



INCOME DISTRIBUTION: ITS IMPACTS ON INFLATION AND BALANCE OF PAYMENT

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Public sector reforms: lower costs - greater efficiency. Are there successful examples in Eastern Europe?

Freedom and Solidarity Foundation

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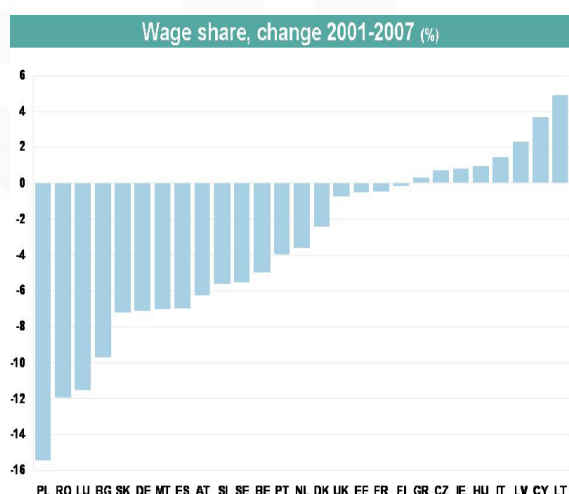
Conference room „Beta 2”, Reval Hotel Latvia, Elizabetes street 55, Riga

I would like first to thank the Freedom and Solidarity Foundation for giving FEPS the opportunity to add its voice to the debate around the Baltic situation, and especially about the state of the play in Latvia.

However, speaking about the present financial, economic and social crisis in Latvia is substantially different from the exercise I have been asked to complete about this issue in the Eurozone.

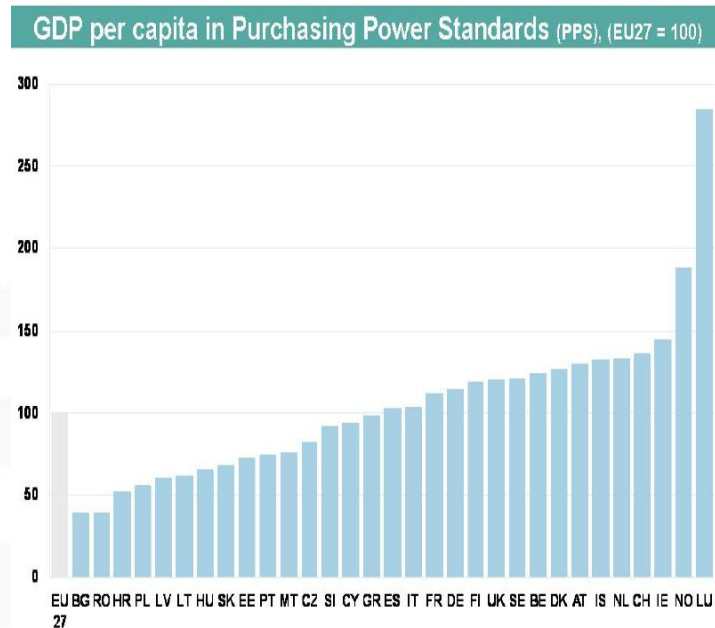
In this respect, I apologise in advance for recasting the narrative of the present crisis, but this analysis could help us in viewing the crisis through a different angle than the consensual one, which states that Latvia is suffering from a balance of payment crisis.

One of the main differences in analysing the roots of the current crisis between the Eurozone Member states and Latvia lies in the fact that Latvia at least experienced growth in the adjusted wage share in GDP from 2001 to 2007¹.

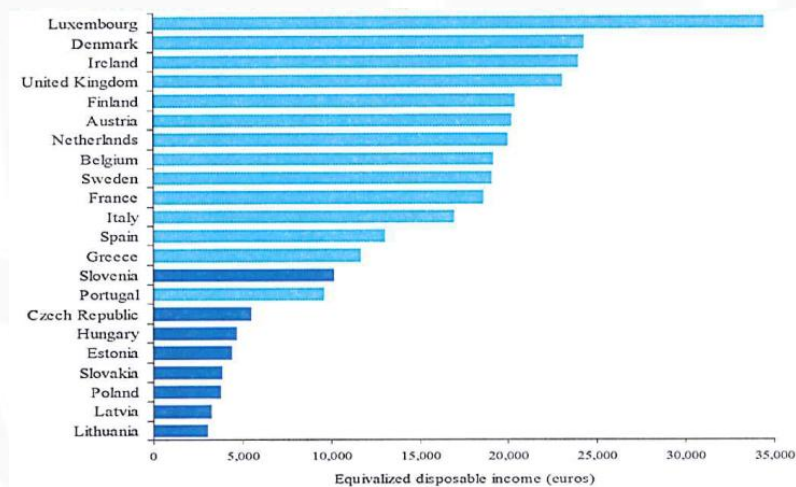


¹ Ameco database.

However, considering purchasing power standards as an indicator for income, one notices that Latvia is still in the group of countries with low income levels²



The average income is much lower in Latvia than in other EU countries.



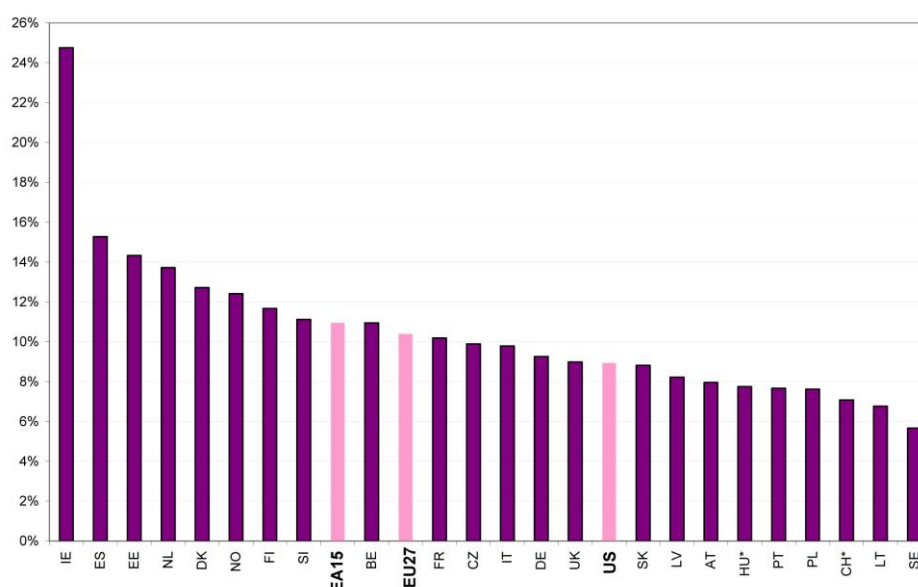
One also notices that the Latvian minimum wage for 2006 was also the lowest in the European Union³. It is also apparent that income distribution in these “fat years” did not go in the direction of less inequality, but that the contrary was the case:

² Eurostat.

³ Eurostat.

Population Sub-group	Total disposable income accruing to the group (expressed in percent of the national average)								
	Slovenia	Czech R.	Slovakia	Hungary	Estonia	Poland	Lithuania	Latvia	EU8 Group
p05	32	36	29	17	19	20	16	10	24
p10	48	50	46	39	37	35	32	29	40
p15	56	57	54	47	45	43	41	37	48
p20	62	62	60	53	50	49	47	42	54
p25	68	67	65	59	54	55	53	47	59
p30	73	71	69	63	60	60	57	52	64
p35	77	75	73	68	64	65	63	57	68
p40	82	78	77	72	69	70	68	62	73
p45	86	82	81	77	74	76	73	68	78
p50	90	86	85	82	80	81	79	75	83
p55	94	91	89	86	87	87	85	81	88
p60	99	95	93	91	94	94	91	89	94
p65	105	101	98	97	101	101	99	97	100
p70	111	107	103	103	109	108	107	107	107
p75	117	113	109	110	118	117	117	118	115
p80	124	120	116	118	130	128	129	129	124
p85	133	131	126	129	143	142	144	145	136
p90	146	144	139	145	161	162	169	166	154
p95	166	165	161	176	196	195	208	207	183
p100	232	269	327	366	310	312	323	382	310
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Gini Index	0.239	0.249	0.279	0.321	0.327	0.328	0.348	0.383	

At the same time, the growth of investment compared to the growth of disposable income (household investment rate) did not increase as much as for the EU 15 or 27.



Furthermore, inflation rose while the rate of saving decreased. In fact the rate of change in gross fixed investment was positive from 2005 to 2006 but decreased the following year and was negative for the year 2008⁴.

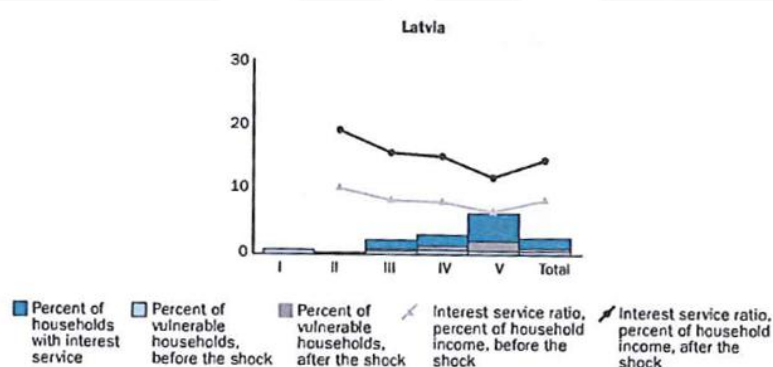
With an increase in lending of 51.8% in real terms in 2006, this clearly provided a stimulus to overheat the economy. In 2007 the increase in credit, after correcting for inflation, was close to 25 percent, still strong enough to feed a rise in spending. The most worrisome element in this scenario is that it was made possible by foreign credit. Out of the total loans provided to local residents, 76.9 percent were denominated in foreign currency in 2006; the rate went

⁴ IMF (2009), "Republic of Latvia: Request for Stand-By Arrangement", IMF Country Report No. 0/03.

up to 86.4 and 88.2 percent in 2007 and 2008 respectively. With such high rates of foreign borrowing, the ratio of Latvian gross external debt to GDP rose from 114.7 percent in 2006 to 134.1 percent in 2008. By 2006, the private sector held 95 percent of foreign debt⁵. In a 2006 Article IV Consultation report, the Fund warned that: *“banks exposure to credit and market risks rose, and currency mismatches of households widened.”*

With the majority of foreign currency liabilities in the hands of the private sector, and high exposure of Swedish banks, the level of the current account deficit (over 22 percent of GDP in both 2007 and 2008) became a cause for concern. A tight situation in the balance of payments increased the risk of a devaluation, and hence the potential for a rise in non-performing loans.

However, only a fraction of households in each quintile hold debt, and that share expectedly increases in the higher quintiles. Among the new EU member countries (except Hungary), fewer than 5 percent of households in the first quintile appear to have a mortgage, suggesting that few low-income households would benefit from mortgage restructuring schemes that include use of public funds. The pattern for total debt in suggests great variability across countries, with more than 40 percent of households holding some debt in Belarus and some 20 percent in Bosnia and Herzegovina, Hungary, and Poland. So, financial deepening has so far been concentrated in relatively few households.



⁵ IMF (2009).

Here we reach one of our conclusions. The rise in wages in Latvia in the recent years implied a rise in consumption and in prices which should have been a the signal for more investment in the real economy of Latvia. Instead, the richest households and enterprises preferred to save and invest in financial markets. This caused a deterioration of Latvian external debt, through the import of financial products and goods labelled in foreign currencies, coupled with a two digit inflation rate.

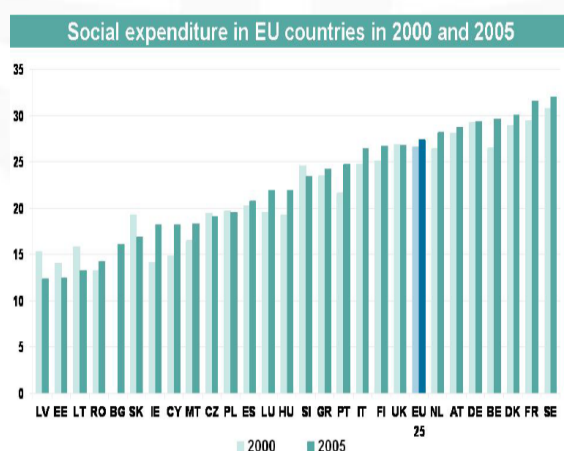
This suggests that the current narrative of the IMF and the European Commission stating that Latvia is uncompetitive and must devaluate in a way or another, is at least questionable.

However, if one wants to take seriously the IMF and the European Commission recommendations, or more exactly conditions, for an austerity plan, one should consider carefully social justice issues, which, as we tried to show, is definitively part of economic policy and certainly not an outcome.

Social expenditures and social justice

From the above consideration, it should be clear that a devaluation would be more inclined to enhance social justice than “internal devaluation”.

Moreover, in analysing social expenditures in EU countries in 2000 and 2005 it is apparent that first Latvia retained the lowest levels, but more importantly, that social expenditures in Latvia decreased between 2001 and 2005⁶



⁶ Eurostat.

The IMF and Latvia reached an understanding on July 27, 2009 on a staff-level agreement for the first review under Latvia's Stand-By Arrangement (SBA) with the IMF. The agreement was endorsed by the IMF's Executive Board on August 27, 2009, clearing the way for the disbursement of about €195.2 million (US\$278.5 million). This will bring the level of total disbursements from the IMF under the SBA loan programme to €780.7 million. This is in addition to the €1.2 billion tranche made available to Latvia in July by the EU. One of the key revisions from the original agreement that had been reached earlier in January is that the new fiscal deficit ceiling has been revised upward to up to 13 % from the original target of 5 %. This is intended to allow for 1 % of GDP in additional resources for social safety nets. The authorities are firmly committed to putting the budget deficit on a rapidly declining path starting from 2010 and have outlined measures to this effect.

As per the most recent agreements reached by the Government, the EC and the IMF, the fiscal deficit for 2009 is 10% of GDP; 8.5% for 2010 ; 6% for 2011; and by 2012 it will be 3%. Considering the commitment of Latvia to introduce the euro in 2013, it is projected that by then Latvia should be in compliance with the EU fiscal deficit requirements. Latvia is dependent on international loans to fund its budget deficit and has had to make harsh decisions to obtain the money. It has decided to slash its budget by 500 million lats (\$1 billion) this year and has said it will make similar reductions in each of the next two years. The cuts have included further reductions in public sector salaries and a 10 % reduction in pensions.

There will be substantial budget cuts applied to the education sector – wages will decrease by 40% compared to the 2008 level. Apart from that there is also a rush to reform and close down many schools. Similar trends are also visible in the health care sector. Pensions and sickness payments, as well as supports for new parents were cut. A reduction of 10% was applied to pensions. Sick-leave payments were also reduced to a maximum period of 26 weeks instead of 52 weeks. Cutting pensions was a sensitive issue. The government had earlier been very explicit in promising that pensions would not be cut but a few days after local, European Parliament and national elections the government approved pension reductions. Cuts are also being implemented across all levels of the civil service and public administration. Business entrepreneurs demanded that public administration should be reduced and eventually they reached an agreement with the government that staff in public administra-

tion should be cut by 30%. This substantial cut may endanger the ability of public administration to fulfil its obligations. *“People are already counting centimes, not lats, thus we cannot agree to cut pensions any further. More than 90% of pensioners receive less than 200 lats and this does not allow people to cover the basic needs for survival,”* said Aina Verze from the Pensioners’ Federation.

Moreover, despite the fact that Latvia has ratified the ILO Minimum Wage Convention, the current minimum wage fails to comply with the principles of the Convention such as considering the needs of the employee’s family and living costs of the country. The current minimum wage also contradicts government policy from 2003 which envisaged a gradual increase of the minimum wage to reach 50% of the average salary level by 2010.

Finally, employers’ associations and other business organisations have been strong advocates for decreasing the size of the public sector in the economy – both by reducing the number of people employed in the public sector and also reducing their wages. There was an agreement reached between employers and the Government about cutting the number of employees in public administration by 30%. Regarding other employees in the public sector – the wages in the field of education have been substantially cut by as much as 40%.

However, in the current situation access to commercial loans for SMEs is limited. The interest rate is only one of the issues. Other factors are that there are many domestic companies who can no longer meet the new more stringent financial stability criteria for accessing bank loans, and the liabilities of many companies have increased or the value of their assets has decreased due to the crisis. Thus, many SMEs are unable to get access to additional loans.

Finally, let us remark that VAT rate increased whereas Latvia has a flat tax rate, increasing the tax burden on low incomes groups.

To conclude, we must notice that Latvia received a new allocation of 120.8 million Special Drawing Rights (SDRs) into its account at the IMF, equalling about \$188.8 million. This allocation, which was part of the G20 global economic stimulus plan to disburse \$250 billion in new SDRs to all IMF member countries, will add to the country’s official level of reserves and

automatically boost the balance sheet of Latvia's central bank by suddenly making it appear more creditworthy. This could improve its access to more affordable credit on international capital markets. Latvia could choose to switch any amount of its new SDRs into a hard currency and use it for any number of purposes at the cost of a small user charge, and without any new IMF policy conditionalities.

The way forward: the Eurozone:

We have to treat two questions in this very short concluding section. First it has been argued that the source of the crisis was not necessarily the lack of competitiveness of the Latvian economy. We suggested that the Latvia economy suffered from an unequal distribution of income in time of boom, even if wages were increasing, which resulted in a decrease of investment rates. This both created inflation in the Latvian economy, thanks to poor investment in the investment goods and increased the debt in foreign currencies. Moreover, one can also notice that exports were higher than imports in 2006 and 2007. This suggests that Latvian troubles lie perhaps not in its lack of competitiveness, materialised by a balance of payment crisis, but in its short-termism, magnified by the development of an important financial sector, exacerbated by a liberal tax system.

However, whatever the real cause of the crisis, Latvia maintained its desire to keep its fixed exchange rate to the Euro for being able to enter the Eurozone, as soon as possible. We would agree with this aspiration if the European Union had used the current crisis, given the state of public finance in many member states belonging to the Eurozone, for elaborating and implementing what could be called a Solidarity Pact. However, the European Commission, together with the IMF, defending the orthodoxy on monetary policy, did not act in this way and will surely not do so in the future. If one looks, for example, at the conditions and the warnings from the European Commission to Greece, one can doubt the degree of solidarity within the EU.