

## Latvia and Greece: Less is more

**Michael Biggs and Thomas Mayer**

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### Key Points

- Despite considerable differences, there were also many similarities in economic performance between Latvia and Greece before their respective adjustment crises. After the immediate crisis, however, economic activity rebounded sharply in Latvia but continued to contract in Greece.
- This paper argues that this difference was due primarily to developments in credit. In Latvia credit growth fell sharply, and the economy was deleveraging aggressively by 2009. When the pace of deleveraging started to stabilise, the rebound in the credit impulse caused domestic demand growth to recover. Real GDP has increased about 20% since reaching its trough in the third quarter of 2009.
- Owing to more generous external assistance for Greece, credit growth declined more slowly and only turned negative in 2011. Credit growth kept falling through 2011 and 2012, the credit impulse remained negative, and domestic demand and GDP continued to contract.
- It has been a widely held view that countries facing a credit crunch under a fixed exchange rate regime are doomed to failure, as they cannot use currency weakness to regain competitiveness. The Latvian case, however, suggests that internal adjustment, while costly, is certainly achievable.

### A tale of two countries

At first glance, Latvia and Greece seem to have little in common: One, a Baltic country of some 2 million inhabitants that was part of the Soviet Union until 1991, and the other, a Mediterranean country of about 11 million that has been a member of the European Union since 1981. In Latvia, over-borrowing by the private sector triggered the crisis. In Greece, the culprit was the public sector. At second glance, however, a number of commonalities emerge, as enumerated below.

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- Both countries experienced rapid growth during the 2000s, with Latvia recording annual average GDP growth of 9.0% and Greece, 3.3% between the first quarter of 2004 and the first quarter of 2008.
- Growth in both countries was accompanied by rapid credit extension, with bank loans to residents growing at an annual average rate of 47.2% in Latvia and 17.9% in Greece between the first quarter of 2004 and the first quarter of 2008.
- Despite very strong growth, governments ended up with considerable budget deficits, reaching 6.8% of GDP in Latvia in 2010 and 15.7% in Greece in 2009.
- Domestic demand in both countries grew much faster than domestic supply, with the result that the current account reached a deficit of 26.7% of GDP in Latvia in the fourth quarter of 2006 and 16.7% of GDP in Greece in the fourth quarter of 2007.
- As a result of these excesses, both countries suffered a debt and balance-of-payments crisis in the late 2000s, with Latvia receiving an EU balance-of-payments assistance programme and an IMF stand-by programme at the end of 2008 and Greece an EU adjustment and IMF standby programme at the beginning of 2010.
- Both countries pursued economic and financial assistance in a fixed exchange rate regime, with Latvia choosing not to break the peg of its currency to the euro and Greece choosing not to leave EMU.

Here the similarities end. The size of financial assistance to the two countries differed significantly, which allowed them to follow different adjustment paths. In the following we shall argue that less generous assistance to Latvia forced a front-loaded debt reduction that paved the way for a more dynamic recovery. More generous assistance to Greece softened the economic blow emanating from the debt and balance-of-payments crisis but also weakened the recovery. As a result, Greece may well fail to lower its public debt to sustainable levels in the future while Latvia has successfully concluded its adjustment programme.

### Unequal assistance

Latvia was ill-prepared for the financial crisis that began in 2007 and culminated with the bankruptcy of Lehman Brothers in September 2008. As risk aversion grew in global financial markets, Latvia's large external deficits could no longer be funded by private capital inflows. Hence, in December 2008, a number of institutions and countries agreed to provide multilateral financial assistance to Latvia in an amount altogether of €7.5 billion, consisting of the following elements:

- €3.1 billion under a balance-of-payments assistance programme by the European Community,
- €1.7 billion under an IMF stand-by arrangement,
- €1.9 billion by a group of northern countries, including Sweden, Denmark, Finland, Norway and Estonia,
- a €0.4 billion loan from the World Bank and

- a €0.4 billion loan by the European Bank for Reconstruction and Development, the Czech Republic and Poland.

Thus, Latvia received financial assistance from abroad in the amount of €3,468 per head of its population (or 34% of 2012 GDP).

Greece was initially little affected by the financial crisis as its membership in the eurozone protected it from the doubts that foreign investors might have harboured about the stability of the exchange rate. However, when the newly elected Greek government revealed in the autumn of 2009 that the government budget deficit was running out of control and that government finance data had been systematically misreported in the past, Greece experienced a government debt crisis in early 2010 that grew into a banking and balance-of-payments crisis during the following two years. In order to shield the eurozone from the potentially disastrous fall-out of Greek government default, the Eurogroup on 2 May 2010 decided to help Greece with bilateral loans of €80 billion that were combined in a pool by the European Commission (the so-called 'Greek Loan Facility'). This programme was complemented by an IMF stand-by agreement in the amount of €30 billion. It was envisaged that the total of €110 billion would be disbursed until mid-2013 and that Greece should then be able to return to the markets for its funding needs in the course of that same year.

However, the implementation of the programme and the performance of the Greek economy were disappointing and the country's return to the markets became unrealistic for the foreseeable future. Against this background, the euro area finance ministers approved a second economic adjustment programme for Greece on 14 March 2012. Undisbursed amounts of the first programme (from the Greek Loan Facility) were topped up by an additional €130 billion, to be disbursed in the period 2012-14. The new programme was to be financed by the European Financial Stability Facility (EFSF), which had been fully operational since August 2010. Under the second programme, Greece is to receive financial assistance in the amount of €164.5 billion until the end of 2014. The EFSF will contribute €144.7 billion and the IMF €19.8 billion (as part of a four-year €28 billion arrangement under the Extended Fund Facility for Greece that the IMF approved in March 2012).

Thus, Greece is set to receive total financial assistance in the amount of €237.5 billion (122% of 2012 GDP), which is equivalent to €21,237 per head of the population. This is more than six times the amount that Latvia received per head of its population. Moreover, the Greek banking sector was supported by the ECB through emergency lending assistance and (like banking sectors in other EMU countries) through generous general refinancing operations. This allowed Greek banks to obtain balance-of-payments funding through the Target2 interbank payments system in the amount of up to €107.8 billion in the third quarter of 2012 (of which €51.1 billion was still left at the end of 2013).

Last but not least, private investors in May 2012 were coaxed into the forgiveness of part of their claims on Greece. Private Sector Involvement (PSI) extinguished €106 billion of Greek debt (54% of GDP). But it also generated new debt of €30 billion to the EFSF (the 'credit enhancement' needed to back the debt exchange), and an

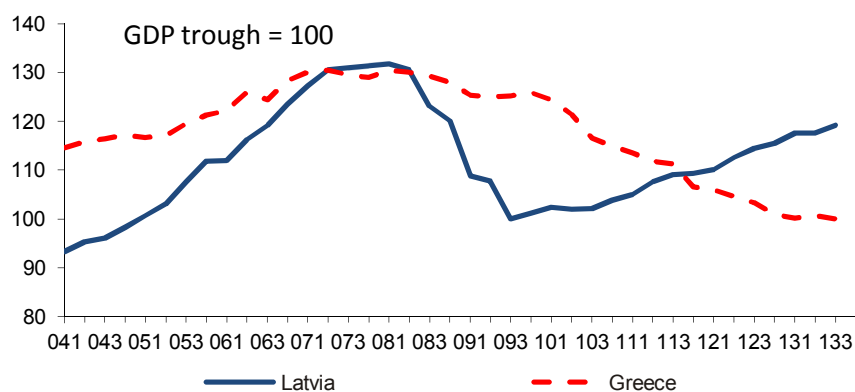
estimated €36 billion of losses for Greek banks, which needed to be recapitalised. The net debt reduction thus amounted to €40 billion (20% of GDP).<sup>1</sup>

## Unequal results

Latvia's excesses exceeded those of Greece, but its adjustment was much more rapid. This is largely attributable to a faster reduction of debt, enforced by less generous external financial assistance.

Figure 1 compares quarterly real GDP data in Latvia and Greece, with the trough of the recession set to 100. Latvia reached the trough in the third quarter of 2009. We assume that Greece saw the trough in the fourth quarter of last year. The drop of GDP from peak to trough was quite similar in the two countries. But in Latvia the drop occurred over 6 quarters, while GDP declined over an estimated 22 quarters in Greece.

Figure 1. Latvia and Greece: Real GDP

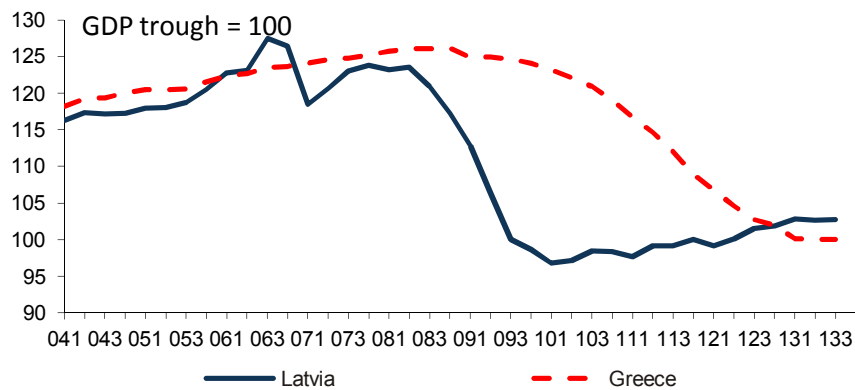


Source: Haver Analytics.

As a result of the slower adjustment in GDP, the blow to the labour market also came over a longer period of time in Greece. The percentage changes in employment and unemployment were again very similar in the two countries (Figures 2 and 3). But it took 14 quarters in Latvia for employment to hit the trough, and it will most likely take more than 22 quarters in Greece to complete the adjustment of employment. Unemployment rose over 7 quarters in Latvia and an estimated 21 quarters in Greece. The difference in adjustment speeds is also visible in the development of current account balances in the two countries (Figure 4).

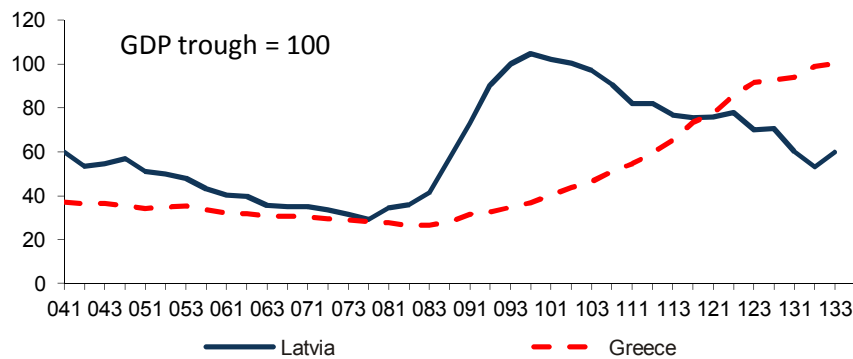
<sup>1</sup> See Miranda Xafa, "Life after Debt - The Greek PSI and its aftermath", *World Economics*, Vol. 14, No. 1, January-March 2013.

Figure 2. Latvia and Greece: Employment



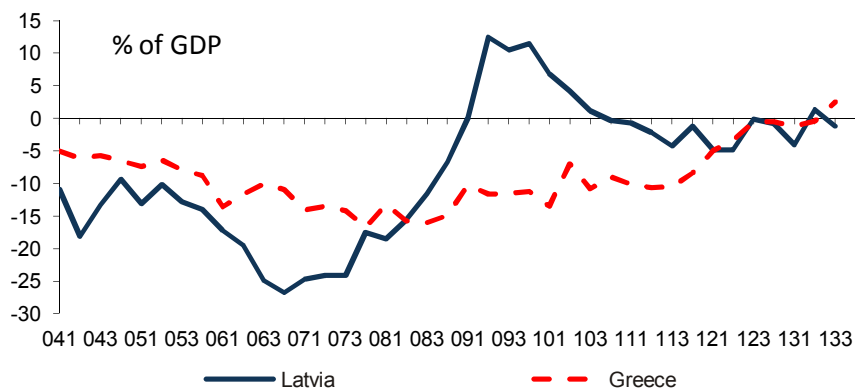
Source: Haver Analytics.

Figure 3. Latvia and Greece: Unemployment



Source: Haver Analytics.

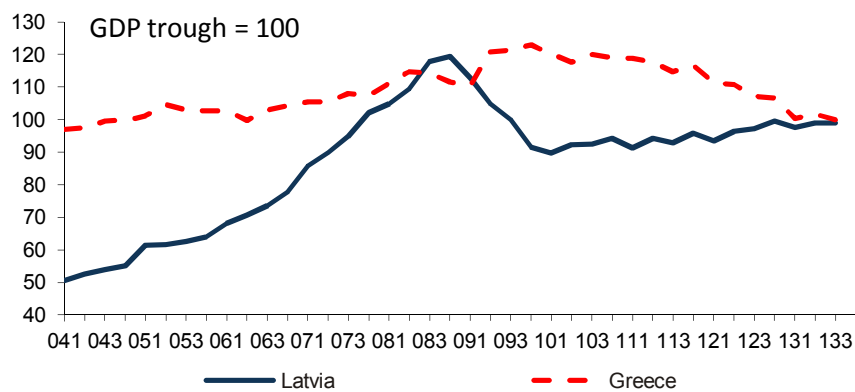
Figure 4. Latvia and Greece: Current account



Source: Haver Analytics.

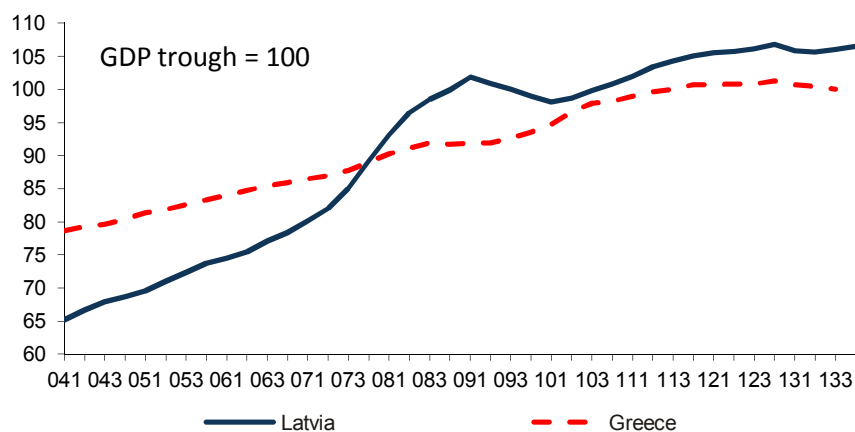
Possible reasons for the difference in adjustment speed in the real economy could be differences in price and labour cost developments or fiscal policy. As far as price and labour cost developments are concerned, differences are much less pronounced. Unit labour costs rose much more in Latvia during the boom and came back somewhat faster there than in Greece during the bust, but there is little difference in the developments of consumer prices (Figures 5 and 6). Taken together, it seems unlikely that differences in the development of costs and prices can explain the difference in the developments of the real economy and the current account.

Figure 5. Latvia and Greece: Unit labour costs



Source: Haver Analytics.

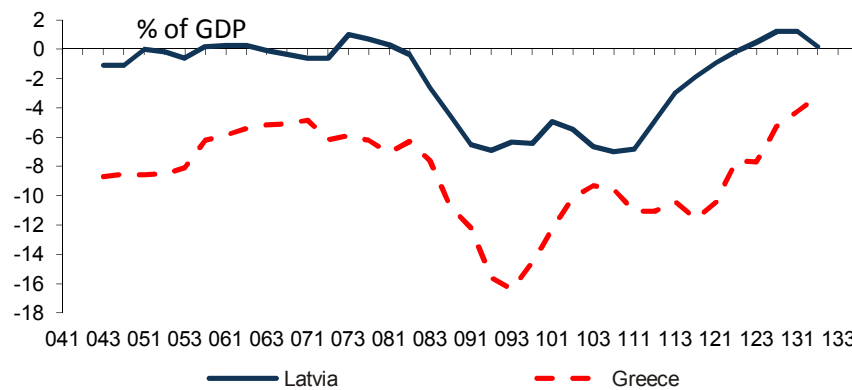
Figure 6. Latvia and Greece: Consumer prices



Source: Haver Analytics.

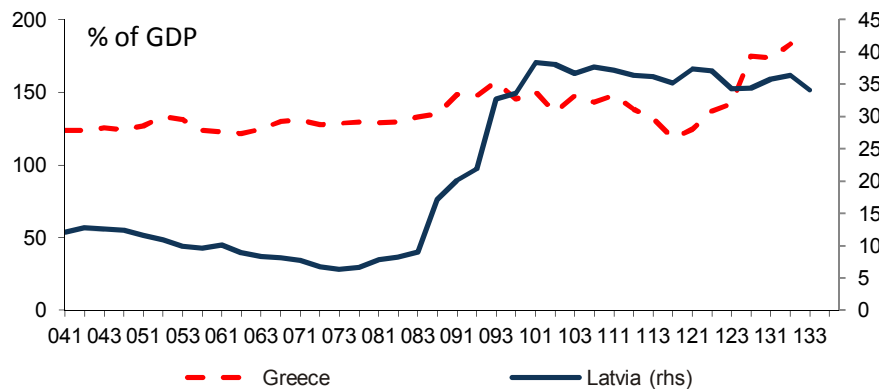
As can be seen from Figure 7, government budgets initially improved faster in Greece than in Latvia. The budget deficit peaked in Greece 16 quarters before reaching the trough of the recession (assumed for the fourth quarter of 2013) and fell sharply in 2012-13. In Latvia, deficits continued well into the recovery (beginning in the fourth quarter of 2009), and the budget turned into a surplus only 8 quarters after the trough of the recession. As a result of higher government deficits at the beginning of the downturn, the government debt ratio began to rise in Greece already six quarters before the trough in the recession, while the increase in Latvia began four quarters before the trough. Latvia saw its debt-to-GDP ratio rise by 30 percentage points from 8% in the first half of 2008 to 38% in the first quarter of 2010. In Greece, the debt ratio increased by more than 50 percentage points so far (and may rise further), from about 130% in the first half of 2008 to 183% in the second quarter of last year. The rise of the public debt ratio in Greece started from a much higher level and brought the ratio to levels that are clearly unsustainable in the long run despite the debt forgiveness in 2012. All in all, the differences in fiscal policy also fail to explain the difference in real economic performance. *Ceteris paribus*, the more aggressive fiscal tightening in Greece should have led to faster real economic adjustment than in Latvia. The fact that the opposite happened points to other factors that were more influential than fiscal policy.

Figure 7. Latvia and Greece: Government budget deficit (4-quarter moving average)



Source: Haver Analytics.

Figure 8. Latvia and Greece: Public debt



Source: Haver Analytics.

A simple explanation for Latvia's rebound could be that growth was so negative in 2009 (-17%) that it simply had to rebound thereafter. This explanation is not convincing, however, as even after the sharp contraction in 2009 was known, institutions such as the IMF continued to be surprised by the strength of Latvia's rebound. In the IMF's April 2010 World Economic Outlook (WEO), Latvian GDP growth for 2010 was expected to be -4%. In the end, it came out as -0.9%. In the WEO in April 2011 and 2012, the IMF expected growth in those years of 3.3% and 2.0%, respectively, whereas the final outcomes were 5.5% and 5.6%. In short, from 2010 to 2012, the IMF had to revise upwards its GDP growth forecasts by a cumulative 9.0%. The strength of the Latvian rebound confounded conventional macroeconomic thinking. In Greece, in contrast, GDP growth disappointed expectations year after year.

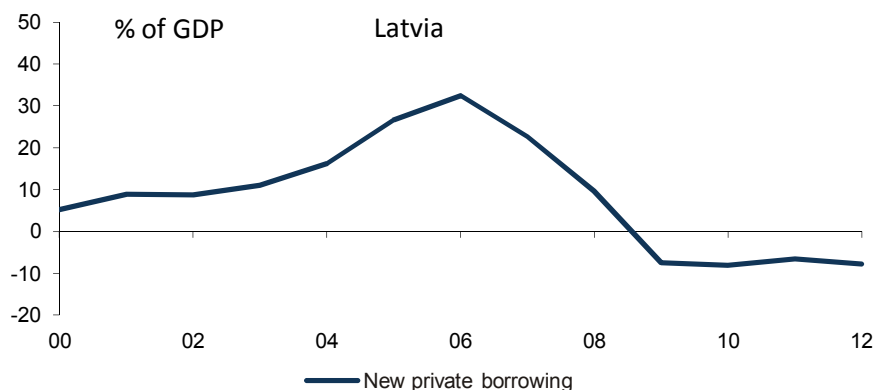
An alternative explanation could be that Latvia's recovery was based on external demand. In 2010 exports amounted to 50% of real GDP in Latvia, and just over 20% in Greece. However, while Latvia certainly benefited from a recovery in exports, this does not explain the magnitude of the cycle. As Blanchard et al.<sup>2</sup> argue, the decline in

<sup>2</sup> See O. Blanchard, M. Griffiths and B. Gruss, "Forensics of the Latvia Crisis", paper presented at the Brookings Panel on Economic Activity, Brookings, 19-20 September 2013.

GDP during the downturn was far greater than can be explained by exports, and a large part of the surprise in the rebound was driven by domestic demand.

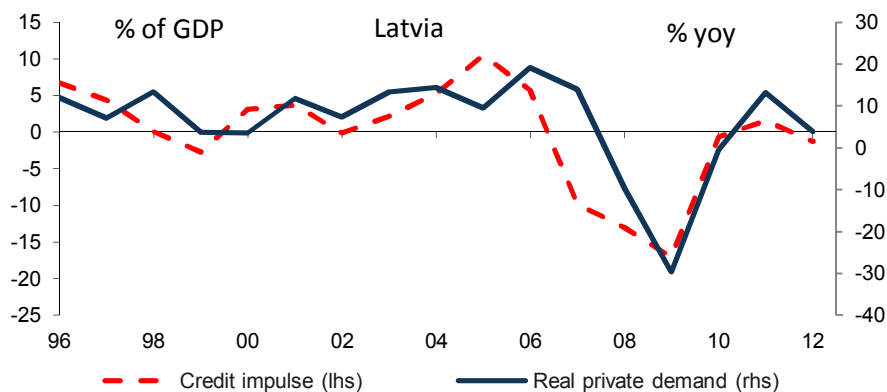
In our view, the bulk of the difference in the performance between Latvia and Greece can be explained by developments in private credit. As we have argued before, the relevant credit variable when assessing the impact on domestic demand is not credit growth, but the change in new borrowing (roughly the change in credit growth).<sup>3</sup> We call this the 'credit impulse'. Developments in credit in Latvia are shown in the figures below.

Figure 9. Latvia: New private borrowing



Source: Haver Analytics.

Figure 10. Latvia: Credit impulse and private domestic demand growth



Source: Haver Analytics.

IMF expectations in mid-2010 (published in their Article IV Staff Report of 9 December 2010) were for contributions to Latvian growth of +5.0% for net trade and -8.7% for domestic demand. Instead, net trade contributed 0.1%, and domestic demand -1.5%. The net trade contribution was 4.9% less than anticipated, and the domestic demand contribution was 7.2% more. Exports did play a role in the recovery – the IMF expected export growth in Latvia in 2010 of 5%, while actual export growth came in at 12%. However, the big surprise was that the IMF forecast private consumption growth of -9.0% while it came in at +2.3%. In a forecast made in mid-2010, they missed consumption growth for 2010 by 11.3%.

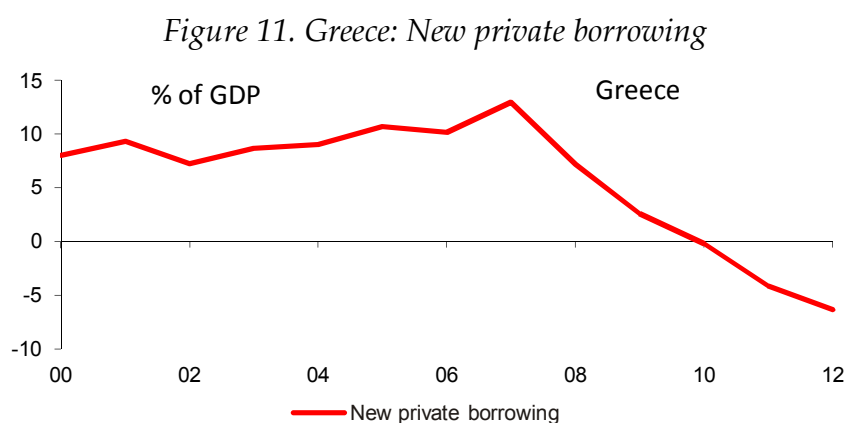
<sup>3</sup> See, for instance, M. Biggs and T. Mayer, "Bring credit back into the monetary policy framework", P.E.F.M Policy Brief, Political Economy of Financial Markets programme, European Studies Centre, St. Antony's College, University of Oxford, August 2013.



In 2006 new private borrowing in Latvia amounted to more than 30% of GDP (Figure 9). It fell mildly in 2007 and more sharply thereafter to less than -7% of GDP in 2009. This implied a cumulative negative credit impulse of around -40% in 2007-09, which in turn led to a decline in real demand from peak to trough of 36% over this period (Figure 10). This is exactly the sort of demand collapse one would expect given the magnitude of the negative credit impulse.

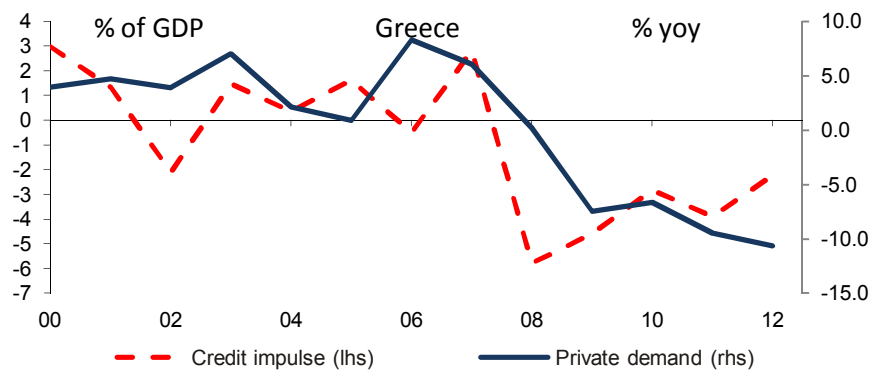
In 2010 new private borrowing remained sharply negative (i.e. credit growth was negative), but because the level of new private borrowing was roughly unchanged, the credit impulse rebounded to neutral territory and real private demand growth turned positive. The credit impulse and demand growth remained at roughly these levels in 2011 and 2012. As the figure above shows, developments in demand growth were not a surprise when seen in the context of the credit impulse. However, mainstream economists such as those in the IMF tend to focus not on the credit impulse but on credit growth.<sup>4</sup> As credit growth was negative from 2010 to 2012, they expected demand growth to be weak. When it rebounded in line with the credit impulse, their GDP growth forecasts needed to be revised upwards dramatically.

In Greece, in contrast, new borrowing actually increased in 2007 and 2008, and while it fell in 2009 and 2010, it remained positive (Figure 11). Credit growth only turned negative in yoy terms in Greece in 2011 (two years after Latvia, and well after the start of the Greek crisis). It was only in 2012 that new borrowing in Greece reached the negative levels that it reached in Latvia in 2009. As a result, the credit impulse in Greece was negative from 2009 to 2012, and real private demand growth contracted throughout (Figure 12). The fact that credit increased in 2010 might have been one of the factors that caused the IMF to overestimate 2010 GDP growth in the April WEO (they forecast growth of -1.0% for 2010, whereas it came in at -4.9%).



<sup>4</sup> See, for example, the Brookings paper by Blanchard et al., 2013, op. cit.

Figure 12. Greece: Credit impulse and private domestic demand growth

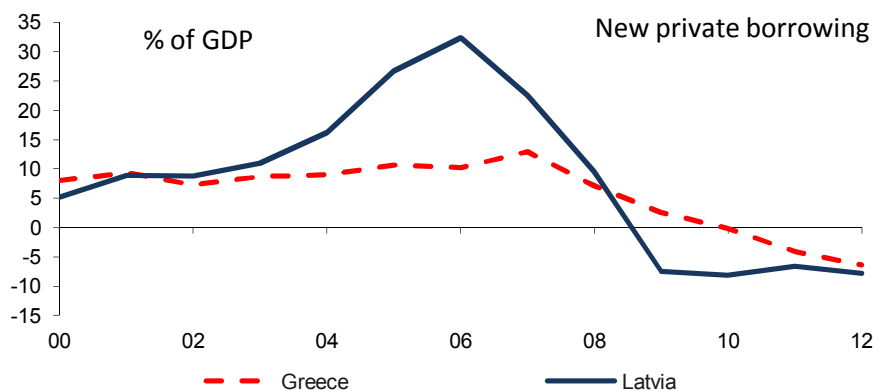


Source: Haver Analytics.

Greece was able to afford a much more gradual pace of credit adjustment thanks to the much more generous external support. New government borrowing was funded externally, government debt was reduced and the ECB provided generous funding for the banking sector. Especially the latter allowed banks to reduce private-sector lending more gradually than was the case in Latvia. There, external support was much less generous and pressure for fast and comprehensive adjustment stronger.

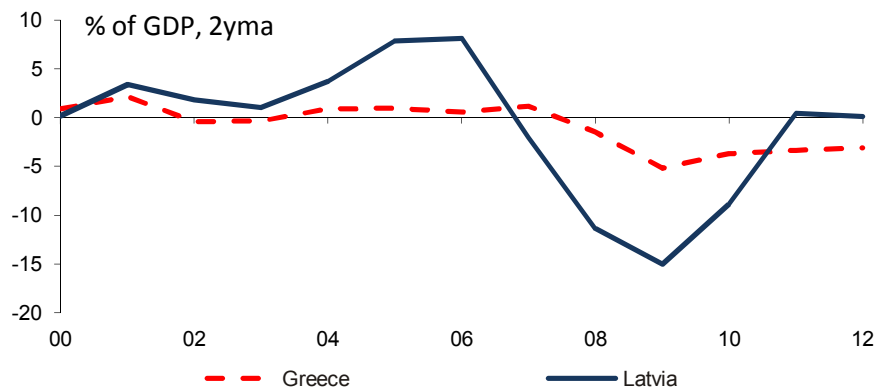
The differences are perhaps clearest when the two country series are compared directly. In Latvia new borrowing increased far more aggressively than it did in Greece, and it fell more dramatically as well. However, after 2009 new borrowing levels stabilised in Latvia, but continued to decline in Greece. As a result, the credit impulse rebounded in Latvia but stayed negative in Greece. The credit impulse is a 2<sup>nd</sup> derivative and is consequently quite volatile. To reduce some of this volatility, we compare the 2-year moving averages (2yma) in the figure below.

Figure 13. New private borrowing



Source: Haver Analytics.

Figure 14. Credit impulse



Source: Haver Analytics.

We are certainly not trying to argue that credit is the only variable of importance in the economic cycle. Fiscal policy, changes in terms of trade and external demand shocks are but a few of the factors that can cause demand growth to fluctuate in a manner that is not necessarily captured by changes in private sector credit. In addition, the marginal unit of spending could be financed out of savings rather than borrowing. Nevertheless, we would argue that the bulk of the changes in spending in Latvia and Greece over the past five years can largely be explained by developments in private-sector credit. The reason that this is not adequately recognised is due to the tendency of economists to look at credit growth rather than the credit impulse.

## Conclusions

Despite the difference in geographical location and cultural background, there were a lot of similarities in economic performance between Latvia and Greece before they made their respective adjustment to the crises. At 24% for Latvia and an estimated 23% for Greece, even the drop in GDP during the downturn was very similar. But there was also an important difference: The pace of adjustment was much faster in Latvia than in Greece. In our view, this was due primarily to a front-loaded de-leveraging of the private non-bank sector in Latvia. Owing to more generous external assistance for Greece, the process of de-leveraging could be slower.

Fast de-leveraging in Latvia laid the ground for an early economic recovery. Owing largely to a positive credit impulse (resulting from a slowdown in the pace of de-leveraging after an early large drop), real GDP has increased about 20% since hitting its trough in the third quarter of 2009. By contrast, de-leveraging in Greece was more gradual and the credit impulse has remained negative for longer.



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