Latvian government resigns as crisis deepens in Eastern Europe

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Latvia's centre-right government resigned last Friday, against the background of a worsening economic crisis. This is now the second European government to collapse as a result of the international financial crisis, following the government of Iceland, which resigned in January after mass protests had filled the streets of Reykjavik.

The Latvian government's resignation was preceded by the two largest coalition members, the People's Party and the Green/Farmers Union, withdrawing their support for conservative Prime Minister Ivars Godmanis. The government had consisted of a fragile coalition of six right-wing, business-friendly and, in part, extremely nationalist parties.

The massive protests in recent weeks had led to tensions in the government. Thousands of demonstrators took to the streets in protest at the austerity measures, demanding the government's resignation and the calling of new elections. The largest demonstrations since independence saw approximately 10,000 participants protesting in mid-January in front of the parliament building in Riga, with violent clashes between demonstrators and the police.

Of all the Eastern European states, Latvia's economy has been hit the hardest by the economic crisis. While the country had recorded double-digit economic growth in previous years as a result of massive foreign investments, Latvia now faces an abrupt decline. The country's 2.3 million inhabitants face the worst recession of all the 27 European Union member states. In order to balance an enormous budget deficit, the Godmanis government had agreed on tax increases and austerity measures, which led to the protests.

In order to avoid the threatening collapse, in the past months the Latvian central bank has spent a fifth of its foreign exchange reserves and has requested international aid in order to support the economy. In December, the European Union Commission, the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development (EBRD) and several EU member states agreed to provide Latvia with a stabilization credit worth over €7.5 billion.

But these measures could not halt the rapid decline. This year, experts are forecasting a further drastic breakdown in Latvia's economic performance and a rise in unemployment to 12 percent from the present official rate of 8 percent.

Like the two other Baltic states of Lithuania and Estonia, Latvia is saddled with enormous deficits, with a high portion of these debts (up to 90 percent) being denominated in foreign currencies. The coupling of Latavia's national currency, the lat, to the euro is already being discussed in this regard. This would only result in a further massive devaluation of the lat. In turn, this would increase the burden on companies and individuals, whose debts are denominated in foreign currency, at the same time raising the price of imported goods.

The situation in Latvia is symptomatic of economic conditions throughout Eastern Europe.

At the beginning of the year, Poland's economy was regarded as being sturdy enough to weather the crisis without needing assistance. Experts now fear the country will soon be in difficulty. Approximately 25 percent of the country's debts and loans are denominated in foreign currencies. The steep fall in the value of the zloty, which has lost approximately 20 percent in value against the euro since the beginning of the year, means that the value of these foreign debts continues to rise. The country's TIG 20 share index sank at the beginning of the month to a five-year low. Warsaw is now seeking to couple the zloty more closely to the euro to slow this decline.

In the Czech Republic, the koruna lost approximately 16 percent over the last six months in relation to the euro. Industry, which is largely dependent on auto manufacturing, as in neighbouring Slovakia, is experiencing historically unprecedented losses.

Next to the Baltic states, Hungary is also among the hardest hit by the crisis. In the last few months the country has seen a veritable flight of capital as foreign investors have withdrawn their money. Moreover, the country is burdened with a high level of state and private sector debt to mainly foreign creditors, with approximately 60 percent being denominated in foreign currencies..

Last year, Hungary had to approach the IMF for assistance; with the EU also providing aid. Measured against the euro, the Hungarian forint has lost over a fifth of its value in the past six months. There is a great danger that banks, which strongly depend on their Western European parent companies, will face a drying up of credit.

The collapse of the Latvian government is being met with great concern in political and media circles. It has become all too clear that all the states of Eastern Europe are facing substantial difficulties and that this can also pose a danger to the political and social stability of Europe as a whole. A recent editorial in Germany's *Süddeutsche Zeitung* articulates these fears.

"The great crisis," the paper writes, "could mortally scar these countries, which have only recently embraced democracy. They are plunging from boom into a deep recession without any gradual transition." Now that the bankruptcy of the capitalist system is becoming plain for all to see, fear is growing that the general population could become politically radicalised.

The editorial cites Poland as an example: "The population is deeply disconcerted, 70 percent of Poles now believe that the pro-EU centre-right government of Donald Tusk is not in control of the situation." The "almost mythical confidence" in Western capitalism has been shaken to its core. The editorial notes with concern that "scepticism towards the free market" is growing steadily.

Western Europe is also increasingly feeling the consequences of the crisis. This has become particularly clear in the case of Austria.

The banks in this alpine republic have net assets in Eastern Europe of approximately $277 billion. Austria's financial commitment in Eastern Europe amounts to approximately 70 percent of the country's gross domestic product. This is followed by Belgium, Sweden and Greece, who have each assigned credits in this region valued at a third, a quarter and a fifth of their GDPs respectively.

A loss of just 10 percent in the value of these credits in Eastern European would deliver a blow to the Austrian banks equivalent to approximately 7 percent of the country's GDP. If Eastern Europe falls into a continuing and deep recession, the losses could become twice or three times higher.

In view of the dramatic situation, nothing is being excluded in Austria. Following reports of the possible bankruptcies of a number of East European states, the News magazine *profil* pointed out that West European states were also under threat. It headlined its recent editorial: "Does State Bankruptcy Threaten Austria?"