This paper is an excellent, well-written, readable and accessible description of the macroeconomic boom and bust cycle in Latvia from 2000 to 2012. It presents the key facts and data—at least as well as possible given serious data challenges. It provides an unbiased analysis of different explanations for the economic crisis and recovery—a viewpoint which is much appreciated given the often-heated discussion by some macroeconomists on what actually happened in Latvia.

Nonetheless, many of you may still be wondering “Why Latvia?” Why should this distinguished group of authors and scholars dedicate an entire session to understanding the details of a small country that operated under a number of unique circumstances—especially during a period when many larger and more systemic economies were under severe economic distress? My comments will begin by answering this question and explaining why Latvia’s experience is worth closer investigation. The last part of my comments then discusses three major insights from the paper—as well as the follow-up questions these insights inspire.

I. Why Latvia?

Latvia provides one of the few examples of a country which did not follow the standard, recommended response to a balance-of-payments crisis—allow a rapid devaluation of the currency in order to regain competitiveness and reduce the need for external financing. Instead, Latvia chose to maintain its currency peg and attempt an “internal devaluation”—i.e., improve competitiveness through reductions in relative real wages. This process involved a period of sharply higher interest rates, a severe recession, and a fiscal contraction. In the past, other countries faced with similar balance-of-payments crises often hoped to adopt this strategy and avoid a currency devaluation—but most countries that embarked on this strategy soon abandoned it. Latvia is one of the limited examples of a country that persisted on this difficult path, avoided a currency devaluation, and accomplished an internal devaluation—much to the surprise of many economists and much faster than anyone expected.

In order to understand exactly how Latvia’s approach differs from the standard crisis response, it is useful to revisit a basic open-economy macroeconomics model. I will use what any graduate from MIT’s PhD or MBA program calls the BB-NN model (which is basically a variant of the Salter-Swan or dependent economy model). In this model, a country attempts to meet three constraints. First is the “external constraint”, represented by the BB line, which requires that a country is in balance-of-payments equilibrium. Second is the “internal constraint”, represented by the NN line, which requires that a country has output at potential. Third is the rather nebulous “social peace” line, represented by the P line, which requires that real wages are above a level \( w \) in order to avoid protests and riots. The
lines are graphed relative to output \((Y)\) on the horizontal axis and competitiveness (the ratio of the exchange rate to wages or \(e/w\)) on the vertical axis.

In many examples, especially after a period of rapid growth financed by large capital inflows, a country finds itself in a situation shown in Figure 1. The three lines in the model do not cross and the country is in the position marked by the dot A labeled “Latvia 2006”. The country has output \((Y)\) above potential and is to the right of the NN line. The country also has a large balance-of-payments deficit and is to the right of NN line. Real wages are still high enough (helped by the overvalued exchange rate) that workers are “at peace” and not protesting.

**Figure 1: Alternate Crisis Responses**

A country, however, is not able to stay at point A. At some point foreigners are no longer willing to finance the current account deficit and the country does not have sufficient reserves to maintain the overvalued exchange rate. The most common response to this balance-of-payments crisis is for a country to move to point B, the “Devaluation Option”. This involves a major and quick currency depreciation \((e \uparrow)\) and a sharp recession \((Y \downarrow)\). The country quickly moves to external balance, but the decline in real wages often causes protests and riots – the lack of “social peace” represented by the country being located above the P line.

Latvia, however, chose not to follow this standard response to a balance-of-payments crisis. Instead of devaluing its currency, it chose to keep \(e\) constant and instead move to a point such as C (labeled “Latvia 2011”). This involved a more gradual decline in real wages \((w \downarrow)\), which moves the country up on the graph, but not as far as if the currency had been devalued. This also involved a sharp increase in interest rates and recession \((Y \downarrow)\), which may have moved the country more or less to the left on the graph relative to what would have occurred with a devaluation. (We will return to this question later.) This also involved outward emigration, which shifted the NN line to the left.

The key point from Figure 1 is that Latvia chose a different alternative than most other countries choose when responding to crises. To further make this point of how unique the Latvian response was, Figure 2 below shows how countries responded to the period of global financial turmoil from 2007-2011. Details are available in Forbes and Klein (2013), but the graph basically shows the number of countries that chose to either: (1) sharply increase interest rates; (2) allow large currency depreciations; (3) intervene in foreign exchange markets using large amounts of reserves; and (4) increase controls on capital outflows. The graph shows that the most popular response was to allow currency depreciations—which Latvia avoided. Only a few countries selected to raise interest rates—especially from 2009 onwards.
Returning to the case of Latvia, many economists did not think that raising interest rates sharply, undergoing a severe recession, maintaining a currency peg, and instead undergoing an internal devaluation would work. Many believed Latvia would not have the political will to persist with these difficult macroeconomic measures over the long period of time required to complete the adjustment. Others worried that given nominal wage rigidities, it would be impossible to generate the needed decline in real wages and improvement in competitiveness without a currency adjustment. Latvia proved the skeptics wrong. Several years after the crisis began, it is now safe to say that Latvia provides a model of an alternative response to a balance-of-payments crisis for countries that do not wish to devalue their currencies. Therefore, understanding Latvia’s experience and how this adjustment occurred is important—and worth a case study.

Not only does Latvia provide a key example of a country that adopted an alternative response to a balance-of-payments crisis, it also provides insights on two other key debates in international macroeconomics—the advantages and disadvantages of large, front-loaded fiscal consolidation and of free capital mobility. Latvia is often cited by commentators on each side of these major debates as an example for or against a specific policy. The paper by Blanchard, Griffiths and Gruss is therefore extremely useful to better understand exactly what occurred in Latvia, and how the country is used (or abused) to make specific points.

Here is an example. One prominent debate occurring in the blogosphere is whether the Latvian strategy should be a model for other countries. One side of this debate is expressed by Paul Krugman, who asks: “Would you have expected that Latvia be lionized as the hero of the crisis?” To make his point, he graphs real GDP for Latvia and several other small countries in the region with real GDP indexed to 100 at its peak for each country. Krugman’s analysis is copied below as Figure 3. It shows that Latvia has clearly performed worse than the others.
On the other side of this debate, however, is the Geoeconomics Center at the Council on Foreign Relations. They argue that instead, we should consider trends in GDP when GDP is indexed at 100 from the post-2007 trough (instead of the peak). As shown in Figure 4 below (which is copied from their website), Latvia now performs second best in the group.

Resolving this debate (and the many others) in the blogosphere that involve Latvia is beyond the scope of my comments today. But the key point is that the paper by Blanchard, Griffiths and Gruss is an extremely useful reference to understand the different lines drawn in these discussions. For example, with regards to the above debate, their paper documents the substantial boom and overheating in Latvia that preceded its crisis—and which leads to the different interpretations of whether Latvia’s GDP path was a model of above-average or below-average performance.

II. Key Insights—and Corresponding Questions

In addition to provide an excellent description of an alternative response to a balance-of-payments crisis and helping inform the blogosphere debates, this paper also provides a number of useful insights and lessons. Of course, it is impossible to generalize from events in one small and in many ways unique country to the rest of the world. And the authors are very careful not to overstate any lessons from the Latvian experience. Nonetheless, the experience provides useful evidence supporting three issues.

First, the crisis in Latvia was in many ways a standard balance-of-payments crisis. It was preceded by all of the typical vulnerabilities that generally precede crises—such as large capital inflows from abroad;
negative real interest rates; a bubble in housing; a sharp increase in imports; imports dominated by consumption goods rather than investment; rapid growth in private credit; large and unhedged borrowing in foreign exchange; a very large current account deficit; and foreign capital inflows predominately in the form of “hot” money instead of foreign direct investment. (See Frankel and Saravelos, 2012.) Standard early-warning models were identifying Latvia as being highly vulnerable to a standard balance-of-payments crisis.

Yet, despite all the warning signs blinking bright red, the government was unable to prevent the economy from overheating and avoid a severe crisis. Several steps were taken to reduce credit growth, but these steps were too little, too late. This example suggests that even when a crisis is relatively easy to identify in advance, it is still extremely difficult for policymakers to take preventive measures in a timely fashion. Is there a way to develop more automatic stabilizers to prevent crises if policymakers cannot act in time due to political or other constraints? Unfortunately the evidence in the paper further indicates that any type of automatic stabilizers would be difficult to construct. For example, Figure 5 in the paper shows the real-time, cyclically-adjusted, fiscal balance in Latvia—and how this number was substantially revised over time. This challenge to access accurate information on key statistics in a timely fashion highlights the challenge in preventing bubbles and crises in advance—even through automatic adjustment.

Second, the paper highlights the importance of quickly adjusting competitiveness. A key factor in Latvia’s ability to persist with its alternative strategy was the surprisingly rapid internal devaluation. This appears to have occurred due to a combination of productivity increases, layoffs, and emigration. This success, however, raises even more questions on exactly how it was accomplished and if the experience could be replicated. For example, how important was Latvia’s small size in order to be able to boost exports as part of its recovery? Does this experience suggest that labor market flexibility (firing) and mobility (emigration) are the key criteria to regain competitiveness with a fixed currency? If so, should countries hoping to share a currency (such as the euro) focus on these criteria rather than sharing fiscal risks (which is often included equally with labor market flexibility and mobility as a key criteria for an optimal currency area)? What are the long-term repercussions of this type of internal devaluation—especially if it involves policies such as the emigration of skilled workers?

Perhaps the most important question raised by this example is on the size of the contraction. If a country chooses to respond to a balance-of-payments crisis through an international devaluation instead of currency devaluation, will this generate a larger or smaller recession? Returning to Figure 1 above, will the leftward movement (decline in Y) from point A to point B be greater or less than to point C? It is impossible to know the counterfactual, especially given the global turmoil that immediately followed Latvia’s “bust”—but better understanding why the contraction may have been less (or greater) under Latvia’s crisis-response strategy would be a useful addition to the paper.

To further make this point, consider the comparison shown in Figure 5 below. The graphs show the effect on real GDP over the six quarters following a country’s decision to increase interest rates sharply or allow a major currency depreciation (both in period 0) during the Global Financial Crisis (2007-2011).
The effects are estimated using a propensity-score matching methodology to construct the counterfactuals of what would have happened to GDP growth in each country if it had not had the increase in interest rates or currency depreciation. The panel on the left shows that countries which raised interest rates substantially—a key tenet of Latvia’s strategy—generally saw a sharp and significant decline in real GDP growth immediately and over the next three quarters relative to the counterfactual. The panel on the right shows that countries which allowed large currency depreciations initially saw a contraction in GDP (over the first quarter), but then experienced an improvement in real GDP after several quarters so that real GDP growth was significantly greater than the counterfactual after six quarters. Could Latvia have seen this type of more rapid recovery if it had followed the standard crisis response and allowed its currency to depreciate?

Figure 5: Changes in Real GDP after Different Responses to the Global Financial Crisis

Source: Forbes and Klein (2013)

A final key insight (and corresponding question) from this paper is of the importance of supporting banks in order to enable a country to recover from a crisis. Latvia’s banking system managed the crisis better than in many other countries. One key factor highlighted in the paper was the support of foreign parents for local subsidiaries. Another key factor was that because the currency did not depreciate, banks were not faced with as many bankruptcies and a corresponding increase in non-performing loans that generally follow when companies and consumers have unhedged liabilities (even if the banks had directly hedged their assets and liabilities against currency risk). Moreover, although one major domestic bank in Latvia required sovereign support, this did not create the large fiscal burden that occurred in other countries (such as Ireland).

The relative success in stabilizing the banking system in Latvia was undoubtedly a key component of its overall recovery. But – returning to the key issue of why the Latvian experience is worth closer investigation—how did Latvia’s decision not to devalue influence the recovery of the banking system? If Latvia had chosen the standard currency-devaluation response, would this have generated a widespread increase in non-performing loans that would have caused more widespread banking collapses? Could this strategy have risked the support of foreign parents (or generated more financial support from them)? A closer look at how Latvia’s decision not to devalue its currency interacted with the financial system would add another useful dimension to the paper and help better understand one potential benefit of this alternative crisis response.
III. Final Thoughts
To conclude, this paper is an excellent case study of what happened in Latvia over the 2000’s. It is a textbook case of the standard buildup to a balance-of-payments crisis. But then it provides a rare example of a non-standard response. The case study is a superb example for teaching concepts, and for better understanding one of the options that countries consider when faced with a balance-of-payments crisis. Latvia’s experience also provides useful insights on several major questions—such as why it is so difficult for policymakers to prick bubbles, how a country can regain competiveness with a fixed exchange rate, and the importance of a strong banking system. Each insight, however, generates more questions—especially on how this example could generalize to other countries. As a result, more case studies in this vein—of large and small countries—would be helpful to better understand the policy options countries face.

References