

Macroeconomic Policy Regimes in Emerging Countries - Candidates for Currency Union

(Dys)functionality of the Macroeconomic Policy Regime in Latvia

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Abstract

This paper has a goal to explore the concept of macroeconomic policy regimes (MPRs) on the one hand and on the other, to analyse the functionality and development of MPRs in emerging countries which are on their way of joining a currency union. MPRs of the Central and Eastern Europe within the framework of the European Union applied to the case of Latvia will be analysed using a post-Keynesian approach. Functional MPRs are considered those that bring sustainable economic growth, employment and more equitable income distribution. A macroeconomic policy regime consists of policies (monetary policy, fiscal policy, wage policy, foreign economic policy and industrial policy), the financial sector, and the institutional frameworks in which the economies are embedded. Six elements can thus be differentiated: monetary policy, fiscal policy, wage development/policy, foreign economic policy, industrial policy and the financial sector. The observations and findings made so far point towards the direction of a dysfunctional development of the MPR in Latvia, causing great instability in the economic development, capital outflow and large employment losses.

1. Introduction

This paper has the goal to explore the concept of macroeconomic policy regimes (MPRs) on the one hand and on the other, to analyse the functionality and development of MPRs in emerging countries which are on their way of joining a currency union. The concept of MPR will be applied to Latvia using a post-Keynesian approach. Latvia is chosen as a representative of the group of Central Eastern European countries (CEECs), EU members and candidates for joining the European Monetary Union², for the reason that it is small, open, and net debtor country, that attracted high capital inflows especially in the real estate and financial intermediation sector, and starting in 2000 until 2007 experienced the highest growth rates together with the other two Baltic countries within the group of CEECs.

The aim of this paper is then to explore if the macroeconomic policy regime in Latvia has been functional using a normative approach. Functional MPRs are considered those that bring

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¹ This paper is part of my forthcoming doctoral thesis “Macroeconomic Policy Regimes in Central Eastern Europe – Convergence Towards the European Monetary Union” and the research done for the book “Macroeconomic Policy Regimes in Western Industrial Countries” by Herr/Kazandziska (2011b). I would sincerely like to thank Eckhard Hein and Hansjörg Herr for their invaluable comments and generous support. Furthermore, I am grateful for the scholarship for completing my Ph.D. received by the Hans Böckler Foundation.

² The group of Central Eastern European countries includes: Hungary, Poland, Czech Republic, Latvia, Lithuania (which joined the European Union in 2004), and Bulgaria and Romania (that entered in 2007).

sustainable economic growth in the long run, employment and more equitable income distribution. A macroeconomic policy regime consists of policies (monetary policy, fiscal policy, wage policy, foreign economic policy and industrial policy), the financial sector and the institutional frameworks in which the economies are embedded.

A special focus will be put on emerging countries which have characteristics of a small, open and net debtor economy. In the latter the external sector plays a quite important role, therefore the foreign exchange policy will be given a special emphasis. Establishing horizontal and vertical linkages between capital flows (especially foreign direct investment) and the domestic industry is also of paramount importance. Industrial policy can help the process of economic restructuring, direct capital towards sectors and specific firms with the aim to increase the prospects of domestic investment, productivity, and improve the terms of trade. Introducing industrial policy and extending the external sector as a part of MPR are new contributions of this paper.

In chapter two the contours of a MPR will be set. Moreover, all the elements of the latter will be addressed in detail. What follows is a sketch of a functional macroeconomic policy regime. In the third chapter the focus will be put on the Latvian economy and the development of its MPR, as well as assessment of the functionality of all the elements of the Latvian MPR on the basis of the functional macroeconomic regime drafted in the second chapter. Conclusions will obtain a special space in the last chapter.

2. Model of a functional macroeconomic policy regime

There is a lack of coherent body of literature dealing with and specifically defining MPRs. A quite important contribution towards developing the macroeconomic regime concept was made by Heine/Herr/Kaiser (2006:18) where the characteristics of a functional economic regime recommended for the industrial countries are set. As they put it: “economic regime is characterised through 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:2) developed a definition of MPR. 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”.

For the reason that Latvia, similarly to the other CEECs has also certain characteristics of a developing country (especially in terms of the currency quality, degree of dollarization/euroization and financial system development) I will also partially include the development literature. Within the latter, Priewe/Herr (2005:44) analysed macroeconomic regimes of developing countries and formulated the former as “a set of conditions and their interaction including economic institutions which create growth or not“. Some aspects from the regime analysis of Priewe/Herr (2005) will be as well used in the examination of the MPR in Latvia.

In this paper I will attempt to make a contribution in the formulation of an MPR of emerging countries, candidates for accession in a currency union. MPR consists of policies (monetary policy, fiscal policy, wage policy, foreign economic policy and industrial policy), the financial sector and the institutional frameworks in which the economies are embedded. Six elements can thus be differentiated: monetary policy, fiscal policy, wage development/policy, foreign economic policy, industrial policy and the financial sector. Each of these elements has an institutional dimension, whereas only monetary, fiscal, industrial and foreign economic policies always have a policy dimension. The financial sector does not have a policy and therefore it has often been separately treated in the analysis of the macroeconomic policy mix. Wage development can be translated in wage policy when agents in the labour market exist, who act on a macroeconomic level and take into consideration the macroeconomic effects of their decisions (Herr/Kazandziska 2011b:79).

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. Particularly the emerging economies of CEE tend to be small³, open economies and also in many ways, dependent on the growth of and changes in the world market. Furthermore, the emerging countries in CEECs similarly 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). Their financial systems often lack prudential regulation and are at a lower level of development relative to the developed countries. Hence, it is plausible to argue that for emerging countries the foreign economic policy and industrial policy (in improving competitiveness and hence, the current account balance) seem to play a more important role than for the developed economies.

³ Measured in terms of the size of GDP.

Institutions pave the way the policy instruments can be applied, and only when certain institutions are in place certain type 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.⁴ Because of space limitations, I will put a greater focus on the 'policy' part, yet not neglecting the major institutional changes which help us draw a comprehensive picture about a one MPR. In this paper one possible solution for a functional MPR is presented which is shown in Table 2.1. What follows is a separate analysis of the elements of a MPR.

	Strategy	Objectives	Instruments	Institution in charge
Foreign economic policy	<ul style="list-style-type: none"> - Supporting export growth and reduction of income elasticity of imports, - Providing exchange rate anchor (adjustable peg), - Stimulating FDI inflows- 	Improvement of the current account balance	<ul style="list-style-type: none"> -Foreign exchange intervention -Capital controls - Regulations (domestic content requirement) 	Central bank The government
Financial system	<ul style="list-style-type: none"> - Support of development loans (esp. to manufacturing sector and the SMEs) - Restriction of foreign currency exposure. 	<ul style="list-style-type: none"> - Provision of sufficient, affordable finance for the private sector (esp. manufacturing sector) - Securing stability in the financial system 	<ul style="list-style-type: none"> -Regulations (setting reserve requirements for different types of assets), - Regulations regarding separation of banks and other financial institutions 	Central bank The government
Industrial policy	<ul style="list-style-type: none"> - Targeting specific sectors/companies 	<ul style="list-style-type: none"> - Increasing competitiveness, - Increasing innovation capacity, - Improving the terms of trade and the current account, - Increasing economic growth. 	<ul style="list-style-type: none"> - Subsidies - Policy loans, - Conditional provision of foreign currencies, - Regulations of entry/exit and capacity expansion in specific markets 	The Government, development banks
Wage policy	<ul style="list-style-type: none"> - Wage norm - Wage coordination between firms/sectors 	<ul style="list-style-type: none"> - Preventing inflationary/deflationary development, - Securing a minimum income for the poorest households. 	<ul style="list-style-type: none"> - Supporting wage negotiations at macroeconomic level, -Extension of collective agreements, -Minimum wages 	Social partners The government
Monetary policy	<ul style="list-style-type: none"> - Maintaining low real interest rate 	<ul style="list-style-type: none"> - Prevention of speculative capital 	<ul style="list-style-type: none"> -Interest rate -Regulation 	Central bank

⁴ E.g. the breakdown of the Soviet Union.

		flows - Prevention of panics in the financial system as a lender of last resort	measures for providing stability and sufficient finance in the financial sector	
Fiscal policy	- Allowing for automatic stabilizers to work, - Anti-cyclical fiscal policy	- Increasing employment, - Stabilizing aggregate demand, - Reducing income inequality	- Direct job creation, - Progressive taxation, - Inheritance and property tax, - Wealth tax, - Increasing spending in infrastructure, R&D, education, etc. - Comprehensive welfare system	The Government (at all levels)

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. For this purpose, the balance-of-payments-constrained-growth model (BPCG) (Thirlwall 1979) will be applied. The BPCG model, originally synthesized by Thirlwall (1979) and modified by Thirlwall/Hussein (1982) and McCombie/Thirlwall (1997) 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. The balance-of-payments growth rate is determined by two main factors: export growth and income elasticity of demand for imports.⁵ Through stimulating exports to achieve a higher growth rate, by 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.

If capital flows are allowed to cover for the deficit in the current account, the situation does not significantly change, as very large financial inflows would be needed, which is not sustainable in the long run without putting the debt service in danger (Thirlwall/Hussein 1982).

⁵ The formula describing this relationship is: $y = \frac{x}{\pi}$,

where y is balance-of-payments growth rate, x stands for export growth and π for income elasticity of demand for imports (Thirlwall 1979:49).

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. 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).

Capital inflows can be an important source of funds which is usually lacking in the emerging countries, but even more importantly, they have proven to be, a source of disruption causing the domestic currency to appreciate and current account deficits to soar. Imports of capital and intermediate goods are needed for production, but they can be translated into exports only partially. It is often the case that the capital inflow is used for imports of consumption goods (and often even of goods which are domestically produced) 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).⁶ Industrial policy, therefore, plays an important role in restricting the income elasticity of imports and navigating capital flows towards those sectors where the export prospects are high so that a more sustainable growth, without endangering the external balance will be achieved.

From the above said, it becomes clear that emerging countries ought to apply certain forms of capital controls or capital management to prevent capital inflow and capital outflow and thereby protect their financial system (Prates/Cintra 2010:70).

A stable anchor for the exchange rate is also necessary to reduce the vulnerability to exchange rate changes, particularly against negative effects of devaluation. Connected to the question of stable exchange rate is the importance of having high level of foreign exchange reserves, which can also increase the thrust and the credibility in the currency (Priewe/Herr 2005). The best way to obtain foreign currency is through exports as the prolonged interventions of purchasing foreign currency by the central bank might prove to be too costly.

To summarize, in order to achieve a higher economic growth, the government should adopt policies that increase labour productivity (education, specific vocational training, etc.), and exports (from currency depreciation to export subsidies, etc). However, the government should also create policies that reduce the income elasticity of import demand. This is when

⁶ 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).

the industrial policy, including targeting and support of specific sectors, which produce high value-added products are crucial for securing an increase in exports, is especially needed.

2.2. Financial sector

That a positive development and size of the financial sector has an important role to play for economic growth in a country was highly stressed by the Post Keynesian school (Priewe/Herr 2005:124). One way to measure positive development is the credit-to-GDP ratio. In fact, a so-called credit-investment-production-income-savings process needs to be put in motion (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 will then make investment and increase employment, which will stimulate the creation of output, income and savings (Davidson 2011:141, Arestis 1992:109, Lavoie 2011:35).

In the emerging countries, connected to the question about the quality of the currency is the level of dollarization/euroization. High preference for a foreign currency as a store of value initially, and as unit of account and medium exchange at a later stage, signifies that the financial system is becoming increasingly vulnerable (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 as its revenues are usually in a domestic currency. The same statement is valid for the household sector. Only firms operating in the export sector can have revenues in a foreign currency. Thus, a situation of currency mismatch in most of the balance sheets of the macroeconomic actors which can be supplemented by maturity mismatch (when assets have a different maturity than liabilities) can be created.

A high increase of credit expansion towards the real estate and the household sector (in some countries, predominantly in foreign currency) is a characteristic of a bubble created also in emerging countries. In order to prevent the creation of bubbles, the central bank can monitor the net wealth⁷ to disposable income ratio of the private sector (Arestis 2011:99). In order to have a functional development, the financial sector as a separate element of the MPR should show a stable performance, non-banks need to be regulated so as to prevent speculative activities and financial crashes and last but not least, capital controls should be implemented to avoid the problems of dollarization, to stabilize the exchange rate, to enable a more autonomous monetary policy and to protect the weak financial sector (Priewe 2008).

⁷ Net wealth is calculated as total assets minus total liabilities of the private sector (Arestis 2009:14).

2.3. 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 impact particular industries and firms 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 firstly seen in the increasing current account deficits, as many branches in the service sector are non-tradable (primary and secondary education, child and elderly care, government services and legal services) (Chang 1994:57-58). Sole reliance on the service sector for economic growth seems to be a very dangerous strategy, for the productivity cannot rise at as high rate as the productivity in the manufacturing (Chang 1994:58). The role of the industrial policy is further to regulate and coordinate the entry of new firms in specific markets and to regulate the capacity expansion of the existing firms (Chang 1994:67).⁸ Positive externalities that arise from investment in knowledge and R&D create social gains. Thus, the government can facilitate the coordination between complementary investments in research by the firms (Richardson 1960). Investment in R&D, especially in the infant industries and experimentation in know-how and technology is of great importance, thus the government's involvement (via subsidies, tax reliefs, patents, etc.) can stimulate creation of new and diversified knowledge, which is one of the main factors for sustainable growth in the emerging economies.

The industrial policy comes into play in making sufficient finance available to the firms, particularly small- and medium-sized, channelling capital to the sectors which have high growth prospects, connecting R&D, education and technological innovations with the companies sector, stimulating exports of higher value-added products and limiting imports solely to capital goods needed in the production process and lower value-added, intermediate products.

2.4. Wage development/policy

Wages can potentially have very 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-

⁸ One example is 'conditional entry' whereby the government conditions the entry of new firms or capacity expansion with the current or expected demand in the respective industry (Chang 1994:67).

133). Too high nominal wage increases (over productivity development) can *ceteris paribus* potentially cause price increases. Too low wage increases have negative effects on consumption, demand and employment in the short run, and cause a sluggish productivity development which will further weaken economic growth in the long run (Hein/Stockhammer 2010). Therefore, the Post Keynesian school recommends a certain rigidity of nominal wages.⁹ Assuming constant distribution claims of firms, the government and the external sector, the wage policy would ideally take into account productivity development and the inflation target set by the central bank (Hein/Stockhammer 2011:130).¹⁰ This means that unit labour costs should grow in line with the inflation target set by the central bank, which will prevent deflation from appearing, as well as will prevent a change in the income shares, provided that mark up of the firms remains unchanged.¹¹ 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, wage anchor will help to keep the exchange rate stable as well.

Labour market institutions also need to be considered. To be able to achieve this wage policy benchmark, wage coordination needs to be strengthened and the collective bargaining process, if necessary, needs to be supported by the government.¹² In countries where collective bargaining is weak and the extension of collective agreements is possible only under very limited conditions and is rare, introduction of minimum wages should be applied (Herr/Kazandziska 2011a). The former should increase in accordance with the wage norm described previously, provided that wages follow this model as well.

⁹ Both the parking-it and the horizontalist stream within the Post Keynesian school accept this formulation of a wage policy.

¹⁰ Wages (as part of unit labour costs) are one of the most important factors determining the price level in a closed economy (Keynes 1930, Riese 1986).

¹¹ By inflation target we 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.

¹² Wage coordination includes both horizontal (between sectors) and vertical coordination (within sectors) (Hein/Schulten 2004:538).

To increase registered employment especially in less developed regions within one country and reduce the informal economy, the government can act as an employer and secure a so called ‘reservation’ wage which effectively sets a minimum wage. Though this policy, the government will also increase adherence to the minimum wage policy (Herr/Kazandziska 2011a:13).

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: ‘activist’ and ‘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 their perception about the creditworthiness of their clients which changes when the expectations of banks change (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 increase in interest rates in booms.

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 as explained above (Rochon/Setterfield 2007; Hein/Stockhammer 2010). These economists share the opinion that the central bank ‘parks’ the interest rate at certain level and leaves the wage/incomes policy the role of combating inflation.¹³

Since that this paper focuses on emerging countries, a more general recommendation for central banks would be to keep the long run real interest rates positive at a low level, with 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).

¹³ Within the ‘parking-it’ approach there are 3 proposals: the ‘Smithin’ rule (Smithin 2007:114), the ‘Kansas City’ (Wray 2004:27), and the ‘Pasinetti’ rule (Lavoie/Seccareccia 1999).

Not less important is to provide stability of the exchange rate because currency devaluations erode the domestic currency's reputation, they also cause the currency premium as well as the external debt to increase (Herr 2009), and destabilize the financial markets. For this reason, it is of utmost importance that the central bank intervenes in the foreign exchange market and introduces capital controls.¹⁴

2.6. Fiscal policy

Fiscal policy has an important role to play in the economy. Post Keynesian supporters argue that fiscal policy should be assigned the role of securing full employment, real stabilisation in the economy and more equal income distribution (Hein/Truger/van Treeck 2012). In this study, the authors propose constant budget deficit/GDP ratios, which under the condition of a constant rate of GDP increase will help maintain fiscal sustainability because the public debt/GDP ratio will then also converge to a certain value.¹⁵ Anticyclical fiscal policy which will also allow for a complete effectuation of automatic stabilizers is to be used for the purpose of stabilizing aggregate demand (ibid. p.28).

In the emerging countries, the government needs to undertake large public investments in order to increase not only productivity and economic growth, but also to provide social programs to reduce poverty and the income inequality. Extensive welfare systems including unemployment benefit schemes, social aid, and public health care are just a few examples of government's active involvement. Investment in infrastructure, provision of public goods, provision of education centres, research facilities, libraries, laboratories is of utmost importance for increasing labour productivity and extends the capacity to export. It should also increase the provision of kindergartens, care facilities for the elderly, schools and universities.

However, it is important to note that due to the lower currency premium and currency quality in the emerging countries compared to the developed ones (driven by different factors, like: economic, political, social instability, exposure to exchange rate risk) and in times of financial and economic crisis, even a small increase in deficits can cause downgrading of the government bonds and capital flight. This means that there is a more limited space for the governments to use deficit spending. Consequently, we can argue that the level of public debt should be kept at a lower level than in developed countries, especially in a foreign currency (Priewe/Herr 2005:56).

¹⁴ Even the IMF supports the use of capital controls on capital inflows under certain conditions (Ostry et al. 2011:9).

¹⁵ Hein/Truger/van Treeck (2011:28)

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 economies which are candidates for entry in a currency union will be examined. The focus will be put on two periods: pre-crisis, or boom phase (1995-2007) and 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 of all the elements of MPR applied to Latvia separately. Assessment of the latter and recommendations will follow.

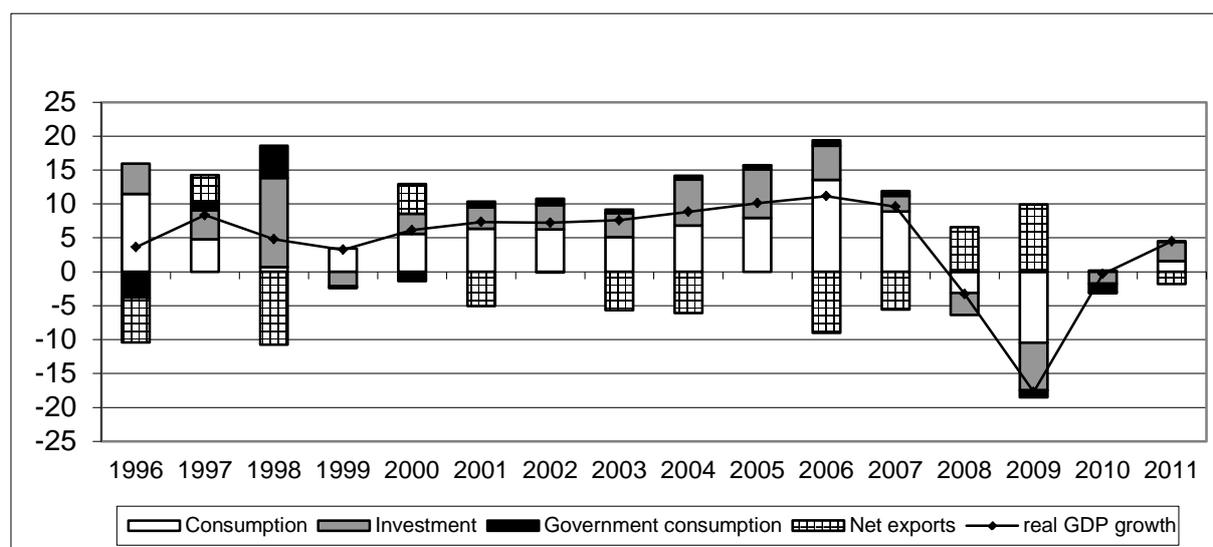
3.1. Economic development

After the early transition phase (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 nearly 6% (Ameco 2012). The GDP growth during the former has been mainly affected by consumption (see Figure 3.1). The second place has been reserved for private investment. The deficit in the private balance was covered by current account deficits.

However, the relatively high growth was not supported by employment creation. In fact the employment rate was only 0.35% on average for the respective period. Hence, it is because of the strong and prolonged increase in GDP and not employment that we can observe big increases in productivity 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 the private consumption and investment fell sharply in 2008. Latvia was forced to apply tight fiscal policy with very low level of government spending, which coupled with very large declines in private consumption and investment was a very important cause for reduction in the 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 managed to achieve surplus in the current account, though not due to the improvement in the export performance, but rather as a consequence of the severe cuts in wages, unemployment increases and the loss in purchasing power which was *inter alia* manifested in drops in consumption, as well as imports.

Figure 3.1 Contributions of components of aggregate demand to GDP growth



Source: author's calculation based on Ameco 2012.

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 USD, 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 ERMII, in order to fulfil the Maastricht criteria for accession in the EMU.

The development of the current account balance of Latvia is a result of the negative contribution of the external sector in the economic growth. The deficit of the current account increased 12 fold between 1992 and 2008 (Figure 3.2). This development was mainly a consequence of the erosion of the balance of trade in goods and the overvalued currency after 2004. As the capital inflows increased, the income part of the current account was also put under pressure. Cumulative interest payments, as well as profit repatriation led to a situation in which the balance of the income account from positive, turned to negative values starting from 2003.

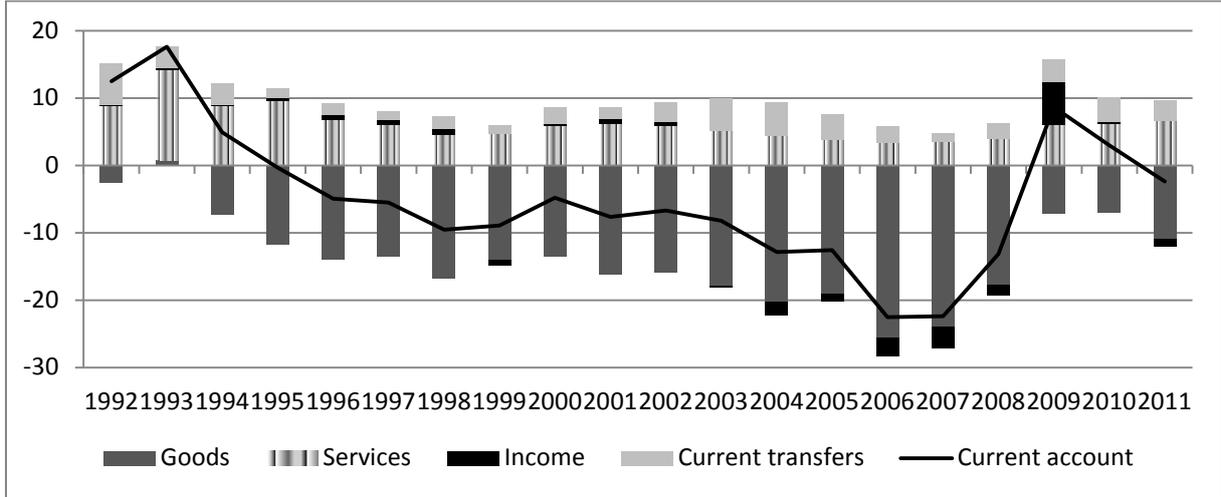
The increase in imports was financed mainly by capital inflows in the form of interbank loans, and secondly, intercompany loans as a part of other investment flows (Figure 3.3).¹⁶ The second important source of finance is FDI; though, it remained low in comparison to other CEECs. During the growth phase, the latter has mainly been directed towards the real estate sector, financial intermediation, trade, energy (gas) and transport and communication sector.

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

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 services sector and the real estate attracted FDI as high as 3% of GDP and 1.5% of GDP, respectively (Swedbank 2012). As described by Mencinger (2007), FDI does not necessarily have to create mainly positive results, which can be also confirmed in the Latvian case. Namely, the influx of foreign direct investment 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).

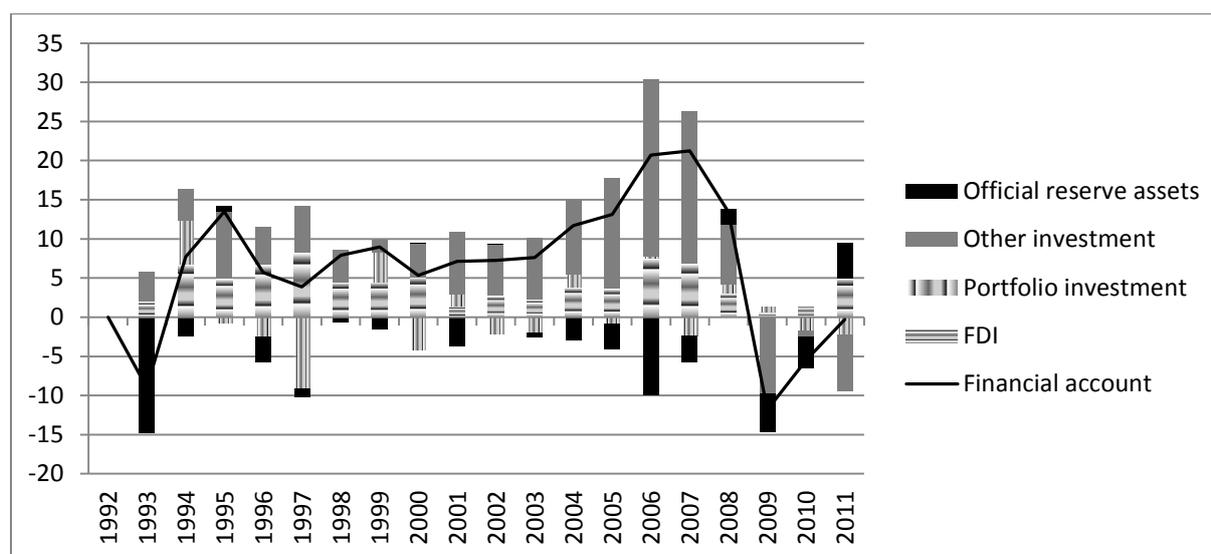
The high amount of external liabilities created through the capital inflows led to an increased vulnerability of the financial system, which can also be seen in the development of the financial sector explained in the next section. External debt has increased very strongly especially after 2004. In 2007, the amount of the external debt stock was USD 39 billion which equals to 136% of GDP (see Table 3.1). The reserves to external debt ratio has throughout the years dramatically declined as well, which proves the fact that there is a danger of not being able to maintain the fixed exchange rate regime and to keep the whole financial system stable. Another indicator which shows the capability of the economy to repay its external debt is the external-debt-to-export ratio. The latter has increased to 320% in 2007 (see Table 3.1).

Figure 3.2 Contributions to the current account balance (% of GDP)



Source: author’s calculation, Bank of Latvia

Figure 3.3 Capital flows, net (% of GDP)



Source: author's calculation, Bank of Latvia

Table 3.1: External vulnerability indicators for Latvia

	Real effective exchange rate (index, 1999=100) Latvia	Real effective exchange rate (index, 1999=100 EMU-16)	Current account balance/GDP (%)	total trade/GDP (%)	external debt/GDP (%)	Reserves/external debt (%)	External debt/exports of goods and services (%)
1995	69.8	121.0	-0.3	87.5	8.8	109.3	20.7
1996	79.5	117.7	-5.0	101.1	22.1	53.1	47.1
1997	91.3	104.1	-5.6	101.5	45.0	27.6	96.0
1998	94.38	101.1	-9.8	106.8	47.1	25.7	99.8
1999	100.0	100.0	-9.0	90.0	55.7	21.5	138.0
2000	112.4	94.4	-4.7	90.3	62.0	17.5	148.8
2001	112.2	96.5	-7.5	92.7	63.7	21.7	153.1
2002	108.0	97.2	-6.7	91.5	73.1	18.2	178.8
2003	99.0	104.4	-8.2	96.7	78.7	16.3	187.0
2004	99.3	103.7	-12.8	103.5	90.1	15.4	205.0
2005	99.5	102.8	-12.4	110.0	88.8	15.7	185.9
2006	104.0	102.0	-22.7	111.2	112.8	19.4	251.4
2007	111.4	100.8	-22.3	104.7	135.7	14.2	320.5
2008	123.8	106.8	-13.3	99.3	124.3	12.0	290.3
2009	126.6	116.3	8.8	89.3	161.6	15.9	368.3
2010	122.8	109.4	3.0	109.0	164.7	18.3	306.2
1995-07	98.5	103.5	-9.8	99.0	68.0	28.9	156.3
2008-10	124.4	110.8	-0.5	99.2	150.2	15.4	321.6

Notes: ¹⁾ Total trade is calculated as the sum of exports and imports of goods and services.

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 and even capital outflow (Onaran 2011b:224). As the parent companies faced financial difficulties, the pace of profit repatriation significantly increased, and with it reinvested earnings in the country shrank (Bank of Latvia 2012). The domestic currency was also under strong pressure to depreciate. The latter became so pronounced that the Latvian government was forced to ask for financial aid from IMF and the ECB to keep the exchange rate stable (Onaran 2011b:225). The response of the EU in 2009 to provide financial assistance to Latvia was rather belated because the country has already in 2008 fallen in recession. In the agreed Memorandum of Understanding with the EU, (and under pressure from the Swedish government and banks who own the majority of shares in the Latvian banks, to defend the exchange rate under any circumstances), a mix of structural and fiscal austerity measures are required, *inter alia*, public sector wage and employment cuts, and increases in taxes (Memorandum of Understanding between the European Community and the Republic of Latvia 2009).

In order to assess the functionality of the foreign economic policy as a part of MPR, we can use the indicators current account balance/GDP and external debt/exports. As previously elaborated, there has been a dramatic increase in both, which proves that growth above the balance-of-payments constraint will cause also a decline in GDP. Therefore, we can speak of dysfunctional foreign economic policy. A recommendation would be that the government, joined by the central bank, links foreign economic policy to industrial policy; that it supports export growth and reduction of income elasticity of imports; that it provides stable exchange rate anchor, and stimulates FDI inflows under specific conditions (see also subchapter 2.1).

3.3. Financial system

Latvia's financial system experienced a very dramatic transformation from bank-based system (firstly monobank and only later dual bank system) under the Soviet Union, whereby the financing for firms was in the form of policy loans and whereby non-banks of a sort we have today, were not present (Herr/Tober/Westphal 1994), towards highly liberalised system whereby there are no separate regulations for the commercial banks and non-banks. However, banks have a dominant role in the financial system.¹⁷ 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 is related to the entry of the Central Eastern European countries in the EU (see Figure A1 in the appendix). Moreover, 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 43% in 2006, and 62% in 2009 (Claessens/van Horen/Gurcanlar/Mercado 2008:43; Claessens/van Horen 2012:30).

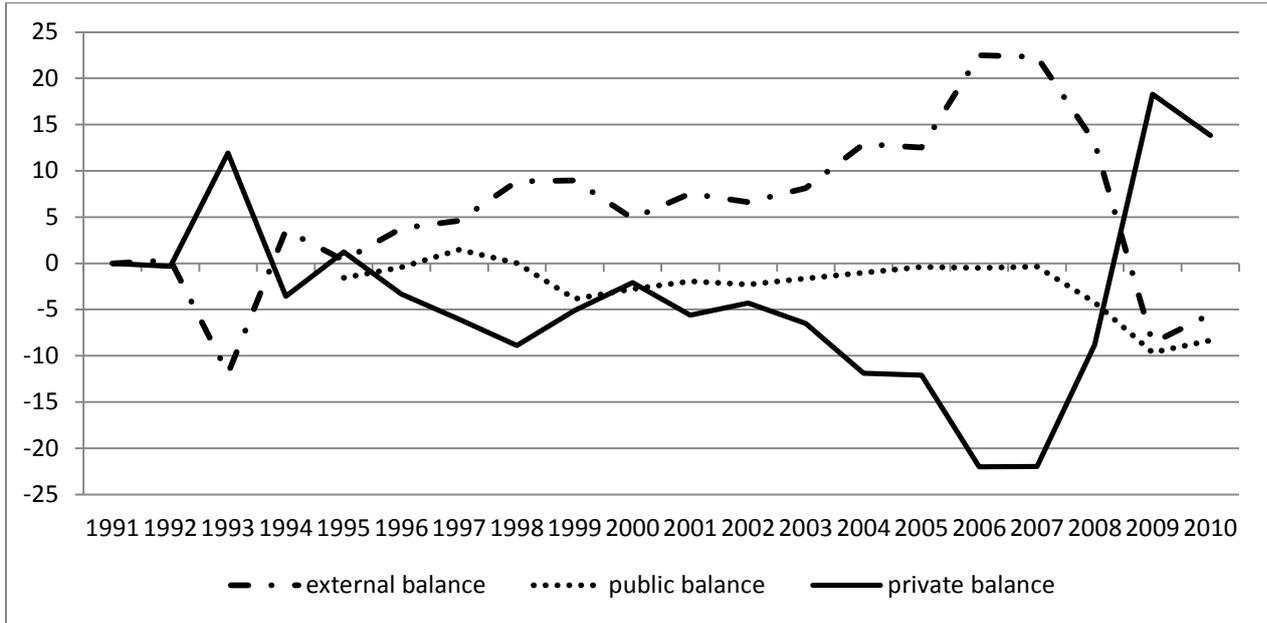
In Latvia there has been an increase in the development of the financial sector which can be confirmed by the availability of credits. As it can be seen from Table 3.2 high credit expansion can be particularly spotted beginning from 2004 onwards. The biggest share of loans belonged to loans to financial corporations and the business sector, but this would change in favour of households. The loans granted to households have had a particularly impressive growth (especially mortgage loans).¹⁸ In this report it is also emphasized that in 2009 even one third of the total mortgage lending was in a foreign currency (ibid. page 128). Hence, the development of the financial balances of the private sector turned negative already in the mid 1990s. The deficits of the private sector had to be financed by capital inflows and hence, the creation of current account deficits. The spending of the government was only slightly higher than tax revenues,¹⁹ approaching zero right before the start of the financial crisis (see Figure 3.4).

¹⁷ In the period 2005-2008, 92% of total assets belonged to the banks and the rest 8% to the non-banks (EBRD 2009:13).

¹⁸ In 2007 the mortgage loans to the households amounted to 34% of GDP (EBRD 2009:186)

¹⁹ In 2007 the budget balance to GDP was minus 0.35% (Ameco 2012).

Figure 3.4: Financial balances of the different sectors (% of GDP)



Source: author’s calculation based on Eurostat

Furthermore, a great relevance for emerging countries is the foreign currency exposure. 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 3.2).

Table 3.2: Loans and deposits of the different actors

	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	650.8	-10.6
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 public enterprises (% of total loans)	5.8	5.2	3.1	2.6	1.7	1.1	2.0	2.7	3.1	3.9	3.2	2.9
out of which in foreign currency (% of public company loans)	60.9	42.0	51.3	49.9	73.8	83.1	94.8	95.5	97.2	98.5	60.2	96.5
Memo item: 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 (index, 2002=100)	100.0	117.8	150.8	202.2	291.3	399.7	449.3	426.9	452.5	472.2	299.7	5.1
out of which 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
Deposits of households (% of total deposits)	53.5	56.6	56.0	57.5	59.7	61.4	59.6	57.2	53.8	52.7	57.4	55.8
out of which in foreign currency	51.2	48.3	41.3	44.4	46.8	48.4	54.9	60.2	60.3	57.9	46.7	58.3
Deposits of private financial and non-financial companies (% of total)	37.2	36.8	37.4	37.0	35.9	33.1	33.7	37.0	38.0	40.1	36.2	37.2
out of which in foreign currency	44.3	36.8	33.0	32.9	38.1	37.2	42.0	49.1	50.9	48.5	37.0	47.6
Deposits of public enterprises (% of total)	9.3	6.6	6.5	5.6	4.5	5.4	6.7	5.8	8.3	7.2	6.3	7.0
out of which in foreign currency	27.0	29.2	15.0	11.1	11.7	10.2	12.2	11.5	18.9	31.2	17.4	18.5

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

As a result of the burst of the bubble in 2008, the balances of the private sector turned positive. As the trust in the domestic currency and the financial system (especially taking into consideration the rise in non-performing loans²⁰) deteriorated and the suspicion for a depreciation of the Lat rose, the private sector increased their demand for foreign currency deposits. At the same time, banks went on giving foreign-currency denominated loans, and a so-called liability-euroization developed (Priewe/Herr 2005:162-163). If we supplement the above-said with the fact that the external debt has also tremendously increased, we can say that euroization has not been far away from Latvia. The high foreign currency liabilities of the government and the households point towards a danger of a currency mismatch in their balance sheet as their revenues are mostly in a domestic currency. The large share of debt in a foreign currency exposes the debtors to the danger of devaluation.

The functionality of the financial system will be checked by looking firstly, at the provision of company credit, particularly in the manufacturing sector. In the case of Latvia we see a decline of the latter. Hence, we can undoubtedly argue that the development of this element of MPR was also dysfunctional. The recommendation is for the government and central bank to join their forces in providing sufficient, affordable finance for the manufacturing sector and securing stability in the financial sector through defining conditions for bank's exposure to foreign capital, setting reserve requirements for different types of assets, and separating banks from other financial institutions.

3.4. Industrial policy

In the Central Eastern European countries the process of de-industrialization and even more, industrial decline that started becoming visible already in the early 1990s was especially pronounced among the Baltic countries. After having built a strong industrial base within the framework of the Soviet Union, starting from 1991/1992 with the crash of the Soviet bloc, the industrial output severely shrank. Even though the industrial production started to increase after 1999, the level of the industrial output from 1992 was not reached until 2006 (Figure A2 in the appendix). Furthermore, employment in the industrial sector increased at a very moderate rate and already in 2007 showed signs of decline.²¹ The exception is the construction sector where the employment has in fact increased at the most which proves the

²⁰ See Table 3.2.

²¹ See Table A1 in the appendix.

fact that there has been a creation of a bubble in the housing market, as well as the stock market as we saw earlier. Latvia is also another example of a boom-bust cycle, which seems unsustainable in the long run (Onaran 2007).

Looking at the import and export structure per sector, we can observe a positive development in a sense that there has been an increase the share of chemical and heavy industry in the total exports (see Table A2 in the appendix). Yet, still due to much higher rise in imports, the trade balance of products in both industries remains negative. Furthermore, the share of high tech exports to the total manufacturing exports is also low in international standards²². In Latvia the contribution of high value added exports in the total manufactured exports was on average 7% between 2006 and 2008. For comparison, in Hungary the former was 24% for the same period (World Bank 2012).

At the same time, we can observe an increase in the value added, especially in the real estate, construction, wholesale, retail trade, transport, accommodation and administrative and support service activities sector (as a result of the rise in the subsector warehousing and support activities for transportation). There has also been a rise in employment, but at a very modest rate and not sufficient to compensate for the employment losses in the manufacturing sector. These subsectors attracted the biggest amount of FDI inflows as well. These are also the sectors with lowest collective agreement coverage.²³

One indicator that shows how active the government's involvement is in creating industrial policy is the government's spending on research and development. From Table 3.3 it becomes clear that the Latvia's government spent the lowest amount of funds for research and development (both as a share of total government spending and as a share of GDP) than the other Central Eastern European countries (CEECs), members of the EU.

Beginning from 2008 we can see a decline in employment and industrial production in the manufacturing sector. Latvia's share of manufacturing output in total output is lower than the average of the CEECs.²⁴ The same is true for the service sector. It is particularly worrisome that the former decreased its spending on R&D in the aftermath of the crisis (the period 2008-

²² High tech industries include: manufacturing of electrical equipment, computers, electronic and scientific products, pharmaceutical products and aerospace (World Bank 2012).

²³ Central Statistical Office of Latvia (2012).

²⁴ Author's calculation based on Eurostat (2012).

2010), while on average the countries in the EU and the rest of CEECs applied an active policy of increasing government funding for R&D.

Table 3.3: Government outlays on research and development in Central and Eastern Europe

	Government outlays on R&D (% of total government spending)		Government outlays on R&D (% of GDP)	
	1995-2007	2008-2010	2004-2007	2008-2010
EU-27	1,54	1,51	0,70	0,75
Euro area-17	1,56	1,58	0,73	0,79
Bulgaria	0,83	0,79	0,29	0,31
Czech Republic	1,18	1,34	0,53	0,58
Estonia	1,14	1,64	0,44	0,69
Latvia	0,59	0,52	0,24	0,22
Lithuania	0,93	0,57	0,34	0,23
Hungary	0,77	0,84	0,39	0,42
Poland	0,82	0,79	0,31	0,35
Romania	0,68	0,82	0,27	0,33
Slovenia	1,16	1,26	0,56	0,61
Slovakia	0,76	0,75	0,27	0,29

Note: data represent averages for the corresponding period. Due to change in methodology in 2007, data about government outlays are only available from 2004 onwards.

Source: Eurostat 2012.

The functionality of the industrial policy can be evaluated by looking at exports of high value-added products and expenditures by the government on R&D. Because of the fact that both have been low, we can say that there has been a dysfunctional development. But, recently there were some good news from the side of the government. Namely, in April 2012 the Ministry of Economics made a proposal for an active industrial policy that would help Latvia have a more sustainable growth (Ministry of Economics of the Republic of Latvia 2012). However, the Cabinet of Ministers still has to approve it and we have to wait and see to be able to judge the outcome of this proposal.

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 local, company level (Eurofond 2011).

At the same time, there are companies where there is no presence of unions, and/or are not members of employers' associations and the wages are set individually by the employer without wage negotiation. Very rarely do wage negotiations take part at industry level (Funk/Lesch 2004:266). There are whole sectors where no employers' associations exist.²⁵ Private firms in the service sector, especially the SMEs tend to avoid becoming members of employers' associations (Eurofond 2009). Extension of collective agreements is possible under the condition that the employers that sign the collective agreement employ at least 50% of the workers in the corresponding sector or produce 60% of the output in the whole sector (Eurofond 2009:6, CesIfo 2012).

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. During the boom period, trade union membership even declined (from 28% in 1995 to 16% in 2007) (Viser 2011).

The area in which trade unions and employers' organizations have an important contribution is setting of 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

²⁵ The employer organization density (i.e. the share of employees employed in firms which are members of an employer association) was 30% in 2009 (Eurofond 2009).

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 for determining the wage development. In Latvia on average for the period 1995-2007 we can see a higher growth of unit labour costs than in the Euro area, and thus, a loss of competitiveness on the side of Latvia (Table 3.4). Yet, between 2000 and 2002 the unit labour costs even marked a decline, as a result of wage increases below productivity.

Table 3.4: Labour market indicators, 1995-2011

	ULC percentage change (Latvia)	ULC percentage change (Euro area)	nominal wage growth	productivity growth	inflation rate	Minimum wage- change (%)*
1995	-1.90	n.a.	8.80	10.60	25.00	n.a.
1996	21.70	2.50	27.30	5.60	17.60	n.a.
1997	9.20	2.60	13.00	3.80	8.06	n.a.
1998	1.10	1.50	6.20	5.10	4.29	n.a.
1999	2.40	1.60	7.50	5.10	2.13	n.a.
2000	-2.20	1.90	7.40	9.60	2.64	13.09
2001	-1.80	2.80	4.30	6.10	2.52	2.03
2002	-1.40	2.20	2.80	4.20	1.95	24.33
2003	5.50	2.20	11.00	5.60	2.94	5.70
2004	6.90	1.00	14.50	7.60	6.19	4.34
2005	16.60	1.60	25.10	8.40	6.90	-3.64
2006	17.30	1.20	23.30	6.00	6.57	12.77
2007	29.30	1.90	35.10	5.80	10.08	33.15
2008	19.90	4.10	15.70	-4.20	15.25	33.48
2009	-7.50	4.20	-12.70	-5.30	3.26	10.61
2010	-9.50	-0.40	-6.00	3.50	-1.22	-0.14
2011	2.20	1.30	4.40	2.20	4.20	11.10
1995-07	7.90	1.90	14.30	6.40	7.45	11.47
2008-11	1.30	2.30	0.40	-0.90	5.37	13.76

*Note: The averages for the minimum wage are calculated for the period 2000-2007 because of a lack of data.

Source: author's calculation based on Ameco 2012.

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 governments of the largest EU economies in order to reduce the budget deficit (Onaran 2011b). 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. What

was achieved was not only wage cut in the public administration, but decline of wages in the private sector as well. Hence, the average wage declined by almost 13% in 2009 and 6% in 2010 and the result was a deflationary development. In 2010 it was decided to cut even the minimum wage (Table 3.4).

Furthermore, collective bargaining coverage dropped to less than 20% in 2009 (Eurofond 2009) and trade union density declined to 14.8% in 2008 (Viser 2011).

The wage norm for stability-oriented wage policy (that wage increases move in line with the productivity development in the medium run and the inflation target set by the central bank) will be the criterion for checking the functionality of the wage development/policy. Wage increases have been above the proposed wage norm on average for the period 1995-2007 (specifically after 2005), but below the norm during the crisis (see Table 3.5). To be able to achieve wage development within the wage norm, which would be a stable anchor for prices too it is necessary that higher wage coordination and involvement of social partners in the collective bargaining process takes place.

Table 3.5 Labour market indicators (% change)

	inflation target	Medium term productivity growth	nominal wage growth	Wage norm	deviation of the wage norm
1995	25.00	4.70	8.78	29.70	-20.92
1996	17.60	4.70	27.34	22.30	5.04
1997	8.06	4.70	12.97	12.76	0.21
1998	4.29	4.70	6.21	8.99	-2.78
1999	2.10	4.70	7.52	6.80	0.72
2000	2.00	4.70	7.44	6.70	0.74
2001	2.00	4.70	4.32	6.70	-2.38
2002	2.00	4.70	2.78	6.70	-3.92
2003	2.00	4.70	11.04	6.70	4.34
2004	2.00	4.70	14.49	6.70	7.79
2005	2.00	4.70	25.07	6.70	18.37
2006	2.00	4.70	23.25	6.70	16.55
2007	2.00	4.70	35.09	6.70	28.39
2008	2.00	4.70	15.72	6.70	9.02
2009	2.00	4.70	-12.72	6.70	-19.42
2010	2.00	4.70	-6.01	6.70	-12.71
2011	2.00	4.70	4.41	6.70	-2.29
1995-2007	5.62	4.70	14.33	10.32	4.01
2008-2011	2.00	4.70	0.35	6.70	-6.35

Notes: ¹⁾ the Latvian central bank does not explicitly have an inflation target. Hence, the Euro zone target of 'close to 2% inflation rate' is taken as an implicit target after 2000. Deviation of the wage

norm shows by how much the actual wage development deviates from the wage norm in percentage points.

²⁾ Wage growth is calculated as a year-on-year percentage change of the nominal compensation per employee.

Source: author's calculation based on Ameco 2012.

3.6. Monetary policy

One crucial institutional change with respect to monetary policy was the creation of 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 rate were liberalised (EBRD 2002:170; EBRD 2003:164).

Very similar to the ECB, the Bank of Latvia set maintenance of price stability as the main objective of monetary policy.²⁶ It is not clear, though, what price stability actually means, as the central bank does not explicitly set nor publish 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.²⁷ 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, 1995-2011

	Inflation rate (CPI)	Nominal refinancing interest rate	convergence to the Euro area*	Real refinancing interest rate	real refinancing rate minus GDP growth	Bond yields	Real long interest rates minus GDP growth	Real long interest rates minus productivity growth
1995	25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
1996	17.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
1997	8.1	4	n.a.	-4.06	-12.4	n.a.	n.a.	n.a.
1998	4.3	4	n.a.	-0.29	-5.09	n.a.	n.a.	n.a.
1999	2.1	4	1	1.87	-1.38	n.a.	n.a.	n.a.
2000	2.6	3.5	-1.25	0.86	-5.27	n.a.	n.a.	n.a.
2001	2.5	3.5	0.25	0.98	-6.37	7.57	-1.51	1.13
2002	2	3	0.25	1.05	-6.18	5.41	-3.48	-0.95
2003	2.9	3	1	0.06	-7.54	4.9	-6.94	-4.04
2004	6.2	4	2	-2.19	-11.05	4.86	-11.42	-7.27

²⁶ Check the website of the Bank of Latvia for more detailed information about the objectives, the structure and the monetary policy instruments of the Bank of Latvia (<http://www.bank.lv/en/about-the-bank-of-latvia/objectives-of-the-bank-of-latvia>).

²⁷ See the website of the Bank of Latvia for more information.

2005	6.9	4	1.75	-2.9	-13.02	3.88	-14.67	-9.25
2006	6.6	5	1.5	-1.57	-12.73	4.13	-12.83	-6.38
2007	10.1	6	2	-4.08	-13.68	5.28	-13.84	-8.94
2008	15.3	6	3.5	-9.25	-5.98	6.43	-5.14	-13.11
2009	3.3	4	3	0.74	18.47	12.36	26.56	4.13
2010	-1.2	3.5	2.5	4.72	5.06	10.34	11.18	6.15
2011	4.2	3.5	2.5	-0.7	-5.2	5.91	n.a.	n.a.
1995-07	7.5	4	0.94	-0.93	-8.61	5.15	-9.24	-5.1
2008-11	5.4	4.25	2.88	-1.12	3.09	8.76	10.87	-0.95

*Note: 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.

Source: author's calculation based on Ameco 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 which supported higher capital inflow. On average, the real interest rate was negative during the boom period which was conducive for investment and credit-driven consumption. That monetary policy during this period was expansionary is additionally proven by the fact that the difference between real short term interest rates and real GDP growth was negative.

In 2009 and 2010 as a result of the decreasing inflation rate in 2009 and deflation in 2010, real interest rates turned positive, which proves the argument that the central bank has very limited space to use interest rates to revive investment and economic growth when there is deflation.

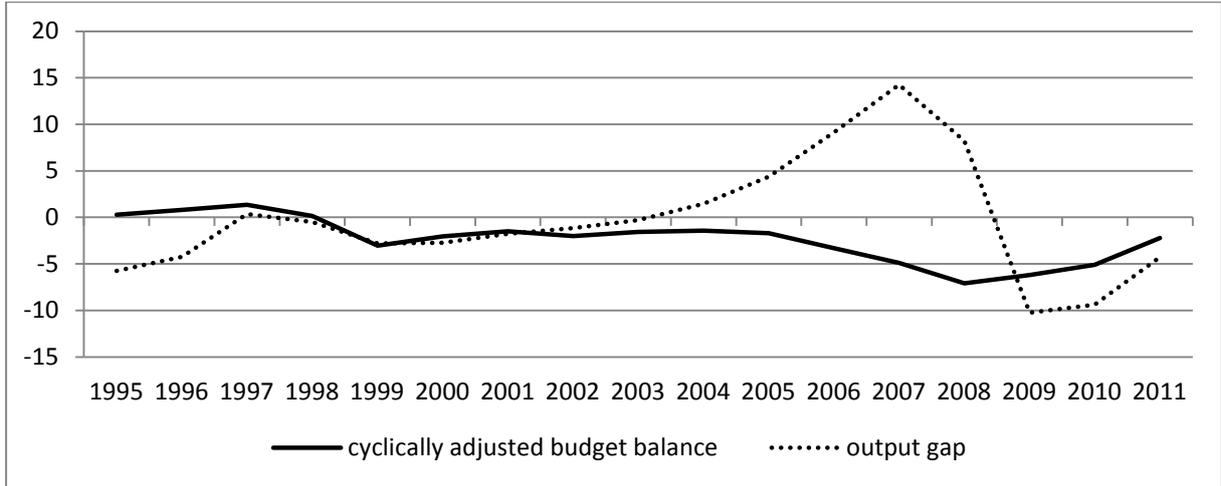
Monetary policy in the model used in this paper is considered functional if it complements the other elements of MPR in a sense of prevention of speculative capital flows and provision of finance. For this purpose, we can look at the development of real long-term interest rates compared to GDP growth. In the period 1995-2007 the monetary policy was expansionary which can be seen from the negative real long-term interest rate/GDP. During the crisis, we observe a restrictive stance. Also the real long-term interest rate started increasing faster than productivity which means a possible change in income distribution in favour of rentiers,

which is not conducive to investment, growth. For this reason, we can argue that monetary policy during the period of crisis was dysfunctional.

3.7. Fiscal policy

The usage of fiscal policy is restricted by the Maastricht criteria and the objective to maintain the exchange rate peg within the agreed margins, under the condition of full capital liberalisation. The budget deficit (except in 1999) stayed below the 3% limit for the budget deficit/GDP and the public debt/GDP was also below the 60% margin set as requirements in the Maastricht Treaty (Table 3.7). However, in order to be able to assess what kind of fiscal policy stance was applied, we need to look at the structural deficit. Figure 3.5 shows that except for the period 1998-2002, in the rest of the years the fiscal policy was moving in a pro-cyclical direction.

Figure 3.5 Structural budget balance and output gap



Source: Ameco 2012, EU Commission 2012b

Especially troublesome was the procyclical stance during the crisis which was promoted by the European Commission (see previous subchapters). As a response to the financial and economic crisis, the government of Latvia implemented a series of cuts in public spending including reduction in public sector wages. The VAT has been increased to 21% in 2012 (Ministry of Finance of the Republic of Latvia, MoF 2012)²⁸. The reduced VAT was increased from 10% to 12%. In 2010 capital gains tax of 15%, capital income tax (on dividends, interest) of 10% and financial stability duty of 0.036%²⁹ were introduced (MoF

²⁸ until 2009 it was 18%.

²⁹ This is to be paid by the Latvian banks, Latvian branches of foreign banks and foreign branches of Latvian banks (European Commission 2012a:9)

2012). The spending of the government on social security benefits has been the lowest in the European Union. On social protection the government spent only around 14% of GDP, while in the Euro area the average was 20% in 2010 (Eurostat 2012). As the government states:

“These fiscal targets³⁰ 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 implement its strategic goal – to adopt the euro as of January 1, 2014.” (The Government of Latvia 2012:4).

Table 3.7 Fiscal indicators for Latvia (1995-2011)

	Public debt	budget deficit	cyclically adjusted budget deficit	output gap
1995	15.15	-1.56	0.29	-5.76
1996	13.93	-0.44	0.81	-4.23
1997	11.11	1.48	1.36	0.36
1998	9.60	0.03	0.17	-0.50
1999	12.47	-3.86	-3.04	-2.80
2000	12.36	-2.79	-2.05	-2.74
2001	14.14	-1.96	-1.51	-1.76
2002	13.60	-2.29	-2.00	-1.16
2003	14.66	-1.62	-1.56	-0.29
2004	14.96	-1.03	-1.43	1.45
2005	12.47	-0.39	-1.70	4.37
2006	10.69	-0.48	-3.30	9.16
2007	9.04	-0.35	-4.90	14.24
2008	19.79	-4.24	-7.10	8.22
2009	36.75	-9.67	-6.20	-10.26
2010	44.70	-8.32	-5.10	-9.37
2011	44.80	-4.20	-2.20	-4.27
1995-07	12.63	-1.18	-1.45	0.80
2008-11	36.51	-6.61	-5.15	-3.92

Source: Eurostat, author's calculations

The ratio structural balance/output gap is the criterion for testing the functionality of fiscal policy. In the case of Latvia, after 2003 the government used procyclical fiscal policy, i.e. after this year we can talk about dysfunctional fiscal policy in Latvia.

The recommendation is that the government firstly allows for automatic stabilizers to work. Moreover, it should get involved in a direct job creation (because of the problem of low

³⁰ 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).

employment even in the growth phase). In addition, discretionary fiscal policy is strongly recommended especially because governments in emerging countries still need to undertake public investment in infrastructure and provision of public goods, necessary for higher and more socially and ecologically sustainable growth. To reduce income inequality, progressive taxation, inheritance tax and higher spending on social programs need to be a part of the government's agenda.

4. Conclusions

The analysis of the macroeconomic policy regime in Latvia can serve to a certain extent as a benchmark for examination of other small emerging countries that are approaching the EMU membership. Adhering to Maastricht criteria, means limitation in the usage of active fiscal policy. Liberalisation of foreign trade, financial and labour markets is also on the agenda of the EU Commission. Therefore, more than ever it is important that emerging countries which are at a lower level of economic development and wish to join a currency union, to sustain their competitiveness through an active industrial policy. Capital controls need to be brought back in the debate about macroeconomic policy management of the new member states. There ought to be regulations regarding the specific capital inflows and outflows because as also elaborated earlier, the negative consequences of dollarization/euroization are manifold.

Overvalued exchange rate, high external debt, increased foreign currency deposits and loans, and loans directed towards non-tradable sectors put the financial system and the whole economy in a great danger. Sacrificing external balance for higher economic growth is not a sustainable strategy in the long term, as the increase in growth creates a need for further increase in imports which deteriorates the balance of payments further and poses problems for sustaining the economic growth.

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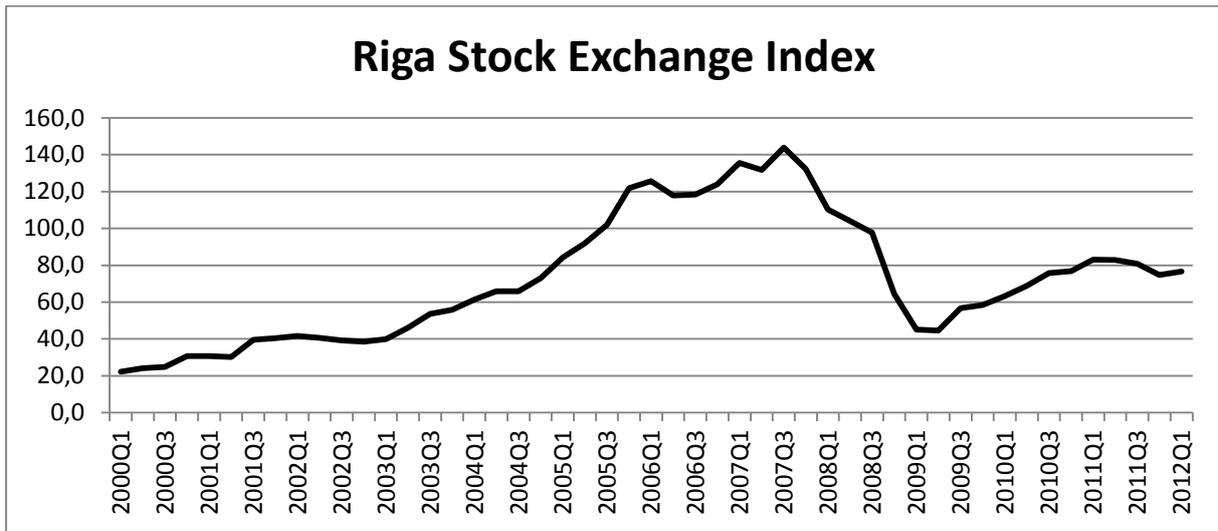
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Appendix

Figure A1: Stock exchange development, 2000-2012



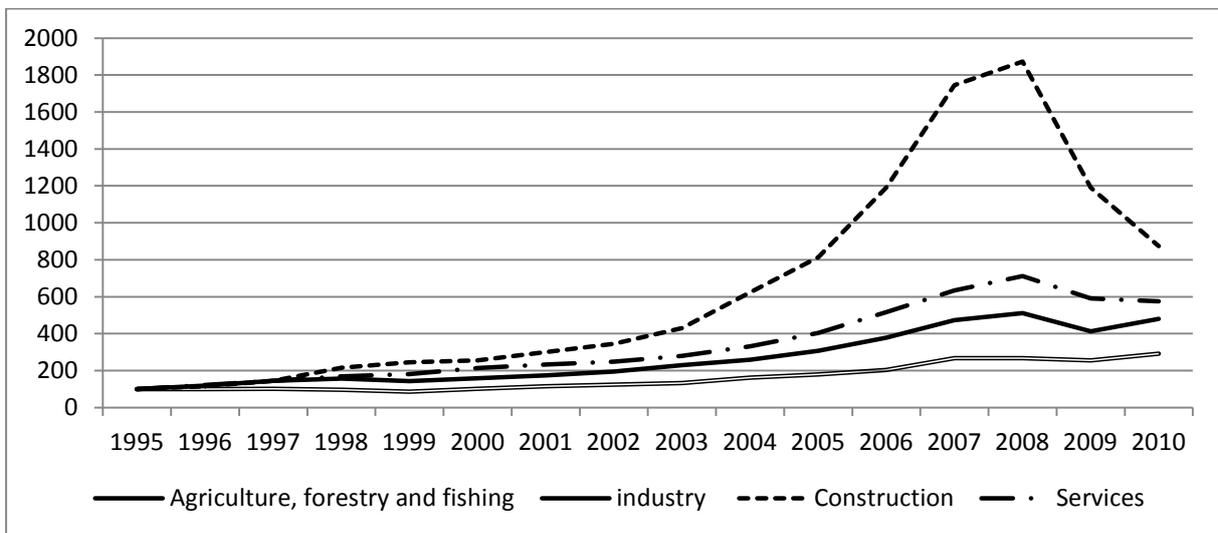
Source: Eurostat 2012

Table A1: Employment per sector (index, 2000=100)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2000-07	2008-10
Total	100.0	101.2	104.2	106.2	107.5	109.2	114.5	118.7	119.8	104.0	99.0	107.7	103.4
Agriculture, forestry and fishing	100.0	103.0	108.1	100.9	99.2	86.7	89.0	78.6	66.7	63.3	61.3	95.7	62.1
Industry (except construction)	100.0	100.7	104.3	105.2	100.7	100.9	102.1	99.8	98.9	82.2	82.9	101.7	84.6
Manufacturing	100.0	100.7	105.6	106.5	101.9	102.0	103.6	101.0	98.0	79.6	80.2	102.7	82.5
Construction	100.0	116.3	105.2	132.9	152.4	161.7	182.8	226.1	229.9	140.8	113.4	147.2	147.5
Services	100.0	99.5	103.2	105.2	107.3	112.0	118.0	123.7	128.3	117.2	111.8	108.6	119.1

Source: author's calculation based on Eurostat 2012

Figure A2: Output growth per branch (index, 1995=100)



Source: author's calculation based on Eurostat

Table A2 Exports and imports per commodity

	Exports growth	Imports growth	Differential	share in total exports (1995-2007)	share in total exports (2008-2010)	share in total imports (1995-2007)	share in total imports (2008-2010)
Light industry	12.7	13.2	-0.5	67.9	52.9	44.5	46.8
Live animals and animal products	16.7	28.0	-11.3	2.8	4.1	2.1	3.4
Vegetable products	33.6	22.8	10.8	1.2	5.6	3.2	4.2
Fats and oils	55.7	24.2	31.4	0.1	0.3	0.8	0.8
Prepared foodstuffs	17.4	21.5	-4.1	7.2	7.8	6.2	7.7
Mineral products	30.6	10.0	20.6	3.4	5.2	13.6	16.0
Raw hides, leather	4.8	15.9	-11.1	0.8	0.3	0.4	0.3
Wood and articles of wood	20.1	35.1	-15.0	30.1	17.4	1.7	1.6
Pulp of wood; paper and paperboard	23.3	23.4	-0.2	2.2	1.8	3.8	2.7
Textiles	6.5	16.0	-9.5	12.8	4.9	6.7	4.5
Footwear	6.2	13.7	-7.5	0.4	0.3	0.8	0.9
Articles of stone, plaster, cement, glassware and ceramic products	16.0	20.2	-4.3	2.0	1.9	2.4	2.0
Miscellaneous products	11.5	22.3	-10.8	4.9	3.2	2.8	2.6
Works of art	340.4	88.1	252.3	0.0	0.0	0.0	0.0
Chemical industry	15.6	20.1	-4.5	7.9	11.1	14.8	16.1
Chemical products	13.7	18.5	-4.8	6.3	8.1	10.1	10.9
Plastic and rubber articles	26.0	24.9	1.1	1.7	3.0	4.6	5.1
Heavy industry	14.8	20.0	-5.2	24.0	35.5	40.7	36.7
Precious, semiprecious stone and metals	16.7	37.6	-20.9	0.3	0.2	0.3	0.3
Base metals	17.6	24.1	-6.4	11.8	14.3	8.4	9.5
Machinery, mechanical app.; electr. equipment	18.3	20.8	-2.5	7.9	13.2	20.0	16.8
Transport vehicles	14.2	19.4	-5.2	3.3	6.8	9.9	8.1
Professional products	20.0	22.0	-2.0	0.8	1.0	2.0	1.7
Arms and ammunition	167.0	40.5	126.5	0.0	0.0	0.1	0.2
Other goods	40.5	47.0	-6.6	0.2	0.4	0.0	0.4

Source: author's calculation based on the database of the Central Statistical Office of Latvia.

List of abbreviations

CEE	Central Eastern Europe
CEECs	Central Eastern European countries
ECB	European Central Bank
EBRD	European Bank for Reconstruction and Development
IMF	International Monetary Fund
LV	Latvia
R&D	Research and development