Latvia learns from the biggest crash of them all

Guy Norton, Euromoney

THE NARROW COBBLED streets of the Old Town area of the Latvian capital of Riga are still clogged with luxury cars but an outsider's first impressions are deceptive. A closer examination of the harsh realities of the downturn in the Latvian economy points to a different picture of life in the Baltic state after GDP shrank by 18% last year.

Car repossessions because of loan defaults outnumbered new purchases in 2009, with repo men the only beneficiaries and former owners, car salesmen and leasing companies the prime victims.

The trials and tribulations of the car market following the triumphs of previous years perfectly illustrate the dangers of excess that have come to haunt Latvia in the past 18 months. In the middle of the last decade Latvia was touted as one of the great economic success stories of New Europe. After its economy was laid low by the Russian debt default of August 1998, the Baltic republic firmly reoriented itself politically and economically in the direction of the European Union, which it joined in 2004.

That, however, is arguably when the country's troubles started. EU membership seems to have gone to Latvians' heads and prompted a drive for economic convergence with western European living standards, resulting in a bank-driven consumption and construction boom that sent wages and prices rocketing, torpedoing any hopes of rapid entry into the eurozone. This failed, however, to dim the optimism in the country, with economic growth accelerating to average 10% in the three years after it joined the EU. Among the so-called Baltic Tigers, Latvia's economy was the most vibrant for most of the decade. Flush with cash provided by foreign banks that moved into the country at the start of the millennium and have ultimately come to control most of the Latvian banking sector, Latvians indulged in an orgy of spending. "We're all oligarchs now" could have been the mantra for a country that maintains a love-hate relationship with Russia, but whose population still includes a sizeable minority of ethnic Russian inhabitants.

Reaping the whirlwind

Since the onset of the global credit crunch and associated economic downturn in 2008 Latvian GDP has shrunk by almost 25%, real estate prices are down 70% from their peak and unemployment has soared to 22%. Non-performing loans have jumped to 17%. Add in the social price paid for the €7.5 billion bailout of Latvia in late 2008 by a coalition led by the EU, the IMF and the World Bank, which has entailed sharp cutbacks in public sector wages and services, including wholesale closures of schools and hospitals, and it's no surprise that Latvia turned into a political tinderbox.

Violent street protests in January 2009 indicated the depth of anger and incomprehension among Latvians about the economic crisis. Continued protests led in February to the collapse of the government, which became the first administration in the EU to disintegrate because of the global economic downturn. Social discontent continues to rumble on, with protesters having built a small tent city in Riga in front of the building housing the cabinet of ministers, demanding that the government act to reduce unemployment and reform the electoral system. Furthermore, given the bleak economic prospects there's a fear that the country's brightest and best will seek their fortunes abroad, leaving the country to bear the social costs of the infants, the infirm and the plain indolent.

Some observers fear that Latvia has all the makings of a failed state, claiming that by 2012 education, medical care and personal security will largely be services available only commercially, with tax revenues largely used to repay the growing national debt.

Given the high-speed political carousel that passes for democracy in Latvia – there have been 15 governments since independence in 1991 – it's arguably difficult, if not impossible, to pin the blame for the economic meltdown on any particular political party, much less an individual politician. Nevertheless, the downturn has brought the foibles of Latvian politicians into sharp relief. Nobody more so than one-time finance minister Atis Sklateris. In late 2008, he gave a now notorious interview to Bloomberg TV about Latvia's economic crisis, during which he answered a question about the causes of Latvia having come to borrow money from the IMF as "nothing special". The phrase "nasing spesal", mocking Slakteris's broken English and impenetrable accent during the interview has since become part of Latvian folklore, featuring on T-shirts, with Sklateris's hapless TV performance having come to symbolize the lack of credibility among certain sections of the country's political elite.

Unlikely local hero

Thankfully, cometh the hour, cometh the man. In March 2009, Valdis Dombrovskis became prime minister, having cobbled together a ramshackle coalition government that has managed, against the odds, to re-establish a sense of stability in politics and the economy and steer the country away from total disintegration. An unlikely local hero, Dombrovskis is singularly lacking in the razzmatazz that has often been the hallmark of the country's leaders, especially during the boom years when governments exhorted the population to follow their example and spend until they dropped.

Dombrovskis served as finance minister from 2002 to 2004 – ensuring that the country was fiscally fit for EU entry – then spent the intervening period until March 2009 as a member of the European Parliament. He therefore has insider knowledge of how the EU ticks and what to expect in terms of economic directives from Brussels.

What he might lack in charisma he makes up for in determination.

Perhaps more than anyone else he has demonstrated that Latvian politicians can display political drive and social responsibility, whether to his own population or to the international lenders that have bailed out the country. Dombrovskis is yet to have completed his seeming Mission impossible and turned the Latvian economy around but he has probably rescued it from the brink of disaster, pushing through austerity measures that have so far entailed spending cuts of Lats700 million ($1.3 billion), more than 10% of GDP.

He might not survive the test of parliamentary elections in October, given the clear danger of populist rivals inspiring a political backlash against the austerity measures. Should the election results go against him he can at least comfort himself with the knowledge that he will have left government with the country's economic prospects in a far better state than he found them. As Latvia's president, Valdis Zatlers, tells Euromoney: "The crisis isn't over and the structural reforms in education and healthcare are a very sensitive political issue, where the government needs to explain to all stakeholders in society that the changes are for their long-term benefit. But credit should go to those who've governed for the last year and have been so successful at crisis management."

Latvia's central bank governor Ilmars Rimsevics

"We've disappointed a lot of currency speculators who'll remember that Latvia is not a bankrupt state. I'm personally proud that we burnt some hedge funds"

Ilmars Rimsevics, Central Bank
Another key figure whose stock has risen during the crisis is central bank governor Ilmars Rimsevics. "Rimsevics was really one of the very few people to raise concerns about the credit boom but he was ignored," says Valdis Siknis, general manager of Nordea Bank in Latvia. Martins Gravitis, a Latvian central bank official, says that Rimsevics's favourite analogy is of feeling like a policeman who turns up at a drug-fuelled rave and asks the revellers to turn the music down, only to be told to chill out, pull up a chair and smoke a spliff.

Saviour of the lat

Rimsevics himself says: "There's no doubt that as a nation we enjoyed the economic boom period somewhat childishly." Although Rimsevics failed to win the battle against excessive lending, he can at least claim to have won the battle for the Latvian lat, which, contrary to almost universal expectation, has not been forcibly detached from its peg against the euro. "Amid all the market speculation in 2009 that Latvia was a few days away from going bankrupt, we soberly found the political consensus to defend the currency, he says. "At the central bank we were very clear about our stance on the lat and that there were no benefits to be gained from devaluation." While at one point in June 2009 the defence of the lat looked futile, the against-all-odds defeat of the FX vultures has arguably proved to be the Latvian central bank's finest hour. "We've disappointed a lot of currency speculators who'll remember that Latvia is not a bankrupt state," says Rimsevics. "I'm personally proud that we burnt some hedge funds."

Although he always felt that speculation against a fully covered currency board regime was foolhardy and was 100% convinced of the correctness of the decision to defend the lat, he admits: "When you see the country's foreign exchange reserves dwindling, it's not a pleasant feeling." Latvia not only had to contend with the burden of several billion dollars betting on an enforced devaluation but also the weight of academic opinion from such luminaries as Nobel laureate Paul Krugman, who claimed that Latvia would inevitably be forced to devalue. "Krugman and others may have predicted the demise of the lat but nobody predicted the commitment of the Latvian central bank and the government," says Rimsevics.

Although Rimsevics concedes that a devaluation of the lat would have had serious implications for other currency regimes across central and eastern Europe, he says that the central banks and commercial banks that offered support did so because they wanted to help Latvia and not just to save their own financial skins. Although there has been considerable domestic controversy over the role played by foreign banks, particularly Swedish ones, in precipitating Latvia's boom-to-bust disaster, Rimsevics says that the crisis has arguably underlined the need for greater, not lesser foreign participation in Latvian banking to avoid a repeat of the costly Lats1 billion rescue of Parex Banka in December 2008, which sparked widespread market panic. "The Swedish banks proved to have deeper pockets than the Latvian state and were able to recapitalize their daughter banks, which shows that foreign ownership is crucial," Rimsevics says.

Rimsevics says that Latvia has turned a corner, as reflected in sharply lower overnight interest rates and credit default swap spreads but that the government needs to deliver a credible budget for 2011 for a textbook recovery from an economic crisis to be complete.

One irony of the valiant defence of the lat is that a key political goal is to achieve eurozone membership as soon as possible, with 2014 set as the target date. "Adopting the euro will be a sign that we have achieved the next level of economic development," says state secretary of finance Martins Bicevskis. "The fiscal discipline needed for eurozone membership will help demonstrate that we have a sustainable, safe economic model." For Bicevskis, like everyone else in Latvia, the crisis has proved to be a useful, if painful lesson. "We are learning a lot and have a lot to learn. We have many problems, but we are solving many of them," he says. He concedes that the closure of schools and hospitals in particular has been socially traumatic but is ultimately necessary. "It's clear that the infrastructure network for education and healthcare we inherited from the Soviet era was not efficient. Our mistake was to not implement reforms in the boom times, but the crisis has forced us to take those hard decisions as Latvia doesn't have the money for a soft landing."

International plaudits

While there has been a lot of pain, Latvia is beginning to reap some of the gain, winning itself plaudits from ratings agencies and international lenders. "There are grounds for optimism, given the scale of adjustment that has already occurred, and the successful passage of an ambitious 2010 budget," says Frank Gill, sovereign analyst at Standard & Poor’s, which recently revised the outlook on Latvia’s BB+ rating to stable from negative. "Latvia has taken measures that would be very difficult to implement in many western European countries." As Riga mayor Nils Usakovs rightly maintains: "If teachers’ salaries in the UK had been cut by 40% there would have been a revolution."

And as David Moore, the IMF representative for Latvia who was parachuted into Riga at the height of the crisis in mid-2009, admits: "Latvia has gained itself a lot of credibility because of what it has done over the last year."

The country has also reaped some social benefits from the crisis, with president Zatlers observing that there has been a return to traditional Latvian values. "Contributions to charities and attendances at cultural events have gone up during the crisis," he says. There’s also a greater sense of social solidarity between ethnic Latvians and ethnic Russians, with the election in June 2009 of Usakovs as the first ethnic Russian mayor of Riga seen as highly symbolic. Usakovs says that while recessions in the 1990s tended to hit the Russian population hardest, this time ethnic Latvians and Russians have been equally affected, which has helped to ease the social tensions between them. In contrast to richer countries such as Iceland, where there has been a surge of nationalism and anti-immigrant violence in a knee-jerk reaction to the country’s sudden reversal of economic fortunes, prime minister Dombrovskis is keen to the emphasize that Latvia remains open to offers of foreign investment, including from its one-time imperial master, Russia. "Our relationship with Russia is developing constructively and we are looking to boost economic ties," he says.

Alexander Kalinovski, president of Rietumu Banka
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The prime challenge now for Latvia is to push on with reforms to make the switch from recession to recovery in 2011. Although the pace of the economic slowdown is diminishing, GDP is still due to shrink by a further 4% this year and unemployment might well pass the 25% mark by the end of 2010. Nils Melngailis, chairman of Parex Banka, says: "It seems like we are turning a corner in terms of economic fundamentals, but it will take a while for the ordinary person on the street to feel it. Things will get worse for some people before they get better." But as Arnold Slesers, chief economist at Parex Asset Management, notes: "The sheer magnitude of the correction was a shock, but the fact that

Latvia is a small open economy means that there is flexibility and scope for recovery." There's certainly a sense of optimism among entrepreneurs and bankers that have successfully weathered the worst of the storm. "The situation in Latvia isn't as critical as the media portray it to be," says Lotte Tisenkopfa, managing director of eco-cosmetics firm Madara. "It's not that tragic here, this is a normal country to work and live in." Certainly the impression portrayed by some sections of the Swedish media especially, that Latvia is somehow akin to Somalia with snow, looks ludicrously wide of the mark. Alexander Kalinovski, president of Rietumu Banka, says: "In reality the situation in Latvia is never as bad or as good as it appears to be." He says that after the unsustainable consumption and construction boom, the economic crisis has reintroduced a welcome sense of reality. "We're back to common sense, back to where Latvia belongs, a developing economy which is still far from being at the EU average level."

He says that not having participated in the race for mass lending, consistently profitable Rietumu is well placed to benefit from any upturn. "Today in an environment of hugely decreased lending possibilities, a readiness to finance and maintain relationship banking principles stands us in good stead."

There's a similar message from Ainars Ozols, chairman of SEB Banka, which, along with Swedbank, is held to be one of the leading villains of the piece according to conspiracy theorists who claim that the Swedish banks are effectively an economic army of occupation in Latvia. "We want to maintain client relationships, so haven't sold off any of our bad loans and have never stopped lending, granting €360 million of new loans in 2009 alone," he says. While the Scandinavian banks are accused by critics of acting as the financial sector equivalent of crack cocaine dealers, luring supposedly unsuspecting Latvians into debt addiction only to let them go cold turkey when their money ran out, the reality, as ever, is more subtle. Siknis at Nordea is never more animated that when he enthuses about the bank's Lespeju Skola – School of Opportunities – initiative, which helps to retrain the bank's unemployed customers to become more competitive in the labour market. Cynics might argue it's a classic case of closing the stable door after the horse has bolted but it's undeniably far better than doing nothing to help.

Tourism as a tasty side order

Although nobody in Latvia claims there are any instant fixes to the country's structural problems, one sector widely seen as able to pay a near instant return on investment is tourism. Even those who doubt that ambitious plans for tourism to be a big economic driver and generator of new jobs are realistic concede that it can nevertheless provide an important short-term fillip for the development of a new, improved Latvian economy. "Tourism can be a very tasty side order, but not a main course on the Latvian economic menu," says Martins Kazaks, chief economist for Latvia at Swedbank. "It can be developed as a useful niche business but nothing more." Still, the obvious lure of attracting hordes of free-spending foreign tourists to fill the gap left by the 30% fall in consumer spending in Latvia in 2009 is enough to have spurred both central and local government to loosen the purse strings and come up with cash to ensure that hopes of a tourism boom have some financial underpinning. In the first instance, and as a rare exception to the tax increases that have proved to be the rule since the economic downturn hit Latvia, the opposition persuaded the ruling coalition in mid-March to agree to cut the value-added tax rate for the tourism sector from 21% to 10%. In a similar vein, while the Dombrovskis government has vetoed the purchase of new ambulances and school buses, it has dug deep to support national airline airBaltic, with the promise of a Lats15.6 million capital injection. Under the plan outlined by transport minister Kaspars Gerhards, the government will issue convertible bonds, which will be purchased by the Latvian State Radio and Television Centre, so retaining state control over 52% of the airline’s shares. The company’s other main shareholder, Baltijas aviacijas sistemas, owned by airBaltic president Bertolt Flick, will match the government’s contribution.

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For its part airBaltic has its own ambitious plan to reinforce its position as the leading Baltic airline, announcing that it is to invest €92 million to build a new terminal at Riga International Airport to cope with the growing number of passengers.

Commenting on the company’s ambitious plan, Flick says: "The infrastructure of the Riga International Airport has already reached its design capacity limits, and so a new terminal is acutely needed to accommodate the growing passenger numbers." The new terminal, which will built by 2013, will enable Riga airport, where passenger numbers increased by 10.2% in 2009 and are expected to be up 15% this year, to handle up to 5.5 million passengers a year. In 2009 airBaltic achieved a 30% increase in passenger numbers in 2009 and earned record profits of €20 million. "We are the clear market leader in the Baltics, with a cost base below other low-cost carriers such as easyJet and we’re constantly working on improving the quality and range of our products and services," says Flick. Consequently airBaltic is confident that it will be able to raise the necessary project finance for the new terminal from commercial banks on a standalone basis, rather than have to rely on any form of government guarantee. A tender for the construction and architectural design of the new terminal will be launched shortly and airBaltic will develop the new terminal in cooperation with Riga airport’s operator, Turkey’s TAV Airports Holding. TAV won a public tender to operate the airport in partnership with Latvia’s Skonto Bruve in March 2009 and has announced an overall

€250 million investment plan.

The airline is also playing a big role in an initiative to boost visitor numbers in the Latvian capital. "Riga is airBaltic's most important city. Riga is our home base. We also see a future here, both for us as a company and for Riga as a northern metropolis," says Flick. "That is why airBaltic is investing our intellectual and financial resources, so that Riga can fulfil its true tourism potential."

In November airBaltic, the Riga City Council, the Latvian Hotel and Restaurant Association (LVRA) and the Latvian Travel Agents' Association teamed up to launch a marketing campaign through the newly established Riga tourism development bureau under the Live Riga brand to promote Riga overseas as an up-and-coming Nordic metropolis. The collaborative effort behind the Live Riga campaign is a prime example of the sort of joined-up thinking that was sadly lacking in the boom times, when organizations in both the public and private sectors tended to think about short-term revenues and profits.

As Riga's mayor notes with bemusement: "Before I was elected Riga had never been properly advertised as a tourist destination."

Usakovs is also hopeful that some tourists will turn into investors in the country. "Tourism sends out the message that Riga is alive and open for business, which will have a spillover effect on the rest of the economy," he says.

Latvia aims to revive tourist industry

The Live Riga marketing campaign paid immediate dividends in its first three months, with December, January and February all registering a sharp uptick in the number of visitors to Riga from the seven countries targeted in the launch campaign – Estonia, Finland, Germany, Lithuania, Norway, Russia and Sweden. "We see that successful city branding, if done professionally, brings immediate and clear results," says airBaltic's chief commercial officer, Tero Taskila.

One welcome focus of the flawed property boom was on building new hotels, with the result that Riga now boasts accommodation to suit every taste and pocket, ranging from bargain-basement hostels to glitzy five-star spa complexes.

And while Russian technopop maestro DJ Smash's club hit rightly proclaims Moscow Never Sleeps, Riga is hardly soporific either and is mercifully free of the type of overbearing face control and service with a snarl attitude that can make nightlife in the Russian capital such a chore. It's no provincial backwater either, with Riga firmly established on the roster of venues for performances by top music acts as well as international DJs. What's more, with vacancy rates having soared and rental values plummeted, landlords have been desperate to lease out empty premises, with the result that a new generation of young Latvian entrepreneurs have been finally able to afford to realize their dreams and open a bar, club, restaurant or shop. As Kalinovskis at Rietumu Banka recalls, that would have been unthinkable during the boom times. "Property prices became so expensive that it was impossible for people to set up businesses." To ensure that the tourists lured to Riga by the advertising campaign enjoy their time Usakovs says that the city has beefed up security, creating a special tourist police squad staffed with multilingual officers to deal with problems faced by tourists. Usakovs is also proud of his efforts to crack down on tourist scams by turning the table of bar owners who overcharge tourists and then threaten them with violence if they don't come up with as much as $4,000 for a bottle of local bubbly Rigas Shampanksa. Where revoking licences has failed to work – firms often re-register under a different name — Usakovs positively beams when he relates how the city authorities have turned to hardball but legal tactics such as cutting off rogue premises' heating or ordering document checks by police every 15 minutes to help drive customers away and serial offenders out of business. Usakovs has taken a similarly hard line with taxi cheats, ordering police blitzes on taxi firms, fining them heavily for minor infringements on vehicle maintenance and incomplete documentation. Longer term he says that the city plans to slash the number of licensed taxi drivers, allowing only legitimate firms to ply their trade.