Opening Address by Ilmārs Rimšēvičs, Governor of the Bank of Latvia, at the annual Bank of Latvia Conference "Latvia beyond the Crisis: Towards Sustainable Economic Growth"

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Ladies and Gentlemen,

It is a real pleasure to welcome you today at the annual 7th conference organised and hosted by the Bank of Latvia. The number seven has been endowed with a symbolic meaning from times immemorial; for many, this number has served and continues to serve as a reference or a starting point for some creative endeavour. There are seven days in a week, and the rainbow boasts of seven colours. Similarly, for the seventh year now Latvia is a Member State of the European Union. This period of seven years has, to some extent, been a cycle of wasted opportunities for Latvia. In its attempts to attain the goal of converging, with every coming year, towards the wealthiest and most prosperous EU countries, Latvia made a serious mistake by opting for one of the most simplistic policies of "full-speed ahead", which failed Latvia and made it go from boom to bust.

At the very first conference hosted by the Bank of Latvia seven years ago, the focus was on **how to lay foundations for a dynamic and at the same time sustainably balanced economic growth** leading to an even deeper integration with the common European market and gradually growing and lasting welfare of the nation.

It took some time for this focus to be acknowledged, however, because the idea of catching up with the European welfare states in a short period of time was so enticing! Alas! Four to five years passed, and the enlightenment came with almost zero budget revenue accumulated and the domestic economy slowing down; but, as the saying goes – it never rains, but it pours: the global financial crisis struck and, in order to fend off even more serious trouble in the banking sector and the economy at large, the country was forced to bail out the second largest bank of Latvia. What followed afterwards, including the need to borrow from the European Commission and the IMF as well as from our neighbours, here in Latvia knows everybody.

Soon after the accession of Latvia to the European Union, the Bank of Latvia, having noticed the signs of economic overheating to surface, put the instruments at its disposal to work – the interest rates were gradually raised and, afterwards, the minimum reserve requirement for commercial banks was increased, simultaneously appealing to the government to reduce the budget deficit and to accumulate a surplus reserve, to introduce a lending tax, to push up property registration fees, and to introduce a capital gains tax. Warnings about the emerging signs of overheating, among them inflation hikes and the formation of the real estate price bubble, were voiced at the Bank of Latvia conference as well.

In the meantime, contrary to the economic logic, the public was sustained on the promises of “seven fat years”. These promises only aggravated the already exaggerated future income expectations. Along with the financing for commercial banks, enormous amounts of funds were injected into the economy via boosted budget expenditure –, raised wages and salaries, additional boosts to domestic demand, structural undermining of the economy, and increasing weakening of competitiveness.

The previous seven years made many believe that we were catching up with the European welfare states at a high speed. Today it is obvious that these seven years were wasted in an economic merry-go-round. Indeed, the years have been used wastefully and the time has passed in vain hopes. In terms of economic progress, the country now stands almost in the same starting positions as prior to the accession to the EU. Consequently, economic policy agenda has rebounded to the issue of seven years before: **how to ensure sustainable economic growth in the future.**

When around two years ago the global financial situation aggravated and uncertainty heightened, devaluation remedy was prescribed for Latvia as the primary instrument to fight the crisis. It was argued that it would painlessly lead to the regaining of competitiveness and, likewise, would support the economy in times of downturn. However, the expertise of the Bank of Latvia and those who had some knowledge of the Latvian economy suggested that **the only way to make competitiveness improvements irreversibly sustainable**, without forcing the economy to plummet even deeper, was solely a gradual cutting of expenditure to achieve high correlation between spending and the income earned; it was the auditing of functions, **the implementation structural reforms**.

Sceptics argued that such policy implied a protracted recession; their predictions notwithstanding, Latvia has quickly returned on the path to recovery. Meanwhile, the international lessons of the crisis teach that via **devaluation one cannot attain prosperity**: one of the latest researches published this summer by the IMF reveals that during the recent crisis the countries with fixed currencies were doing neither better nor worse than the countries with floating currencies. The future forecasts signal rather irrefutably that countries with fixed exchange rates will certainly report higher growth than the ones with the floating exchange rate.

Speaking about Latvia, positive GDP changes have been recorded in the first two quarters of the current year. Moreover, the economy is much stronger structurally and, with the ongoing reforms successfully accomplished, ready to step back onto the path to sustainable recovery in the near term. The current buoyant upswing in production and exports along with the expanding export market shares testify to noteworthy improvements in competitiveness. It is of paramount importance! The turnover of goods exports in the year to August has increased by 44%. The growth in manufacturing is measured by a two-digit indicator, with the annual increase in August at 20.4%. The unemployment rate, although still soaring high, has started on a downward trend, with registered unemployment dropping for the sixth consecutive month and standing at 14.6% of economically active population at the end of August.

The Latvian government has accomplished a good work of stabilising the economy during the crisis; it has earned international recognition and even admiration on behalf of the captains of large sea-going vessels surrounding Latvia, a small boat in the global economic waters. The only thing we could regret is the need for the government to act and carry out structural reforms and optimise the public sector in the crisis situation; if it had happened in the expansion phase, economic overheating would have been curbed and fiscal policy instruments in support of the declining economy would have been enhanced

Today's conference is dedicated to quite a practical theme – from crisis to sustainability. A short while ago, Latvia suffered from the loss of competitiveness, which has been irrefutably restored in the course of the past year or year and a half owing to the government's consistent activities in implementing the anti-crisis programme. Nevertheless, the Latvian success story has not been written to the end as yet, and the fate of regaining competitiveness will be decided along with the adoption of the budget for 2011: the country has entered the concluding phase of large expenditure cuts. Peace and quiet currently ruling the Latvian financial markets is a delusion; the still large credit default swap spreads, albeit now contracting somewhat, and Latvia's extremely low credit ratings imply that the investors' are very carefully watching the developments in Latvia and their focus is on the budget for 2011.

Latvia, as a small and open economy, depending on exports and investments, **should take greater care of its image and credibility than the large economies**. I believe we all know that credibility or trust can be gained when it is perfectly clear that an economy is reducing its excessive spending compared to revenue, as well as the huge debt. If we are credible, we get lower interest rates on our external debt, hence more money can be used for the development of the economy.

As we can see from our own experience and that of other European countries, the commitment to consolidate the budget as per revenue implies credibility, while lack of such commitment means the opposite. Thus, without cutting expenditure, Latvia's ratings that are the green light to lending, investment, business expansion, as well as reduction of the sovereign debt would never be upgraded. To ensure Latvia's financial sustainability, we need at least one more budget consolidation in the amount of 400 million lats. Moreover, the consolidation has to be achieved by cutting expenditure rather than raising taxes. Should we choose to raise taxes, we would dig the crisis pit even deeper and risk becoming a country with economic stagnation lasting for years and years.

In such a case, economists would no longer call us "another Argentina", a phrase somebody might be quite pleased to hear (actually he would be really glad if something like that happened!); they would rather name us "another Portugal" who has also tasted the bitter cup of stagnation to the dregs with all respective consequences some time ago: growing unemployment, grey economy, decreasing amounts of collected taxes, price rises, lower income and ever increasing external debt. The competitiveness of companies and the Latvian economy, having recovered as a result of difficult decisions, would also deteriorate. Thus, right now Latvia has an opportunity to choose its way.

Therefore it would suffice to say the level of 6% of the deficit, the target rate for the next year, is the very minimum the government has to achieve. If the global economic uncertainty turns out to be less pronounced and the Latvian economy grows more rapidly, that would imply a chance to achieve a more accelerated and higher-level fiscal consolidation than expected before. No doubt, such opportunity should be definitely made use of.

Consistent reduction of budgetary expenditure will ensure a possibility to repay the accumulated debts on reasonable interest rates on the due date for refinancing the loan granted by the international lenders in the market. If the refinancing is performed in balanced budget conditions, Latvia will be able to refinance the debt without difficulty and at a much cheaper rate. However, if the refinancing is carried out under persistently excessive budget deficit conditions, we might experience unpleasant surprises, given the still low confidence level of foreign investors. And it is no abstract budget that is going to suffer – it will be each sector of the economy, each person, and each and every group of the population. I would like to point out [*Chart*] that for debt servicing Latvia will spend 270 million lats this year and 300 million lats next year. This money could be channelled into heating the Latvian economic development; at this stage, alas, it is just wasted.

Finalising the fiscal policy issue, I would like to stress that we should also be aware of the fact that **maintaining the budget deficit, which is very high in Latvia, continues to be a drag on Latvia's economic growth**. The expectations based on certain theories that the budget deficit might stimulate the "heating" of the economy unfortunately have not come true. With a high level of budget deficit and an uncertainty as to its reduction persisting, the banking sector, as we can see it also in Latvia, is not resuming lending: each day banks store excess liquidity in the amount of 1 billion lats with the Bank of Latvia, and it is quite obvious that they are literally waiting for the budget for 2011; Latvia's assessment by investors is not improving – the low ratings testify to that; and the population is cutting its spending, both feeling and understanding that the consequences of the deficit policy will be unfavourable for the economy and might trigger raising of taxes in the future, hence people try to save additional money for a rainy day.

Ladies and Gentlemen!

As we can see, there is still a lot to do to improve the economic sustainability in Latvia, and I do hope today's conference will increase awareness of these processes. I do hope that the speakers at the conference – our guests from far and near – will enable us to see through the everyday routine and problems and look at the developments of the

Latvian economy in the European context, namely, what the road to crisis has been like elsewhere in Europe, how Europeans have fought against it, and what should we take into account in the future when making economic policy decisions.

The Conference conclusions will hopefully reduce excessive illusions in Latvia – I would even call them dangerous illusions – that at this stage a larger budget deficit could help Latvia sooner achieve accelerated growth and welfare.

I do hope today we will strengthen the awareness that our ability to prevent long-term stagnation will depend on the soundness of decisions taken when cutting budget expenditure in the remaining rounds.

I expect that this time policy makers will listen to the Bank of Latvia's opinion and the mistakes of 2005–2008 will not be repeated. And, learning the lesson from our neighbours Estonians, we will have written a new book on how a small economy, pursuing reforms and optimising its spending reasonably, has been able to recover in a short time, create new jobs, increase tax revenue, and ensure sustainability and undoubted growth.

Ladies and Gentlemen!

May our work in this conference be rich in discussions and conclusions. It is nobody else but us who are able to address and resolve the issues and challenges faced by the Latvian economy.

I am really happy now, looking back and comparing the atmosphere and the mood two years ago when the global crisis reached Latvia and I was not really sure if we could manage to pull through. Today the situation is absolutely different! However, there is but one detail that we should bear in mind: in this final stage of recovering the economic sustainability we cannot make another mistake.