1918
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Latvia Country Seminar
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Capital Flows, Competitiveness and Economic Growth in Latvia

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All viewpoints personal!


NEZ KĀPĒC MAN IR ŠAJŪTA, KA BERU KAUT KĀDĀ BEDRĒ...

Next 14½ minutes

1) Economic growth in Latvia
2) Capital flows and economic growth
3) Panel data estimations
4) Contributions to economic growth in Latvia
5) Some policy conclusions

1) Economic growth in Latvia

- A roller coaster
  - From ‘Baltic Tiger’
  - … to basket case
  - … to ?
- Parallel to other Baltic States – and several other CEE countries
  - But volatility in Baltics extreme

Figure 1: GDP growth in Latvia and the Czech Republic, %, annual data 1996-2011*

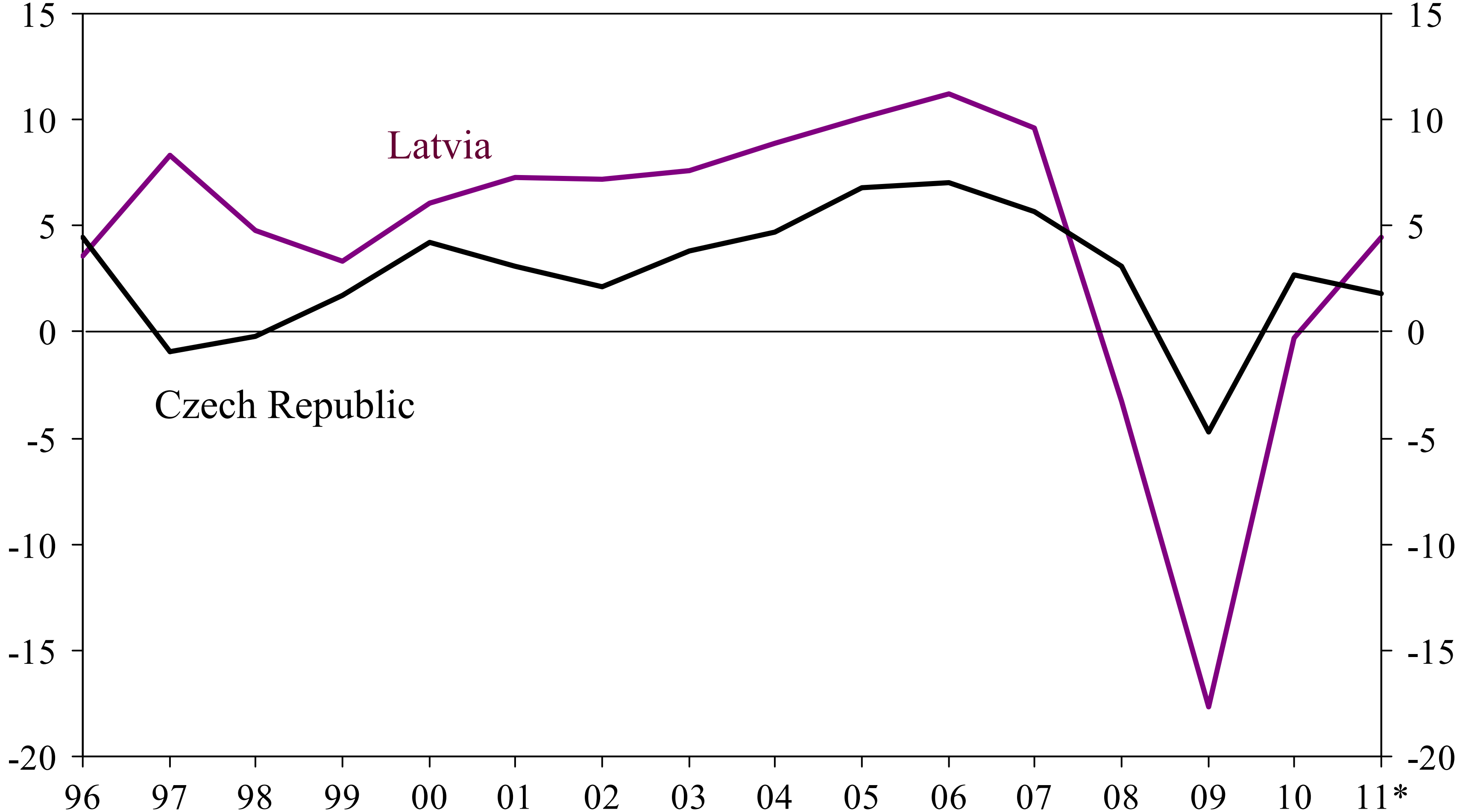


Figure 2: Current account balance and economic growth, Latvia, annual data 1995-2011*

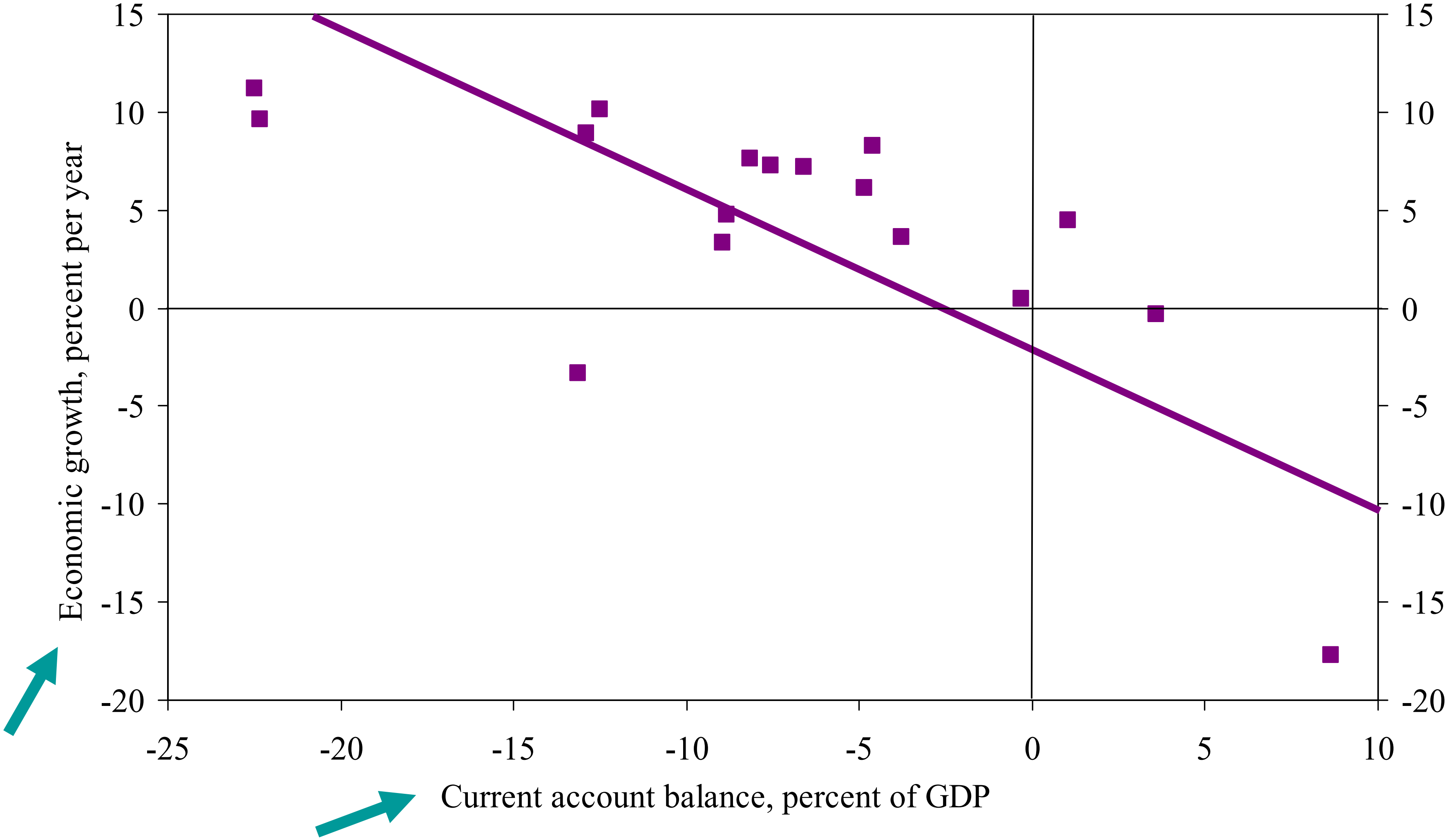


Figure 3: Current account balance and economic growth, CEE countries, annual data 1995-2011*

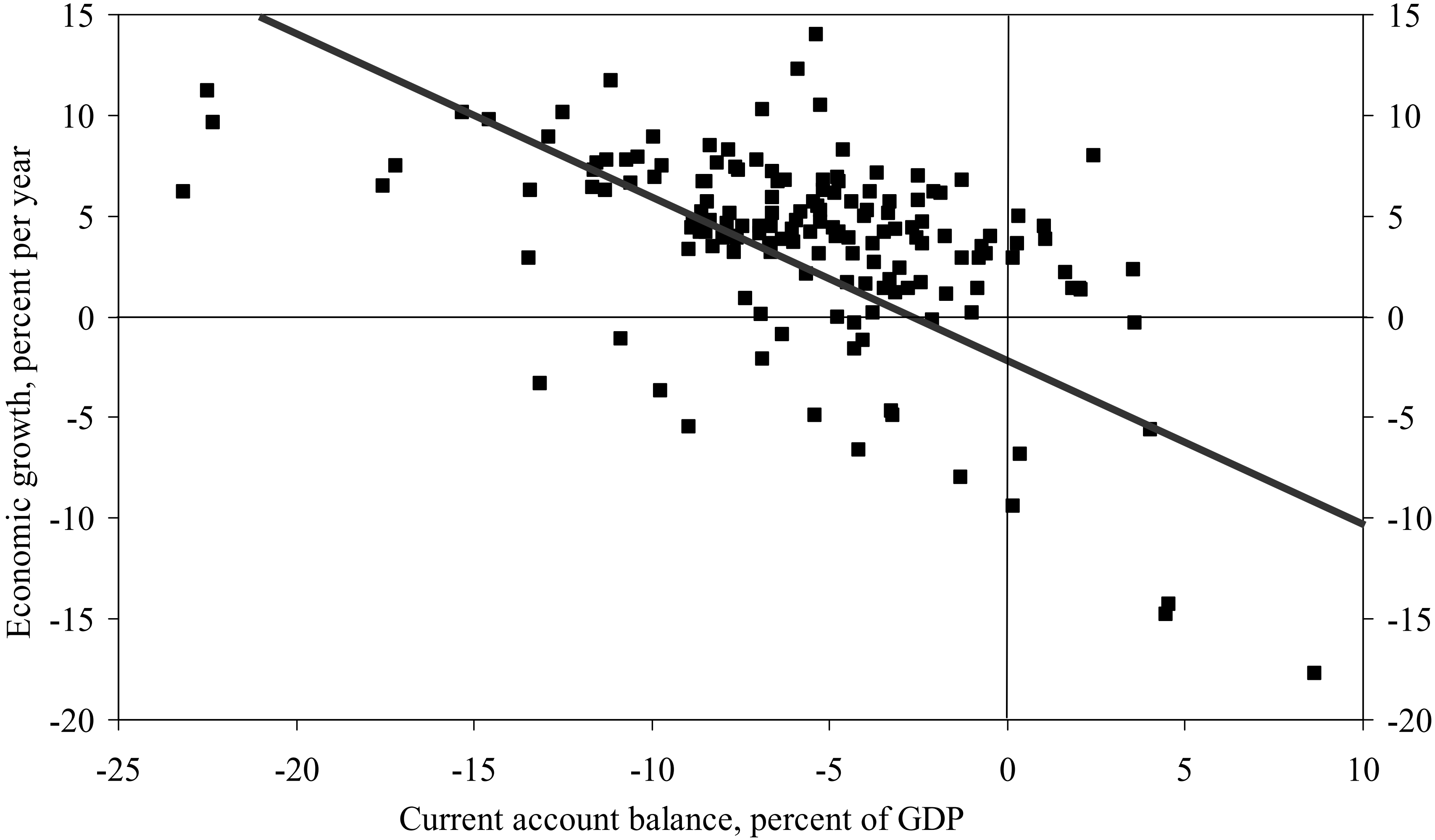
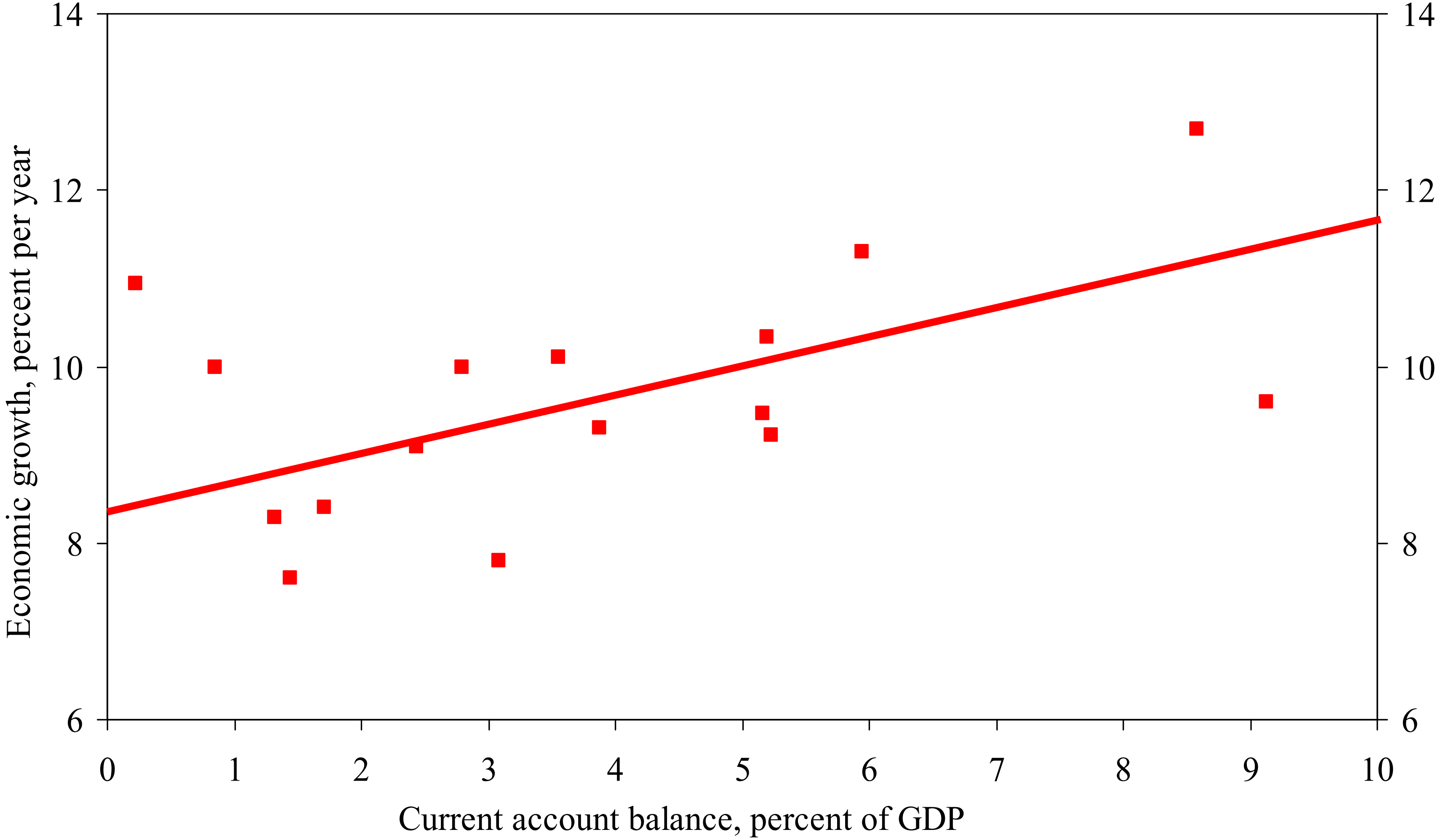


Figure 4: Current account balance and economic growth, China, annual data 1995-2011



Questions

- How does short-term economic growth depend on international capital flows (current account)?
- How much of changes in economic growth in Latvia can be explained by capital flows?

2) Capital flows and economic growth

Capital inflow (current account deficit)

→

Access to extra resources from abroad

- Possibility to build up production capacity ⇒ production ↑ in longer term ← 'Neo-classical growth model'
- Increase in demand in short term → non-traded production ↑ → demand-driven economic boom
  - Relaxation of 'balance of payments constraint'

Capital outflow (capital account surplus)

- 'Sudden stop' → demand-driven recession

3) Panel data estimations

Use statistics to ‘draw lines’ to find relationships

Data

- 10 CEE countries
- 1995 to 2010

Explain → year-to-year economic growth

Explain by:

- Current account balance (percent of GDP)
- Growth in unit labour cost relative to euro area (percent)
- Other variables (control variables) → economic growth in Europe, crisis indicators, income level, etc.

Panel data estimations

- Fixed effects → remove long-term, structural growth differences
- 'Instrumentation' → only effect from current account to growth
- Many robustness checks

Results

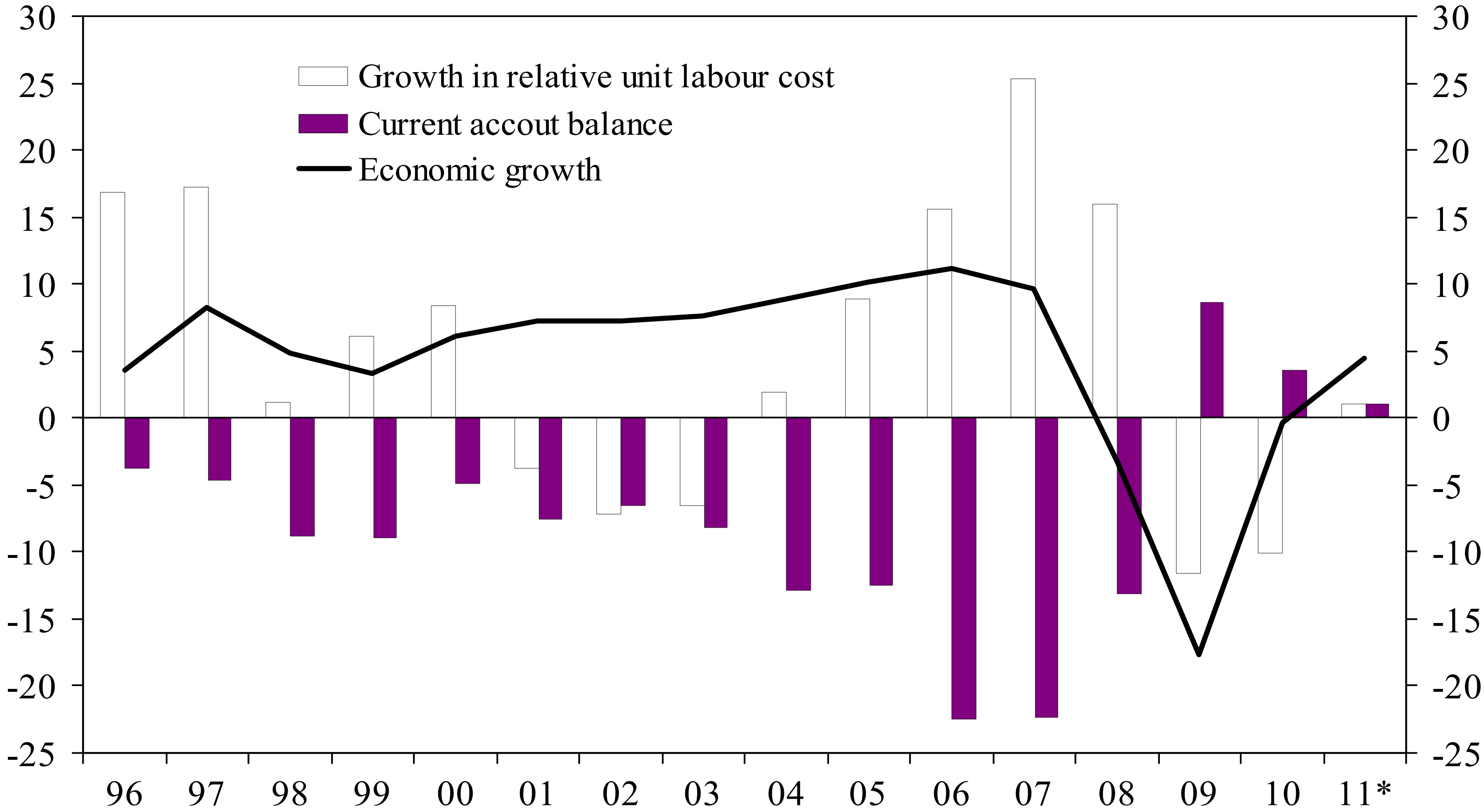
- Capital inflows (current account deficits) ⇒ contemporaneous growth ↑
  - Estimate → depends on whether crisis is included or not
  - Current account balance ↓ 10%-points ⇒ growth ↑ 2-5%-points
- Growth in relative unit labour cost ⇒ growth ↓
  - Lag of two years (*j*-curve effect)
  - Growth in unit labour cost ↑ 10%-points ⇒ growth ↓ 1-2%-points two years later

4) Contributions to economic growth in Latvia

Simulate the contributions to changes in economic growth in Latvia of:

- External capital flows (current account)
- International competitiveness (changes in relative unit labour cost)

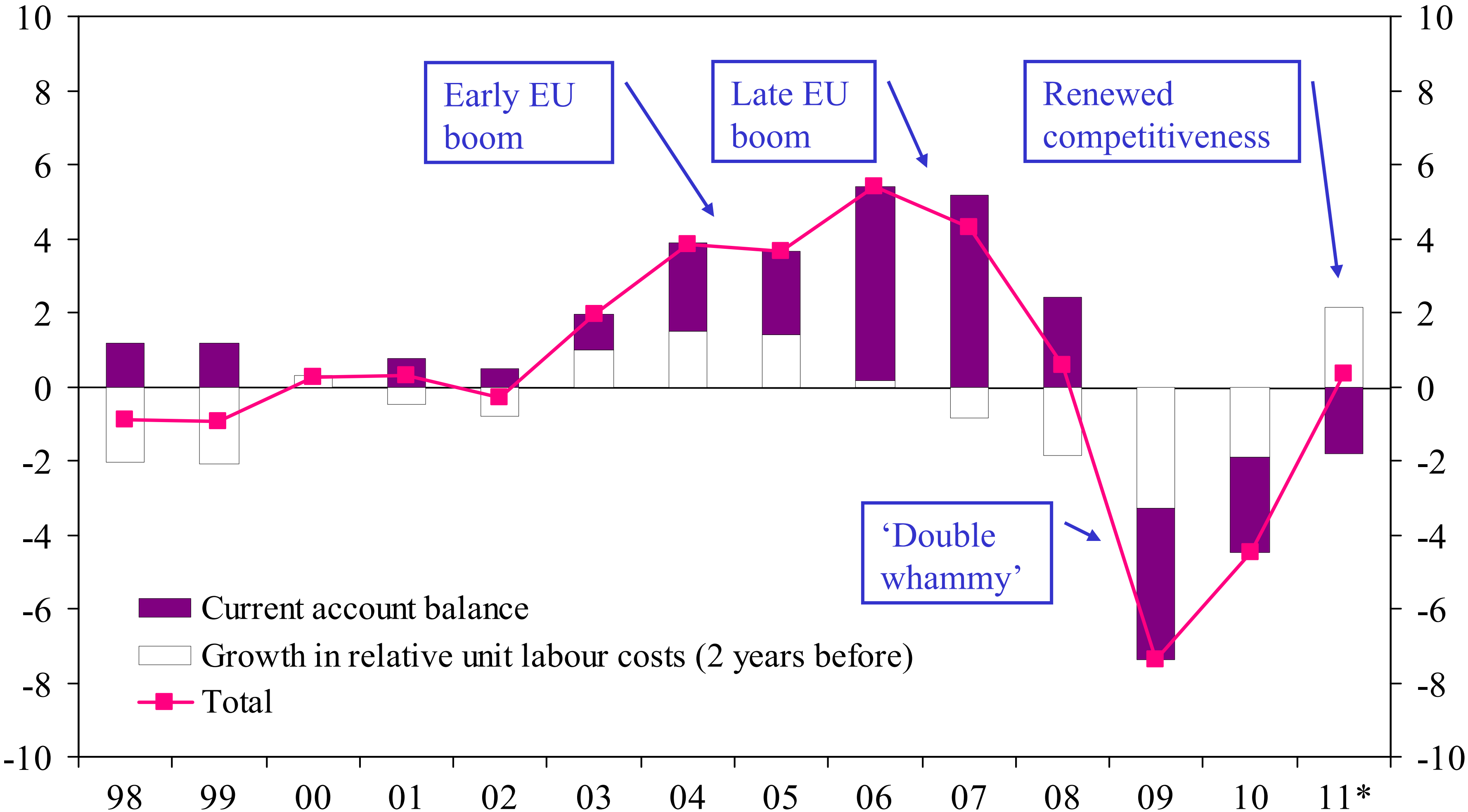
Figure 5: Growth in relative unit labour cost, %; current account balance, % of GDP; economic growth, %; Latvia, 1996-2011*



Contributions relative to baseline ‘normal’ values

- ‘Normal’ value of current account balance (external capital flows) = –4 percent of GDP
- ‘Normal’ value of growth in relative unit labour cost (international competitiveness) = 3 percent

Figure 6: Simulation of contributions to changes in economic growth; growth in relative unit labour cost and current account balance, %-point



Conclusions

- A large part of changes in Latvian economic growth, can be explained by changes in international capital flows
- Growth driven by demand from capital inflows ‘mistaken’ for long-term growth, hiding other weaknesses
  - EU membership as confidence shock → two phases
    - 2004-05 → external capital ↑ and competitiveness ↑ ☺
    - 2006-07 → external capital ↑↑ and competitiveness ↓ ☺☺
- Sudden stops in capital inflow
  - 2009-10 → external capital ↓↓ and competitiveness ↓ ☹☹☹

5) Some policy conclusions

Economic growth in Latvia

- Wild roller-coaster ride
- External capital flows of great importance
- … often ‘drowning’ other effects, including competitiveness
- Effects after EU membership → quite predictable
  - As other emerging-market economies after ‘confidence shock’ ← Latin American ‘boom-recession cycle’

Upshot

- ‘Neo-classical model of growth’ relying on capital import →

handle with care!

Latvian governments

- Little appetite for contractionary policies during boom
  - Capital flows and credit expansion
  - Supplementary budgets to make sure budget never in surplus…

EU / European Commission

- Before entry → prepare countries better on effects of European integration
  - Free capital flows + "confidence shock" [Baltics, Slovenia]
  - Migration

Improve welfare through counter-cyclical policies

- Capital controls (e.g. Israel) not possible due to Internal Market
- Credit volumes
  - Affect supply → capital requirements, reserve ratios, 'coordination', consumer protection regulation, etc.
  - Affect demand → stamp duties, down payment rules, loan-length requirements, credit card limits, tax deduction, 'financial education', etc.
- Fiscal policy
  - Traditional counter-cyclical policy
  - 'Forced saving', release of private pension funds, taxes on consumption typically financed by borrowing (cars, boats, travel, summer houses)
  - Accumulation of reserves → cf. China and Estonia ☺

Creating <u>sustainable</u> long-term growth

- Infrastructure → roads, public transportation in cities
- Education → tertiary level (‘clear convergence goals’)
- ‘Inclusive society’ → activation of marginalised groups (discouraged, disabled, addicts, elderly)
- Make it pay for low income earners to participate in registered economy → redistribute tax burden
- Reduce licensing requirements, red tape
- Serious fight against tax evasion
- Combat influence peddling, corruption

Overall conclusion

- International capital flows as fire
  - Warms nice, can get you burned
- Latvia was careless during the EU boom
- Latvian bail-out ☺ ← illiquidity crisis
- Renewed competitiveness after 'internal devaluation' → breathing space
- Time for structural reforms to lay foundation for sustainable long-term growth
  - … and reduce reliance on fickle international capital flows