

## [Cold comfort](#) [1]

Written by [Sam Bowman](#) [2] | Wednesday 13 June 2012



Oliver Blanchard, Chief Economist at the International Monetary Fund, [blogged on Latvia's economic miracle this week](#) [3]. Latvia has begun to recover from a deep recession of about 10% in 2008, despite or because of a deep austerity plan and little monetary stimulus (in order to maintain a peg with the Euro). With 5.5% growth in 2011 and an estimated 3.5% growth in 2012, Latvia now has "one of the highest growth rates in Europe, the peg has held, and the fiscal and current accounts are close to balance."

Among the causes of Latvia's success, Blanchard names the following as being important:

*3. Wages were flexible, at least relative to the generic European labor market. The initial adjustment came with a dramatic reduction in public sector wages, and thus a direct improvement in the fiscal position. Together with unemployment, lower public sector wages put pressure on private sector wages to adjust. A note of caution is needed here however: private sector wages, which are the wages which matter for competitiveness, have adjusted much less than public sector wages (by how much is a matter of some disagreement). Indeed, I worry that nominal wages have started to increase, while more adjustment still has to come to maintain current account balance as output recovers. One has to hope that increases in productivity will do the trick. This takes me to the next point.*

*4. There was?and, looking forward, there still is?substantial room for productivity increases. Latvia has income per capita of half the European Union average. Being far behind the technology frontier, it has a lot of room for catch up. [This is always important to remember when comparing economic growth across different countries: [playing catch-up is a lot easier than leading the field](#) [4].]*

*5. Latvia is a small, open economy?although less so than its Baltic neighbors. With exports around 50% of GDP, improvements in competitiveness can have large effects on both imports and exports, and in turn on GDP.*

*6. Public debt was very low to start, less than 10% of GDP. Even today, public debt remains around 40% of GDP. This more or less eliminated foreign investors? worries about default on sovereign debt, and allowed for a quicker return of Latvia to international financial markets.*

*7. The Latvian financial system was largely composed of relatively friendly foreign banks?better than unfriendly foreign banks, or friendly but weak domestic banks. For the most part, the Swedish banks recapitalized their banks and maintained their credit lines to the Latvian subsidiaries.*

*reducing the intensity of the sudden stop and of the credit squeeze.*

*Latvian policymakers would surely want me to add yet another reason?the strong front loading of fiscal consolidation: over the first two years of the program, the cyclically adjusted primary balance was increased by 11% of GDP. I am not sure.*

Latvia's neighbours in Estonia have experienced an even greater reversal of fortune. Last year, Estonia grew by 8%, and that trend looks set to continue. Despite this, Paul Krugman used a [rather misleading graph](#) [5] to suggest that Estonia cannot claim any "economic triumph", because output is still below its 2007 peak. (Which the [Estonian president laid into Krugman over on Twitter](#) [6].)

The problem with Krugman's graph is that it is context-free, and ignores the rapid (and clearly unsustainable) boom that Estonia experienced in the 2000s. It seems likely that much of Estonia's growth in the 2000s, like many Eurozone periphery countries, was malinvestment driven by credit expansions.

As such, recovery is not just a matter of boosting demand again, but liquidating those malinvestments and regearing the economy towards, as Arnold Kling called it in his paper for the ASI, "[patterns of sustainable specialization and trade](#)" [7]. This lumpy, disaggregated view of the economy is a surprisingly fringe one, but it's quite a lot more convincing to me than the focus on enormous aggregates that conceal the processes of change that take place in economies.

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