Latvia's Economic Potential: Recovery and Reforms

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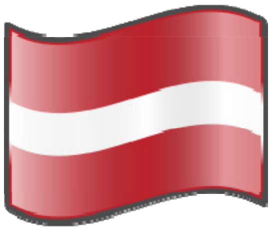
Background



- Latvia is a strong reformer – and has needed to be
- Latvia is recovering well from the 2008-09 crisis – but challenges remain, especially high unemployment
- As elsewhere, future economic growth will be in a context of macro policy constraints
- How then to improve growth rates, but sustainably?

Outline of presentation

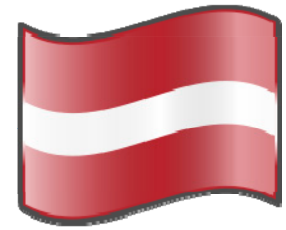
- Latvia and the EU-IMF-supported program (*Ex Post Evaluation*)
- The current IMF view on Latvia (*2012 Article IV Consultation*)
- Latvia's microeconomic reform challenges *(Selected Issues*)

-> all three reports available on www.imf.org

Role of the IMF

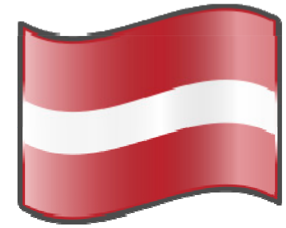
- Lending for balance-of-payments needs
- Surveillance (monitoring and consultation)
  - Bilateral (“Article IV”): for all 188 members
  - Multilateral, including World Economic Outlook
- Technical assistance
  - Fiscal sector (e.g. tax administration, public financial management); monetary and financial sectors; statistics; and related areas

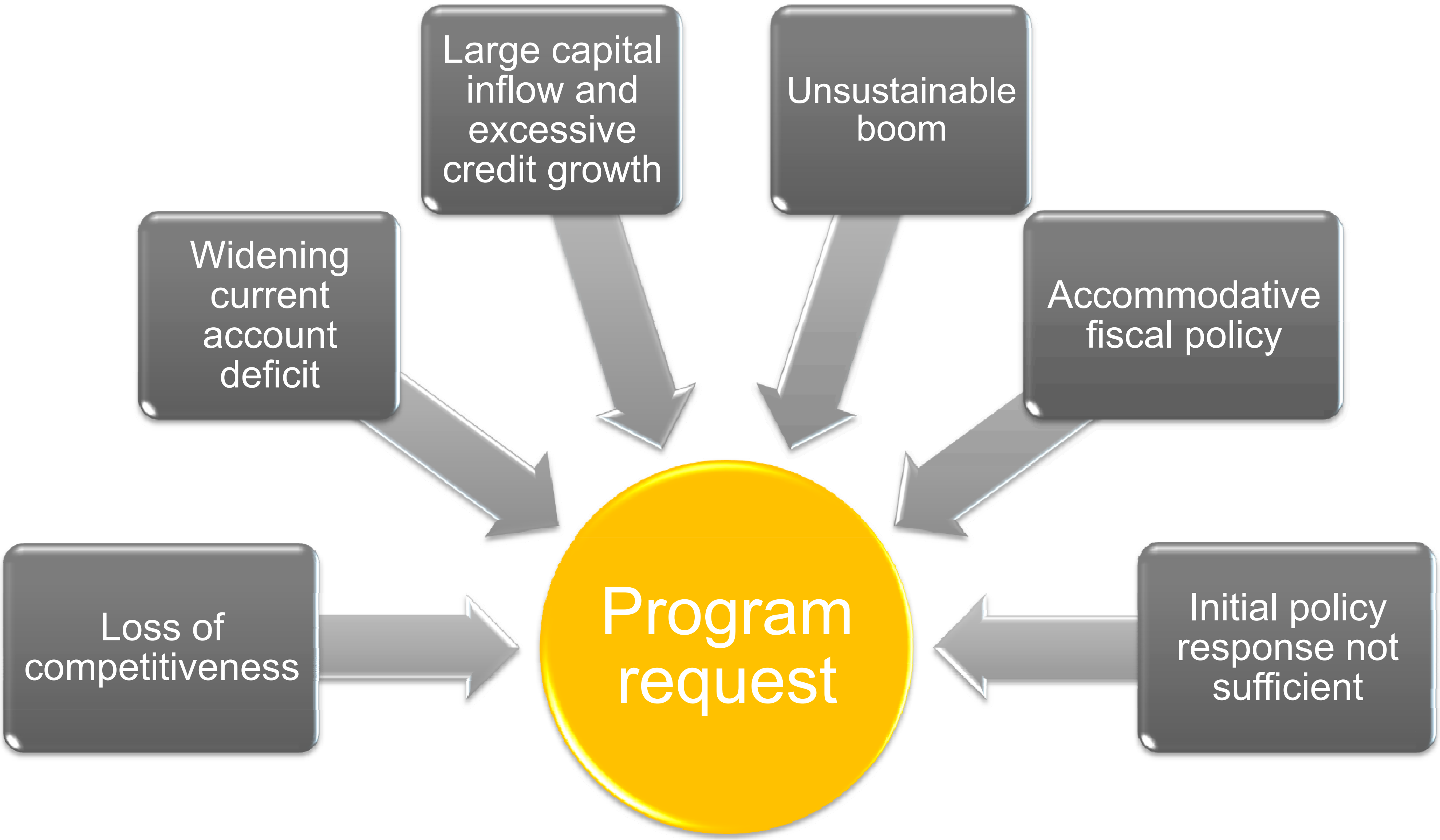
International support for Latvia



- Rapid international response to 2008 crisis
  - €7.5 billion available to Latvia; €4.5 billion drawn
- IMF one of several contributors:
  - EC: €3.1 billion package; €2.9 billion disbursed
  - IMF: €1.7 billion “Stand-By Arrangement” (SBA); €1.1 billion disbursed
  - Nordic governments: €1.8 billion (precautionary)
  - Others: €0.9 billion made available; Latvia drew from World Bank (€0.4 billion) and EBRD (€0.1 billion)
- IMF Board approved SBA in December 2008; later extended SBA to December 2011

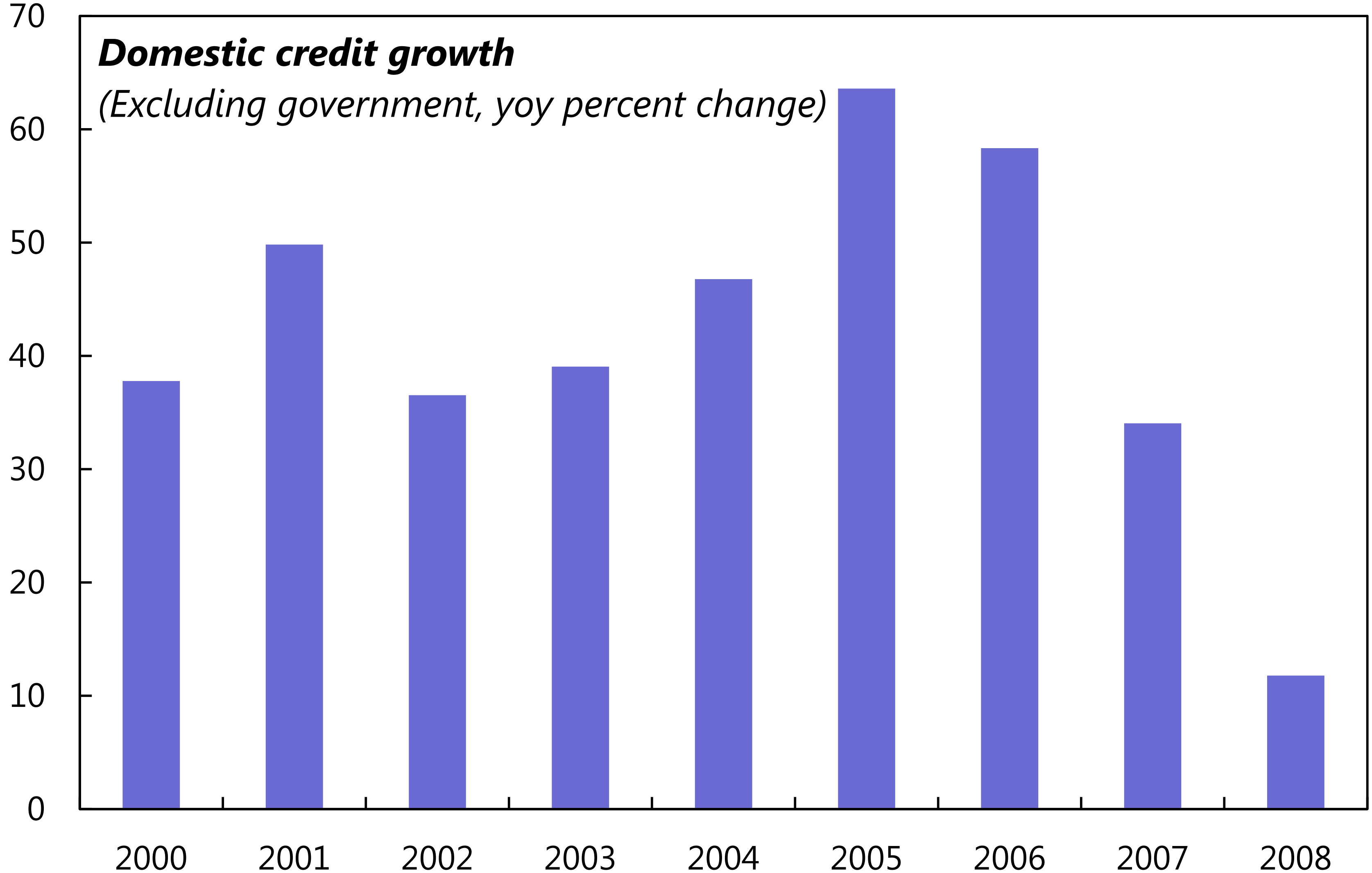
Vulnerabilities in 2008





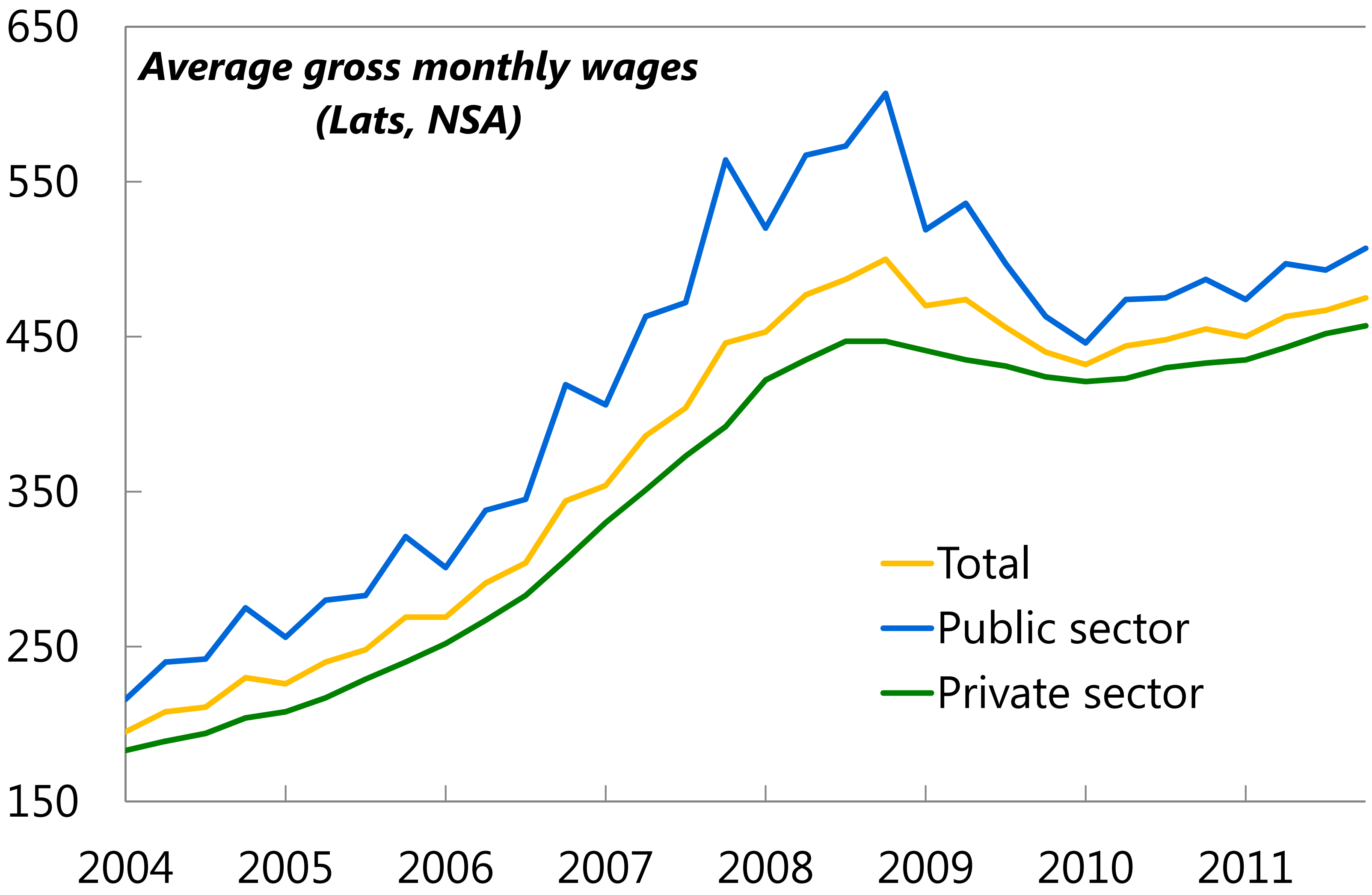
Origins of the crisis (1)

Inflows from abroad contributed to a lending boom



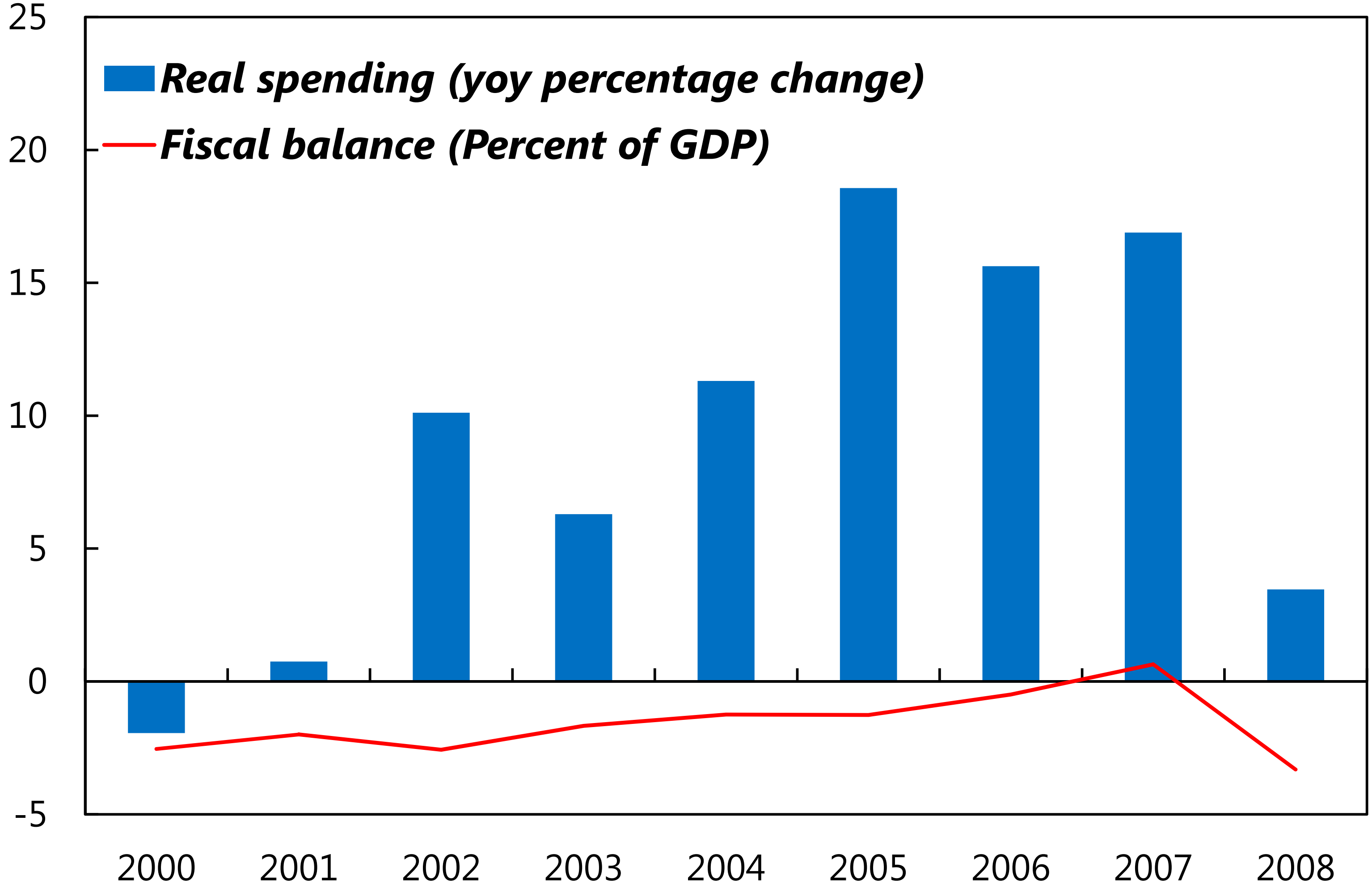
Origins of the crisis (2)

Pre-crisis, wages increased by 20-30 percent a year, eroding competitiveness



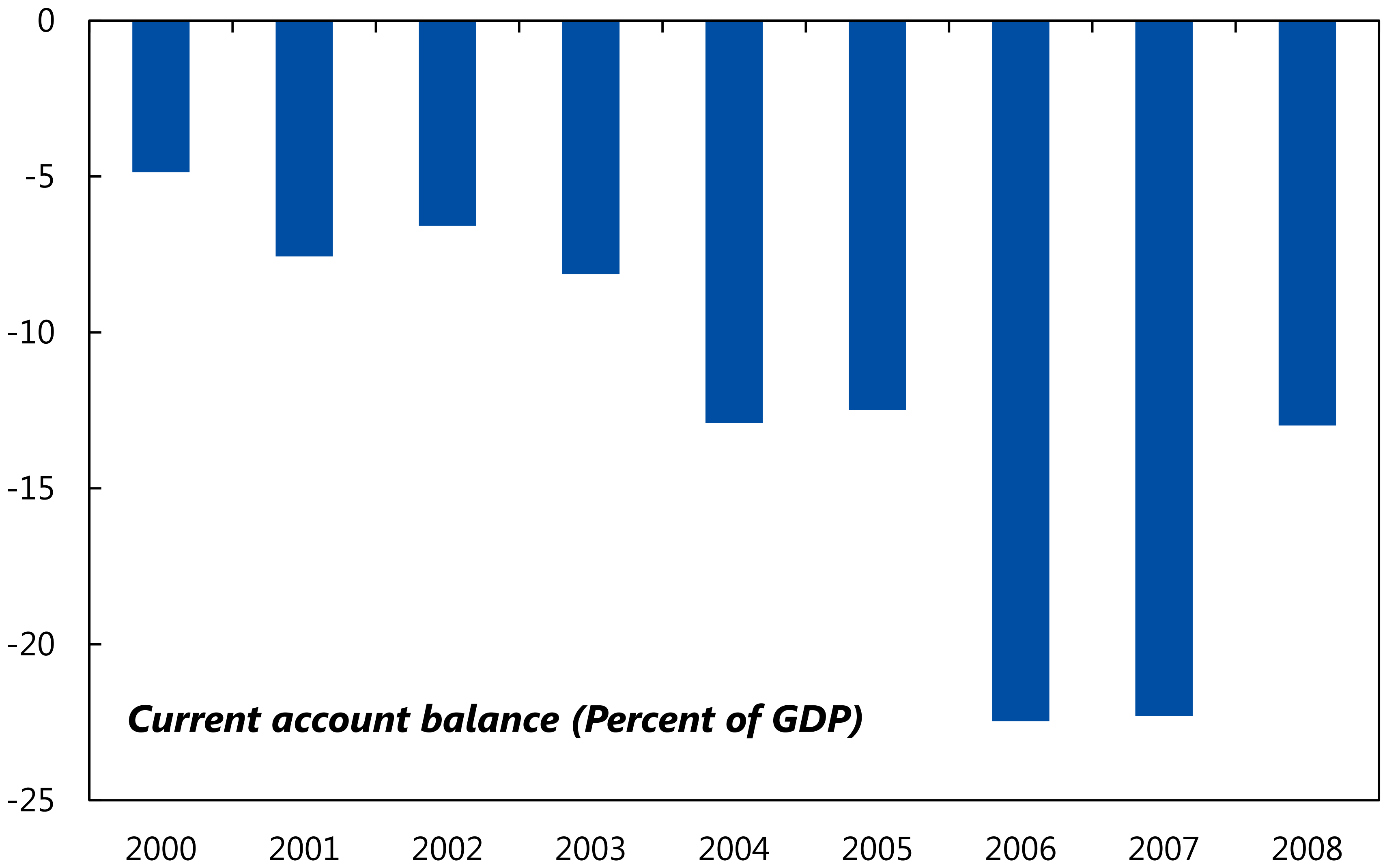
Origins of the crisis (3)

Cyclically strong revenue kept fiscal deficits low while real spending increased …

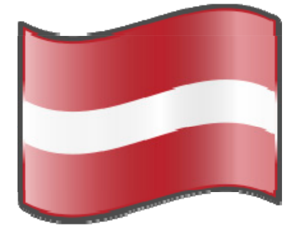


Origins of the crisis (4)

… and the current account deficit worsened to more than 20 percent of GDP



Latvia’s decision to keep the peg



The strategy of maintaining the peg and relying on internal adjustment was debated widely and extensively

Why the peg stayed

- Program ownership
- Devaluation would have had large balance sheet effects
- Spillovers may have been large

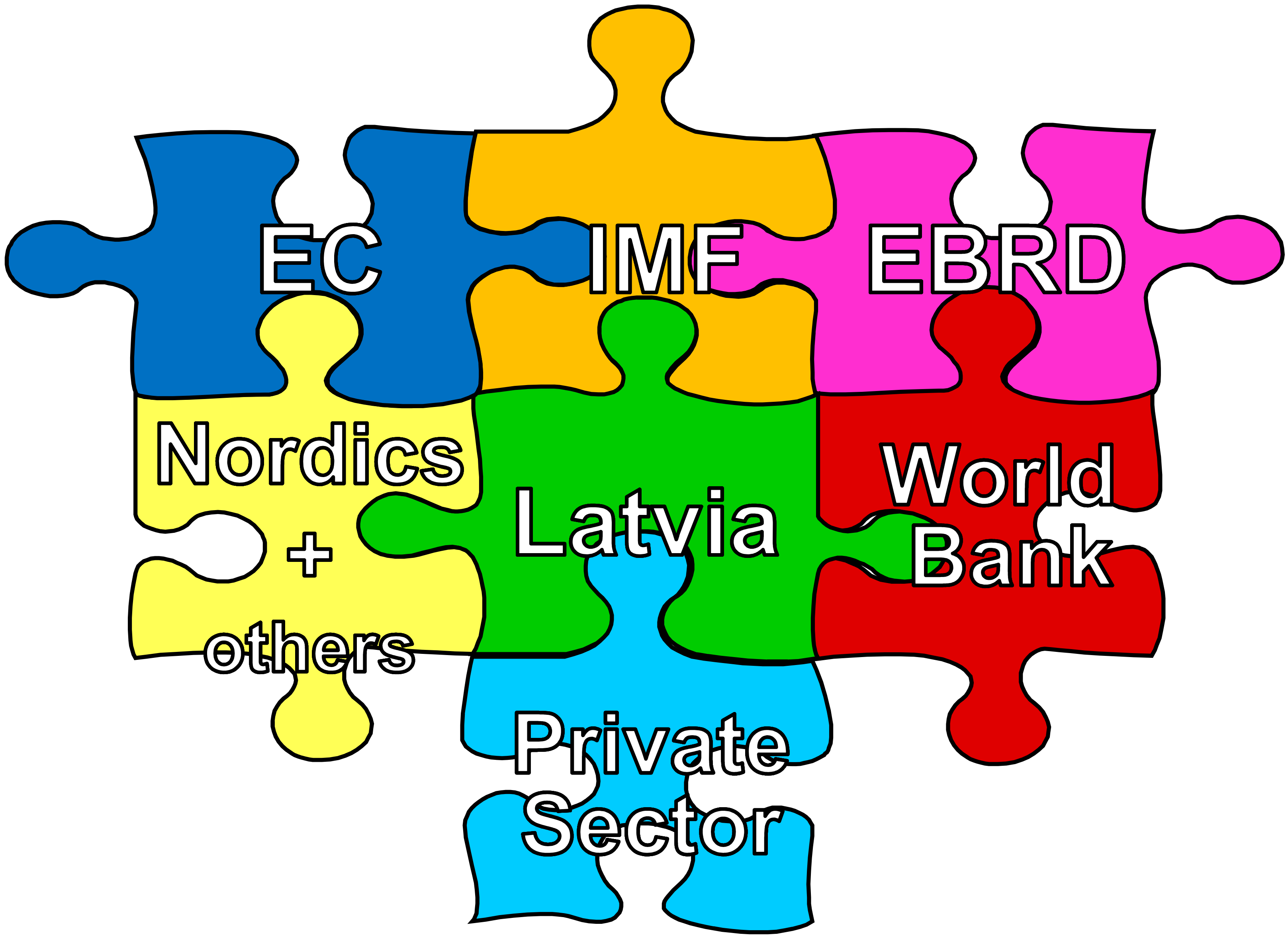
Alternatives (rejected)

- Widen the exchange rate band to full 15 percent permitted under ERM2
- Accelerate euro adoption

EU-IMF joint support

- EU Balance-of-Payments facility has similar goals to an IMF Stand-By Arrangement
- Besides financial and fiscal issues, EC covers structural policies, including use of EU funds
- Other country programs jointly supported by EU-IMF:
  - From 2008, new EU members: Hungary, Romania
  - From 2010, euro area countries (with ECB support): Greece, Ireland, Portugal

Coordination and ownership



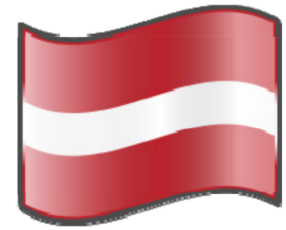
Latvia program: goals at launch

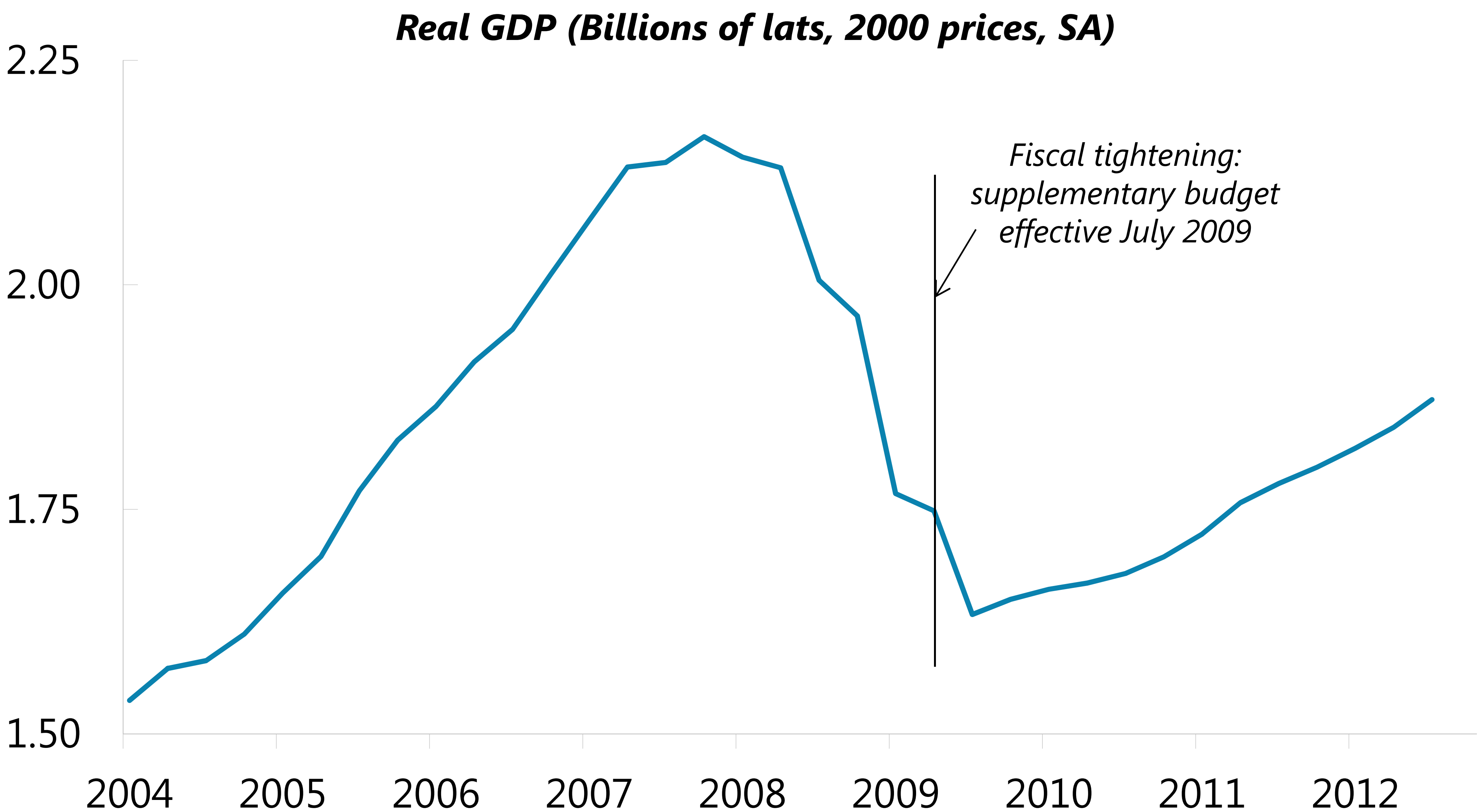
- Counter balance-of-payments strains
  - Correct current account deficit
  - Address liquidity crisis
- Stabilize financial sector
  - Restore depositor confidence
  - Structural reforms in anticipation of deteriorating credit quality
- Fiscal adjustment
  - Reduce external financing needs
  - Wage cuts to help correct a competitiveness problem, while maintaining the long-standing peg to the euro
- Program exit strategy: euro adoption
  - Post-program assessment by EU institutions and members

Macroeconomic developments

- Much deeper downturn than originally expected
  - Real GDP contracted 18 percent in 2009; 2011-12 growth > 5%
  - Unemployment peaked near 20 percent; eased but emigration
- Big swing in current account balance
  - 2007 deficit of 22 percent of GDP
  - 2009 surplus of 9 percent of GDP (though inflated by bank losses); broadly in balance (small deficits) in 2011-12
- Prices and wages adjusted
  - Wages fell 10 percent in 2009, led by public sector
  - Consumer prices fell 1.4 percent in 2009 (e.o.p.); excluding indirect tax effect, fall was 6.5 percent
  - Substantial improvements in competitiveness
  - Strong export growth in 2010 and beyond

Macro developments: real GDP

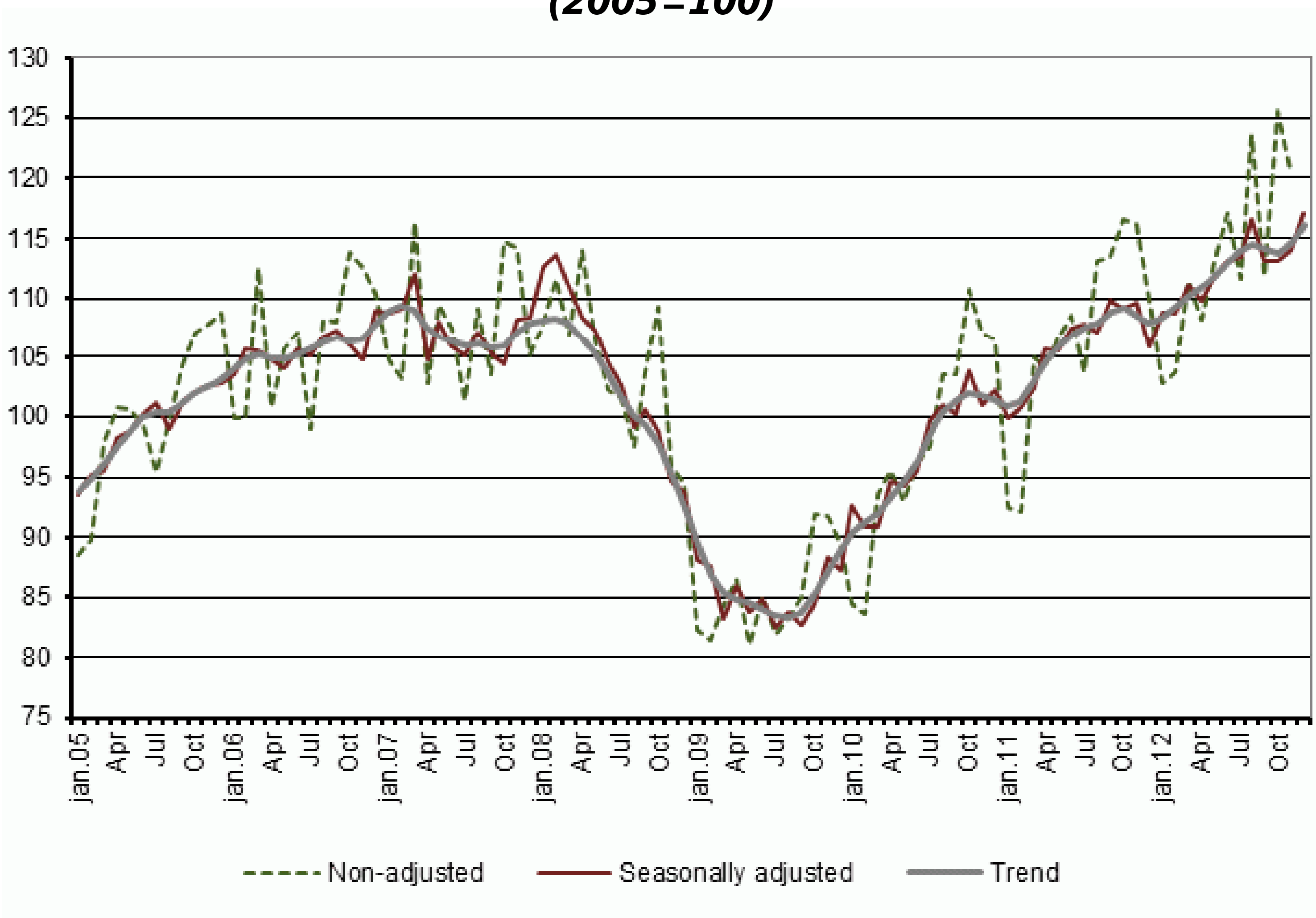




Source: Statistics Latvia.

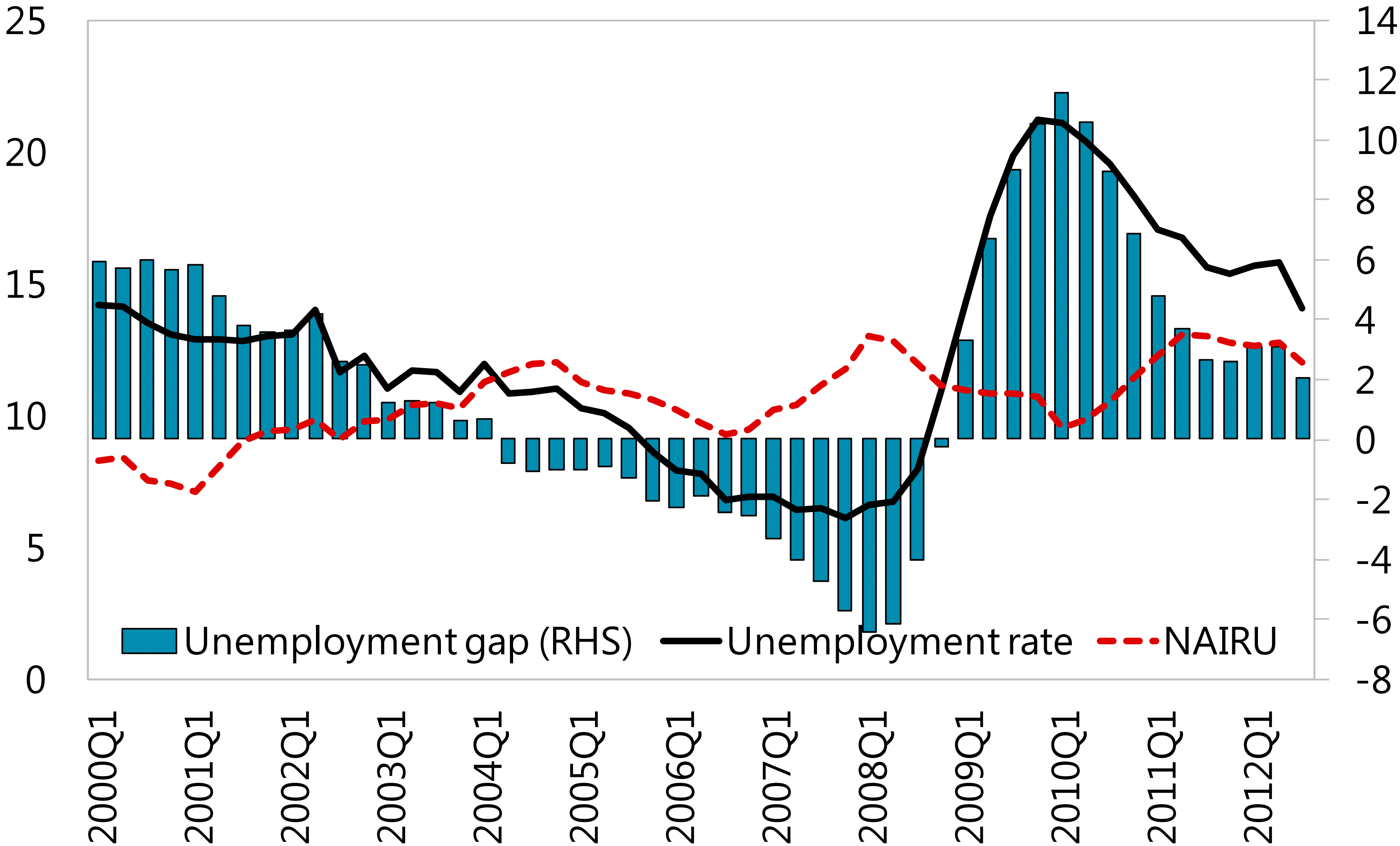
Macro developments: industry

Industrial production volume index (2005=100)



Source: Statistics Latvia.

Macro developments: unemployment



Sources: WEO; and IMF staff estimates.

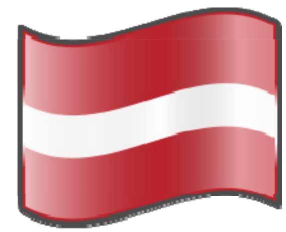
Implementing the program (1)

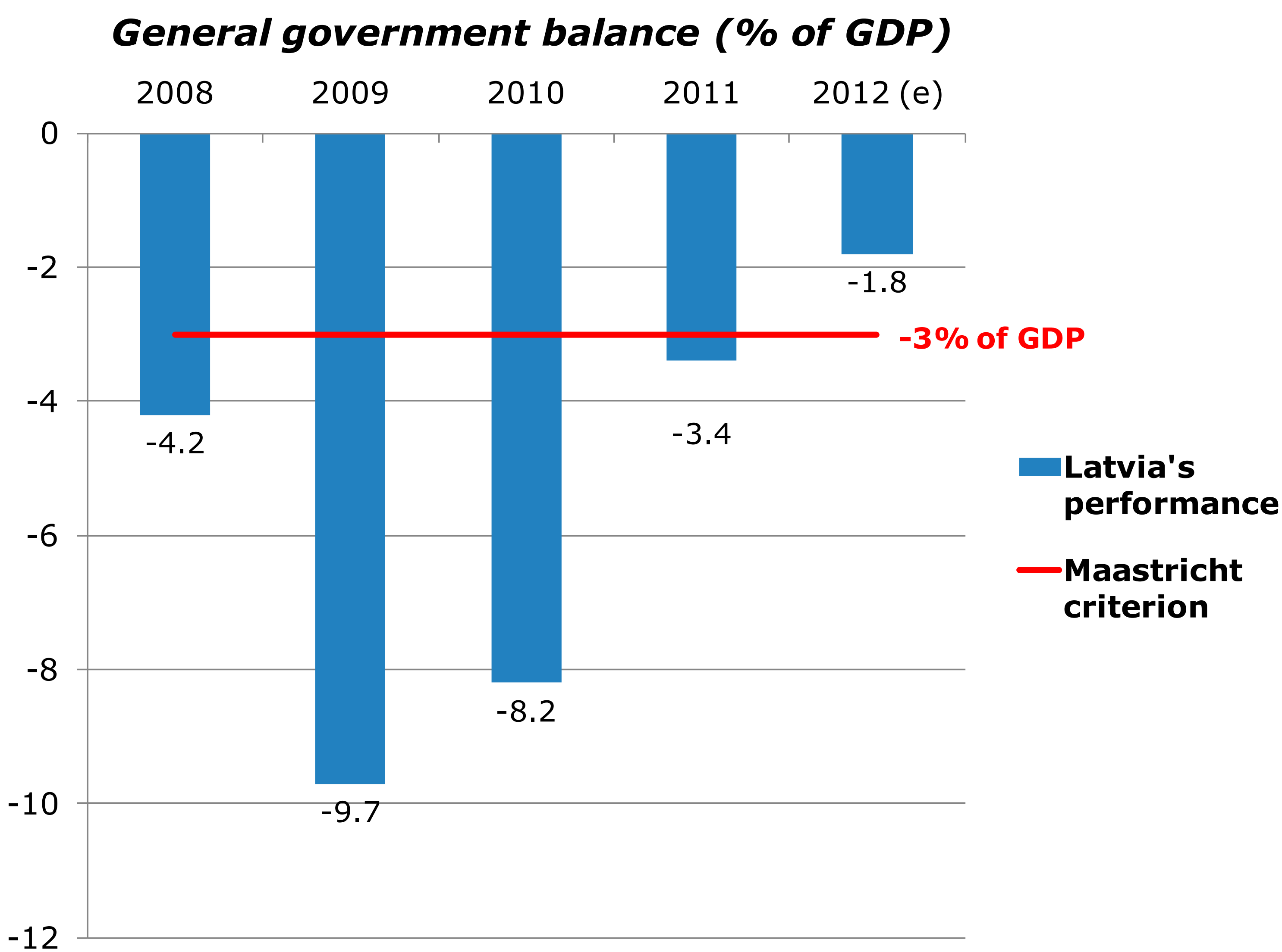
- Financial sector
  - Improvements in supervision and monitoring
  - Strengthened intervention capacity
  - Stabilization and restructuring of systemically large Parex Bank; later restructuring of MLB
- Debt restructuring
  - First round of insolvency reform in 2009, followed by new insolvency law effective in November 2010
  - Progress in out-of-court restructuring

Implementing the program (2)

- Fiscal policy: emerged as major challenge for remainder of the program
  - Balancing act
    - *Wider* fiscal deficit target needed for 2009 and beyond, given revenue slump and basic social assistance needs
    - Medium-term fiscal adjustment also needed for policy consistency with exchange rate peg, euro adoption
  - Not just *how much* to tighten, but *how*
    - Across-the-board cuts risky
    - Structural reforms needed to underpin permanent deficit reduction
    - IMF consistently stressed the need to protect social safety net spending, despite large cuts elsewhere

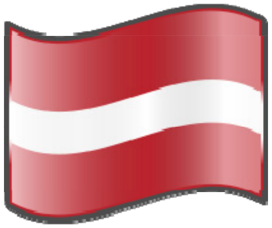
Fiscal performance: meeting Maastricht

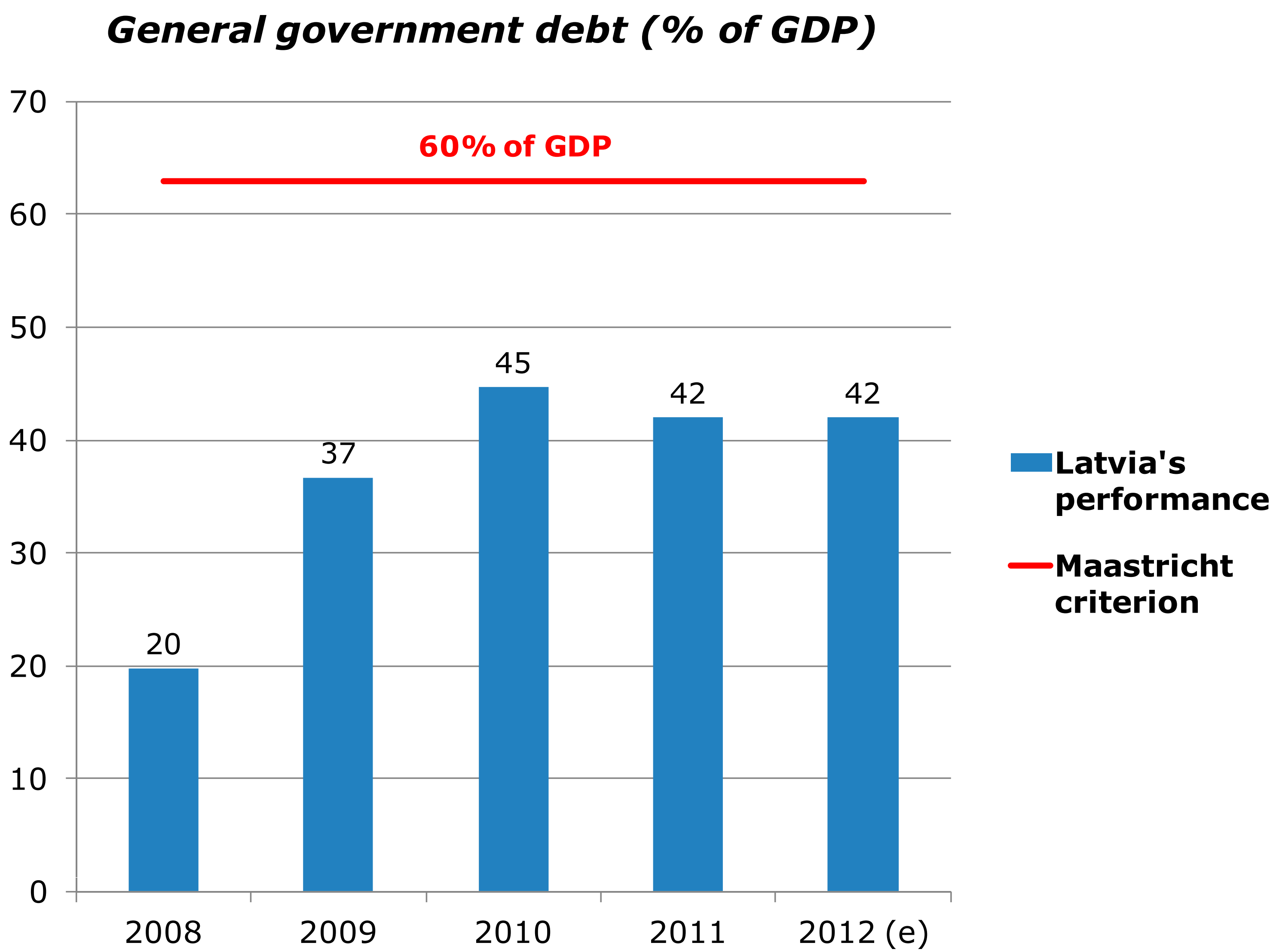




Source: IMF (Staff Report for the 2012 Article IV Consultation and Second PPM Discussions)

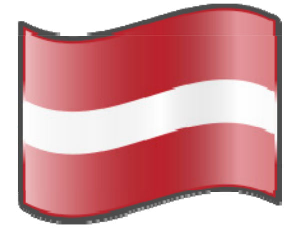
Maastricht criterion: public debt



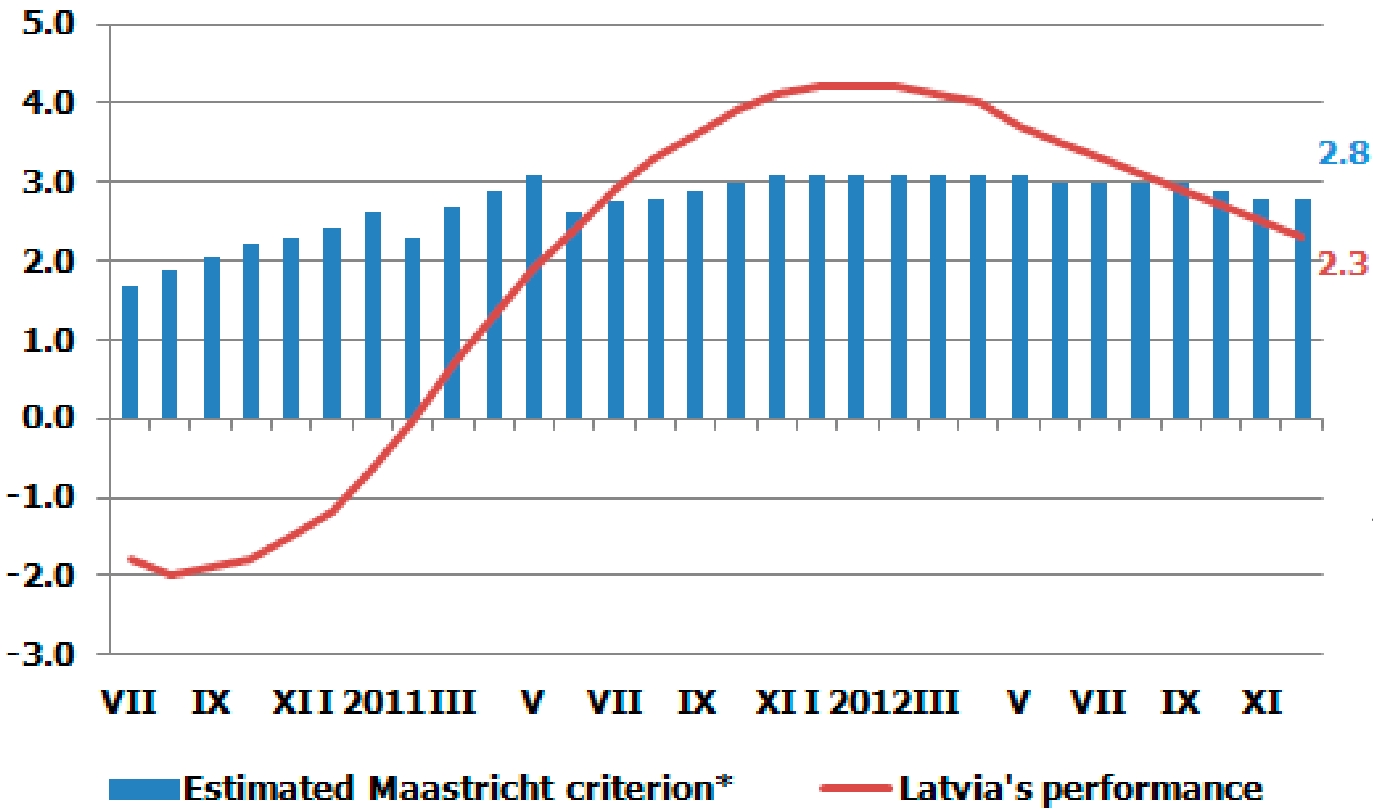


Source: Latvian State Treasury.

Maastricht criterion: price stability



Average annual inflation rate of the last 12 months (%)

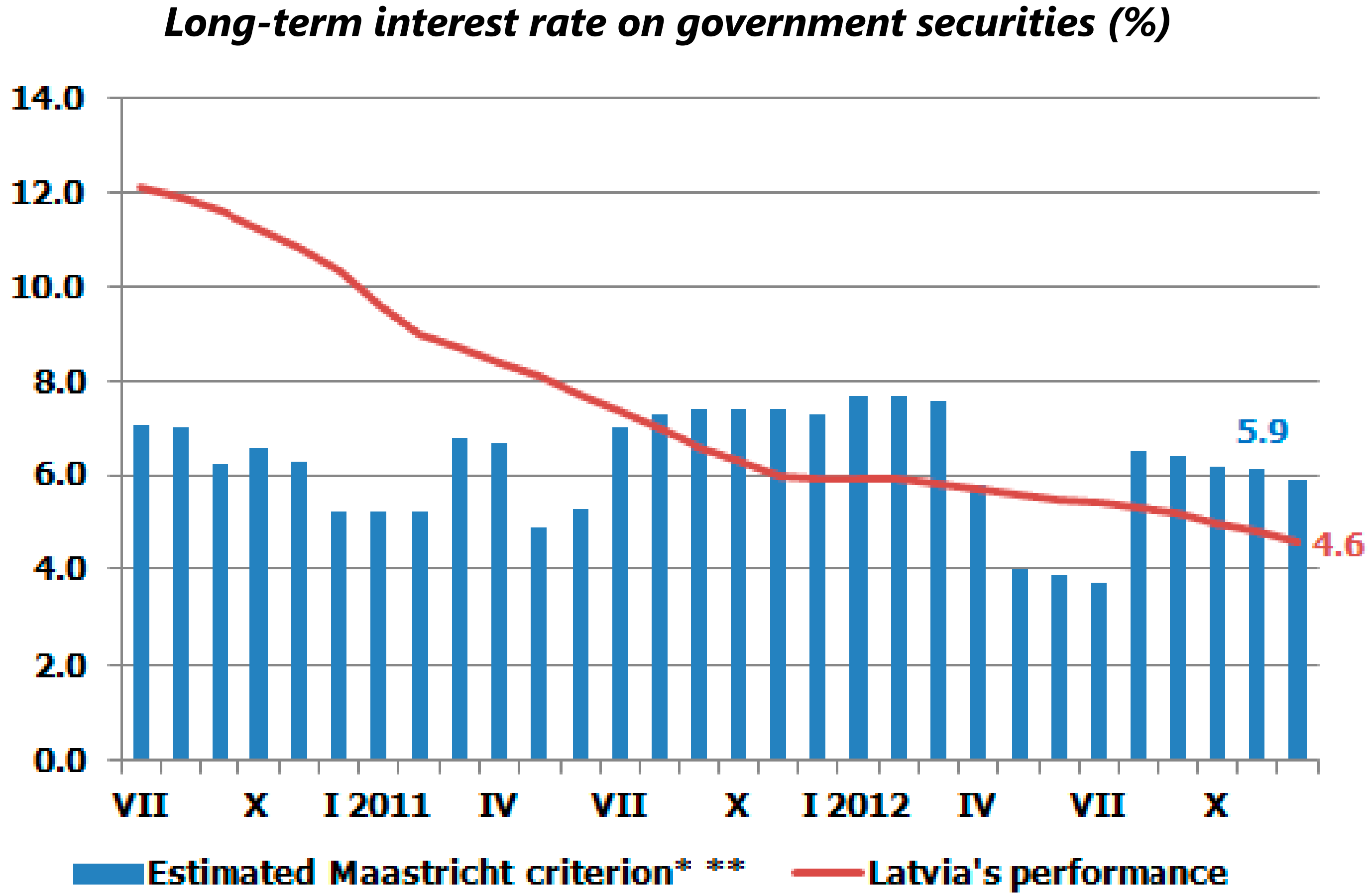


Note: indirect tax increases had been effective in 2011

* *The estimate of the Maastricht criterion does not include countries with deflation.*

Source: Bank of Latvia, http://www.bank.lv/en/eu-and-euro/compliance-with-the-maastricht-criteria

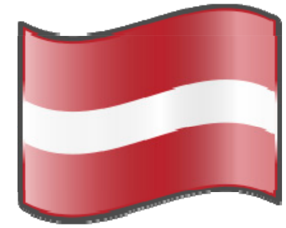
Maastricht criterion: interest rates



** The estimate of the Maastricht criterion does not include countries with deflation.*
*** In view of the ECB Convergence Report of May 2012, starting from April 2012, the estimate of the Maastricht criterion does not include countries with very limited access to financial markets.*

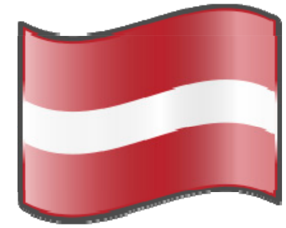
Source: Bank of Latvia, http://www.bank.lv/en/eu-and-euro/compliance-with-the-maastricht-criteria

Country-specific conditions



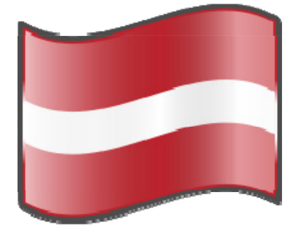
- Strong program ownership, allowing frontloaded fiscal adjustment
- Explicit and credible program exit strategy
- Despite structural fiscal (flow) imbalance, low initial public debt (stock)
- Relatively flexible labor markets
- Large upfront current account adjustment, even before the impact of fiscal adjustment
- Fiscal adjustment cushioned by EU structural funds
- Commitment by foreign parent banks to maintain exposures in Latvia

Beyond the EU-IMF-supported program



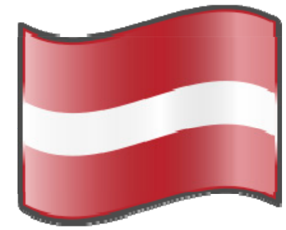
- Latvia made early repayment in full to the IMF in December 2012
- Banking system continues to recover
  - rapid increase of non-resident deposits (NRDs) warrant vigilance
- Authorities target euro adoption in January 2014
  - Economic case for euro adoption is strong
- More reforms needed to help reduce unemployment and enhance competitiveness

Competitive strengths and weaknesses



- Identifying country-specific challenges?
  - International survey evidence
  - Latvia-specific analysis
  - Program partners’ experience in Latvia

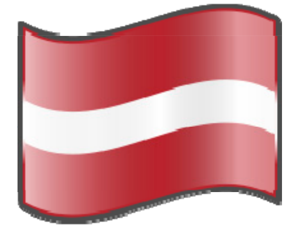
Survey evidence: overview



- *Doing Business 2013* (World Bank)
  - Latvia 25 out of 185 (vs 21 previous year)
  - In line with Estonia (21) and Lithuania (27)
- *Global Competitiveness Report 2012-2013* (WEF)
  - Latvia 55 out of 144 (vs 70 two years ago)
  - But lags Estonia (34) and Lithuania (45)

  -> useful information in the subindicators

Latvia-specific analysis

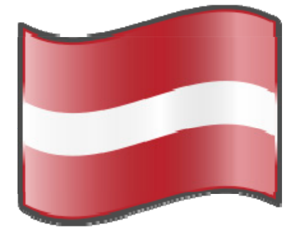


- *Latvian Competitiveness Report 2011*
  - Strengths: export growth and diversification; physical infrastructure for transport and logistics
  - Weaknesses: inequality; limited innovation and manufacturing productivity; higher and vocational education; underdeveloped financial markets; informal economy
- Ministry of Economics half-yearly report
- Input from Latvian and regional stakeholders

Program partner experience

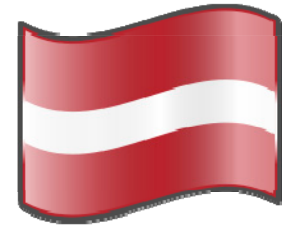
- European Commission
  - BoP program structural benchmarks
  - Europe 2020 -> country-specific recommendations
- IMF
  - SBA: lighter on structural conditionality, but joint EC-IMF benchmarks on SOE reform
  - Surveillance and technical assistance, e.g. Legal Department TA on insolvency reform

Where to reform



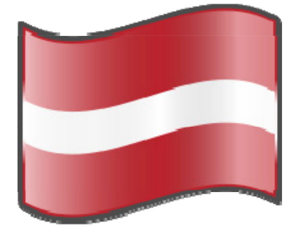
- We focus on three priority areas:
  - Judicial efficiency and insolvency framework
  - Governance and transparency of government-owned enterprises
  - Higher and vocational education

Judicial efficiency: diagnostic

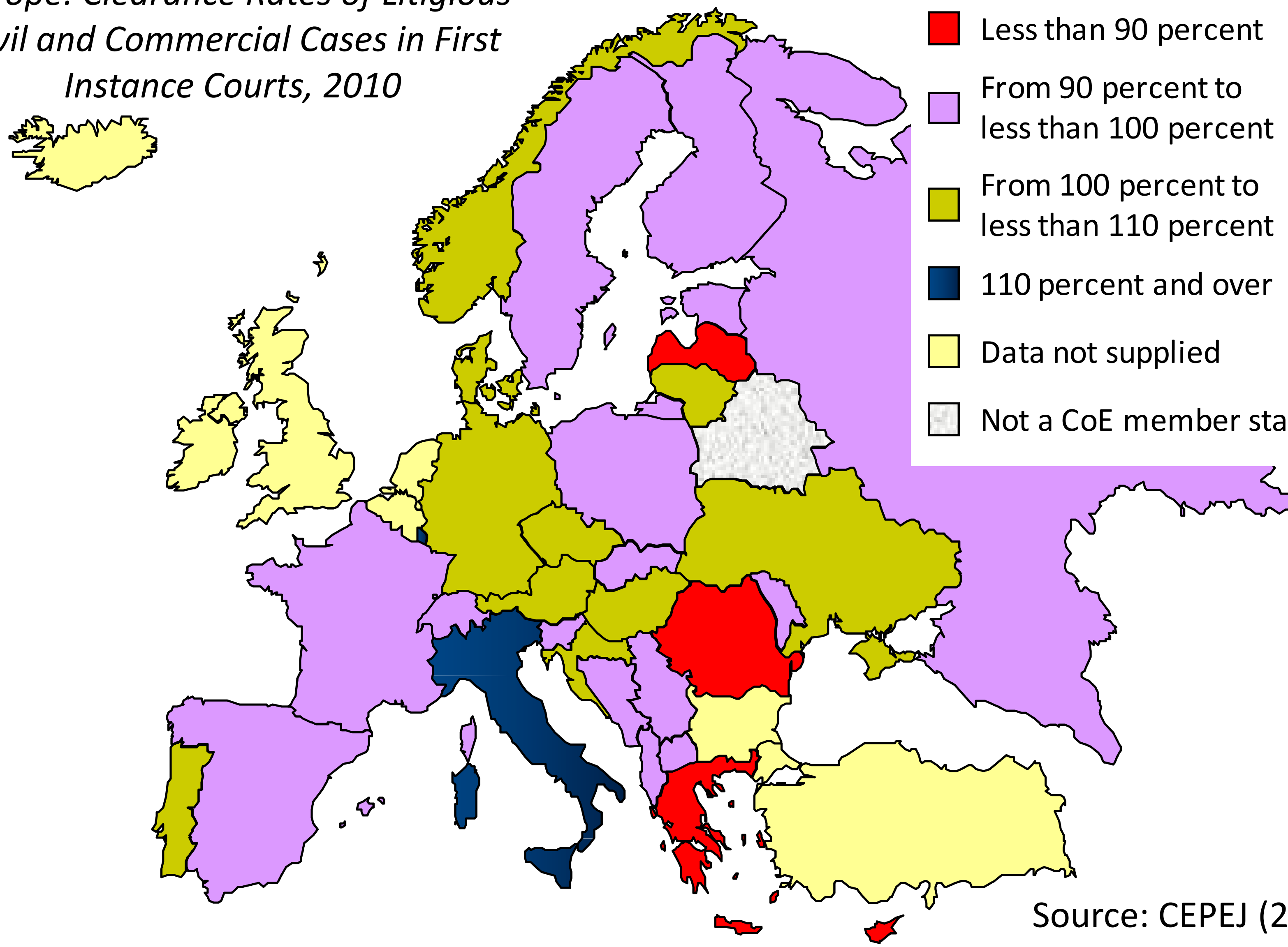


- Efficiency indicators favorable for administrative and criminal courts
- But for civil courts, clearance rates have been low by EU standards
  - post-crisis workload
  - low access fees
  - excessive scope for delaying tactics
  - problems with arbitration system as alternative
- Stakeholder complaints of court system “bottleneck”

Judicial efficiency: diagnostic

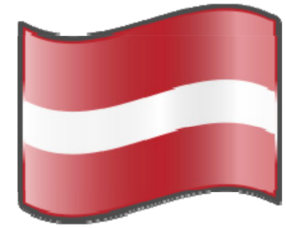


Europe: Clearance Rates of Litigious Civil and Commercial Cases in First Instance Courts, 2010



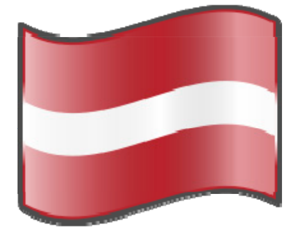
Source: CEPEJ (2012).

Insolvency: diagnostic



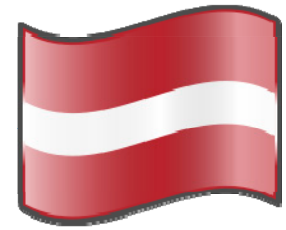
- Major improvements to law in 2009-10: legal protection proceedings (LPP); out-of-court restructuring; shift from two-test to one-test procedure
- New law prone to abuse: cases of investors being put into insolvency on the basis of disputed claims -> a high-profile ruling a year ago turned out to be inconsistent with the new law
- Potential to deter investors if not addressed

Judicial efficiency: authorities' response



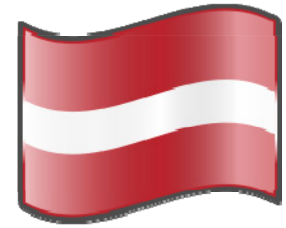
- Videoconferencing to address witness delays, publication of anonymized court decisions to promote transparency and reduce uncertainties
- Law on judicial power: evaluation process for judges, by judges
- Tighter evidentiary requirements for first instance, to reduce scope for delaying tactics in second instance (amendment to civil procedure law)
- Phased introduction of "pure instance" system to reduce fragmentation of court competencies
- Draft law on mediation: approved by government, now with parliament

Insolvency: authorities' response



- Clarification of existing insolvency law
- Amendments being drafted; but also open in parliament
- Recognition of misuse of LPP, working on response

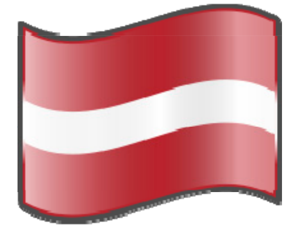
Judiciary & insolvency: assessment



- Civil courts: many good measures in train, including evaluation process for judges
- Room to accelerate transition to “pure instance” system for civil courts; legislative approval needed
- Streamlining arbitration system could ease the burden on civil courts; mediation law can help too
- Insolvency: keep to the “cash-flow” test in line with best international practice

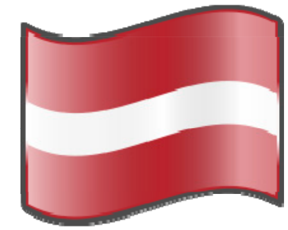
  -> case for introducing (non-suspensive) appeal process; but focus on better implementation

SOEs: diagnostic



- Some SOEs have performed well: BICG (2012) finds corporate governance strong in Citadele, Lattelecom
- Fiscal and governance risks came to light in others:
  - Latvenergo (2010); airBaltic (2011); PV (2012)
- IMF and EU programs had included structural benchmarks on SOEs since 2010; progress uneven
- NGO reform proposals: clearer policies on ownership and transparency; supervisory boards; consider privatizations & capital market development

SOEs: authorities' response



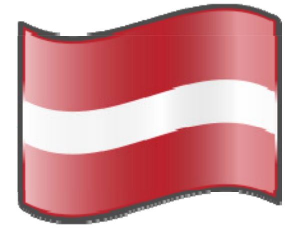
- SOE listing compiled in 2010
- Two concept papers approved in May 2012
  - Partially centralized ownership institution (CGI)
  - Improved reporting
- Working group reviewing each SOE
  - privatize or retain?
  - CGI or line ministry to hold?
- But draft legislation is still pending

SOEs: assessment

- Progress slower than hoped under program
- CGI model has worked well in some neighboring countries
- Enhanced reporting is critical to reduce risks of repeating past unpleasant SOE surprises
- Any privatizations should be orderly and transparent
- Supervisory boards make sense in principle, but capacity constraints?

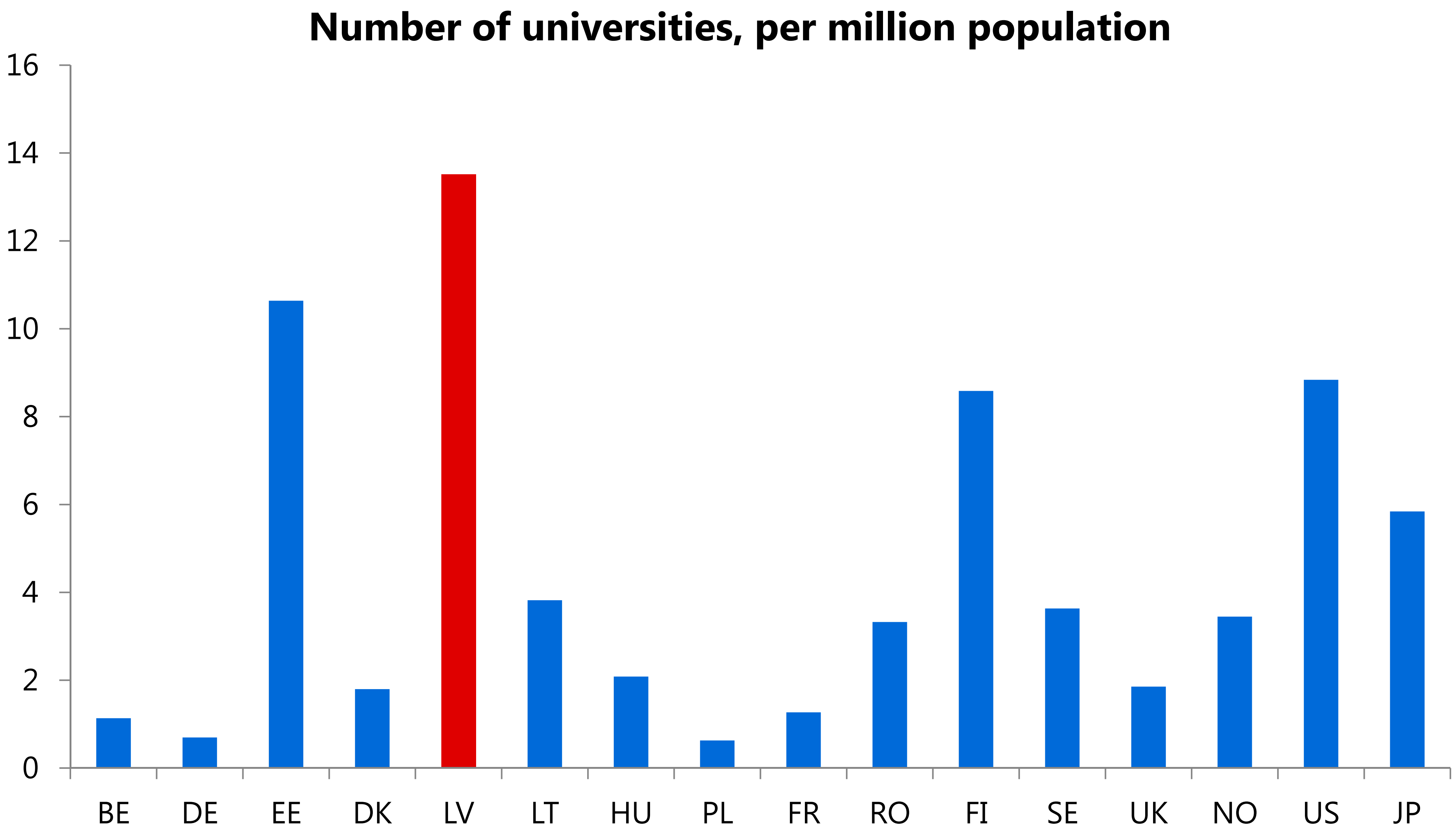
  -> then CGI needs to be strong

Higher education: diagnostic



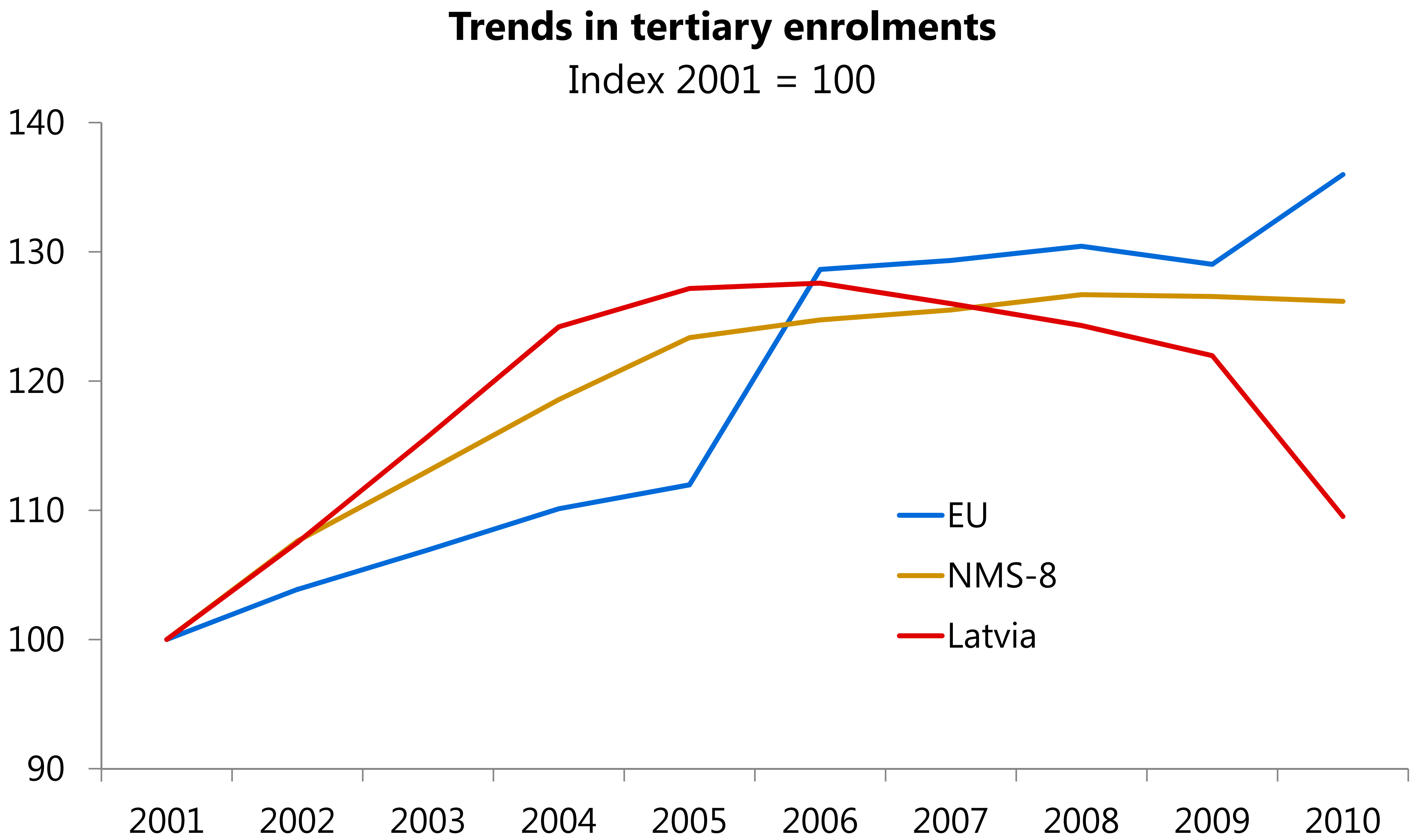
- Limited resources thinly spread over large number of institutions
- Falling number of students
- Quality of Latvian higher education lagging behind the neighboring countries
- HEIs not open to international competition
- Governance and evaluation of HEIs

Higher education: diagnostic



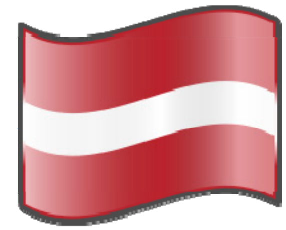
Source: Ministry of Education and Science (2012).

Higher education: diagnostic



Source: Eurostat.

Higher education: authorities' response

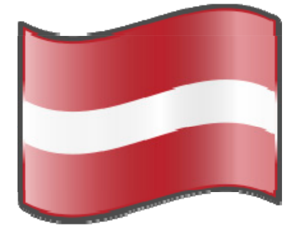


- Improved accreditation process
- "Budget places" for the programs of good quality accommodating labor market needs
- Concentration of the higher education sector
- New governance model
- Opening HEIs to international competition
- Work on the proposal for a new financing model
- Evaluation of the scientific institutions

Higher education: assessment

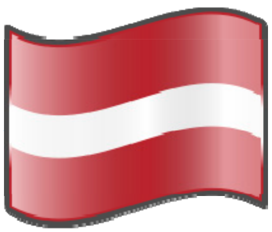
- Pressing sustainability and quality challenges
- Reform proposals would respond to the underlying problem
- But political economy obstacles; traditionally independent sector
- Dialogue important; political support crucial
- Allocation of funding, including EU structural funds, will affect incentives

Vocational education: diagnostic



- Misalignment of study program content with labor market needs
- Schools are struggling to secure practical training for students in companies; limited interest from employers' side
- Different financing and governance models of general and vocational education result in an unhealthy competition for students
- Underinvestment in the sector

Vocational: authorities’ response

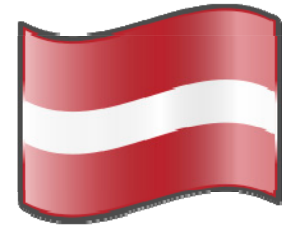


- Concentration of the resources in fewer VET schools
- Modernization of 11 schools
- Content revision with the participation of employers
- Plans to transfer the ownership of VET schools to local governments or sector associations
- Promotion of VET attractiveness
- Teachers’ training
- VET schools’ involvement in adult education

Vocational education: assessment

- Resource concentration in fewer institutions is welcome especially given falling number of students
- But competition for students between the VET schools and general education schools raises concerns
- Decentralization of VET governance would have risks
- Greater employer involvement needed in providing practical training to students
- Important to ensure that the cooperation between the employers and VET sector continues after the end of the ESF project

Other areas: more work needed



- Labor markets
  - High unemployment and inequality -> scope for tax-benefit reforms
  - World Bank study forthcoming
- Competition policy: capacity issues
- Industrial policy: World Bank reviewing; emphasis on resolving coordination failures and stakeholder dialogue
- Other fiscal-related reforms
  - sectoral (e.g. healthcare)
  - administrative (human resources, procurement)

Conclusions (1)

- Latvia now recovering well; remaining challenges are widely recognized
- Large and painful adjustment, though mitigated by large and coordinated international support
- Reform plans in focus areas are generally consistent with a diagnostic—but these areas are difficult ones, in sectors with traditions of independence
- Task is to balance valid concerns: institutional independence, and institutional accountability

Conclusions (2)

- Good measures in train to address court delays; room to improve implementation of new insolvency law, but avoid backsliding from best international practices in 2010 law
- SOE reform plans address long-standing risks, but political agreement needed on legislation and implementation -> transparency critical
- Higher education: the plans would raise quality, if implemented
- Vocational education: decentralization plan has pros and cons; how best to address local government incentives to support general over vocational?
- In sum: the reform plans are there -> implementation key

Thank you!

http://www.imf.org/external/country/lva/rr/index.htm

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