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YEARNING FOR STABILITY

Rubles, *kerenkas*, ostmarks, lats. Major changes in the value – both nominal and real – of people's money almost every decade. The distribution and redistribution of property, agrarian reform, nationalisation, collectivisation, privatisation.

Since the founding of the independent Latvian state in 1918, its economy has been tossed and torn, taken apart and reassembled more than once. That is why we have seen such a strong desire by the Latvian people to make sure that at least something in the economy is stable during the periods when they have had the opportunity to run their own country.

Latvia naturally adopted a market economy both in the period between the two world wars (granted, with an inclination toward state capitalism during the period of Ulmanis' authoritarian rule) and after the recovery of independence, but this is not a system characterised by stability. In a market economy, the growth is driven by competition. The system's most important characteristic is what the famous Austrian economist Joseph Schumpeter has described as "creative destruction", which eliminates market participants who have outlived their time to create room for newer, more effective and richer enterprises and products.

But even in such a sea of instability people need some anchor or point of reference. Both during the first and the second period of Latvian independence this sense of stability, of safety and belonging has, in paradoxical fashion, been created by money, which is so often seen as dirty or even amoral. People make jewelry out of the prewar silver 5 lats coin with its famous profile of a young Latvian woman. When the 5 lats note came into circulation in 1993, many Latvians were proud of the way it combined elegance with the traditional symbol of strength, the oak tree. On a less tangible but economically even more important level, during both periods the stability of the lats has been considered very important both by the country's leaders and by its people.

Reading the information gathered in this book about the Bank of Latvia and the Latvian economy over the last 90 years, one cannot escape noticing the misery visited on the country's inhabitants by the monetary manipulations of foreign powers.

During World War I and the following War for Independence, a huge variety of money flashed across the Latvian landscape. A motley parade of paper notes was printed by the czarist and Kerensky governments of Russia, by the German occupiers, and by the Latvian Soviet government of Pēteris Stučka (who put a sledgehammer and a scythe in place of the hammer and sickle used by the Russian Soviets). During those chaotic times, even some cities and local governments – Rīga, Cēsis, Jelgava and Ventspils – tried to pay their bills in coupons and promissory notes they printed themselves. The one thing these currencies had in common was that sooner or later they all rapidly lost value. After the first period of independence came another round of occupations, and the period from 1940 to 1991 was an object lesson in the unreliability of foreign money.

As Gatis Krūmiņš pointedly notes in his article, during World War II, both the Soviet and the German occupiers used monetary policy with the clear goal of plundering Latvia.

After the Soviet army entered the country on 17 June 1940, the exchange rate between the lats and the Soviet ruble was set at one to one. This was very far from the actual relationship between the purchasing power of the two currencies. Before the occupation, the nominal price of goods in Latvia was significantly lower than in the USSR, and, by setting the exchange rate at parity, the new regime presented all the newly arrived Soviet apparatchiks and military personnel with a very valuable gift – the chance to go on a shopping spree. Stories about the wives of Soviet officers coming to the Opera House wearing very expensive but quite inappropriate pieces of clothing have become a part of Latvian folklore. But the laughter soon ended. Before long, the stores were empty, and, during the first half of 1941, the inhabitants of Latvia were already experiencing a chronic lack of goods and lines outside the stores.

The German occupiers imitated the Soviets by setting an artificially high exchange rate between the Reichsmark used in the conquered territories and the ruble. In less than two years the economic role played by money was destroyed. The occupying forces distributed the minimum amount of goods necessary for survival by means of rationing cards or "šeines". All other economic activity took place on the black market, sometimes for money whose real value was from 20 to 100 times less than the official rate, sometimes on the basis of primitive barter, using cigarettes and alcohol as the universally accepted form of payment.

After the war at the end of 1947, the Soviet regime secretly prepared and suddenly implemented yet another monetary reform, this time with the goal of decreasing the amount of money in circulation. Cash holdings were exchanged for the new money at the rate of 10 to 1 and the value of bank deposits over 3 000 rubles decreased significantly.

After Stalin's death in 1953, the economic situation seemed to stabilise. Nevertheless, in a planned economy in which prices were not determined by supply and demand but rather by central planners for political reasons, money lost both its economic function and its stability. The 1961 monetary reform was purely nominal. It got rid of an extra zero on ruble notes and on price tags by changing all the old rubles for new ones at the rate of 10 to 1. This exchange draws attention to the fact that even in a planned economy it is impossible to completely eliminate the effects either of supply and demand or of the inflationary impact of changes in the correlation between the amount of money in circulation and the supply of goods available. The only thing that socialism could accomplish was to distort these relationships to a greater or lesser degree. During the 1970s and early 1980s, known as the period of stagnation, ever larger waves of increasingly useless money sloshed around behind the facade of the economy, and none of the regime's propaganda could keep this tide from washing away the pillars of the state. The signs of monetary pathology became ever more apparent: the lack of goods, the lines in front of the stores, the various forms of barter and privileged access to goods embodied in the word "blats". They all demonstrated the degree to which socialism had degraded money as a measure of economic value. Unsurprisingly, at the end of the 1980s, the derisive term "wooden rubles" was widely repeated in Latvia to describe this money.

The desperation of economic degeneration led the Soviet government to try one last despotic attempt to resolve their monetary problems. At the end of January 1991, the government suddenly announced that all the old 50 and 100 ruble notes would no longer be accepted in payment, and limited the amount of money depositors could take out of their bank accounts. This only accelerated the system's collapse by strengthening people's conviction that the regime could not be trusted.

In light of this historical experience, it becomes clear why stable and reliable money was considered to be one of the basic values of the independent Latvian state. Just as the Germans still cannot forget the hyperinflation of 1923, when people took money to the store in wheelbarrows and the number of zeros on price tags increased almost daily, monetary chaos has left a deep mark on the historical subconscious of the Latvians. A stable currency has a powerful psychological attraction. Perhaps this experience, which has taught people to equate any changes in the currency with robbery, leads many to still believe the unfounded notion that Latvians suffered some kind of losses in 1993 when the lats was introduced at the rate of one to two hundred Latvian rubles.

During both periods of independence the Latvian state has done a great deal to satisfy people's desire for stability.

After the conclusion of the War for Independence, it was not easy for the newly founded Latvian state to restore order in the chaotic monetary system and to rein in inflation. But after a transitional period with the Latvian ruble, the lats was put into circulation in 1922, and it was backed by gold, the soundest foundation which the world knew at that time.

During discussions of the by-laws of the Bank of Latvia in the *Saeima* (the Latvian Parliament) Jānis Vesmanis, a representative

of the *Saeima* Finance Committee and member of the Council of the Bank of Latvia, laid out the ideas underlying the Latvian monetary system and the role of the central bank. They are relevant to this day. Vesmanis emphasised that providing for a stable means of exchange, that is, for money, has been one of the greatest tasks of the new state since the day of its founding. This goal would not change in the future, because "where you have unstable money, an unstable currency, there businessmen cannot be sure that they won't suffer losses when buying and selling."[1]

The new state had two instruments to ensure this stability: backing the currency by gold and foreign reserves, and ensuring the independence of the Bank of Latvia.

The Bank of Latvia paid constant attention to the first instrument. As Āris Puriņš points out in his article, during the whole period of its existence, the paper money issued by the Bank of Latvia was backed by a significantly higher level of reserves than was required in the Bank's by-laws.

After the beginning of the world economic crisis in 1929, Latvia maintained the gold standard it had set in 1922 much longer than most other countries. The UK abandoned the gold standard in 1931 and was soon followed by the Scandinavian countries. Estonia went off the gold standard in 1933, and Roosevelt significantly decreased the value of the US dollar with respect to gold in 1934. To stop the outflow of its foreign currency reserves and gold, Latvia initially introduced stricter capital controls and made the buying of foreign currencies for lats subject to administrative approval. Nevertheless, the country held to the gold standard until 1936, when the decision by France, the main country of the so-called "gold bloc", to untie the franc from gold forced the Ulmanis government's hand. The lats was repegged to the British pound sterling at a new exchange rate, which meant a 38% fall in its value. At a time when international trade was already quite limited, governments had more opportunities to intervene in the economy, and the Ulmanis government softened the impact of the devaluation by lowering import tariffs and by other administrative means.

The second guarantee of stability was the independence of the Bank of Latvia from the government, which might well be interested in printing money to ease any problems with the budget. In his speech to the Saeima, Jānis Vesmanis clearly stated that one of the new bank's main advantages would be "independence from the composition of the government, from various political changes in the make-up of the government, from the influence of various political groups. From this point of view we have a complete guarantee with regard to the Bank of Latvia, because its Council is independent, it cannot be recalled, it is appointed for three years".[2]

It is, however, true that prominent members of the main political parties always had positions in the Bank's Council, and, after the Ulmanis coup, the Bank was used to finance various priority projects of the government.

Nevertheless, we cannot say that the independence of the Bank was an illusion. In 1927, the government asked the Bank of Latvia to ease its credit policies in order to help farmers whose flocks had been hit by an epidemic. The Council's response, which Āris Puriņš has found in the Latvian State Archives, was strict: "No government demand can force the Bank of Latvia to change its principled decision not to increase or decrease the total volume of credit, which is determined by the Bank's main responsibility – its monetary policy." Help for the farmers had to come from the state budget.

One might think that 50 years of occupation would have changed Latvians' attitude toward money and budgetary policies, cut the country off from its heritage, and introduced a new mentality. Yet, when Latvia regained its independence, it returned to the policies it had followed before the war.

For the re-established country, the lats was a fundamental confirmation of independence. More than that, its own currency was also the basis for stability, a safeguard against the hyperinflation unleashed by the collapse of the USSR, which saw prices rise by almost 1 000% during Latvia's last year in the Soviet ruble zone. The introduction of the Latvian ruble in 1992 allowed the country gradually to regain control of the value of its money, and in 1993, when the lats was introduced, inflation had already fallen tenfold. It continued falling, and in 1998 Latvia entered a five-year period during which inflation never exceeded 3%.

Since 1971 when the US abandoned the gold standard, the yellow metal was no longer widely used as a peg for currencies. Nevertheless, even during this period, which was dominated by growing globalisation and the free flow of capital, many small countries with open economies sought an anchor for their currencies to protect them from precipitous changes in their exchange rates. In 1994, the Bank of Latvia pegged the lats to the SDR, the IMF's synthetic currency unit, which included the world's most important currencies the US dollar, the German mark, the British pound sterling, and the Japanese yen. When Latvia joined the EU and accordingly committed itself to joining the common currency, the lats was repegged to the euro at a fixed exchange rate with a corridor of ±1%.

This was Latvia's new "gold standard", and, when in 2008, the world experienced the largest financial crisis since the 1930s, the Bank of Latvia followed in its predecessors' footsteps and firmly declared its determination to maintain the fixed exchange rate, whatever the loud proponents of devaluation at home and abroad might say. This time Latvia was not left to deal with its problems alone as in 1936, and its policies were supported by a loan from the IMF and the EC.

But the longing for stability is just one side of the coin. On its flip side lie the constant psychologically understandable worries about possible calamities. The currency and the main channels for its circulation, the banks, feel this unease first and most sharply. Alongside and sometimes even despite the security of its money, during both periods of independence, Latvia has experienced episodes of banking panics. The effects of the bankruptcy of the Austrian bank *Creditanstalt* reached Latvia in July 1931, and those banks that were associated with Germany could no longer pay out money to their depositors. Frightened clients rushed to the other banks as well. In one day 5 million lats were taken out of banks in Riga alone, and only a limit placed on the redemption of deposits by the *Saeima* saved the banks from going under. Similar spasms of fear took place after the signing of the Munich Agreement in September 1938, when the UK and France agreed to let Hitler take part of Czechoslovakia, and again a year later after the beginning of World War II.

Such bouts of nerves have been highly noticeable (and, quite possibly, purposely induced) after Latvia renewed its independence. JSC *Rīgas Komercbanka* in 1999, JSC *Parex banka* in 2008, and JSC Swedbank in 2011 all suffered, to a greater or lesser degree, from sudden surges of fear. In 2007 and again in 2009, when talk of a possible devaluation became widespread, the lats came under considerable pressure. Over the last 90 years, periods of stability have been much less common than periods of disorder and insecurity. That cannot help but affect people's thinking and actions.

The yearning for stable values is the most prominent theme uniting both periods of independence. However, another fundamental similarity is Latvia's economic backwardness compared to the West and the resulting need to attract capital and investment, the prerequisites of growth. Both periods of independence began with the collapse of the empire to the East, which left behind an economic wasteland. The Latvian economy was devastated not only by the war, which raged on its territory for five years without interruption, but also by Russian policy, which induced a massive number of Latvia's inhabitants to leave their homes and become refugees during World War I and evacuated almost all of the factories on Latvia's territory. The economic ties formed with Russia up to 1914 were cut off after the war by the new Soviet regime, and Latvia had to start building its economy almost entirely from scratch.

The situation was not much better when Latvia regained its independence in 1991. After the collapse of the USSR, the country did not have to overcome the ravages of war. Nevertheless, the long period of isolation from the world economy, which had changed and developed rapidly over the course of 50 years, as well as the sundering of trade ties with most of the former Soviet republics, meant that, once again, Latvia had to rebuild its economy almost completely anew.

This made the policy of development a central concern for politicians and society. The challenges were the same, but the international economic environment in 1991 was completely different than the one in which Latvia found itself in 1920.

World War I put an end to what has been called the first wave of globalisation, and in the interwar years trade restrictions and capital controls were widely used, especially after the beginning of the Great Depression in 1929. There was almost no international economic cooperation, and the small new border state could not hope for significant foreign investment, let alone financial aid for the restoration of its economy from international organisations or individual states. Private banks avoided making long-term loans to industrialists, because the economic situation was too unstable and the possibilites for profit too small.

It cannot be said that there was no foreign investment in Latvia. 50% of the capital invested in industry came from other countries, and, as Viesturs Pauls Karnups notes in his article, it was the fact that the lats was backed by gold that helped give these investors the confidence to invest in Latvia. However, that was not enough.

It was these circumstances in the 1920s that in large part led to the decision to make the Bank of Latvia not only a central bank, but also to let it act as a commercial bank. The Bank of Latvia had to fulfill the functions that in more recent times would be characteristic of a development bank. It gave loans to farmers who had received plots of land through the agrarian reform of 1920 but did not have enough money to invest in making their farms more efficient. It also put up money for the largest modernisation project of the interwar years, the construction of the Ķegums hydroelectric power station.

The international economic environment was completely different in the 1990s when Latvia regained its independence. The second wave of globalisation was gaining in strength, given fresh impetus by the collapse of the Soviet empire. International capital and trade flows grew larger every year, presenting heretofore seemingly backward countries with the opportunity to rapidly increase their standard of living. International economic cooperation was also becoming broader and deeper with the construction of the European common market and the strengthening of various international organisations for promoting free trade and providing aid. Moreover, the most modern economic thinkers had focussed a great deal of attention on low inflation

as an important prerequisite for growth. This was a natural reaction to the stagflation experienced by the US and Western Europe in the 1970s. On the political side, this reaction found expression in the triumph of US President Ronald Reagan's and British Prime Minister Margaret Thatcher's neoliberal policies. It was crystalised in what is now known as "the Washington consensus". In such an economic and intellectual environment, it was unimaginable that the Bank of Latvia would become anything other than a pure central bank whose main objective is "to maintain price stability in the country", as is written in the Law "On the Bank of Latvia" adopted in 1992. It is also no surprise that, in contrast to the policies pursued before, Latvia adopted one of the most liberal currency and capital regimes in the world.

But the yearning for growth has also led the Latvian economy astray, making the developmental curve much bumpier than it might have been. Between the wars, the lack of capital or of valuable properties that could serve as security for loans led to the widespread use of personal guaranties. These effectually unsecured loans often meant not only losses for banks and enterprises but also led to political scandals that undermined faith in the new country's parliamentary system. After the re-establishment of independence, there were two times when financial crises signalled the start of an economic downturn: when JSC *Banka Baltija* collapsed, and when the real estate bubble burst. On both occasions, it was the hope for fast profits and the reluctance of various state institutions to put a brake on the deceptively rapid growth that led to the inevitably sorry conclusion.

The period from 2004 to 2007 deserves particular attention. A golden shower of loans poured over Latvia's cities and countryside. Latvia as an independent country had never had access to such a large amount of money. It seemed that the long-awaited developmental leap had finally begun and would allow the country to catch up with the Western welfare states in a few years. Most politicians were not ready to point out the predictably dangerous consequences of the widespread euphoria and even took steps to help the bubble swell.

The experience gained during the years leading up to the crisis also points to a need to take a new look at the coordination of Latvian development policy. During the 1930s, the government had too much influence over the Bank. In contrast, after Latvia joined the EU in 2004, the Bank of Latvia and the government each started following different, incompatible policies. The Bank of Latvia pegged the lats to the euro with a narrow exchange rate corridor and was determined to get the country ready for joining the euro area in 2008. On the other hand, the government, even though it formally supported this goal, in fact pursued a fiscal policy that was not aligned with it.

Being able to agree on goals and to cooperate in achieving them is not a violation of institutional autonomy. But if different institutions pursue contradictory policies for an extended period, the results, as we have seen, can be very unpleasant.

If one looks at the statements of official institutions and researchers both in Latvia and the EU in 2003 and 2004, it becomes clear that even in their worst nightmares nobody could imagine how big the coming bubble would be and how fast it would grow. Everyone was aware that there was a certain risk of inflation, and when the lats joined the Exchange Rate Mechanism II on 29 April 2005, the EU announcement stated: "The agreement on participation of the Latvian lats in ERM II is based on a firm commitment by the Latvian authorities to achieve a sustainable reduction in inflation. The authorities recognise that strengthening the fiscal stance will be instrumental to this end, while it would also contribute to an orderly and substantial reduction of the current account deficit."[3] In the 8 March 2005 evaluation of the Latvian convergence programme for 2004–2007, the European Council forecast 4.3% inflation for Latvia in 2005 and 3.0% in 2006.[4] In fact, the actual rise in prices was considerably larger.

Without a real agreement on goals, an effective and coordinated action to stem the tide of money pouring into the real estate sector became impossible. It seemed that in Latvia everyone continued moving down their own path, hoping that the others would eventually join them. The Bank of Latvia, of course, held to the euro peg. It also raised the refinancing rate, thereby indirectly influencing interest rates on loans in lats, but that could not affect loans in foreign currencies. The government continued its expansive fiscal policy and did not do anything to limit speculation in real estate by means of more restrictive tax or administrative policies. The owners of many Latvian banks threw caution to the winds and did everything they could to increase market share, but the banking regulators both in Latvia and abroad were unwilling to act to cool this feverish growth.

This is an important lesson for the future. Without a basic consensus among the most important political and economic actors, it is difficult to introduce fundamental economic changes, all the more so if that requires standing against the winds prevailing in the economy at the time. But any sailor will tell you that it is possible to move forward even against the wind, if you have the skill and a crew that knows how to work together.

This book helps the reader understand how powerfully the Latvian economy is affected by the international economic environment. At times, Latvia has been rocked by waves that have their origin far from its shores. The 1929 Wall Street crash started the Great Depression, and as a result Latvian foreign trade shrank by more than 70%. The devaluation of the Thai baht in 1997 initiated a crisis, which led to the Russian default and all its attendent effects on Latvian exports and banks. The bankruptcy of the New York investment bank *Lehman Brothers* in 2008 led to a worldwide financial crisis that seriously exacerbated Latvia's economic downturn.

As a small country with an open economy, Latvia will have to reckon with the powerful positive and negative effects of the external environment in the future as well. In such unstable surroundings, it is all the more important that the country's monetary system reflects both the economy's needs and society's expectations. The history of Latvia provides many examples of how monetary policy, if it is subordinated to some other goal than price stability, can become a weapon of economic destruction. The country should never be allowed to find itself in such a situation again. On the contrary, we must ensure that the monetary system lays the basis for economic growth in a way that is comprehensible for the inhabitants of Latvia. This factor should also be taken into account, because, as the Austrian economist Schumpeter wrote, "The monetary system of a people reflects everything that the nation wants, does, suffers, is."[5]

ENDNOTES

[1] *Latvijas Republikas I Saeimas stenogrammas.* II sesija, 5. sēde. Rīga : Latvijas Republikas Saeima, 1923, 24. apr., 165. sl.

[2] Ibid., 170. sl.

[3] *http://ec.europa.eu/economy_finance/publications/publication6193_en.pdf* [cited 03.07.2012].

[4] *Eiropas Savienības Oficiālais Vēstnesis.* C 177, 2005, 19. jūl., 8. lpp.

[5] Schumpeter, J. *Das Wesen des Geldes.* Göttingen, 1970, S. 1.