



6 June 2008

## Macroeconomic policy

### 1. Executive Summary

The Foreign Investors Council in Latvia (FICIL) would like to note that macroeconomic conditions in Latvia have changed very significantly since the previous High Council meeting in June 2007. Although inflation is high and has even increased during the year, Government has used tools at its disposal to lead the economy towards comprehensive stabilisation — reduction of both internal (inflation) and external imbalances.

It is too early to suggest a macroeconomic policy that is oriented towards supporting growth but such a need might arise in near time. However, efforts to stabilise internal demand should not reduce the determination to carry out supply side reforms that are crucial for productivity growth and sustainable long-term development of the economy.

### 2. Recommendation/Suggestions

1. Given the high uncertainty about macroeconomic trends in Latvia for the rest of 2008 and 2009, fiscal policy will inevitably need to adapt to changing environment. We think that the current policy stance is appropriate but we also call the Government to be open-minded and be ready to support growth in case economic situation deteriorates significantly.
2. FICIL believes that in current circumstances the successful absorption of EU funds becomes even more important. While there were worries during the excessive growth period that EU funds could contribute to economic overheating, there is no ground for such attitude any more, rather to the contrary, EU funds now can only play a positive macroeconomic role.

### 3. Rationale

Although there is still a chance that Latvia's macroeconomic situation will develop according to the soft landing scenario (defined here as GDP growth slowing down but not turning into contraction), the current trends are indeed a cause of very significant concern and require both decisive and sophisticated policy response.

Reversal of previous trends in consumption and investment has been more abrupt than most experts predicted. Investment was already close to recession in Q4, 2007 and is almost definitely shrinking at the moment. If there is any growth in private consumption right now, it is very small, the latest retail trade data for March and economic sentiment surveys suggest that the downward trend still has at least some way to go.

Export performance has surprised on the positive side in H2, 2007 and early 2008. However, there are doubts both about the reliability of statistical data and the ability of exporters to sustain the current performance, whatever it is, in the face of global slowdown, especially as it has turned

out recently that its overall impact on EU economy will be stronger than previously thought. These circumstances make even the latest downward-revised forecasts of the Bank of Latvia: 5% GDP growth in 2008, to look very optimistic, especially in the light of the 3.6% preliminary yearly GDP growth estimate for Q1, 2008 by the Central Statistics Office. Although this number might still be revised, it is very credible, given that there has been a contraction in retail and manufacturing. As that the economy is on the downward trend, it is extremely unlikely that the GDP growth for 2008 as a whole will exceed that of the first quarter. If the 5% growth is achieved then one will be able to say that the country has sailed through very dangerous seas in an amazingly successful fashion.

We recognize that in the current situation Government has to handle two at least partially contradictory tasks — (1) creating macroeconomic conditions conducive to structural reforms required for increasing the long term growth potential and (2) supporting economic activity to avoid the deepening of downward spiral in internal sector. Here we address both of them in turn.

### **Decisive supply side reforms for long term growth prospects**

Excessive attempts to protect purchasing power both from the effects of economic overheating in Latvia in 2006-2007 and global energy and food price rises would seriously damage the long-term growth potential. Significant adjustments are required both after unsustainably rapid income growth in the previous boom years and in the face of tightening supply-demand balance of important global commodities. According to the official statistics, real wages increased by ca. 20% in 2007, which was far ahead of productivity growth. Although the convergence of living standards in Latvia towards EU average levels and even exceeding them is a highly desirable long-term goal, this process can't run ahead of fundamental improvements in Latvian economy or there will be very unpleasant long-term consequences. All social groups in Latvia have to understand that wage rises to which they have grown accustomed for the previous couple of years have to slow down significantly for a while. Even a temporary decline of purchasing power might need to be accepted, if global energy and food prices stay high or continue to rise.

We will not discuss here in detail the specific structural reforms required, leaving that for more detailed discussions and consultations, moreover, we believe that there is a broad consensus between FICIL and Government on those issues. However, it is absolutely necessary to point out the importance of incentives to economic actors that are largely shaped by macroeconomic conditions. During the period of economic overheating the incentives were skewed in favour of local market. Though this was a very profitable short-term policy for many companies, it is not sustainable long-term strategy for the country as a whole as productivity growth requires increasing specialisation that in most industries is not possible within the local market. Therefore the economy should be allowed to slow down even though this process may be unpleasant for some companies and individuals. Internal demand growth trend had to change, entailing a pause in the rise of consumption, to reorient the economy towards external markets.

### **Preventing excessive contraction of internal demand**

A sharp slowdown or even a mild contraction of internal demand is compatible with continuous GDP growth. However, if due to mutually self-reinforcing decline of confidence, consumption, business revenue, employment and labour income a deep downward spiral emerges in the internal sector, export growth will not be able to outweigh these effects and the whole economy will slip into recession. Although this is not our baseline scenario, the risks of such developments are not negligible.

Currently the Government maintains the stance that 1% of GDP budget surplus goal for 2008 is still on the agenda even in the changed circumstances and expenditures might need to be cut. We think that this public position should be maintained to assure financial markets. However, it has to be reminded that the budget surplus goal was initially intended as a countercyclical measure in the circumstances of economic overheating. The abrupt change of economic trends has turned this goal into what will most likely be a pro-cyclical measure, i.e., one deepening the downturn. It has to be reminded that one of the factors ensuring relative macroeconomic stability in developed countries since the Second World War has been allowing the so-called automatic stabilisers to work during downturns, i.e., accepting the temporary deteriorations of fiscal position due to falling tax revenues, increasing unemployment benefits etc.

Not only excessive attention to short-term GDP growth and failure to implement supply side reforms can damage long term growth prospects but also very deep downturn. Such scenario would lead to the abandonment of even sound investment projects in internal sector, bankruptcy of fundamentally healthy enterprises leading to an unemployment spike, business disruptions and a new emigration wave.

At the same time, Government should not soften the impact so much as to create an illusion for companies and individuals that there is no need to change their strategies. We repeatedly emphasize that this will be a very complicated balancing act<sup>1</sup> and stand behind Government in its effort to steer the economy through this very difficult period.

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<sup>1</sup> A good example of policy that satisfies both objectives would be tougher energy efficiency requirements. It is a well known fact that insulating houses in many circumstances is financially advantageous to the owner regardless of the positive environmental impact. However, according to research reported by The Economist (*The Elusive Negawatt*, issue of May 9, 2008, [http://www.economist.com/displaystory.cfm?story\\_id=11326549](http://www.economist.com/displaystory.cfm?story_id=11326549)) people tend to act irrationally, demanding unreasonably short payback periods from energy efficiency investments, about 2-3 years. In Latvian circumstances the problem is compounded by inability of residents in multi-apartment houses to agree among themselves. Therefore, such measures could be made mandatory, starting with the worst-performing buildings and in the event of failure to fulfil these requirements, efficiency improvements could be ordered by public authorities and later charged to the owners.

This policy would achieved multiple objectives: (1) stimulate demand for construction services, (2) reduce the imports of energy thus lessening the economy's sensitivity to fluctuations of energy prices (3) in the long run save the resources of residents, increasing their spending power.