Latvia bailed out by IMF and European Union

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On December 23, the International Monetary Fund approved a €1.68 billion (US$2.35 billion) rescue loan for the ex-Soviet republic of Latvia. The loan to the Baltic country is part of a €7.5 billion (US$10.5 billion) bailout that includes other funds from the European Union, the World Bank and Sweden.

The European Union (EU) has offered 3.1 billion euros, the European Bank for Reconstruction and Development has given a loan of €100 million, and the Nordic countries added €1.8 billion with the World Bank contributing €400 million.

The money will largely be used to prop up the Latvian currency and recapitalise its financial sector. Latvia was the second EU state, after Hungary, to receive an international financial bailout last year.

The total package amounts to over €3,000 for every man, woman and child in the country. Simon Johnson, former chief economist of the IMF, said that in comparison with Latvia's size, the loan was one of the largest ever offered by the Fund.

The IMF statement issued to accompany the loan claimed the measure was necessary to "stem the loss of bank deposits and international reserves", "restore confidence in the banking system" and maintain Latvia's fixed exchange rate with the euro.

Since the financial crisis began the IMF has also given emergency loans to Iceland, Pakistan and Ukraine.

IMF Chairman Dominique Strauss-Kahn said that Latvia faced "severe economic challenges", exacerbated by "concern over the sustainability of Latvia's external debt and increasing vulnerabilities associated with the unsustainable credit and growth boom that followed Latvia's accession to the EU."

"A deep recession and a drawn-out recovery appear inevitable," Strauss-Kahn added.

The joint bailout is a desperate move, not just to save the Latvian economy from meltdown but to shore up the financial and monetary systems of the whole of Europe. Without the cash injection, Latvia's currency, the lat, was expected to collapse in value, forcing it off its fixed exchange rate with the euro. This would have had a huge destabilising effect on investor confidence across Eastern Europe, threatening all the other economies of the region that are tied to the euro.

Fears of the knock-on effect that a collapse of the Latvian currency and economy would have had on Eastern Europe were expressed in the fact that the Czech Republic, Poland and Estonia together contributed 400 million euros to the bailout, despite the fact that their own economies are in a precarious position.

Since August, private sector deposits in Latvian banks have fallen by 10 percent, precipitated by a run on Parex Bank, Latvia's second largest and owned by Latvian-based capital. Since then the Latvian Central Bank has struggled to maintain the currency's peg against the euro.

Neil Shearing of London-based firm Capital Economics, stated that while the bailout "should prevent widespread defaults by Latvian firms and banks, the conditions attached will deepen the recession next year."

"There's a good chance that GDP could contract by 10 percent" in 2009, Shearing warned. Latvia's GDP fell by 2 percent in the first half of 2008 and by 4.6 percent in the third quarter of the year. The Latvian government predicts that the country will be in recession into 2010.

Measures have been announced that make plain it will

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be the Latvian working class who pay for the emergency loans and general financial woes. Cuts in public sector wages and state spending have been announced, while the regressive sales tax will be raised from 18 percent to 21 percent. Protests against the hike in taxes have taken place in the capital, Riga.

The official unemployment rate is project to jump to 9 percent in 2009.

The Latvian government has been ordered by the EU and the IMF to reduce its budget deficit below 5 percent of gross domestic product in 2009, with further reductions until 2011.

A spokesperson from the World Bank insisted that its loan to Latvia was contingent on the implementation of "public service reforms"—code for privatisation and cutbacks in the provision of vital services.

In its press statement issued on the announcement of the loan, the World Bank also sought to encourage foreign finance capital not to pull out from Latvia:

"We also call on major financial institutions operating in Latvia to continue adequate financing of their activities and the national economy. We appreciate very much that foreign banks have affirmed their long-term trust in Latvia and support to their branches in Latvia."

This was a plea in particular to Scandinavian capital, which is especially exposed in the Baltic States. Swedish banks dominate Latvia's financial sector and are fearful that full exposure of their liabilities there could undermine their entire operations and spread financial panic across the region.

Swedbank, one of Sweden's largest banks with major interests in the Baltic States, has attempted to reassure investor confidence in the Latvian banking system in order to prevent the banking crisis from spreading into Scandinavia. Speaking just prior to the IMF loan announcement, Swedbank CEO Jan Liden stated that his firm had "a strategic long-term commitment towards Latvia."

"Latvia and the Baltic markets are a key part of our operations today and in the future. Swedbank will continue to support the Latvian financial system, support our customers, develop our Latvian subsidiary and make sure it is adequately capitalised," said Liden.

Swedbank has announced that it will cut staff by 10 percent at its Latvian operation, with further job cuts likely across the 300 branches it owns in the Baltic countries.

The crisis in Latvia is just one headache for Scandinavian capital, which over the past decade, has attempted to expand beyond its domestic base to reap profits in Eastern Europe. Swedbank also has over 150 branches in Ukraine, whose economy is now one of the most fragile in Europe due to financial turmoil, falling commodity prices and Kiev's ongoing energy dispute with Russia. Total lending by Swedish banks in Eastern Europe is equal to 25 percent of the country's GDP.

The crisis in Latvia also poses fundamental questions about the possibility of any eastward expansion of the Eurozone—the group of EU countries that use the euro currency. While the bailout of Latvia has, for now, enabled it to retain its currency's peg to the euro, there seems to be little prospect of Latvia or any of the other eastern European countries being able to adopt the euro for the foreseeable future. The criteria for membership of the Eurozone, established in the 1992 Maastricht Treaty, includes levels of financial stability, public debt and budgetary restraints to which none of the eastern EU states are able to adhere. Even current members of the Eurozone in Western Europe, such as Ireland, are finding it difficult to remain within the rules of the currency.

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