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Aldis Austers*

How Great Is Latvia's Success Story?

The Economic, Social and Political Consequences of the Recent Financial Crisis in Latvia

The current state of Latvia can be best described in medical terms: the patient is pale, but alive. The financial woes have been successfully resolved, but economic, social and political challenges remain. The crisis is continuing to affect the fabric of social and political life in Latvia. This paper looks at the economic, social and political consequences of the recent financial crisis and the ensuing economic collapse in Latvia and suggests some remedial actions.

Latvia is a country of extreme contrasts. During 23 years of independence, the country has seen periods of both high growth and deep slumps. Economic development has been generally positive since the early 1990s, more and more people have enjoyed enhanced well-being, and Latvia has become accepted as a fully fledged member of the international society of sovereign states, including the club organisations of wealthy Western states like the North Atlantic Treaty Organization (NATO) and the European Union (EU). As of 1 January 2014, Latvia is a member of the eurozone. Latvia has also been invited to start accession talks for the Organisation for Economic Co-operation and Development (OECD).

On the other hand, Latvia, like other Baltic countries, but in contrast to other Central and Eastern European states,[1] has meticulously followed the path of neoliberal economic policy-making since the 1990s. This neoliberalism implied the prioritisation of business interests (very low taxes on capital), small government (limited social welfare) and economic openness (integration in Western economic structures). As a consequence, this business-oriented economy, in combination with a political and administrative elite initially composed largely of members of the Soviet nomenclature, made possible the enrichment of a few, while leaving a considerable part of society without substantial improvement, and in some cases with deterioration. Labour unions in Latvia remain weak, and civic society, while being vivid and enjoying better treatment by the political elite since the parliamentary elections of 2010, lacks financing for large scale activity.

Certainly, the globalised economy presents a great challenge to small nations, as states must compete not only for material resources and capital, but also for people. The rate of success depends on flexibility and resilience. However, as small countries have limited human capital, a high degree of social and political cohesion is of the utmost importance. Unfortunately, the high volatility of economic growth erodes this cohesion, and may make departure to more stable economies an attractive option for local people. Indeed, one has to agree with Milan Kundera that "[f]or small nations, existence is not a self-evident certainty but always a question, a wager, a risk."[2]

The Latvian government is full of optimism. According to the National Development Plan for 2014-20, "[i]n 2020 Latvia will be a country that is Latvian in character and self-confident, secure and resident-friendly, green and well-tended, prosperous, effective and competitive – and a home to industrious, well-educated, creative, healthy

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1 See J. Drahokoupil: The Rise of the Comprador Service Sector: the Politics of State Transformation in Central and Eastern Europe, in: Polish Sociological Review, Vol. 2, No. 162, 2008, pp. 175-189.

2 Quoted in R. Kattel, T. Randma-Liiv, T. Kalvet: Small States, Innovation and Administrative Capacity, in: V. Bekkers, J. Edelenbos, B. Steijn (eds.): Innovation in the Public Sector, Basingstoke 2011, Palgrave Macmillan, pp. 61-81.

Aldis Austers, Latvian Institute of International Affairs, Riga, Latvia.

and happy people."[3] Christine Lagarde, the managing director of the IMF, has praised Latvia and other Baltic countries for their determination in overcoming economic hardships in a decisive manner, for restoring competitiveness and market confidence through severe comprehensive austerity measures. According to Lagarde, Latvia has a bright future ahead.[4]

The optimism of the Latvian government and IMF managing director is not, however, shared by everybody. International economists such as Paul Krugman[5] and Martin Wolf[6] have provided more sobering views. They see the cost that Latvia and other Baltic countries have paid for austerity-led macroeconomic stabilisation as exorbitant in terms of loss in real growth and human capital, and believe it would have been unbearable in other democratic countries. Even the Latvian president, Andris Bērziņš, has become quite pessimistic about Latvia's future prospects, admitting that "unless Latvia achieves the average income level of the EU in ten years' time, it will cease to exist as a politically viable state".[7]

Indeed, Latvian social statistics give little cause for celebration. Among EU members Latvia stands out as a country with one of the lowest income levels, with the greatest inequality and poverty, and one of the highest emigration rates. During the last ten years, Latvia has lost around 15 per cent of its population: 11 per cent due to emigration, four per cent due to demographic decline. Among those who emigrate, more than 80 per cent are aged 18-35. Particularly alarming is that it is not only income difference, but also the quality of life and a better future for children that are cited as major reasons for emigration.[8] Asked about their plans for return, only a few reply positively. This is a clear sign of a lack of confidence in Latvia's future.

The aim of this paper is to look at the economic, social and political consequences of the recent financial crisis and the ensuing economic collapse in Latvia in 2008-10; and at whether the crisis's resolution has helped to create a basis for sustainable economic growth, social cohesion, and political consolidation in Latvia. The economic recovery that started in 2010 is superficial and passing. It obfuscates much deeper damage in terms of social cohesion and political unity, as nationhood is not only about the economic, but also about the political and social dimensions. A good measure of these profound changes is people's pessimism about Latvia's ability to serve their interests and, with that, the observed mass migration of people to Western European countries. If no remedial actions are taken, changing people's gloomy perception of the state and abating their propensity to emigrate, Latvia's further growth prospects will be constrained. A few ideas about remedial actions are aired at the end of this paper.

Some aspects regarding recent Latvian economic calamities

The Latvian case of crisis resolution has attracted considerable international attention and is subject to passionate debate among adherents to various strands of economic thinking. It seems that Latvia's experience is destined to become a popular case study for economics textbooks.

The prevailing wisdom is that, in Latvia, the crisis was preceded by a period of unsustainable economic growth (2004-07), driven by foreign capital and credit, and accumulated internal and external imbalances. At the climax of this period (end-2006), the economy grew in nominal terms by 36 per cent annually and the current account surplus widened to 27 per cent of GDP. The bubble started to deflate in 2007, but the terminal blow was delivered by global financial calamities in autumn 2008. The already distressed Latvian financial system was crippled and the bubble burst, sending the Latvian economy into deep recession. As a consequence, at the end of 2008, Latvia was banned from international money markets and had to ask for international assistance. After turbulent negotiations, assistance of €7.5 billion was agreed with the IMF, the European Commission and several bilateral donors. This assistance was to be released in several tranches, following Latvia's progress in the implementation of the stabilisation programme containing commitments for fiscal consolidation and various structural reforms.[9] The implementation of the stabilisation programme was successful, and Latvia saw the return of economic growth at the end of 2009. Since then Latvia has enjoyed a period of uninterrupted growth: 5.3 per cent in 2011, 5.2 per cent

3 National Development Plan of Latvia for 2014-2020, 20 December 2012, p. 3, available at: http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf.
4 C. Lagarde: Latvia and the Baltics – a Story of Recovery, speech delivered at the conference Against the Odds: Lessons from the Recovery in the Baltics, Riga, 4 June 2012.
5 P. Krugman: Baltic Brouhaha, http://krugman.blogs.nytimes.com/2013/05/01/baltic-brouhaha/?_r=0.
6 M. Wolf: Why the Baltic states are no model, http://www.ft.com/intl/cms/s/0/090bd38e-b0c7-11e2-80f9-00144feabdc0.html#axzz2a3TZC1Qy.
7 Speech by Andris Bērziņš, President of Latvia, at the First World Latvian Business and Innovations Forum, Riga, 3 July 2013.
8 M. Hazans: Emigration from Latvia in the 21st Century: Patterns and Consequences, a presentation at the Diaspora Studies Summer School, Jurmala, 27 June 2013.
9 Latvia's Economic Stabilisation and Growth Revival Program, adopted by the Latvian Parliament on 11 December 2008.

Table 1

Selected facts about Latvia

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
		Boom				Slump			Recovery	
Population (million)	2.27	2.25	2.22	2.21	2.19	2.16	2.12	2.07	2.04	2.01
GDP (€ billions, current market prices)	11.1	12.9	16.0	21.0	22.9	18.5	18.0	20.2	22.2	23.3
GDP (per capita, PPS, EU28=100)	47	50	53	57	59	54	55	60	64	-
GDP growth (% real annual)	8.8	10.1	11.0	10.0	-2.8	-17.7	-1.3	5.3	5.2	4.1
Inflation (%)	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2	2.3	0.0
Government tax revenues (% of GDP)	28.6	29.2	30.6	30.6	29.2	26.6	27.2	27.6	26.6	-
Unemployment (%)	11.2	9.6	7.3	6.5	8.0	18.2	19.8	16.2	14.9	11.5
Balance of current account (% of GDP)	-12.9	-12.6	-22.5	-22.4	-13.1	8.6	3.0	-2.2	-2.5	-0.8
Public debt (% of GDP)	15.0	12.5	10.7	9.0	19.8	36.7	44.5	42.2	41.3	38.1
Private debt (% of GDP)	74.5	94.8	122.1	127.5	132.1	147.4	140.4	125.1	133.0	-

Sources: Eurostat, Central Statistical Bureau of Latvia, author's own calculations.

in 2012 and 4.1 per cent in 2013 (see Table 1 for more details on Latvia's economy).

An alternative view is that the economic growth that Latvia enjoyed between 2004 and 2007 was natural, as it was catching up with developed Europe in terms of income and productivity.[10] Huge current account deficits and elevated inflation were unavoidable by-products of this catching-up: capital and intermediate goods had to be imported, and the redistribution of income from high to low productivity sectors caused overall wage growth.[11] The proponents of this view agree that better discipline regarding government spending and lending from commercial banks was warranted at that time, including an adjustment of the exchange rate, as it would have reduced the risk of abrupt adjustment. Had the global financial turmoil not restricted Latvia's and other emerging countries' access to international liquidity, the extreme speed of Latvia's economic growth would have abated with time.[12] When Latvia was in trouble, the institutions of the EU (most notably the ECB) were too slow to render liquidity assistance,[13] thus sending the Latvian economy into an unnecessarily deep recession (the cumulative peak-to-trough decline of GDP reached 25 per cent and unemployment jumped to 21 per cent – a result much worse than expected at the beginning of the stabilisation effort in 2008).

Yet, in the context of this debate, a few additional conceptual issues regarding Latvia's crisis experience need to be disclosed. First, it seems that small and open emerging economies continue to represent a puzzle to economic professionals. In the case of Latvia, few of the pre-crisis prophecies turned out to be true. Thus, professionals find it difficult to figure out the true nature of Latvia's overheating during the boom. Some commentators hint that it was not a boom at all, rather a normal trend growth determined by a speedy catch-up in productivity level.[14] Another contentious issue is productivity and external competitiveness. The presumed loss of competitiveness due to an excessive rise in labour costs was one of the major pre-crisis concerns. The latest studies reveal, however, that these concerns were groundless, as Latvia's exports grew at that time despite large do-

10 P. Krugman: Latvian Adventures, 19 September 2013, available at: http://krugman.blogs.nytimes.com/2013/09/19/latvian-adventures/?_r=0.

11 B. Bakker, C. Klingen (eds.): How Emerging Europe Came Through the 2008/09 Crisis, International Monetary Fund, 2012, pp. 22-23.

12 F. Di Comite, G. Giudice, R. Krastev, D. Monteiro: The evolution of the Latvian external sector: imbalances, competitiveness and adjustment, in: European Commission: EU Balance-of-Payments assistance for Latvia: foundations for success, European Economy Occasional Paper 120, November 2012, pp. 40-59.

13 A.S. Posen: Geopolitical Limits of the Euro's Global Role, in: J. Pisani-Ferry, A. Posen (eds.): The Euro at Ten: The Next Global Currency, Washington DC 2009, Peterson Institute for International Economics, p. 93.

14 P. Krugman: Latvian Adventures, op. cit.

mestic inflation.[15] The famous "internal devaluation" represents yet another example of Latvia's mystery. The fiscal consolidation and liquidity squeeze in the economy were meant to push down wages and prices to the levels commensurable with productivity. Nevertheless, the prices and wages turned out to be rather "sticky", and adjustment was achieved mainly through more efficient use of labour (i.e., through labour shedding and harder work). Finally, the economic growth which returned in the second part of 2009 was a result of neither fiscal consolidation nor internal devaluation. The real cause of recovery was the release of international liquidity assistance in June 2009,[16] which assured the market that the devaluation and sovereign default had been avoided. Eventually, it was shortage of liquidity that mattered most, and the earlier release of that assistance tranche would have saved much suffering.

Second, the scale and recurrence of financial and economic calamities[17] in Latvia point to serious deficiencies in the institutional set-up of Latvia's macroeconomic and prudential management. The scale and depth of the recent crisis is related to a disagreement between the Bank of Latvia and the government over macroeconomic strategy prior to the crisis. The Bank of Latvia had focused on the fixed exchange rate, but the government was not willing to sacrifice the speed of growth to the fiscal austerity required by a fixed exchange rate. Besides, the Latvian authorities had greatly encouraged the widespread euroisation of the economy (up to 80 per cent of mortgages were issued in euros in 2008), which ultimately limited the scope of action during the recession.

Third, Latvian society continues to suffer from entrepreneurial obsession (also called capital dependency syndrome). Low taxes and a liberal economic regime were introduced in the early 1990s with the aim of attracting foreign investment and promoting business growth. These policies were not revoked when the country was swamped with foreign capital after accession to the EU. In 2013, Latvia had the third smallest government in the EU in terms of public expenditure to GDP and the third lowest level of capital and corporate taxes.[18] Meantime, the profitability of businesses in Latvia is among the highest in the EU. Yet, despite this business friendliness, the cumulative per capita level of foreign direct investment (FDI) in Latvia is still considerably lower than in Estonia. In a similar vein, the development of manufacturing is also considerably lagging behind the other Baltic countries (see Table 2).

Fourth, the Latvian government in particular and society in general has failed to bring the interests of people, such as the quality of education and health care, equity, decent living conditions, etc., to the forefront of the daily political agenda. During the boom, people's loyalty to the political elite and state was bought with large chunks of money. People were given wage increases, generous social benefits (for the richest part of the population), and easily accessible mortgages and consumption loans. When crisis hit, without these benefits people's allegiance proved to be rather thin: first, part of the political elite was kicked out in elections; second, many simply packed their things and emigrated. The lesson is, as it was put by Milton Friedman, that "you can't fool all of the people all of the time." Many felt and still feel cheated and insecure. Each consecutive crisis has added to this feeling of insecurity, alienating people from the state.

The state of Latvia's economy after the crisis

The costs of adjustment have been immense. A quarter of Latvia's economy vanished; many people lost their jobs and property. Although the stabilisation programme has delivered financial stability and economic growth, it seems that the original major problem of Latvia's economic development – a persistent shortage of high value added and well-paid jobs – has not been resolved. The expectations that FDI would deliver sustainable development have not materialised thus far. The latest crisis has made this challenge even more acute, as Latvia has become a much smaller economy, and is destined to become even smaller due to demographic decline and

15 F. Di Comite, G. Giudice, R. Krastev, D. Monteiro: The evolution of the Latvian external sector …, op. cit.

16 The second tranche of liquidity assistance of €1 billion was delivered by the European Commission on 2 July 2009, despite lack of agreement with the IMF, which had become pessimistic about Latvia's ability to proceed with the required measures of the stabilisation programme.

17 In fact, independence has brought a chain of rather severe economic calamities. The economic collapse of the early 1990s occurred when Latvia was transforming from a Soviet-style command economy with immense productive overcapacity (Latvia used to be a manufacturing site for supplies to the whole Soviet Union) to a small market-based economy. At that time, GDP fell by around 49 per cent. In 1995, a banking crisis caused 53 per cent of household deposits to vanish; and in 1998 Russia's financial crisis prompted a peak-to-trough plunge in Latvian GDP of close to 12 per cent. The crisis of 2008-09 represents the latest episode in the drama.

18 In 2011, tax revenues amounted to 27.6 per cent of GDP in Latvia (the EU average was 38.8 per cent). The major part of public revenues came from indirect and labour taxes (24.3 per cent of GDP), leaving the contribution of corporate taxes at a miniscule 3.2 per cent. See Eurostat: Taxation trends in the European Union, 2013 edition. According to the most recent estimates from Latvia's Ministry of Finance, if no changes to the taxation policy are introduced, tax revenues will fall to 25 per cent of GDP in a few years' time.

Table 2

Social comparison between the Baltic countries[1]

	Latvia	Lithuania	Estonia
Some economic facts of social relevance			
Size of government (% of GDP, 2012)	36.5	36.1	39.5
Accumulated FDI per capita (€)	4,533	3,613	9,987
Capital taxes (% of GDP)	3.2	2.1	2.2
Profit share of non-financial corporations (% of gross value added)	53	58	48
Unemployment	16.2	15.7	12.8
Manufacturing (% of GDP)	14.2	22.4	15.7
Gini coefficient	35.4	33.0	31.9
At risk of poverty and social exclusion	40.4	33.1	23.1
Decline in size of population 2000-13 (%)	-15	-16	-6
Public opinion on state of political affairs (% of replies, 2013)			
Trust in national government	20	27	36
Trust in press	41	40	53
Trust in trade unions	36	23	44
My voice counts	26	20	37
Trust in others[2]	27	24	47
Support for both market economy and democracy[2]	15	27	31
Public opinion on state of economic affairs (% of replies, 2013)			
Households affected by the crisis[2]	56	52	50
Satisfaction with life	67	65	71
The state of national economy (very good and good)	20	19	41
National economic situation will improve in the year to come	26	30	29

Notes: [1] Data from 2011, if not otherwise indicated; [2] EBRD: Life in Transition Survey 2011. The worst figures among the three Baltic countries are highlighted.

Sources: Eurobarometer, Eurostat, European Bank for Reconstruction and Development.

emigration.[19] Yet, the capital-to-labour ratio is still very low, and new capital will be needed to sustain growth. A shrinking domestic market and pool of labour will hardly make Latvia attractive for investment.

The single most important element of Latvia's economic adjustment was fiscal consolidation. The expansion of public spending during the boom of 2005-07 created large expenditure overhangs when crisis struck. Without any corrective measures, the budget deficit would have reached 16 per cent in 2009 and 24 per cent in 2010, which was not sustainable. The pace and scale of the fiscal consolidation was determined by two imperatives: first, no external (currency) devaluation; second, the membership of the eurozone as of 1 January 2014. Two-thirds of overall fiscal consolidation was achieved by cutting spending, and the remaining third by increasing taxes.

The good news is that fiscal consolidation was well targeted to make Latvia compliant with the Maastricht criteria in time for eurozone membership. Austerity also enabled cuts in a number of less efficient programmes, and fostered valuable reforms in the health and education sectors. On the other hand, the scale of fiscal consolidation was enormous for peacetime: the amount of overall consolidation stretched over from 2009 to 2011 is estimated at 15 per cent of Latvia's GDP (note that total government expenditure was only 36.5 per cent of GDP in 2012). The measures were cruel: the number of public officials was reduced by one-third and their remuneration bill was cut by 25 per cent. Such measures had serious repercussions on the quality of public services and the social situation. With hindsight, it seems that this fiscal consolidation has failed on two counts. First, the Latvian public sector was not as bloated as it was often depicted (the government is small, and the number of public sector employees had increased only by 11 per cent between 2004 and 2008, which cannot be counted as a serious deflection of human resources from the private sector). Second, the expected wage cut spill-over to the private sector did not happen. The scale of the consolidation had significance only to international lenders but not to the local market because of the small size of the public sector.

Another major problem related to fiscal consolidation was the regressive nature of many measures taken. The increase in value added and excise taxes, the decrease in the threshold for personal income tax allowance, and pension cuts (these were later recalled following a ruling by the Constitutional Court) without proper compensation were among the enacted measures. At the same time, the government refused to follow the advice of international lenders to consider taxes on real estate and capital gains. As a result, the IMF had to admit that the burden of Latvian budgetary consolidation fell disproportionately on the poor.[20]

19 According to official estimates, by 2030, the working age population will shrink by 15 per cent and there will be around 130,000 vacant jobs. See Ministry of Economics of Latvia: Ziņojums par Latvijas tautsaimniecības attīstību, December 2012, p. 82.

20 IMF: Republic of Latvia: First Review and Financing Assurances Review Under the Stand-By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Rephasing of Purchases Under the Arrangement, IMF Country Report No. 09/297, October 2009, p. 24.

Despite sound economic gains, the Latvian economy still has not recovered to the level of pre-crisis development, and still exhibits some signs of its depressed state:

1. Although Latvia's nominal GDP has already surpassed the pre-crisis level, real GDP is still lagging behind its peak by around nine per cent and it could take another two to three years to cover this gap.

2. Unemployment remains stubbornly high, though it is gradually diminishing and reached 11.5 per cent at the beginning of 2014. Long-term unemployment is of particular concern, at 5.7 per cent of economically active people (in Estonia, 3.8 per cent; Lithuania, 5.1 per cent). The Bank of Latvia insists that the high level of unemployment is natural for Latvia due to structural features. The opponents of the Bank of Latvia, however, point to the fact that businesses mostly report shortages of low-paid workers and that well-remunerated positions are filled very quickly.

3. The indicators of market confidence, despite showing substantial improvement, are still negative, suggesting the numb state of Latvia's domestic market. If the pessimism of industry has abated recently, mainly due to improving external conditions, consumers still have very pessimistic views about their prospects.

4. Price dynamics also suggest low activity in the economy. Despite an initial bustle, the annual inflation rate turned into deflation at the beginning of 2013 and since then has remained extremely low. According to the European Commission, the disinflationary effect stems from prudent fiscal spending (among other things).[21]

According to the Global Competitiveness Index (GCI), Latvia's development has reached a transition stage between an efficiency-driven economy and an innovation-driven economy.[22] This indicates that for Latvia there is still room for growth through greater efficiency (most notably among institutions and of the labour force). However, improvements in these areas will not ensure income levels commensurable with advanced European countries. Without targeted policies towards business sophistication, and the creation of new products and technologies, Latvia will remain caught in the middle-income trap. The GCI also reveals that during the crisis Latvia has lost a good degree of advantage in financial sector sophistication. The soundness of banks, easiness of access to loans, and access to financing through local equity markets are still below pre-crisis levels. On the other hand, Latvia has advanced considerably in the area of technological readiness, which was possible mainly due to the wide use of the internet and the availability of up-to-date communication technologies.

According to the GCI, the size of the domestic market and accessibility of qualified labour significantly reduces Latvia's global competitiveness. Emigration represents the biggest problem. Although emigration long predates the crisis, the severity of the slump substantially contributed to the outflow of people. The successive waves of emigration have created a powerful social network of migrants, fostering further emigration of friends and relatives.[23] People have become Latvia's major export product.

Circular migration of people is not a bad thing. It increases labour efficiency, contributes to the cross-border flow of know-how and skills, and ensures higher personal incomes. In Latvia's case, emigration allowed many people to avoid the misery of joblessness and personal default. Each year, large amounts of euros are remitted to Latvia to support family members and repay debts to the banks. It is estimated that if people had stayed, the level of unemployment would be three to six percentage points higher (the actual level was close to 22 per cent).[24] Nevertheless, as young people are those who emigrate, and they are not replaced through immigration, Latvia's population is aging more quickly than suggested by demographic statistics. Moreover, as better educated people dominate among the emigrants, the problem of brain-drain becomes acute. What is more, when young people leave, they cause a huge loss to the society in terms of revenues. If no mechanisms are put in place to recover these losses, "the largely permanent departure of the younger and more educated workers may indeed be costly for those who stay."[25]

On 1 January 2014, Latvia joined the eurozone. It is quite reasonable to believe that accession to the eurozone will boost investment in Latvia and facilitate foreign trade,

21 European Commission: European Economic Forecast, Spring 2013, European Economy 2/2013.

22 For more details about the GCI, see World Economic Forum: Global Competitiveness Report 2012-2013, available at: http://www.weforum.org/reports/global-competitiveness-report-2012-2013.

23 M. Hazans: The Changing Face of Latvian Emigration 2000-2010 (Latvijas emigrācijas mainīgā seja 2000-2010), in: B. Zepa, E. Klave (eds.): Latvia. Human Development Report 2010/2011: National Identity, Mobility and Capability, Advanced Social and Political Research Institute of the University of Latvia, Riga 2011, pp. 71-101.

24 O. Blanchard, M. Griffiths, B. Gruss: Boom, Bust, Recovery. Forensics of the Latvia Crisis, Economic Studies at Brookings, 19-20 September 2013, p. 30.

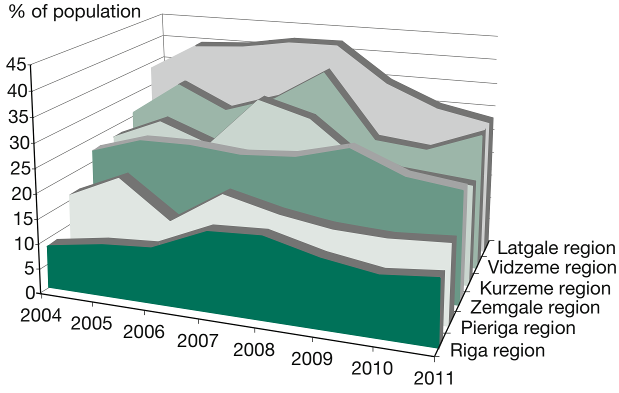
25 Ibid., p. 31.

both with the eurozone and other parts of the world.[26] Eurozone participation, however, will expose Latvia to another kind of risk, related to the country's development. At the moment it is difficult to foresee in which direction Latvia's economy will develop. It could take the same direction as after 2004 when investor euphoria swamped the local market with cheap credit, leading to another cycle of overheating. Or the economy could stay subdued for a prolonged time due to demographic decline and emigration. In both cases the problems stem from Latvia's still low level of income convergence and asymmetric development cycle with core eurozone member states like Germany. Depending on the path of development, Latvia may need either a stronger or, on the contrary, a weaker monetary approach. This is something that the eurozone cannot provide; therefore, one should expect that the one-size-fits-all monetary policy of the ECB will lead Latvia to even sharper cycles of development.

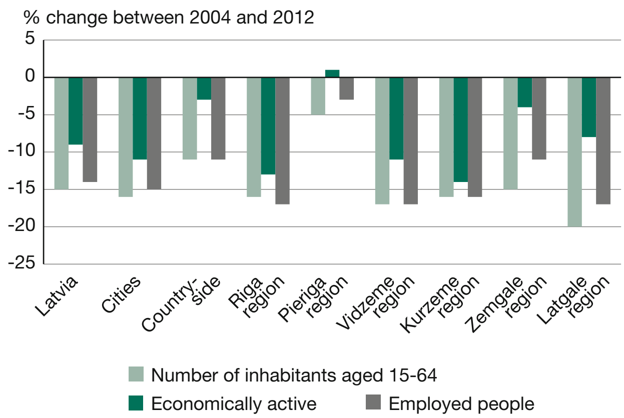
Yet, despite the risks associated with Latvia joining the eurozone, the currency union has geostrategic significance to Latvia. Besides, the hope is that despite the bitter internal strife between the southern and northern member states of the eurozone, the instinct of cooperation will ultimately prevail and, in exchange for greater fiscal vigilance, financial solidarity among the eurozone countries will be enhanced. Indeed, even the seemingly strong states could one day fall from grace, as evidenced by the recent IMF research paper on the prospects of a fiscal union.[27] A loose EU as propagated by the UK and Sweden is not in Latvia's interests. Without solidarity Latvia will be at risk of permanent underdevelopment with huge social and political costs.

Figure 1
Social situation in Latvia's regions

a) Those at risk of poverty



b) Depopulation, 15-64 years old



Source: Eurostat.

The social impact of the crisis

In Latvia, in 2011, 56 per cent of households felt that they had suffered during the economic crisis, and only 38 per cent of people were satisfied with life.[28] Since 2011 the mood has improved; however, that gloomy social picture is not surprising, as the scale of grey economy, large regional disparities, high income inequality, and widespread poverty are notable features of the Latvian economy (see Figures 1 and 2). During the crisis, income inequality subsided to some extent, even though poverty deepened, thus reinforcing social cleavages in Latvia.

After the recession, labour market difficulties have become more widespread and probably more varied:[29]

- The working age population has fallen sharply, long-term unemployment remains elevated, and labour market participation is shrinking. This problem is particularly acute in Latvia's regions, where, despite a general depopulation trend, unemployment is still on rise (see Figure 1).

26 More details about the pros and cons of Latvia's membership in the eurozone are provided in A. Austers, K. Bukovskis: Latvia's Socio-Economic and Political-Institutional Challenges in the Context of the Euro zone Accession, in: Baltic-German Strategic Engagement: Realignment after the Eurocrisis?, Latvian Institute of International Affairs, Friedrich-Ebert-Stiftung, 2013, available at: http://www.liia.lv/site/docs/StrategyTalks2013_A5_GALA.pdf.

27 IMF: Toward a Fiscal Union for the Euro Area, September 2013.

28 European Bank for Reconstruction and Development: Life in Transition. After the Crisis, 2011, available at: http://www.ebrd.com/downloads/research/surveys/LiTS2e_web.pdf.

29 K. Gasior, O. Lelkes: Poverty, Inequality, and the Social Impact of the Financial Crisis in Latvia, in: World Bank: Scientific Research: Latvia: Who is Unemployed, Inactive or Needy? Assessing Post-Crisis Policy Options, 2013.

- The young (15-24 years old) and middle aged (50-64 years old) were hit most severely, with unemployment soaring up to 35 per cent and 17 per cent respectively in 2009, and remaining stubbornly high since.

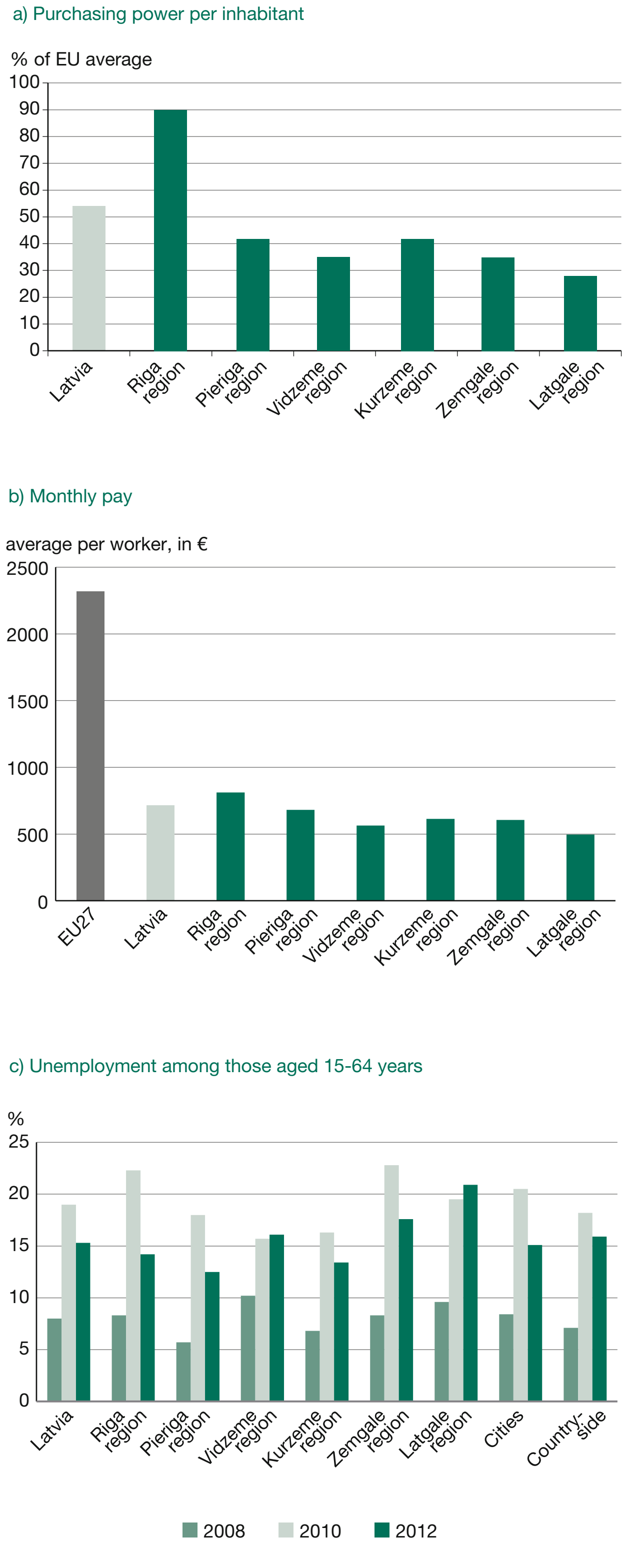
- Many of the unemployed abandoned searches for a new job and resorted to activities in the grey economy (either subsistence farming or low-intensity occasional jobs).[30]

Remuneration is another contentious issue in the context of the recent Latvian crisis. Latvian salaries remain among the lowest in the EU, despite a pre-crisis hike. The average monthly pay in Latvia is 3.5 times smaller than the average level of monthly pay in the EU. The minimum wage in Latvia is set at a level of €320 per month (as of January 2014). Income inequality is particularly huge between Latvia's regions. As depicted in Figure 2, the income level (in purchasing power standard) in the Riga region is close to the EU average (90 per cent); in Latgale, the most depressed Latvian region, the income level reaches only 29 per cent of the EU average.

Many economists argue that the level of wages should be commensurable with productivity. Apparently, the productive capacity of many Latvians seems high enough to allow them to earn decent wages in Western European countries, but not in Latvia.[31] A recent study from IMF experts on wage adjustments during the crisis sheds some light on the cause of the problem. Namely, while no significant wage cuts took place in Latvia, productivity performance substantially increased. This was achieved mainly through harder work and labour shedding. In the meantime, productivity gains have a tendency to materialise in higher profit margins of companies, but not in higher wages.[32] This fact points to weak labour unions and low employment protection in Latvia.

If income inequality had a tendency to diminish during the crisis, poverty, on the contrary, deepened, and society's polarisation increased. According to a World Bank study,[33] social disparity in Latvia is among the highest in the EU. Moreover, the situation seems to be significantly worse than in Estonia and Lithuania, especially with respect to severe material deprivation. Thus, Latvia is a

Figure 2
Economic situation in Latvia's regions



Source: Eurostat.

30 The World Bank has found out that only a minority of those unemployed in Latvia were persistently jobless and that many had informal, low paying or unstable jobs.
31 Around 26 per cent of Latvian emigrants have jobs relevant to their qualification. The situation is somewhat better for those living in continental Europe – around 36 per cent have qualified jobs. See M. Hazans: The Changing Face ..., op. cit., pp. 78-79.
32 O. Blanchard, M. Griffiths, B. Gruss: Boom, bust ..., op. cit. pp. 22-23.
33 K. Gasior, O. Lelkes: Poverty, Inequality ..., op. cit.

country with the highest share of population, first, at risk of poverty (21.3 per cent on average; however, in regions outside the capital this figure fluctuates between 30 and 40 per cent); second, in severe material deprivation (27.4 per cent); and third, living in extreme poverty (one per cent with income of €2 per day and three per cent with income of €4 per day).

The main losers from the crisis, according to the same World Bank study, were children, young adults, single parents, tenants paying a market rate, and those living in urban areas. Many of those who lost jobs during the crisis were well-off beforehand. Encouraged by general euphoria, many had taken mortgages or loans for consumption. During the crisis the ability to service debts sharply diminished. The rate of overdue loans jumped to around 20 per cent.[34] Although the debt misery was to a large extent self-imposed, as in the run-up to the crash saving rates among Latvian households were very low, many became victims to the illusion of wealth.

The European Commission and World Bank studies indicate that Latvia did not have a particularly generous welfare system when compared to other countries in the EU. Besides, Latvia was relatively unprepared to protect households at the onset of the crisis. Initially, Latvia's government's guaranteed minimum income (GMI) programme was only moderately well targeted at the poor – no more than 30 per cent of benefits went to the poorest quintile; the coverage was also very low and reached five per cent of the poorest quintile. However, as recognised by the European Commission,[35] the government managed to respond quickly by introducing reforms. It eased eligibility requirements, extended the duration of unemployment insurance benefits, and introduced public works programmes.

Latvian health statistics are also bleak. The infant mortality rate is the highest among the Baltic countries and the third highest in the EU (behind Romania and Bulgaria). Latvians have the shortest life expectancy (73.9 years) and the third lowest number of years of healthy life (53.7 years for men and 56.7 years for women).[36]

34 M. Kazaks: From Boom to Bust and Back: The Banking System, in: European Commission: EU Balance-of-Payments Assistance for Latvia: Foundations for Success, European Economy Occasional Papers 120, November 2012, pp. 145-148.

35 P. Harrold, I. Santos, E. Sinnot: Fiscal Sustainability, Demographic Change and Inequality: The Social Sectors from Crises to Growth in Latvia, in: European Commission: EU Balance-of-Payments Assistance ..., op. cit., pp. 100-133.

36 Eurostat: European Social Statistics, Luxembourg 2013, Publications Office of the European Union, pp. 67-101.

Between 2004 and 2008, the health sector saw real spending grow by more than 70 per cent, with additional resources focused on hospitals, ambulatory services, and patient pharmaceuticals, to the detriment of outpatient care.[37] In education, the spending increase of 39 per cent was used to boost the number of teaching and non-teaching staff despite falling enrolment numbers. Naturally, during the budgetary consolidation of 2009 and 2010 much of this extra spending had to be scaled back: a great number of rural schools had to be closed, teachers discharged, and much of the newly built hospital capacity had to lie idle or be shut down. Many of the reforms implemented in education and health care were valuable; however, the current risks involve continuous human suffering from a drop in incomes, unemployment, and the intellectual degradation of rural villages linked to the closure of public establishments.

Under severe economic pressure, one would expect a rise in crime level and violence. Fortunately, this has not been the case for Latvia. The general crime level has stayed rather low (around 80 per cent of the European average).[38] The overall number of registered crimes dropped by eight per cent between 2008 and 2010. This seemingly positive development has two rather odd background facts that should be considered. First, policeman, prosecutors, and judges were among those public officials who saw their salaries cut in 2009 and 2010. Second, the number of prison inmates in Latvia is among the highest in the EU: 326.8 per hundred thousand inhabitants, which is twice the average of the EU.

The political impact of the crisis

Massive gaps in income between rich and poor can be harmful to social cohesion and the successful functioning of any society, especially when inequality is perceived as unfair. This argument seems even more pertinent in relation to transition countries like Latvia. In these countries, although initially perceived as a positive signal of increased opportunities, income inequality started to undermine people's life satisfaction when individuals became sceptical about the legitimacy of the enrichment of those benefitting from the reform process.[39]

The EBRD's Life in Transition Surveys show that, in Latvia, trust in other people and institutions fell substantially during the crisis, with only 27 per cent of people showing trust

37 P. Harrold, I. Santos, E. Sinnot: Fiscal Sustainability ..., op. cit.

38 Eurostat: European Social Statistics, op. cit., pp. 205-209.

39 J. Helliwell, R. Layard, J. Sachs (eds.): World Happiness Report 2013, available at: http://unsdsn.org/files/2013/09/WorldHappiness-Report2013_online.pdf.

in others in 2010 (from 37 per cent in 2006).[40] Moreover, the economic crisis has considerably increased Latvian people's aversion to democracy and market institutions, as a mere 15 per cent prefer a combination of democracy and a market economy over other forms of governance (down from 31 per cent in 2006). Such attitudes do not testify to an obtained resilience or immunity to hardships; rather, they suggest a serious legitimacy crisis of the Latvian state and political elite.

Impact on collective citizens' identity

Throughout history, Latvian people have had to endure repeated severe hardships and examinations of resilience. Previous hardships were imposed by foreign rulers, with the latest episodes happening during Soviet occupation. The traumatic historical experience (destruction of the state before the Second World War, violence and repressions during and after the war, life under totalitarianism) and continuous geopolitical tensions with Russia make Latvian people rather sceptical about the fortunes of an independent Latvian state as a collective endeavour of the Latvian community. Such an attitude can be explained by the very short experience of political self-rule. The first democratic Latvian Republic lasted only from 1918 to 1934 (from 1934 to 1940, until the Soviet invasion, the country was ruled by autocrat Karlis Ulmanis). The current republic is the second attempt at democratic self-rule. Certainly, democracy cannot be built in a few years. In this sense, Latvian civic society is maturing, and there has been a lot of progress since the 1990s.

However, recent recurrent episodes of financial and economic disorder resonate with inherited incredulity from past misfortunes, thus building a strong feeling of distrust in the Latvian political system. A striving for self-enrichment, tax evasion, corruption and lately emigration are manifestations of this distrust. The ideals of the Singing Revolution of the late 1980s have long been eaten away by mundane malfeasances and an endless struggle for survival. The general perception of the Latvian people is that society in general and the state in particular have failed to deliver the promised security and welfare.

A study conducted by the Cross-Sectoral Coordination Centre of the Latvian Government recognises the severity of the problem and says that "economic and fiscal problems have resulted in a considerable deterioration of the people's capacity to act", therefore "individual solutions (emigration, the grey economy) prevail over collective solutions (payment of taxes, participation, social entrepreneurship), deepening the crisis in the society."[41] In the terminology of Alfred Hirschman,[42] people have abandoned their "loyalty" to the Latvian state, and, instead of raising "voice", have chosen to "exit". Among the EU's member states, only Lithuania has seen a more intense exodus of people.

It is very popular to attribute the latest wave of emigration to Latvia's economic conditions. Some argue that the economies of Latvia and Lithuania are too small to provide all those economically active with well-paid jobs, therefore, it is natural, like in other episodes of emigration, particularly in the 19th and 20th century, to shed the spare labour to countries with labour shortages. However, there are two major problems with this line of argument. First, the intensity of emigration from Latvia, and also Lithuania, points to the political nature of departure. It is a latent protest against economic, social and political deficiencies. Second, Latvia is a small country with very limited human resources. The departure of too many people will make the financing of the country unbearable for those who stay behind.

In fact, a comparison between public opinion surveys from the three Baltic countries (see Table 2) reveals a large difference between Estonia on the one hand, and Latvia and Lithuania on the other. Estonian people have more positive thoughts on almost every account and, unsurprisingly, Estonia is the only Baltic country whose scale of emigration is still indicated by a single-digit number. This implies a strong correlation between the people's trust in national political institutions and their propensity to emigrate.

Impact on voters' attitudes to political institutions and political preferences

The level of distrust in Latvian political institutions has historically been high, as suggested by public opinion surveys. A crisis of such a magnitude as that which Latvia has recently experienced could not pass by without significant alterations in people's attitudes. Thus, according to Eurobarometer surveys, in Latvia, the level of people's trust in government fell from 32 per cent in 2006 to nine per cent in 2009, and then grew to 20 per cent in 2013. As for political parties and the elite of the country, the attitude towards them is much worse. In 2006 only nine per cent of respondents trusted them, the same as in 2013. How-

40 EBRD: Life in Transition: A Survey of People's Experiences and Attitudes, 2007, available at: http://www.ebrd.com/downloads/research/economics/lits.pdf; EBRD: Life in Transition Survey II, 2011, available at: http://www.ebrd.com/pages/research/publications/special/transitionII.shtml.

41 National Development Plan of Latvia for 2014-2020, op. cit., p. 12.

42 A. Hirschman: Exit, Voice, and Loyalty, 1970.

ever, at the peak of the crisis the trust in parties reached an extremely low level – only two per cent.

A particular feature of the Latvian political system, which is based on parliamentarianism, is that the traditional political cleavages of right and left do not really function. Instead, the political scene is dominated by ethnic issues because a large number (around 32 per cent) of Latvian citizens have Russian or other non-Latvian ethnic origin. This group of Latvian citizens, often referred to as Russian-speakers, has high and consistent loyalty towards political parties claiming the representation of their ethnic interests (education in mother tongue, liberalisation of Latvia's citizenship regime, the Russian language status in Latvia, etc.). The most popular political force at the moment is the Harmony Centre alliance, which has centre-left orientation. Latvian voters in general do not trust parties with a significant Russian presence, as these, like Harmony Centre, are suspected of receiving funding and instructions from Moscow. Therefore, Latvians are inclined to vote for Latvian parties that happen to represent the political spectrum from radical right to moderate right. No popular Latvian party claims to be leftist, although some of them, such as the nationalistic For Freedom and Fatherland, pretend to have a socialist orientation in economic affairs.

The ultimate result of this clear-cut ethnic split among voters is that the normal functioning of opposition along the lines of distribution of national wealth has been inhibited. This to a large extent explains the entrenched business orientation of Latvian politics.

Despite this fact, since the 2006 parliamentary elections the Latvian political landscape has seen considerable changes. First, many of the major political forces at that time have lost their appeal to voters due to the crisis and have no representation in parliament. These are the so-called oligarch or pro-business parties. In 2010 the political scenery was dominated by centre right and right wing parties who claimed to defend justice and anti-corruption activities. Since the state president dismissed the parliament and extraordinary elections were called in 2011, the dominating forces have been Unity and the Reform Party. These parties have identical political programmes: both promote reforms and have invested a lot of effort in restructuring the Latvian economy after the crisis. However, despite the return of economic growth, these two parties are losing public support. The Reform Party is doing particularly badly.

The next parliamentary elections will take place in autumn 2014 and it seems that centre parties are going to suffer, with nationalistic and leftist pro-Russian parties winning. One of the causes of centre parties' demise is emigration. The young and liberal minded are those who tend to emigrate. Voting abroad is allowed in Latvia's elections; however, voter activity outside the country is rather low (although it is increasing) and will not compensate for the loss of support for centre parties within the current electoral system. As a result, more radicalism and conservative populism should be expected from Latvian politics in forthcoming years.

Conclusions

The current state of Latvia can be best described in medical terms: the patient is pale, but alive. The financial woes have been successfully resolved, but economic, social and political challenges remain. The crisis is continuing to affect the fabric of social and political life in Latvia. The current economic recovery is superficial and will not be long-lasting as it lacks a strong social base: first, due to the emigration of mostly young and educated people and the related demographic decline; and second, due to the entrenched business orientation of Latvian politics which prevents the full utilisation of Latvia's human potential. Without any further resolute action, another stroke – if not cardiac arrest – is not far away.

Below are a few ideas about what could be done to alleviate Latvia's problems:

- The government should focus on the remaining structural inefficiencies in vocational and higher education, infrastructure, the court system, and competition; promote more active labour market policies; and invest in science and research.

- The neoliberal ideological orientation should be left to history and politics reoriented towards social democratic tradition. Latvia, as a small nation, needs something like German corporatism, and not Anglo-Saxon liberalism.

- The government budget should be enlarged through broader taxation, including taxes on capital and land. Taxation and the social safety net needs further restructuring in order to make people in Latvia more equal in terms of income.

- The government should devise instruments, including changes to the electoral system, to facilitate cooperation with Latvians living abroad. Latvia needs to adjust to the situation of high cross-border mobility.

- EU support will be of critical importance, as the Latvian government will not be able to raise adequate resources to maintain public services due to emigration.