Country Focus

Latvia

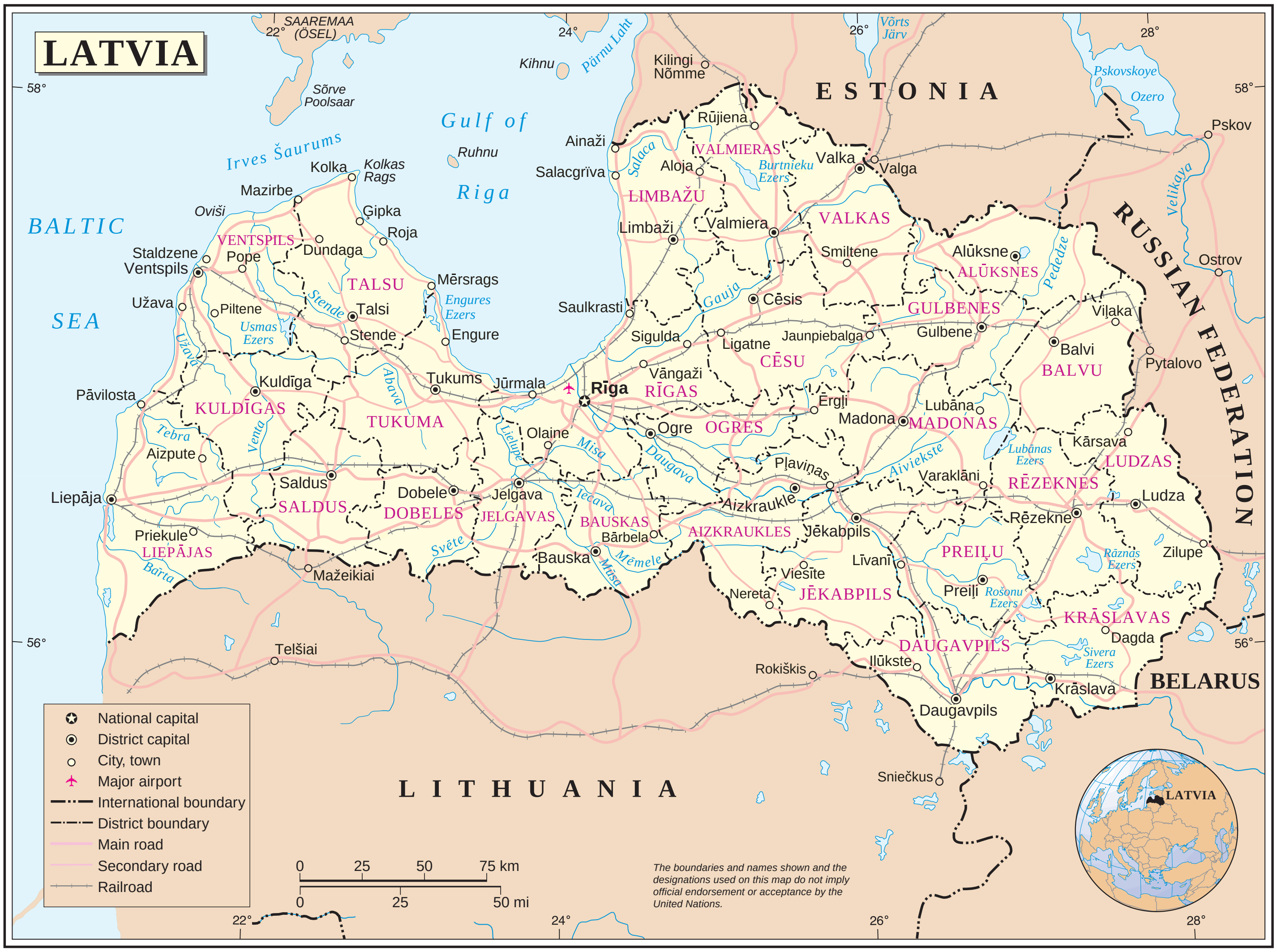
During 2008–10 Latvia suffered the largest recession of any industrialised state since the second world war. While the country has since returned to brisk economic growth, fundamental weaknesses in the political system remain unaddressed, writes **Daunis Auers**.

Accession to the European Union and NATO in 2004 was expected to be a watershed moment in Latvian history. It was seen as a unique opportunity to move beyond the painful modern history of this small Baltic state – Czarist absolutism, Soviet totalitarianism, the horrors (many self-inflicted) of two world wars, as well as the chaotically failed democratic experiment of the independent interwar state – and enter an era of dull, Nordic-like peace and stability.

However, this did not happen. Instead, after an all-too-brief period of speedy economic growth, Latvia stumbled into yet another calamitous economic collapse causing continued social strife and a short-lived, ultimately illusory realignment of the political system.

From Boom to Bust

It was not supposed to be like this. In the mid-2000s Latvia, together with Estonia and Lithuania, was one of the three 'Baltic Tigers' – poster children for the benefits of economic liberalisation and integration with the West. All three experienced double-digit GDP growth, sharply rising salaries



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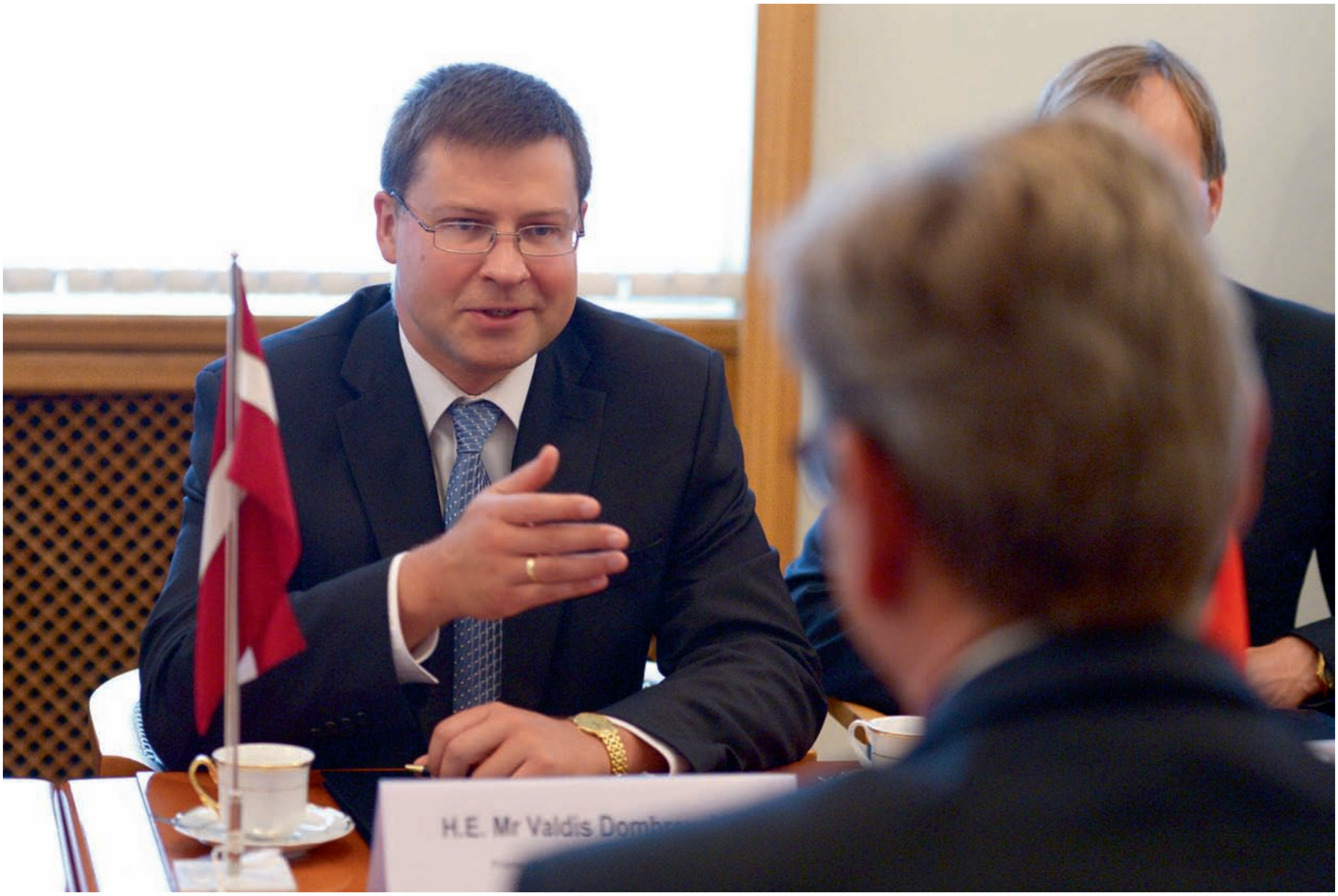

Prime Minister Valdis Dombrovskis has led three centre-right coalition governments since the crisis. Corbis

and a combined state and consumer spending binge that saw much of the visible remnants of the Soviet era – shoddy housing, rusty cars and pot-holed roads – recede into the past. The Latvian versus Russian-speaker ethnic bickering about language, citizenship and education rights that had dominated political discourse in the 1990s declined as the economy roared.

Latvia's rapid growth was based on a quickly expanding credit bubble

Aigars Kalvītis, the hubristic prime minister who presided over the boom years from 2004 to 2007 – an eternity in post-Soviet Latvian politics, where the average prime minister enjoys just 345 days of effective government – confidently predicted 'seven fat years' of growth in his 2005 New Year's Eve address to the nation. Economic convergence with the West, a cherished dream since the collapse of the Soviet Union in 1991, seemed finally within reach.

A dramatic banking collapse in October 2008 revealed this aspiration to be built on sand. Latvia's rapid growth was based on a quickly expanding credit bubble. Cheap Nordic credit had flowed into Latvia from parent banks keen to seize market share in the fast-growing Baltic market. At the same time, domestically owned banks had aggressively expanded their loan portfolios on the back of rising, mostly Russian, non-resident deposits: 105 per cent mortgages were not unusual.

Latvians, who had for the most part led modest lives in the Soviet and post-1991 years, began to consume. Even Liberia's former despot Charles Taylor joined the fun and invested in the Latvian real estate market. Inflation soon rose to double digits and wage increases far overtook productivity gains. Latvia's current account increased to a startling deficit of –27.1 per cent in late 2006; at that time the USA's much discussed and derided current account deficit was a comparatively paltry –7 per cent. Increased tax income led to an expansion of state spending, particularly generous salary increases and significant new capital projects. This orgy of spending was best captured by the avowedly anti-intellectual Latvia's First Party–Latvia's Way party alliance, which campaigned in the 2006 election under the slogan 'Let's put the [economic] pedal to the metal'.

Bailout

The global credit freeze that followed Lehman Brothers' bankruptcy in September 2008 hit Latvia hard. Parex, Latvia's largest domestically owned (and politically connected) bank, was bailed out by the government following the double-crunch of a deposit run by Russian savers coinciding with the scheduled repayment of a syndicated loan. In the following months, banks stopped lending and consumers stopped consuming. Tax income shrivelled. The result was a swift and deep economic

Former Liberian president, and convicted war criminal, Charles Taylor was among the many who invested in Latvia's property boom. Press Association

contraction, indeed the largest recession of any industrialised state since the second world war.

Latvia shed a remarkable 23.9 per cent of its GDP over the next two years. In comparison, Iceland, which received far more press coverage, lost just 10 per cent of its GDP over the space of two and a half years. Unemployment rose above 20 per cent (40 per cent for young people) and the number of people living in poverty soared. Immigration to the UK and Ireland, already high after accession to the EU, soared.

The situation was dire. Latvia was kept solvent by a €7.5 billion bailout deal put together by the International Monetary Fund and the European Commission. Humiliatingly, even neighbouring Estonia contributed to the package, despite a sharp downturn in its own economic fortunes. The deal called for 'fiscal consolidation' – deep spending cuts and tax hikes. Small but significant numbers of usually passive Latvians demonstrated.

The government, then led by Ivars Godmanis (a political dinosaur, who first rose to prominence 20 years earlier as head of government when Latvia broke from the Soviet Union), was unable to deal with this sudden change in fortunes and swiftly collapsed. The political parties that had led Latvia in the boom years were paralysed with uncertainty. The reins of government were eventually taken up by the opposition centre-right anti-corruption New Era party, which led a five-party 'rainbow' coalition under Valdis Dombrovskis, the fresh-faced prime minister culled from the European Parliament seemingly because no one else wanted the job.

The economic crisis revealed the fundamental weaknesses of Latvia's graft-ridden political system

Pop-up Parties

The economic crisis revealed the fundamental weaknesses of Latvia's graft-ridden political system. Over the last two decades, Latvia's political parties have failed to build up the capacity to govern and generate policy effectively. Parties are small, loose collectives of individuals that rarely outlast two election cycles and look more like the recent fad for short-term 'pop-up' shops and restaurants than their rather more solid and rigorous western counterparts. Political parties and party alliances formed just months earlier win elections (with the exception of the mid-economic boom 2006 parliamentary vote) before rapidly losing voter support.

Politicians effortlessly hop from one political vehicle to the next. Ideology is part of the marketing process rather than a philosophical compass to attract like-minded activists and guide policy formulation.

Latvia: Key Facts

Population	2 million
Head of state	President Andris Berzins
Prime Minister	Valdis Dombrovskis
National legislature	Unicameral Saeima of 100 seats, elected every four years
Electoral system	Open list PR system; five districts; share of vote calculated with pure St. Lague formula
Capital and largest city	Riga (population 700,000)
Ethnic breakdown	Latvian (62.1 per cent), Russian (26.9 per cent), other (11 per cent)
Unemployment	11.6 per cent (July 2012)

Ethnicity is the only salient cleavage and all post-1991 governments have been composed of vaguely centre-right ethnically Latvian parties. Until legislative changes that came into force in 2012, parties received all their financing from private, overwhelmingly commercial, sources. These funds were spent on electioneering rather than party membership structures or idea-generating think tanks. Governing parties relied on the limited skills of an inexperienced bureaucracy (that saw many of its best and brightest defect to the European institutions after 2004) to craft policy.

As a result, Latvian parties have been ill-equipped to govern. For many Latvians, the economic crisis gave a welcome opportunity to return to the political conditionality that had served Latvia so well in the 1990s and early 2000s. Latvian voters have long trusted European institutions more than their own; a 2009 Eurobarometer revealed that just 2 per cent of Latvians trusted Latvia's political parties, 6 per cent parliament and 9 per cent the government, while 46 per cent trusted the EU. As in the long drive to EU and NATO accession, international actors gave post-crisis Latvian policy-makers clear austerity-driven guidelines and benchmarks – and, with just a few wobbles, the Dombrovskis government executed them successfully.

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While Latvians were certainly not enthusiastic supporters of austerity (who would be?), opinion polls have shown that they realised its necessity. Latvian voters even re-elected the pro-austerity governing parties (which had either renamed themselves or forged new alliances) with an increased majority in October 2010 and then again in the early election of September 2011. Prime Minister Dombrovskis has now been in office for more than three years.

Austerity provided the opportunity for modest international-lender driven reforms to the political system. Public sector salaries were cut, unified and made transparent, while unpopular structural reforms tackled inefficiencies in the education and health sectors. Other reforms introduced limits to political campaigning and partial state financing of parties.

Back to the Future?

Nevertheless, high hopes for a new era of politics have faded away. These had been raised in the summer of 2011 when then-President Zatlers became an instant populist hero by calling a referendum on the recall of parliament after the legislature had voted against removing the parliamentary immunity of a powerful deputy, Ainars Šlesers, under investigation by Latvia's anti-corruption police for money laundering and bribery. Šlesers is one of Latvia's three mighty 'oligarchs' that amassed great political power and wealth from the murky nexus of politics and business.

The public overwhelmingly voted to recall parliament and the following early parliamentary election saw voters support Zatlers' freshly minted Zatlers Reform Party and reject two of the three 'oligarch' parties. (Voters stubbornly maintain a curious warmth for the most eccentric of the oligarchs, Aivars Lembergs, a conspiracy theory-obsessed mayor of the oil transit rich provincial town of Ventspils who bankrolls the Green-Farmer's Union.)

However, ethnic tensions returned to dominate politics with a polarising but doomed referendum on introducing Russian as an official language in February 2012, and a number of new parties are forming in the run-up to the 2013 municipal elections. Criminal investigations and trials of the oligarchs have ended in a cul-de-sac.

The Latvian economy has been turned turn around and returned to growth in late 2010. By the first quarter of 2012, Latvia had a brisk growth of 6.8 per cent, the highest in an otherwise sluggish EU. It formally left the IMF/EC loan programme in January 2012. A few months later, the Bank of Latvia hosted a self-congratulatory conference where IMF Chief Christine Lagarde hailed it as an example for Greece.

The Latvian economy returned to growth in late 2010 but the political system remains fundamentally unchanged

However, the Latvian political and economic system remains fundamentally unchanged. In late August 2012 Bloomberg reported that Latvian banks now had a higher percentage of non-resident deposits than Switzerland. Luxury property prices are soaring. Politics is as fractious as ever. Latvia seems to have returned back to the future.

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