Economic turmoil in latvia

Economics

1.)In 2008 Latvia experienced a banking crisis that stemmed from a poorly regulated banking sector. The banking sector was using aggressive lending to grow the increased inflow of foreign capital, most of which came from Russia. This lead to a property bubble, similar to what was happening in the United States of America (US), prices were being bid up by borrowers who had access to cheap loans. Before the government could step in to control the bubble that was created the property bubble in the US burst sending a rippling affect through the world.

This was hardest felt by the banking sector, which now had to reclaim their loans while investors were withdrawing theirmoneyas quickly as they could. This put the Latvian banks in a difficult position as much of the funds were tied up in debt capital. The Latvian government'sfailureto rescue the nation's largest bank continued with investors withdrawing their funds quicker and changing it to the euro. This made it very hard to keep the Lat pegged to the Euro. This was further exacerbated by currency speculators selling the Lat short, expecting the government to devaluate the currency.

2.)If the International Monetary Fund (IMF) had not stepped in the struggling Latvian banks would have defaulted on their loans to financial investors both domestic and foreign. The banking system would collapse as the government did not hold enough foreign currency to prop up the lat and keep the banks afloat. This would automatically put the country deep into a recession. Unemployment andpovertywould be certain. The country could possible experience an exodus of countrymen looking for jobs in bordering countries. The European Union could drop Latvia from the EU to protect the entity. The Swedish and Finnish banking sector, and to an extent their economy, would also be in trouble because of the high investment by Swedish and Finnish banks in the Latvian banks. In short the country could have gone bankrupt and put the Swedish and Finnish economies in jeopardy.

3.)The Latvian government could of implemented monetary and fiscal policy to head off the crises or at least lessen its effect. The Latvian government should have monitored the lending of loans by the private financial institutions stricter and ensured the credit growth never got to the point it did. If the government dictated that the banks were to manage their lending policies tighter then the Latvian citizens would not have had access to such vast quantities of inexpensive credit and thus would not have had the means to create such demand in the market leading to double digit inflation. Alternatively the Latvian government could of increased interest rates to slow down borrowing as a pre-emptive maneuverer to avoid the impeding economic meltdown.

The sooner the government acted on curbing the unsustainable growth the less an impact the crises would of had on the economy as well as the impact of the necessary interventions implemented to stop the economic downturn. Most believed however that the Latvian government should have opted to devalue the currency which could have resulted in a swifter recovery with less consequences and hardship economically. However if the Latvian government decided for the devaluation of the Lat they would have seriously hampered their efforts to adopt the Euro as their national currency. Countries such as Greece and Spain are experiencing the same situation currently but are unable to devalue the currency as they have adopted the Euro as their currency.

Due to the Lat being pegged to the Euro a devaluation of the Lat would have had major impacts on statements of financial support. Many individuals or private entities would have generated an income in return for the Lat however their debt was foreign and serviced in the Euro. These individuals and entities would have defaulted on their repayments and the foreign debt predominately from Russia, Sweden and Finland. If this was the case the foreign banks that had loaned money to Latvian banks and Latvian citizens stood to lose their investments or had the investments restructured. It is possible that the foreign banks imposed political and economic pressure on the IMF and the Latvian government to avoid devaluating the Lat versus the Euro in fear of the economic effect in the foreign market.

4.)The short term consequences directly stem from the conditions of the IMF loan. The internal devaluation strategy included increases in interest rates and tax as well as severe wage reductions in the public sector and similar deductions in government spending. These austere conditions imposed by the IMF and the Latvian government were focused on rectifying the economic downturn in the shortest space of time without jeopardising the adoption of the Euro. In the short term the austerity sent the Latvian economy into recession; national output fell by 25%l, unemployment increased from 5. 3% to 20% and is sitting currently around 15% (Weisbrot, 2012), inflation slowed, foreign direct investment left Latvia and the governments' trade deficit climbed. The unemployment situation was worsened by the emigration of approximately 10% of the national workforce who had to seek employment elsewhere (Weisbrot, 2012).

The long term effects were better than most anticipated, the outcome is predominately attributed to the Latvianscultureof enduring hardship and the acceptance by the population of the austerity measures to rectify the negative economic state. Government led by example regarding the decrease in civil servants remuneration along with the retrenchment of a bloated workforce. The positive effect was the replication in the private sector by domestic businesses. Due to the mass reduction in the workforces remuneration Latvia increased the external competitiveness of their goods. This effect aided the Latvian economy in increasing exports and played a role in facilitating the process of economic stability and growth, a path the nation is still to complete.