism of the Latvian Government and IMF Managing Director is not, however, shared by everybody. Such international analysts and columnists as Paul Krugman[5] and Martin Wolf[6] have provided more sobering views. In their view the cost Latvia and other Baltic countries have paid for austerity-led macroeconomic stabilization was exorbitant in terms of loss in real growth and human capital, and would have been unbearable in other democratic countries with larger and less open economies. Even the President of Latvia, Andris Bērziņš, has become quite pessimistic about Latvia's future prospects, admitting that "unless Latvia achieves the average income level of the EU in ten years time, it will cease to exist as a politically viable state."[7]

Indeed, Latvian social statistics give little cause for celebration. Among the EU member countries Latvia stands out as a country with one of the lowest income levels, with the greatest inequality and poverty, and one of the highest emigration rates. During the last ten years Latvia has lost around 15 percent of its population: 11 percent due to emigration and other 4 percent due to demographic decline. Among those who emigrate, more than 80 percent are young people aged 18-35. Particularly alarming is the fact that not only the issue of income difference, but also such considerations as the quality of life and a better future for children are cited as major reasons for emigration.[8] Asked about their plans for return, only a few reply positively. This is a clear sign of a lack of confidence in Latvia's future.

The aim of this paper is to look at the economic, social and political consequences of the recent financial crisis and the ensuing economic collapse in Latvia in 2008-2010, whether the crisis's resolution has helped to create a basis for a sustainable economic growth, social cohesion, and political consolidation in Latvia. The argument is that the economic recovery which started in 2010 is superficial and passing. It obfuscates much deeper damage in terms of social cohesion and political unity, as nationhood is not only about the economical, but also about the political and social as well. A good measure of these profound changes is people's pessimism about Latvia's ability to serve their interests and, with that, the observed mass migration of people to Western European countries. If no remedial actions are taken forcing change in the people's gloomy perception of the Latvian state, and abating people's propensity to emigrate, Latvia's further growth prospects will be constrained. A few ideas about the possible direction of remedial actions will be aired at the end of this paper.

[3] National Development Plan of Latvia for 2014-2020 (20 December 2012), 3.
[4] Christine Lagarde, the IMF Managing Director, „Latvia and the Baltics – a Story of Recovery" (speech delivered at the conference „Against the Odds: Lessons from the Recovery in the Baltics," Riga, 4 June 2012).
[5] Paul Krugman, Baltic Brouhaha, http://krugman.blogs.nytimes.com/2013/05/01/baltic-brouhaha/?_r=0
[6] Martin Wolf, Why the Baltic states are no model, http://www.ft.com/intl/cms/s/0/090bd38e-b0c7-11e2-80f9-00144feabdc0.html#axzz2a3TZC1Qy
[7] Speech of Mr. Andris Bērziņš, the President of Latvia (presented in the First World Latvian Business and Innovations Forum, Riga, 3 July 2013.)
[8] Mihails Hazans, "Emigration from Latvia in the 21st Century: Patterns and Consequences" (presentation in Diaspora Studies Summer School, Jurmala, 27 June 2013.)

1. **Some aspects regarding the Latvian recent economic calamities**

The Latvian case of crisis resolution has attracted considerable international attention and is subject to passionate debate among adherents to various strands of economic thinking. It seems that Latvia's experience is destined to become a popular case study for textbooks in economics.

The prevailing wisdom is that, in Latvia, the crisis was preceded by a period (2004-2007) of unsustainable economic growth, driven by foreign capital and credit, and accumulated internal and external imbalances. At the climax of this period (end of 2006) the economy grew in nominal terms by 36 percent annually and the current account widened to 27 percent of GDP. The bubble started to deflate in 2007, but the terminal blow was delivered by global financial calamities of autumn 2008. The already distressed Latvian financial system was crippled, and the bubble burst sending the Latvian economy into deep recession. As a consequence, at the end of 2008, Latvia was banned from international money markets, and had no choice but to ask for international assistance. After turbulent negotiations assistance to the sum of 7.5 billion euro was agreed with the IMF, the European Commission and several bilateral donors. This assistance was to be released in several tranches, following Latvia's progress in the implementation of the stabilization program containing commitments for fiscal consolidation and various structural reforms.[9] The implementation of the stabilization program was successful, and Latvia was lucky to see the return of economic growth already at the end of 2009. Since then Latvia has enjoyed a period of uninterrupted growth: 5.3 percent in 2011, 5.2 percent in 2012 and 3.8 percent (forecast) in 2013. (More details on Latvia's economy are provided in Table 1.)

The alternative view is that the economic growth that Latvia enjoyed between 2004 and 2007 was natural, as she was catching-up in terms of income and productivity with the developed Europe.[10] Huge current account deficit and elevated inflation were unavoidable by-products of this catching-up: capital and intermediate goods had to be imported, and the redistribution of income from high to low productivity sectors caused overall wage growth.[11] The proponents of this strand of thinking agree that better discipline regarding government spending and lending from commercial banks was warranted at that time, including an

[9] Latvia's Economic Stabilization and Growth Revival Program, adopted by the Latvian Parliament on 11 December 2008.
[10] Paul Krugman, "Latvian Adventures," (blog entry of 19 September 2013), http://krugman.blogs.nytimes.com/2013/09/19/latvian-adventures/?_r=0
[11] Bas B. Bakker and Christoph Klingen, ed., How Emerging Europe Came Through the 2008/09 Crisis (International Monetary Fund, 2012), 22-23.

Table 1

Some selected facts about Latvia

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
	Boom				*Slump*		*Recovery*		
Population (million)	2,32	2,30	2,29	2,28	2,27	2,26	2,24	2,07	2,04
GDP (EUR billion, current market prices)	11,1	12,9	16,0	21,0	22,9	18,5	18,0	20,2	22,2
GDP (per capita, PPS, EU28=100)	47	50	53	57	58	54	54	58	62
GDP growth (% real annual)	8,9	10,1	11,2	9,6	-3,3	-17,7	-0,9	5,3	5,2
Inflation (%)	6,2	6,9	6,6	10,1	15,3	3,3	-1,2	4,2	2,3
Government tax revenues (% of GDP)	28,6	29,2	30,6	30,6	29,2	26,6	27,2	27,6	-
Unemployment (%)	11,2	9,6	7,3	6,5	8,0	18,2	19,8	16,2	14,9
Balance of current account (% of GDP)	-12,9	-12,6	-22,5	-22,4	-13,2	8,6	2,9	-2,1	-1,7
Public debt (% of GDP)	15,0	12,5	10,7	9,0	19,8	36,7	44,5	42,2	41,3
Private debt (% of GDP)	74,5	94,8	122,1	127,5	132,1	147,4	140,4	125,1	-

Source: Eurostat

adjustment of the exchange rate, as it would have reduced the risk of abrupt adjustment. Had the global financial turmoil not restricted Latvia's and other emerging countries' access to international liquidity, the extreme speed of Latvia's economic growth would have abated with time.[12] To her bad lack, Latvia became prey to conjuncture of adverse external events. When Latvia was in deep water, the institutions of the European Union (most notably the European Central Bank) were too slow to render liquidity assistance to Latvia,[13] thus sending Latvian economy into an unnecessarily deep recession (the cumulative peak-to-trough decline of GDP reached 25 percent and unemployment jumped to 21 percent – a result much worse than expected at the onslaught of the crisis at the end of 2008).

Yet, in the context of this debate, a few additional conceptual issues regarding Latvia's crisis experience need to be disclosed. *First*, it seems that small and open emerging economies continue to represent a puzzle to professionals of economics. In the case of Latvia, little of the pre-crisis prophecies turned out to be true. Thus, professionals find it difficult to figure out the true nature of Latvia's overheating during the boom. Some commentators hint that it was not a boom at all, rather a normal trend growth determined by a speedy catch-up in productivity level.[14] Another contentious issue is productivity and external competitiveness. The presumed loss of competitiveness due to an excessive rise in labor costs was one of the major pre-crisis concerns. The latest studies reveal, however, that these concerns were groundless, as Latvia's exports grew at that time despite large domestic inflation.[15] The famous "internal devaluation" represents yet another example of Latvia's mystery. The fiscal consolidation and liquidity squeeze in the economy were meant to push down wages and prices to the levels commensurable with productivity. Nevertheless, the prices and wages turned out to be rather "sticky", and adjustment was achieved mainly through more efficient use of labor (i.e., through labor shedding and harder work). Finally, the economic growth which returned in the second part of 2009 was a result of neither fiscal consolidation nor internal devaluation. The real cause of recovery was the release of large tranche of international liquidity assistance in June 2009[16] which assured the market that the devaluation and sovereign default had been avoided. Eventually, it was shortage of liquidity that mattered most, and the earlier release of that assistance tranche would have saved much suffering.

Second, the scale and recurrence of financial and economic calamities[17] in Latvia point to serious deficiencies in the institutional set-up of Latvia's macroeco-

[12]Francessco Di Comite et al., „The evolution of the Latvian external sector: imbalances, competitiveness and adjustment," in EU Balance-of-Payments assistance for Latvia: foundations for success (European Economy Occasional Paper 120, European Commission, November 2012,) pp. 40-59.

[13]Adam S. Posen, „Geopolitical Limits of the Euro's Global Role," in The Euro at Ten: The Next Global Currency, ed. Jean-Pisani-Ferry and Adam Posen (Washington: Peterson Institute for International Economics, 2009), 93.

[14]Krugman, Latvian Adventures.

[15]Francesco Di Comite, Latvian external sector.

[16]This second in sequence tranche of liquidity assistance of 1 billion euro was delivered by the European Commission on 2 July 2009, despite lack of agreement with the IMF who had become pessimistic about Latvia's ability to proceed with required measures of the stabilization program.

[17]In fact, independence has brought a chain of rather severe economic calamities. The economic collapse of early 1990's is still in living memory when Latvia was transforming itself from the Soviet style command economy with immense productive overcapacity (Latvia used to be a huge manufacturing site for supplies to the whole Soviet Union) to a small market-based economy. At that time GDP fell by around 49 percent. The next major disasters happened in 1995, when due to a banking crisis 53 percent of household deposits vanished, and in 1998, when due to Russia's financial crisis, Latvia saw a peak-to-trough plunge in GDP which was close to 12 percent. The crisis of 2008-2009 represents the latest episode in the drama.

nomic and prudential management. The scale and depth of the recent crisis is related to a complete fall-out between the Bank of Latvia and the government over macroeconomic strategy in the prelude to the crisis. The Bank of Latvia had focused on the fixed exchange rate, but the government was not willing to sacrifice the speed of growth to the fiscal austerity required by a fixed exchange rate. Besides, the Latvian authorities had greatly encouraged the widespread euroization of the economy (up to 80 percent of mortgages were issued in euro in 2008), which ultimately limited the scope of action during the recession.

Third, Latvian society continuous to suffer from entrepreneurial obsession (call it also capital dependency syndrome). Low taxes and a liberal economic regime were introduced in early 1990's with the aim of attracting foreign investment and promoting business growth. Regrettably, these policies were not revoked when the country was swamped with foreign capital after the accession to the European Union. In 2013, Latvia still has the third smallest government in the European Union and the third lowest capital and corporate taxes.[18] Meantime, the profitability of businesses in Latvia is among the highest in the European Union. Yet, despite this business friendliness, the cumulative per capita level of foreign direct investment in Latvia is still considerably lower than in Estonia (see Table 2). In a similar vein, the development of manufacturing in Latvia is also considerably lagging behind the other Baltic countries.

Fourth, and in the meantime, the Latvian state in particular and society in general has spectacularly failed to bring the interests of people like the quality of education and health care, equity, decent living conditions, etc. to the forefront of the daily political agenda. During the boom, people's loyalty to the political elite and state was bought in a blunt manner with large chunks of money. People were splashed cash from wage increases, generous social benefits, and also from easy accessible mortgages and consumption loans. When crisis hit, without these benefits people's allegiance proved to be rather thin: first - part of the political elite was kicked out in elections, second - many simply packed their things and emigrated. The lesson is, as it was put by Milton Friedman, that "you can't fool all of the people all of the time." Many felt and still feel cheated and insecure. Each consecutive crisis has added to this feeling of insecurity, alienating people from the state.

[18] In 2011, the tax revenues amounted to 27.6 percent of GDP in Latvia (the EU average was 38.8 percent). The major part of public revenues came from indirect and labour taxes (24.3 percent of GDP), leaving the contribution of corporate taxes with miniscule 3.2 percent. See Taxation trends in the European Union, (Eurostat Statistical Books, 2013 edition).

Table 2

Social comparison between the Baltic countries[1]

	Latvia	Lithuania	Estonia
Some economic facts of social relevance			
Size of government, percent of GDP	36,5	**36,1**	39,5
Accumulated FDI per capita, EUR	4533	**3613**	9987
Capital taxes, percent of GDP	3,2	**2,1**	2,2
Profit share of non-financial corporations, percent of gross value added	53	**58**	48
Decline in size of population 2000-2013, percent	15	**16**	6
Unemployment	**16,5**	15,7	12,8
Gini coefficient	**35,4**	33,0	31,9
At-risk-of-poverty	**40,4**	33,1	23,1
Public opinion on state of political affairs (percent of replies, 2013)			
Trust in national government	**20**	27	36
Trust in press	41	**40**	53
Trust in trade unions	36	**23**	44
My voice counts	26	**20**	37
Trust in others[2]	27	**24**	47
Support both market economy and democracy[2]	**15**	27	31
Public opinion on state of economic affairs (percent of replies, 2013)			
Households affected by the crisis [2]	**56**	52	50
Satisfaction with the life	67	**65**	71
The state of national economy (very good and good)	20	**19**	41
National economic situation will improve in the year to come	**26**	30	29

Sources: Eurobarometer, Eurostat, European Bank for Reconstruction and Development
Notes: 1) Data from 2011, if not otherwise indicated; 2) Life in Transition Survey 2011, EBRD

2. The state of Latvia's economy after the crisis

The costs of adjustment are immense. A quarter of Latvia's economy vanished, many people lost their jobs and property. Although the stabilization program has delivered financial stability and also economic growth, it seems that the original major problem of Latvia's economic development – a persistent shortage of high added value and well paid jobs – has not been resolved. The expectations that foreign direct investment would deliver sustainable development have not materialized so far. The latest crisis has made this challenge even more acute, as Latvia has become much smaller economy, and is destined to become even smaller and smaller due to demographic decline and emigration.[19] Yet, the capital to labor ratio is still very low in Latvia, and new capital will be needed to sustain growth. A shrinking domestic market and pool of labor will hardly make Latvia attractive for investment.

The single most important element of Latvia's economic adjustment was fiscal consolidation. The expansion of public spending during the boom of 2005-2007 created large expenditure overhangs, when crisis struck. Without any corrective measures, the budget deficit would have reached 16 percent in 2009 and further 24 percent in 2010, which was not sustainable. The pace and scale of the fiscal consolidation was determined by two imperatives: first - no external (currency) devaluation; second – the membership of the Euro zone as of 1 January 2014. Two thirds of overall fiscal consolidation was achieved due to spending cuts, and the remaining third – due to tax increases.

The good news is that the fiscal consolidation was well targeted to make Latvia compliant with the Maastricht criteria right on time. Austerity also enabled cuts in a number of less efficient programs, and fostered valuable reforms in the health and education sectors. On the other hand – the scale of consolidation was enormous for peacetime: the amount of overall fiscal consolidation stretched over from 2009 to 2011 is estimated at 15 percent of Latvia's GDP (note that the size of the government is only 36.5 percent of GDP). The measures were cruel: the number of public officials was reduced by 1/3 and the remuneration bill of public officials was cut by 25 percent. Such measures had serious repercussions on the quality of public services and the social situation. With hindsight, it also seems that this fiscal

[19] According to official estimates, by 2030, the number of working age population will shrink by 15 percent and there will be around 130 thousand vacant working places. See Report on Development of Latvia's National Economy (Ziņojums par Latvijas tautsaimniecības attīstību), (Ministry of Economy of Latvia, December 2012), 82.

consolidation has failed on two counts. First, the Latvian public sector was not as bloated as it was often depicted (the government is small, and the number of public sector employees had increased only by 11 percent between 2004 and 2008, which cannot be counted as a serious deflection of human resources from the private sector). Second – the expected wage cut spillover to private sector did not happen. The scale of the consolidation had significance only to the international lenders but not to the market because of the small size of the government.

Another major problem related to fiscal consolidation was the regressive nature of many measures taken. The increase in value added and excise taxes, the decrease in the threshold for personal income tax allowance, and pension cuts (these were later recalled due to ruling of the Constitutional court) without proper compensation were among the enacted measures. At the same time, the government refused to follow the advice of the international lenders to consider taxes on real estate and capital gains. As a result, the IMF had to admit that the burden of Latvian budgetary consolidation fell disproportionately on the poor.[20]

Despite sound economic gains, the Latvian economy has not still recovered to the level of pre-crisis development, and still exhibits some signs of its depressed state:

1) Although Latvia's nominal GDP has already surpassed the pre-crisis level, the real GDP is still lagging behind its peak by around 10 percent and it could take further 3 to 4 years to cover this gap;
2) Unemployment remains stubbornly high, though it is gradually diminishing and reached 11.5 percent in June 2013. Long-term unemployment is of particular concern - 7.8 percent of economically active people (in Estonia – 5.5; Lithuania – 6.5 percent). The Bank of Latvia insists that the high level of unemployment is natural for Latvia due to structural features. The opponents of the Bank of Latvia, however, point to the fact that businesses mostly report shortages of low-paid workers and that the vacancies on well remunerated jobs are filled very quickly;
3) The indicators of market confidence, despite showing substantial improvement, are still negative, suggesting the numb state of Latvia's domestic market. If the pessimism of industry has abated recently, mainly due to improving external conditions, the consumers still have very pessimistic views about their prospects;
4) The price dynamics also suggest low activity in the economy. Despite initial bustle, the annual inflation rate turned into deflation at the beginning of 2013. According to the European Commission, the disinflationary effect, among other reasons, stems from prudent fiscal spending.[21]

[20]Republic of Latvia: First Review and Financing Assurances Review Under the Stand-By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Rephasing of Purchases Under the Arrangement (IMF Country Report No. 09/297, October 2009), 24.
[21]European Economic Forecast. Spring 2013 (European Commission, European Economy 2/2013.)

According to the Global Competitiveness Index (GCI), Latvia's development has reached a transition stage between an efficiency driven economy and an innovation driven economy.[22] This indicates that for Latvia there is still a room for growth through better efficiency performance (most notably institutional, e.g., courts, competition authorities, public administration, and of labor force). However, improvements in these areas will not ensure income levels commensurable with the advanced European countries. Without targeted policies towards business sophistication and creation of new products and technologies Latvia will remain caught in the middle-income trap. The GCI also reveals that during the crisis Latvia has lost a good degree of advantage in financial sector sophistication. The soundness of banks, easiness of access to loans and access to financing through local equity markets are still below pre-crisis levels. On the other hand, Latvia has advanced considerably in the area of technological readiness, which was made possible mainly due to the wide use of internet and the availability of up-to-date mobile and internet technologies.

According the GCI, the size of the domestic market and accessibility of qualified labor significantly reduces Latvia's global competitiveness. Emigration represents the biggest problem. Although emigration long predates the crisis, the severity of the slump substantially contributed to the outflow of people. Actually, the successive waves of emigration have created a powerful social network of migrants fostering further emigration, e.g., of friends and relatives.[23] Ironically, people have become Latvia's major export product.

A circular migration of people is not a bad thing. It increases labor efficiency, contributes to the cross-border flow of know-how and skills, and ensures higher personal incomes. In Latvia's case, emigration allowed many people to avoid the misery of joblessness and personal default. Each year many hundreds of millions of euro are transferred to Latvia as labor remittances which are used to support family members and repay debts to the banks. It is estimated that if people had stayed, the level of unemployment would have been from 3 to 6 percent higher (the actual level was close to 22 percent).[24] Nevertheless, as young people are those who emigrate, and they are not replaced through incoming immigration, Latvia's population is aging more quickly than suggested by statistics on demography. Moreover, as better educated people dominate among the emigrants, the problem of brain-drain becomes acute. What's more, when young people leave, they cause a huge loss to the society in terms of lost revenues. If no mechanisms are put in place to recover these losses, "the largely permanent departure of the younger and more educated workers may indeed be costly for those who stay."[25]

[22] The GCI assumes that economies in the first stage are mainly factor-driven and compete based on their factor endowments—primarily low-skilled labour and natural resources. Countries will then move into the efficiency-driven stage of development, when they must begin to develop more efficient production processes and increase product quality. At this point, competitiveness is increasingly driven by higher education and training, efficient goods markets, well-functioning labour markets, developed financial markets, the ability to harness the benefits of existing technologies, and a large domestic or foreign market. Finally, as countries move into the innovation-driven stage, companies must compete by producing new and different goods through new technologies and/or the most sophisticated production processes or business models. For more details, see Global Competitiveness Report 2012-2013 (World Economic Forum, 2012).
http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf

[23] Mihails Hazans, „Latvijas emigrācijas mainīgā seja 2000-2010 (The Changing Face of Latvia's Emigration 2000-2010)", In Latvia: Human Development Report 2010/2011 (Advanced Social and Political Research Institute, 2011).

[24] Olivier Blanchard et al., Boom, Bust, Recovery. Forensics of the Latvia Crisis, (Economic Studies at Brooking, 19-20 September 2013), 30.

[25] Ibid, 31.

As of 1 January 2014, Latvia has become full member of the European Monetary Union and has replaced its national currency with the single European currency – the euro. It is quite reasonable to believe that the accession to the Euro zone will boost investment in Latvia and facilitate foreign trade too, both with the Euro zone and other parts of the world.[26] The participation in the Euro zone, however, will expose Latvia to another kind of risks, related to Latvia's development. At the moment it is difficult to foresee in which direction Latvia's economy will develop. It could take the same direction as after 2004 when investor euphoria swamped the local market with cheap credit, leading to another cycle of overheating. Or, the economy could stay subdued for a prolonged time due to demographic decline and emigration. In both cases the problems stem from Latvia's still low level of income convergence and asymmetric development cycle with core Euro zone member states like Germany. Depending on the path of development, Latvia may need either a stronger or, on the contrary, a weaker monetary approach. This is something that the eurozone cannot provide; therefore, one should expect that one-size-fits-all monetary policy of the European Central Bank will subdue Latvia to even sharper cycles of development.

Yet, despite the risks associated with Latvia's accession to the Euro zone, the membership of the Euro zone has geostrategic significance to Latvia. Besides, the hope is that despite the bitter internal strife between the southern and northern member states of the Euro zone the instinct of cooperation will ultimately prevail, and, in exchange for greater fiscal vigilance, financial solidarity among the Euro zone countries will be enhanced. Indeed, in an unpredictable world even the seemingly strong states could one day fall from grace, as evidence from the recent IMF research paper on prospects of fiscal union of the Euro Area suggests.[27] A loose European Union as propagated by the United Kingdom and Sweden is not in Latvia's interests. Without the solidarity Latvia will be at risk of permanent underdevelopment with huge social and political costs.

[26]More details about the pros and cons of Latvia's membership in the Euro zone are provided in Aldis Austers and Kārlis Bukovskis, "Latvia's Socio-Economic and Political-Institutional Challenges in the Context of the Euro zone Accession", in Baltic-German Strategic Engagement: Realignment after the Euro crisis? (Latvian Institute of International Affairs, Friedrich-Ebert-Stiftung, 2013), accessed 22 October 2013, http://www.liia.lv/site/docs/StrategyTalks2013_A5_GALA.pdf

[27]Toward a Fiscal Union for the Euro Area (International Monetary Fund, September 2013).

3. The social impact of the crisis

In Latvia, in 2011, as many as 56 percent of households felt that they had suffered during the economic crisis, and only 38 percent of people were satisfied with life.[28] Since 2011 people's mood has improved; however, that gloomy social picture is not surprising, as the scale of grey economy, large regional disparities, high income inequality and widespread poverty are notable features of the Latvian economy (see Figures 1 and 2). During the crisis, income inequality subsided to some extent, even though poverty deepened, thus reinforcing social cleavages in Latvia.

After the recession, labor market difficulties have become more wide-spread and probably more varied:[29]

- The share of working age population has fallen sharply since before the crisis, long-term unemployment remains elevated, and labor market participation is shrinking. This problem is particularly acute in Latvia's regions, where, despite a general depopulation trend, unemployment is still on rise (see Figure 1);
- The young (15-24 years old) and middle aged (50-64 years old) were hit most severely, with unemployment soaring in their groups up to 35 percent and 17 percent respectively in 2009, and remaining stubbornly high since then;
- Many of the unemployed abandoned searches for a new job and resorted instead to activities in the grey economy (either to subsistence farming or to low-intensity occasional jobs).[30]

Remuneration is another contentious issue in the context of the recent Latvian crisis. Latvian salaries remain among the lowest in the European Union, despite a pre-crisis hike. The average monthly pay in Latvia is 3.5 times smaller than the average level of monthly pay in the European Union. The minimum wage in Latvia is set at a level of 287 euro (as of January 2013). Income inequality is particularly huge among different Latvia's regions. As depicted in Figure 2, if the income level in purchasing power standard in Riga region is close to average level of the European Union (90 percent), then in Latgale, the most depressed Latvia's region, the income level comprises only 29 percent of EU average.

Many economists argue that the level of wages should be commensurable with productivity. Apparently, the productive

[28] Life in Transition. After the Crisis (European Bank for Reconstruction and Development, 2011), accessed on 22 October 2013, http://www.ebrd.com/downloads/research/surveys/LiTS2e_web.pdf

[29] Katrin Gasior and Orsolya Lelkes, „Poverty, Inequality, and the Social Impact of the Financial Crisis in Latvia", in Scientific Research: Latvia: „Who is Unemployed, Inactive or Needy? Assessing Post-Crisis Policy Options", (The World Bank, 16 May 2013).

[30] The World Bank has found out that only a minority of those unemployed in Latvia were persistently jobless and that many had informal, low paying or unstable job.

capacity of many Latvians seems high enough to allow them to earn decent wages in Western European countries, but not in Latvia.[31] A recent study from IMF experts on wage adjustments during the crisis sheds some light on the cause of the problem. Namely, while no significant wage cuts took place in Latvia, the productivity performance substantially increased. This was achieved mainly through harder work and labor shedding. In the meantime, productivity gains have a tendency to materialize in higher profit margins of companies, but not in higher wages.[32] This fact points to weak labor unions and low employment protection in Latvia.

If income inequality had a tendency to diminish during the crisis, poverty, on the contrary, deepened, and society's polarization increased. According to a World Bank study[33], social disparity in Latvia is among the highest in the European Union. Moreover, the situation in Latvia seems to be significantly worse than in Estonia and Lithuania, especially with respect to severe material deprivation. Thus, Latvia is a country with the highest share of population: *first*, at-risk-of-poverty (21.3 percent on average; however, in regions outside the capital this figure fluctuates between 30 - 40 percent); *second*, in severe material deprivation (27.4 percent); and, *third*, living in extreme poverty (1 percent with income of 2 euro per day and 3 percent with income of 4 euro per day).

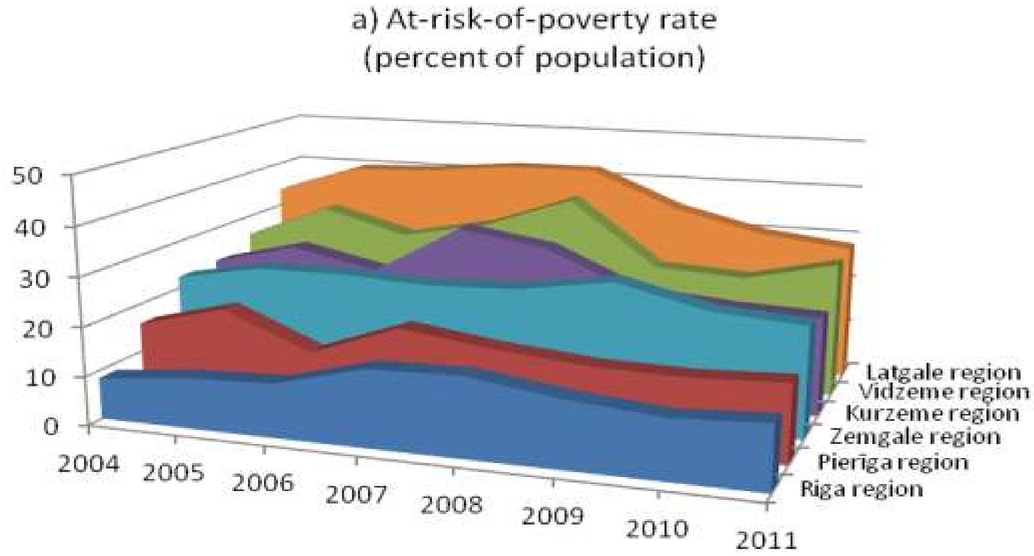
The main losers from the crisis, according to the same World Bank study, are children, young adults, single parents, tenants paying a market rate, and those living in urban areas. Many of those who lost jobs during the crisis were well-off beforehand. Encouraged by general euphoria, many had taken mortgages or loans for consumption. During the crisis the ability to service debts sharply diminished. The rate of overdue loans jumped to around 20 percent in Latvia.[34] Although the debt misery was to a large extent self-imposed, as in the run-up to the crash saving rates among Latvian households were very low, many became victims to the illusion of wealth.

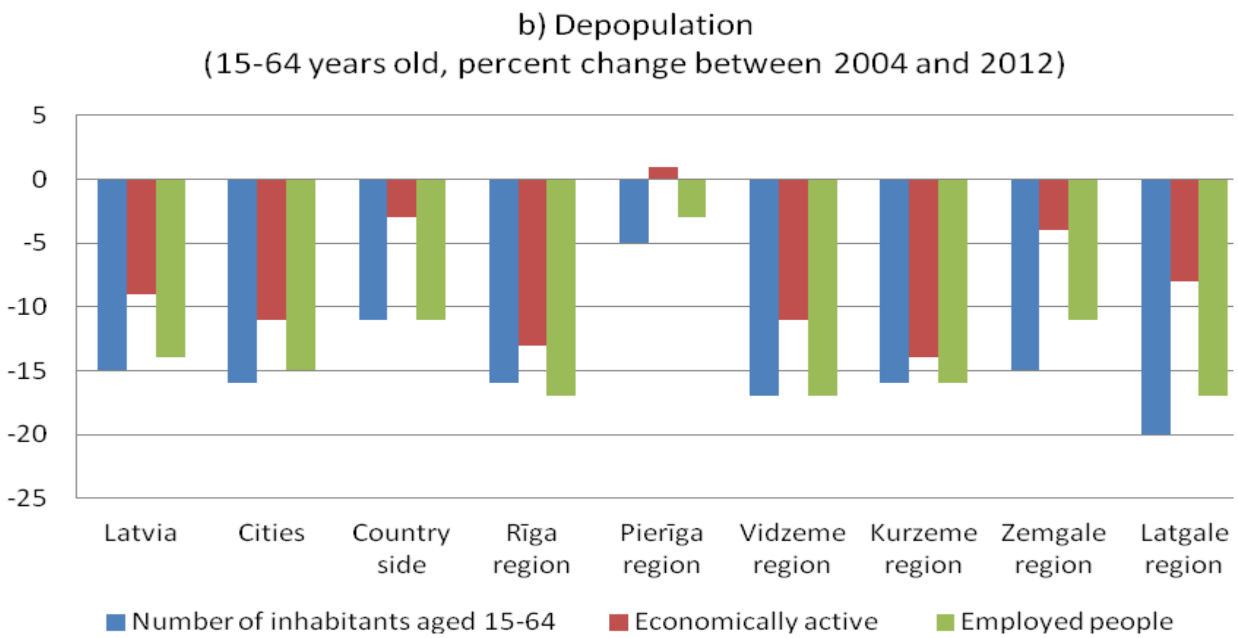
The studies of the European Commission and the World Bank indicate that Latvia does not have a particularly generous welfare system neither when compared to other countries in the European Union. Besides, Latvia was relatively unprepared to protect households at the onset of the crisis. Initially, Latvia's government's guaranteed minimum income (GMI) program was only moderately well targeted to the poor – no more than 30 percent of benefits went to the poorest quintile; the coverage was also very low and reached 5 percent of the poorest quintile. However, as recognized by the European Commission[35], the government managed to respond quickly by introducing reforms. It eased eligibility requirements, extended the duration of unemployment insurance benefits, and introduced public works programs.

[31]Around 26 percent of Latvian emigrants have jobs according to their qualification. The situation is somewhat better for those living in continental Europe – around 36 percent have qualified jobs. See Mihails Hazans, „Latvijas emigrācijas mainīgā seja 2000-2010...", 78-79.
[32]Blanchard et al., "Boom, bust..", 22-23.
[33]Gasior and Lelkes , „Poverty, Inequality..".
[34]Martins Kazaks, „From boom to bust and back: the banking system", in EU Balance-of-Payments assistance for Latvia: foundations for success. (European Economy Occasional Papers 120, European Commission, November 2012), 145-148.
[35]Peter Harrold et al., "Fiscal Sustainability, demographic change and inequality: the social sectors from crises to growth in Latvia", in EU Balance-of-Payments assistance for Latvia. Foundations for success. (European Economy Occasional Papers 120, European Commission, November 2012), 100-133.

Figure 1

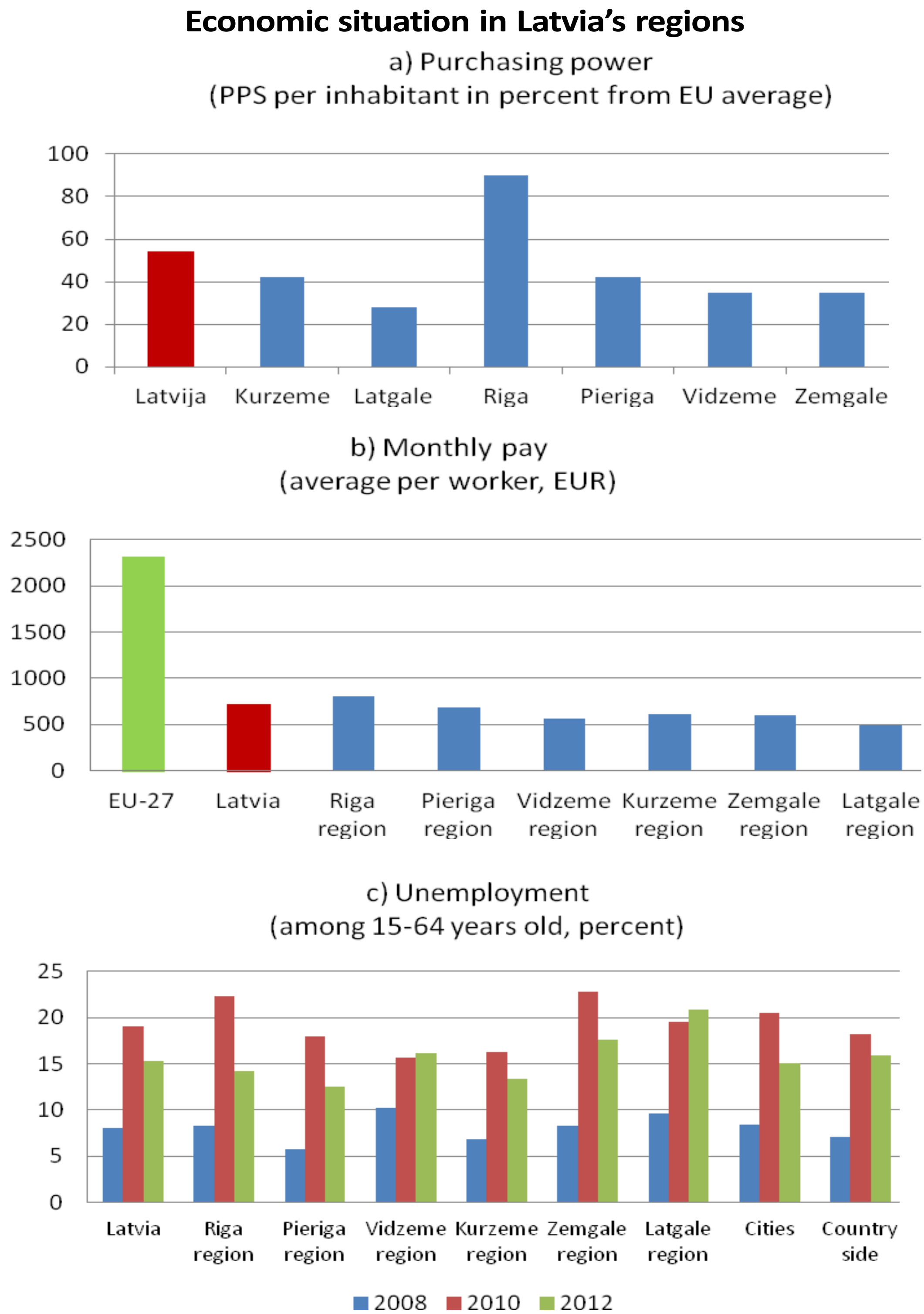
Social situation in Latvia's regions





Source: Eurostat

Figure 2



Source: Eurostat

Latvian health statistics are also bleak. The infant mortality rate is the highest among the Baltic countries and the third highest in the European Union (behind Romania and Bulgaria). In Latvia, people have the shortest life expectancy (73.9 years) and the third lowest number of years of healthy life (53.7 years for men and 56.7 years for women).[36]

Between 2004 and 2008, the health sector saw real spending growth of more than 70 percent, with additional resources focused on hospitals, ambulatory services and patient pharmaceuticals, to the detriment of outpatient care.[37] In education, the spending increase of 39 percent was used to boost the number of teaching and non-teaching staff despite falling enrolment numbers. Naturally, during the budgetary consolidation of 2009 and 2010 much of this extra spending had to be scaled back: a great number of rural schools had to be closed, teachers discharged, and much of the newly built hospital capacity had to lie idle or even be shut down. Fair enough, many of the reforms implemented in educational and health sectors under the pressure of fiscal consolidation were rather valuable, like the optimization of the number of teachers in schools, greater focus on early illness diagnostics and outpatient care in medicine. However, the current risks involve continuous human suffering from a drop in incomes, unemployment and also the intellectual degradation of villages in the countryside linked to the closure of public establishments.

Under severe economic pressure, one would expect a rise in crime level and violence, as some people lose their dignity due to economic hardship. Fortunately, this was not the case for Latvia. The general crime level has stayed rather low (around 80 percent of the European average).[38] The overall number of registered crimes even dropped between 2008 and 2010 by 8 percent. This seemingly positive development has two rather odd background facts that should be considered. First, policeman, prosecutors and judges were among those public officials who saw their salaries being cut in 2009 and 2010. Second, the number of prison inmates in Latvia is among the highest in the European Union – 326.8 per hundred thousand inhabitants which is twice the average of the European Union.

[36]European social statistics, (Eurostat Pocketbooks, 2013 edition, Luxembourg: Publications Office of the European Union, 2013), 67-101.
[37]Harrold, Fiscal sustainability, 100-133.
[38]European social statistics, 205-209.

4. The political impact of the crisis

Massive gaps in income between rich and poor can be harmful to social cohesion and the successful functioning of any society, especially when inequality is perceived as unfair. This argument seems even more pertinent in relation to transition countries like Latvia. Namely, in these countries, although initially perceived as a positive signal of increased opportunities, income inequality started to undermine people's life satisfaction when individuals became skeptical about the legitimacy of the enrichment of those who won out in the reform process.[39]

The Life in Transition Surveys of EBRD[40/41] show that, in Latvia, trust in other people and institutions has substantially fallen during the crisis with only 27 percent of people showing trust in others in 2010 (from 37 percent in 2006). What's more, the economic crisis has also considerably increased Latvian people's aversion to democracy and market institutions, as mere 15 percent prefer a combination of democracy and a market economy over other forms of governance (down from 31 percent in 2006). Such attitudes do not testify to an obtained resilience or immunity to hardships; rather, they suggest a serious legitimacy crisis of the Latvian state and political elite.

- *Impact on collective citizens' identity*

Nietzsche's famous expression - "What doesn't kill us makes us stronger," alongside the locally originated saying - "Weeds don't perish so easily," are widely used in Latvia to cheer one up when depressed. During history, Latvian people have had to endure repeated severe hardships and examinations of resilience. In the past, most of the hardships were imposed by foreign rulers, with the latest episodes happening during the Soviet occupation time. The traumatic historical experience (destruction of the state before World War II, violence and repressions during and after the war, life under totalitarianism) and continuous geopolitical tensions with Russia make Latvian people feel rather skeptical about the fortunes of independent Latvian state as a collective endeavor of the Latvian community. Such an attitude can be explained by the very short experience of political self-rule. The first democratic Latvian Republic lasted only from 1918 to 1934 (from 1934 to 1940, until the Soviet invasion, the country was ruled by autocrat Karlis Ulmanis). The current republic is the second attempt at

[39] World Happiness Report 2013, ed., John Helliwell, Richard Layard and Jeffrey Sachs, last accessed 22 October 2013, http://unsdsn.org/files/2013/09/WorldHappinessReport2013_online.pdf.
[40] Life in Transition, 2011
[41] Life in Transition. A survey of people's experiences and attitudes, (European Bank for Reconstruction and Development, 2007), accessed on 22 October 2013, http://www.ebrd.com/downloads/research/economics/lits.pdf

democratic self-rule. Certainly, democracy cannot be built in a few years time. The propagation of democratic instincts is a painstaking endeavor, happening through trial and error. In this sense, Latvian civic society is maturing. And there has been a lot of progress since the 1990s.

However, recent recurrent episodes of financial and economic disorder resonate with inherited incredulity from past misfortunes, thus building a strong feeling of distrust in the Latvian political system. A striving for self-enrichment, tax evasion, corruption and lately also emigration are manifestations of this distrust. The ideals of the Singing Revolution of the late 1980s have long been eaten away by mundane malfeasances and an endless struggle for survival. The general perception of the Latvian people is that society in general and the state in particular has failed to deliver the promised security and welfare.

A study conducted by the Cross-Sectoral Coordination Center of the Latvian Government recognizes the severity of the problem and points to fact that "economic and fiscal problems have resulted in a considerable deterioration of the people's capacity to act", therefore "individual solutions (emigration, the grey economy) prevail over collective solutions (payment of taxes, participation, social entrepreneurship), deepening the crisis in the society."[42] In the terminology of Alfred Hirschman[43], people have abandoned their "loyalty" to the Latvian state, and, instead of raising "voice", have chosen to "exit". Among the European Union's member states, only Lithuania has seen a more intense exodus of people.

It is very popular to attribute the latest wave of emigration to Latvia's economic conditions. Some argue that the economies of Latvia and Lithuania are too small to provide all the economically active with well paid jobs, therefore, it is natural, like in other episodes of emigration, particularly in the 19th and 20th century, to shed the spare labor to countries with labor shortages. However, there are two major problems with this line of argument. First, the intensity of emigration from Latvia, and also Lithuania, points to the political nature of the people's departure. It is a form of latent protest against economic, social and political deficiencies. Second, Latvia is a small country with very limited human resources. The departure of too many people, as recognized by the experts of the IMF, may make governance of the country too costly for those who stay.[44]

In fact, a comparison between results of public opinion surveys of the three Baltic countries (see Table 2) reveals rather huge distance between Estonia on the one hand and Latvia and Lithuania on the other hand. Estonian people have more positive thoughts on almost every account, and, unsurprisingly, Estonia is the only Baltic country whose scale of emigration can still be measured with a single digit number. This implies a strong correlation between the people's trust in national political institutions and their propensity to emigrate.

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[42] National Development Plan of Latvia for 2014–2020 (December 2012.) 12.
[43] According to the original treatise by Alfred Hirschman "Exit, Voice, and Loyalty" (1970), the members of an organization, whether a business, a nation or any other form of human grouping, have essentially two possible responses when they perceive that an organization is demonstrating a decrease in quality or benefit to the member: they can exit (withdraw from the relationship); or, they can voice (attempt to repair or improve the relationship through communication of the complaint, grievance or proposal for change).
[44] Blanchard et al., Boom, bust.., 30.

- *Impact on voter's attitude to political institutions and political preferences*

The level of distrust in Latvian political institutions has historically been high, as suggested by the public opinion surveys. A crisis of such a magnitude as that which Latvia has recently experienced could not pass by without significant alterations in people's attitudes. Thus, according to Eurobarometer survey's, in Latvia, the level of people's trust in government went down from 32 percent in 2006 to 9 percent in 2009, and then up to 20 percent in 2013. As for political parties and the elite of the country, the attitude towards them is much worse. In 2006 only 9 percent trusted them, the same as in 2013. Meantime, at the peak of the crisis the trust in parties reached an extremely low level – only 2 percent.

A particular feature of the Latvian political system, which is based on parliamentarianism, is that the traditional political cleavages of right and left are not really functioning. Instead, the political scene is dominated by ethnic issues because a large part (around 32 percent) of Latvian citizens has Russian or other non-Latvian ethnic origin. This group of Latvian citizens, often referred to as Russian-speakers, has high and consistent loyalty towards political parties claiming the representation of their ethnic interests (education in mother tongue, liberalization of Latvia's citizenship regime, the Russian language status in Latvia. etc.). The most popular political force at the moment is the "Harmony Center" alliance which has center-left orientation. Latvian voters in general don't trust parties with a significant Russian presence, as these parties, like "Harmony Center", are suspected of receiving funding and instructions from Moscow. Therefore the Latvians are inclined to vote for Latvian parties who happened to represent the political spectrum from radical right to moderate right. No popular Latvian party claims to be leftist, though some of them like the nationalistic "For Freedom and Fatherland" pretend to have a socialist orientation in economic affairs.

The ultimate result of this clear-cut ethnic split among voters is that the normal functioning of opposition along the lines of distribution of national wealth has been inhibited. This to a large extent explains the entrenched business orientation of Latvian politics.

Despite this fact, since the 2006 parliamentary elections the Latvian political landscape has seen considerable changes. First, a large part of major political forces of that time has lost their appeal to the voters due to the crisis and has no representation in parliament. These are the so-called oligarch or pro-business parties. As of 2010 the political scenery is dominated by center right and right wing parties who claim to defend justice and anti-corruption activities. Since the state president dismissed the parliament and extraordinary elections were called in 2011, the dominating forces have been "Unity" and the "Reform party". Both parties have rather identical political programs: both have reform orientations and have invested a lot of effort in restructuring the Latvian economy after the crisis. However, despite the return of economic growth, these two parties are losing public support. The "Reform party" is doing particularly badly.

The next parliamentary elections will take place in autumn 2014 and it seems that center parties are going to be the main losers from these forthcoming elections with nationalistic and leftist pro-Russian parties being the winners. One of the causes of center parties' demise is emigration. The young and liberal minded people are those who mostly emigrate. Voting abroad is allowed in Latvia's elections, however, voter's activity outside the country is rather low (although it has a tendency to increase) and will not compensate for the loss of support to center parties within the current electoral system. As a result, more radicalism and conservative populism should be expected from Latvian politics in the forthcoming years.

Conclusions

The current state of Latvia can be best described in medical terms: the patient is pale, but alive. The financial woes have been successfully resolved, but economic, social and political challenges remain. The negative results of the crisis are continuing to affect the fabric of social and political life in Latvia. The current economic recovery is superficial and will not be long-lasting as it lacks a strong social base. First, due to emigration of mostly young and educated people and demographic decline, and, second, due to the entrenched business orientation of Latvian politics which prevents the full utilization of Latvia's human potential. Without any further resolute action, another stroke - if not even terminal cardiac arrest - is not far away.

A few ideas on what could be done to alleviate Latvia's problems:

- The government should focus on the remaining structural inefficiencies in vocational and higher education, in infrastructure, court system, and competition, promote more active labor market policies, investment in science and research, etc.;
- The neoliberal ideological orientation should finally be left to history and politics reoriented towards social democratic tradition. Latvia, as a small nation needs something like German corporatism, and not Anglo-Saxon liberalism;
- The size of the government should be enlarged through broader taxation, including taxes on capital and land. The taxation and the social safety net needs further restructuring in order to make people in Latvia more equal in terms of income;
- The government should devise instruments, including changes in electoral system, facilitating cooperation with Latvian people living abroad. Latvia needs to adjust to situation of high cross-borders mobility of people;
- The support from the European Union will be of critical importance, as the Latvian government will not be able to raise enough resources to maintain public services at decent quality due to people's emigration.