

Latvia: From Great Recession To Depression

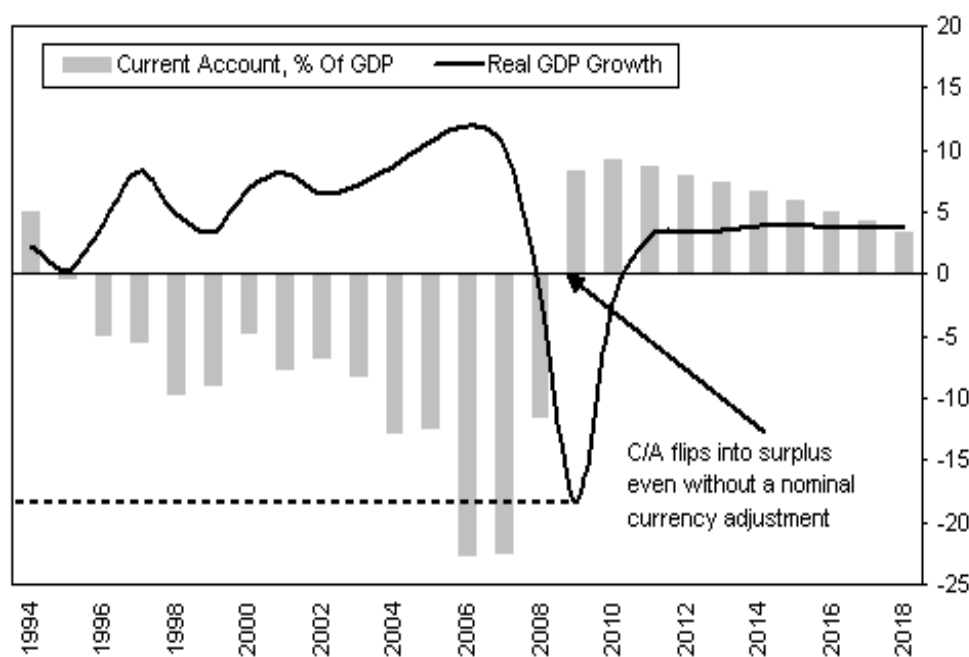
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Few countries have been as badly hit by the global downturn as Latvia.

According to a flash estimate released by the statistical office, the Latvian economy plunged by 18.4% y-o-y during the third quarter, which although below the consensus contraction of 19-20%, was nonetheless a horrific rate of decline. Indeed, this would mark the third successive quarter in which the economy has shrunk at a rate in excess of 18%, and follows two years of slowing growth.

These stark headline figures, in addition to a number of other key metrics, suggest that Latvia's downturn is nothing short of a depression. The economy is set to contract for three years before positive growth emerges towards the end of 2010, with the national output shrinking by over 20% from peak to trough (the US economy contracted by around 30% during the Great Depression).

The severity of the downturn is certainly evident in the chart below, with the current account set to flip into a hefty surplus in 2009, reversing the entrenched deficit of previous years. The current account has already recorded a EUR938.1mn surplus during January-August (from a EUR2.29bn shortfall for the same period a year earlier) without the economy having to endure a nominal devaluation of the lat. Instead, the positive outturn has been driven by an implosion of imports, which have plunged at a rate in excess of 40% for five successive months. This is further reflective of the dire state of the domestic economy.



Real GDP Change (%) And Current Account Deficit (% of GDP)

However, the story does not end here. Even when a recovery tentatively materialises in 2011, the economy will have to contend with stubbornly high unemployment, which will become a structural dynamic persisting over the long term. We now expect the unemployment rate to reach 14.5% in 2009, swelling further to 18.5% in 2010 and unlikely to return to the 2007 lows until after Business Monitor International (BMI)'s 10-year forecast period. Entrenched unemployment, which will see a deterioration in labour skills and even obsolescence in some cases, will keep domestic demand weak and limit the pace of recovery.

Unwinding these massive asymmetries will take years to play out, with resources being absorbed by debt servicing at the expense of productive investment. Indeed, while the excessive borrowing of previous years allowed for higher consumption in the present, it has done so at the cost of future consumption, which must now be lower. Overall, the economy will be worse off since interest payments will reduce consumption possibilities even further.

As a result of the aforementioned factors, I believe it will take at least ten years for the economy to return to 2007 levels (in real GDP terms). To be sure, the massive overhang of private sector external debt, limited export sector and tighter credit conditions (since foreign investors will likely shy away from lat assets), will conspire against growth, ensuring a weak and prolonged recovery.