



Another One Bites The Dust: Latvia

Wed Nov 12, 2008 4:14pm BST

Latvia is the newest victim of the credit crunch. This is not official. No formal application has been made for an IMF bail-out package, nor has it made the front pages of any major newspaper of record on the continent. That said, with the economy contracting by 4.2% in the third quarter (down from 10.1% growth in Q307), the sovereign receiving two downgrades in as many weeks from S&P and the country's second largest lender effectively going insolvent over the weekend, I'm willing to call this one as a full-blown crisis. Consider it like when NBC news called Pennsylvania for Obama before a single vote was counted.

To be sure, it doesn't come as much of a surprise. Amid the hullabaloo of Hungary becoming the first EU member to receive an IMF bail-out package in October, I explicitly stated that next on the list (after Ukraine, which was already in negotiations) in rough order would be Latvia, Estonia, Romania and Bulgaria. On this blog, I highlighted that the capital shortage caused by credit constriction would specifically exacerbate any form of external asymmetry built within an economy, whether that be a high gross external debt load, unsustainable fiscal deficit, large short-term debt refinancing obligations or current account deficit. Latvia is facing problems on all of these fronts. Gross external debt is 134% of GDP, the ratio of short-term external debt to reserves is 305% and the current account deficit exceeds 20% of GDP. Moreover, unlike Bulgaria and Russia, which at least have the cushion of a fiscal surplus, Latvia has posted deficits since 1998.

I have made it clear of the crisis risks that are building across the region, even in relatively better positioned economies such as Russia. So, at this point, it is about looking for signals of whether these risks are actually to play out. In Latvia, the writing was on the wall as soon as there was the run on a major bank (Parex) in the second week of November. In other economies though, the signals might be less obvious.

Russia is a case in point. As a country with substantial reserve holdings, the indicators to look out for are as much to do with trying to ascertain the government's ability and willingness to proactively alleviate the situation as it has to do with the economy's structural profile. In this regard, interbank lending rates, currency movements, reserve levels and the state of the refinancing fund set up by Moscow are key. Worryingly, already we are beginning to see pressures build in all these fronts. Interbank rates at the 3-month+ terms have recently spiked back above their recent highs, while the rouble was devalued by 1% on November 11. Both of these suggest that the central bank is losing control of two key markets which it has originally pledged to maintain stability. Indeed, according to latest data for October 24, foreign exchange reserves were at US\$474bn, or roughly 20% down from their record July high. Moreover, it was revealed on November 12 that the demand from corporates for short-term government refinancing exceeded the funds on offer by 50% or US\$25bn. Other qualitative indicators are also suggestive. According to Russia's Deposit Insurance Agency, 20 commercial banks had been reported as delaying withdrawals from depositors, even as the government had raised deposit guarantees to RUB700,000 or 40 times the average wage. On November 12, the central bank also revoked three banking licenses.

I stress that the Russian government and monetary authorities still have a great deal of ammunition to fend off crisis. However, it is clear from the above indicators that the ammunition is running down fast and consequently, the prospects of a crisis are looming larger.