New Challenges of Economic
and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

MACROECONOMIC POLICY REGIME IN LATVIA

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Abstract. This paper has a goal to apply the concept of macroeconomic policy regimes (MPRs) on the case of Latvia. The MPR of Latvia is assessed to find out if it has had a functional development or not. Functional MPRs are considered those that deliver sustainable economic growth, employment and a more equitable income distribution. A macroeconomic policy regime is a set of policies (foreign exchange policy, industrial policy, monetary policy, fiscal policy and wage policy), the financial system and institutions in which the economies are embedded. The observations and findings made so far point towards the direction of a dysfunctional development of the MPR in Latvia, causing great instability in the economic development, capital outflow and instability in the financial system. This paper provides an alternative model in which the foreign economic policy and industrial policy, with the help of the financial system which provides sufficient finance for the manufacturing sector, play the paramount role in reducing the current account imbalances; wage policy provides anchor for the price development; monetary policy provides stability in the financial system and fiscal policy cares about real stabilization, higher employment and more equal income distribution.

Key words: *macroeconomic regime, open economy policies and institutions, current account, industrial policy, Latvia*

JEL code: E02, E58, E61, E65, F41, F43

1. Introduction

This paper will analyse the functionality of the economic development in Latvia as a representative for emerging countries, candidates for a currency union, using a normative model based on the Post Keynesian view. Latvia is an interesting case for the reason that it is a small, open and net debtor country, candidate for entry in the European Monetary Union. The functionality will be assessed using the concept of a macroeconomic policy regime (MPR). Functional MPRs are considered those that bring sustainable economic growth in the long run, employment and more equitable income distribution. A macroeconomic policy regime is a set of policies (foreign exchange policy, industrial policy, monetary policy, fiscal policy and wage policy), the financial system and institutions in which the economies are embedded.

Due to a lack of continuous data and due to the fact that the concept of MPR is of a qualitative nature, the research methodology will mainly consist of statistical data analysis and descriptive analysis of the relevant macroeconomic policies and institutions which are part of the MPR applied to Latvia.

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In section two the contours of a MPR will be set. Moreover, all the elements of the latter will be addressed in detail. What follows is a sketch of a functional macroeconomic policy regime. In the third section the focus will be put on the Latvian economy and the development of its MPR, as well as assessment of the functionality of all the elements of the Latvian MPR on the basis of the functional macroeconomic regime drafted in the second section. In the last chapter conclusions will be presented.

2. Model of a functional macroeconomic policy regime

An important novelty of this paper is the application of the concept of MPR to Latvia. An MPR can be defined as a set of policies (monetary policy, fiscal policy, wage policy, foreign economic policy and industrial policy), the financial system and the institutional frameworks in which the economies are embedded. Institutions pave the way the policy instruments can be applied, and only when certain institutions are in place certain type of policies are possible. Six elements can be differentiated: monetary policy, fiscal policy, wage development/policy, foreign economic policy, industrial policy and the financial system.

Being that Latvia is a small, open economy and a net debtor country with particularly high debts in a foreign currency, the focus of the analysis will be put on foreign economic policy and industrial policy which play a very important role in improving competitiveness and in correcting current account imbalances. Foreign economic policy in this model has an objective of reducing the current account deficits and achieving a balance in the current account. Through reducing the income elasticity of imports and increasing exports, the country can increase its economic growth and accumulate foreign exchange reserves which are especially important defending the exchange rate pegs of the countries which are candidates for joining a currency (Thirlwall A.P., 1979). Thus, the current account balance-GDP ratio and the foreign exchange reserves-external debt ratio will be some of the indicators to assess the functionality of this element of MPR. Furthermore, foreign economic policy has an important task to manage the capital flows, as well as to prevent currency mismatch in the balance sheets of all economic participants. Hence, the indicator external debt-GDP ratio will supplement the assessment of the foreign economic policy. Against the background of rising economic growth and sectoral shift of production and employment from the manufacturing towards the service sector, especially in the emerging countries where the industrial capacity is not yet exhausted, industrial policy is intended to support particular industries and firms in the manufacturing sector that could increase the economic welfare of the whole country. Productivity in the manufacturing sector can be improved by government's spending on R&D, especially in the infant industries, in know-how and technology. The industrial policy will thus be given the tasks of supporting foreign economic policy, increasing productivity in the manufacturing sector, improving its competitiveness, terms of trade and net exports. Furthermore, the public investment in creating infrastructure for private investment is of crucial importance for the success of industrial policy. Public investment in R&D and public investment in relation to GDP will be used to prove the functionality of industrial policy. The financial system should on the one hand provide sufficient and affordable finance to the manufacturing sector particularly in support of firms that are engaged in R&D, technology advancements and/or to exporting firms. On the other hand, bank credits with speculative purposes (e.g. real estate credits) should be restricted. The financial system should also prevent creation of dollarization/euroization, which produces currency mismatches. Thus, foreign currency loans-total loans ratio and foreign currency deposits-total deposits ratios will be used as indicators to show the level of dollarization/euroization in the country. The ratio loans to the manufacturing sector relative to the total loans to the companies' sector will show the dynamics of the manufacturing sector and the potential for conducting industrial policy.

A certain rigidity of nominal wages is required for the reason that too high nominal wage increases (over medium-term productivity growth) could at least in a closed economy lead to inflation, while too low wage increases to deflation (Keynes, 1930). In an open economy, nominal wages have an impact on functional income distribution and furthermore, have an impact on the real exchange rate. Thus, a recommendation is to adopt a wage policy, whereby nominal wage increases will cover for the productivity trend in the medium run plus the inflation target (Hein E., Stockhammer E., 2011:130). This wage norm will be one of the indicators for checking the functionality of wage policy. The second one is the wage share, which is an indicator for the development in the functional income distribution, while the third one – growth of unit labour costs – shows the competitiveness of the domestic firms. Monetary policy is given the task of preventing panics in the banking system and provision of stability and low-cost financing in the financial system.[2] The real long and short-term interest rates relative to GDP and productivity growth will show us if the monetary policy was expansionary or restrictive and if it has been conducive for real investment or not. Fiscal policy should be responsible for real stabilisation in the economy, reducing income inequality and increasing employment (through direct job creation, training, etc).[3]Thus looking at the structural balance-GDP ratio relative to the output gap will give us an idea about the cyclicality of fiscal policy, while the Gini coefficient before and after tax will show us the effect of redistribution policies of the government.

Table 1

Solution for a functional macroeconomic policy regime

	Objectives	**Instruments**	**Institution in charge**	**Strategy**
Foreign economic policy	• Reduction of the current account deficit and achieving balanced current account; • Capital flow management; • Preventing currency mismatch.	• Foreign exchange intervention; • Capital controls; • Regulations to restrict the foreign currency exposure.	Central bank Government	• Supporting exports and reduction of income elasticity of imports; • Providing exchange rate anchor; • Stimulating FDI in manufacturing.
Industrial policy	• Reviving manufacturing; • Increasing competitiveness; • Increasing innovation capacity; • Improving terms of trade and the current account.	• Subsidies; • Policy loans; • Conditional provision of foreign currencies; • Regulations of entry/exit and capacity expansion in specific markets.	Government development banks	• Targeting specific sectors/ companies; • Provision of public infrastructure for private investment.
Financial	• Provision of low-	• Regulations of	Central bank	• Involvement of

[2] The latter can be achieved through setting regulations that separate banks (and their activities) from non-banks.
[3] More detailed description of the different elements of a MPR and the theoretical basis for the latter can be found in Kazandziska M., 2013.

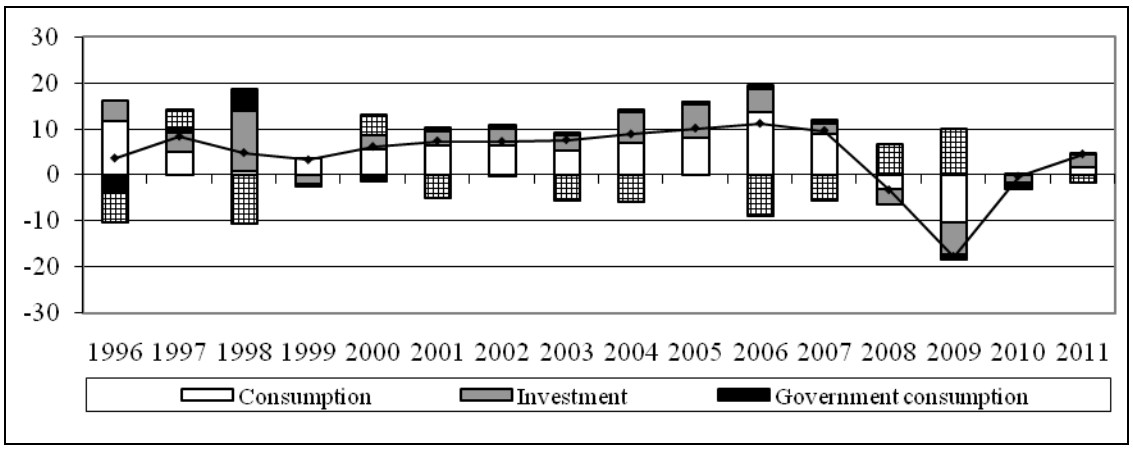
	Objectives	Instruments	Institution in charge	Strategy
system	cost finance for the private sector (manufacturing); • Securing stability in the financial system.	financial instruments. • Regulation and supervision of the financial actors.	Government	the central bank in the credit allocation of the banks.
Wage policy	• Preventing inflation/ deflation; • Stabilizing real exchange rates; • Maintaining a constant functional income distribution; • Securing a minimum income for the poorest.	• Wage negotiations at macroeconomic level; • Extension of collective agreements; • Minimum wages.	Social partners Government	• Wage norm; • Government support of higher trade union involvement in wage bargaining; • Wage coordination.
Monetary policy	• Provision of stability in the financial system; • Prevention of panics in the financial system; • Provision of low-cost financing.	• Interest rate; • Regulation measures for providing stability and finance in the financial system.	Central bank	• Maintaining low real interest rate.
Fiscal policy	• Stabilizing aggregate demand; • Reducing income inequality; • Supporting full employment.	• Public investment; • Public spending; • Taxation (progressive taxation, etc.); • Comprehensive welfare system.	Government	• Functional finance; • Anticyclical fiscal policy; • Automatic stabilizers.

3. Macroeconomic policy regime in the Baltic region – the case study of Latvia

In what follows the MPR of Latvia will be examined. The focus will be put on two periods: pre-crisis, or boom phase (1995-2007) and crisis, or bust phase (2008-2011). Firstly, the economic development and the contributions of elements of aggregate demand to growth will be analysed. Afterwards, I will provide examination and assessment of all the elements of MPR applied to Latvia separately.

3.1.Economic development

During the period 1995-2007 the Latvian economy experienced uninterrupted growth of nearly 6% (Ameco, 2012). The GDP growth during the former has been mainly affected by consumption (see Figure 1). The second place has been reserved for private investment. However, the relatively high growth was not supported by employment creation. In fact the employment rate was only 0.35% on average for the respective period. In 2008 the Latvian economy slid into recession which lasted until 2011. It was among the European countries, which were the hardest hit by the financial and economic crisis. Both the private consumption and investment fell sharply in 2008. At first the government responded with increased spending; however, already in 2009 under the pressure of the EU Commission, the former was forced to apply tight fiscal policy with very low level of government spending, which coupled with very large declines in private consumption and investment was a very important cause for reduction in the GDP growth of around 18% in 2009 (Figure 1). The positive contributions of net exports due to reduced imports were registered only in 2008 and 2009.



Source: author's calculation based on Ameco, 2012.

Fig. 1. **Contributions of components of aggregate demand to GDP growth**

3.2.Foreign economic policy

Latvia introduced a new currency already in 1992. In 1994 the currency was pegged to special drawing rights (SDR). The foreign economic policy has been strictly connected to maintaining the exchange rate peg within the limit of ±1% after Latvia entered the ERMII in 2005. The Bank of Latvia in a few occasions intervened in the foreign exchange market to defend the exchange rate. The decline in reserves can be spotted for the whole period (Table 2); the decline was especially pronounced in 2008 when the government wanted to prevent a devaluation of the Lat. The Latvian government was forced to ask for financial aid from IMF and the ECB to keep the exchange rate stable and to pay back the foreign debt (Onaran Ö., 2011:225).[4] The entry in the EU, as well as the process of deregulation of goods and financial markets caused high capital inflow, mainly in the form of interbank and intercompany credits.

[4] The response of the EU in 2009 to provide financial assistance to Latvia was rather belated because the country has already in 2008 fallen in recession.

Credits create an automatic liability for the debtor; thus the level of external debt has significantly risen (Table 2). The second important source of finance is FDI; though, it remained low in comparison to other CEECs.

The capital flows have also created a deterioration of the current account balances by causing a much larger increase in imports over exports and by increasing the deficit in the income account[5] (Mencinger J., 2007). The current account deficit – GDP increased by 10% on average between 1995 and 2007 and was only reduced amidst the financial crisis due to reduction in imports.

Table 2

Foreign economic policy indicators, selected years

	1995	2000	2007	2008	2010	1995-07	2008-10
Current account balance/GDP (%)	-0.3	-4.9	-22.3	-13.1	5.5	-10.0	-3.8
External debt/GDP (%)	8.8	62.0	135.7	124.3	164.7	73.8	144.5
Reserves/external debt (%)	109.3	17.5	14.2	12.0	18.3	39.2	15.2

Source: Eurostat, 2012;Ameco, 2012

All in all, we can argue that the foreign economic policy has had a dysfunctional development, leading to overvalued currency, high euroization and increased vulnerability of the financial system.

3.3. Industrial policy

We need to look at the structure of the economy in order to find out more about its effect on the current account. In Latvia we can observe that manufacturing has had the slowest increase the value-added. At the same time, we can observe an increase in the value added, as well as capital flows towards the real estate, wholesale, retail trade, transport, accommodation sectors. This led to a creation of an asset price bubble.[6]Latvia is thus another example of a boom-bust cycle, which seems unsustainable in the long run (Onaran Ö., 2007).

One indicator that shows how active the government's involvement is in creating industrial policy is the government's spending on research and development. Latvia's government spent only 0.3% of GDP on R&D, which is lower than the EU-average (Eurostat, 2012).[7] A positive development can be seen when looking at the public investment-GDP ratio. In the bust period we see an increase in the latter compared to the boom phase (Table 3).

Table 3

Industrial policy indicators, selected years

	1995	2000	2007	2008	2010	1995-07	2008-10
Government spending on R&D/GDP (%)	...	...	0.3	0.3	0.2	0.3	0.2
Public investment /GDP (%)	1.91	1.34	5.69	4.86	3.72	2.38	4.29

Source: Eurostat 2012, author's calculation.

[5] Through profit repatriation and increase in the interest liabilities connected to the credit flows.

[6] The stock prices increased by nearly 120 percentage points between the third quarter of 2000 and 2007 (author's calculation based on Eurostat 2012).

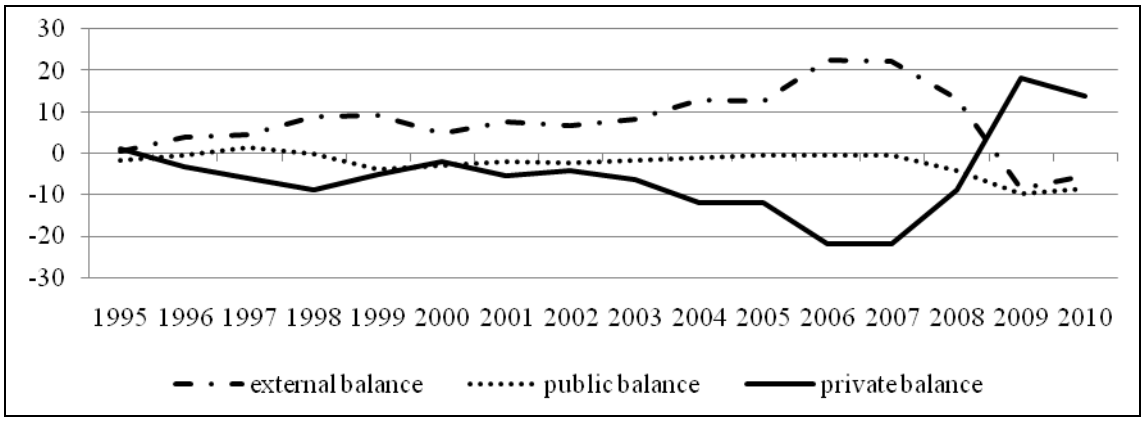
[7] In 2010 the Latvian government spent 0.16% on R&D in percent of GDP, while the EU members on average spent 0.76% (Eurostat 2012).

All in all, we can say that the industrial policy has been dysfunctional, because of having no clear objectives and strategy and because of the low spending of the government on R&D. The negative effects of the switch towards a growth based on the service, rather than the manufacturing sector can be firstly seen in the increasing current account deficits, as many branches in the service sector are non-tradable (primary and secondary education, child and elderly care, etc.) (Chang H.J., 1994:57-58).

3.4.Financial system

The deregulation of the financial market started already in the early 1990s with the elimination of the interest rate controls, credit ceilings and the most restrictions on international capital flows. The former paved the way for entry of foreign capital in the banking sector.[8]

In Latvia there has been an increase in the development of the financial system which can be confirmed by the availability of credits. As it can be seen from Table 4 high credit expansion can be particularly spotted beginning from 2004 onwards. The loans granted to the private sector have had a particularly impressive growth. Hence, the development of the financial balances of the private sector turned negative already in the mid 1990s (Figure 2). The deficits of the private sector had to be financed by capital inflows and hence, the creation of current account deficits. The spending of the government was only slightly higher than tax revenues,[9] approaching zero right before the start of the financial crisis (Figure 2).



Source: author's calculation based on Eurostat, 2012.

Fig. 2. **Financial balances of the different sectors (% of GDP)**

As a result of the burst of the bubble in 2008, the balances of the private sector turned positive. Although most of the loans were granted to the companies' sector, the share of loans to households relative to the total loans has dramatically increased (especially mortgage loans).[10]

[8] The share of foreign-owned banks in total banks increased from 9% in 1995 to 43% in 2006, and 62% in 2009 (Claessens S., van Horen N., 2012:30).

[9] In 2007 the budget balance to GDP was minus 0.35% (Ameco, 2012).

[10] In 2007 the mortgage loans to the households amounted to 34% of GDP (EBRD, 2009:186). Most of these loans were in a foreign currency, mainly denominated in euros.

Table 4

Financial indicators, selected years

	2000	2007	2008	2010	1995-07	2008-10
Total credit provided by the banking sector/GDP (%)	23.3	89.5	89.4	89.6	49.5	89.5
Loans to manufacturing sector/loans to the private sector (%)	...	13.3	14.0	5.9	13.8	10.0
Loans in foreign currency/total loans (%)	...	77.4	87.7	92.2	71.3	90.0
Deposits in foreign currency/total deposits (%)	...	42.6	47.7	53.3	40.5	50.5

Source: author's calculation based on Macroeconomic Development Reports of the Bank of Latvia of various years.

The overvalued exchange rate led to an increase in the demand for foreign currency; hence the increase in the foreign currency loans and deposits and the level of euroization (Table 4). The high foreign currency liabilities of the government and the households point towards a danger of a currency mismatch in their balance sheet as their revenues are mostly in a domestic currency. The large share of debt in a foreign currency exposes the debtors to the danger of devaluation.

The provision of company credit to the manufacturing sector has had a particularly strong decline (Table 4). Thus, although the financial system has marked a positive development in terms of higher credit allocation, it has overall had a dysfunctional development, as only a very small portion of the loans were actually used to support the manufacturing sector and potentially the correction of current account deficits.

3.5. Wage development/policy

Latvia's wage bargaining system, similarly to the Lithuanian and Estonian, shows characteristics of predominantly high decentralization, i.e. the wage negotiations take place mainly at the local, company level (Eurofond, 2011). The trade union density, as well as employer organization density has been low.[11] Furthermore, although there is a possibility for social partners to require an extension of the collective agreements for the whole sector, the collective bargaining coverage has remained very low (Eurofond, 2009).[12]

The area in which trade unions and employers' organizations have an important contribution is setting of the minimum wage within the framework of the Minimum Wage Law. For this purpose, the National Tripartite Commission was formed to support an open discussion about the minimum wage (Eurofond, 2009).

In Latvia on average for the period 1995-2007 we can see a higher growth of unit labour costs than in the Euro area, and thus, a loss of competitiveness on the side of Latvia (Table 5). Yet, between 2000 and 2002 the unit labour costs even marked a decline, as a result of wage increases below productivity.

[11] The employer organization density (i.e. the share of employees employed in firms which are members of an employer association) was 30% in 2009 (Eurofond, 2009).

[12] Extension of collective agreements is possible if employers that sign the collective agreement employ at least 50% of the workers in the corresponding sector or produce 60% of the output in the latter (CesIfo, 2012).

Table 5

Competitiveness and wage policy indicators, selected years

	1995	2000	2007	2008	2010	1995-07	2008-10
Unit labour costs growth (Latvia) (%)	-1.9	-2.2	29.3	19.9	-9.5	7.9	1.3
Unit labour costs growth (Euro area) (%)	...	1.9	1.9	4.1	-0.4	1.9	2.3
Nominal wage growth (%)	8.8	7.4	35.1	15.7	-6.0	14.3	0.4
Productivity growth (%)	10.6	9.6	5.8	-4.2	3.5	6.4	-0.9
Actual inflation rate (%)	25.0	2.6	10.1	15.2	1.2	7.4	5.4
Inflation target (%)[1]	25.0	2.0	2.0	2.0	2.0	7.8	2.0
Medium term productivity growth (%)	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Nominal wage growth (%)	8.8	7.4	35.1	15.7	-6.0	19.1	4.9
Wage norm (%)[2]	29.7	6.7	6.7	6.7	6.7	12.5	6.7
Deviation of the wage norm (%)[3]	-20.9	0.7	28.4	9.0	-12.7	6.6	-1.8
Adjusted wage share/GDP (%)[4]	51.7	49.1	53.0	56.6	48.7	50.0	52.7

* Note: [1]The ECB's inflation target of 2% is taken as a target after 2000, when this level was reached. Before 2000, the actual inflation rate is taken to represent the inflation target. [2]Wage norm is calculated as the sum between productivity growth and the inflation target. [3]Deviation of the wage norm is the difference between the actual wage growth and the wage norm. [4]Adjusted wage share is calculated by dividing compensation per employee by GDP at factor cost per person employed.

In 2008 the government was forced to implement wage cuts in the public sector as a part of the austerity measures imposed by the EU Commission and the governments of the largest EU economies in order to reduce the budget deficit (Onaran Ö., 2011). What was achieved was not only wage cut in the public administration, but decline of wages in the private sector as well.[13]

As explained earlier, the wage norm for stability-oriented wage policy (that wage increases move in line with the productivity development in the medium run and the inflation target set by the central bank) will be the criterion for checking the functionality of the wage development/policy. Wage increases have been above the proposed wage norm on average for the period 1995-2007 (specifically after 2005), but below the norm during the crisis (Table 5). For the wage share, we cannot make a straightforward conclusion, as the data are available only for a relatively short time period when the cyclical variations are also present.

For the reason that the nominal wage increases developed over the wage norm (and thus increased the inflationary pressure) in the boom phase and increased below the wage norm (and created a deflationary pressure) during the crisis period, we can speak of a dysfunctional wage development.

3.6.Monetary policy

The intermediate target towards achieving the main objective of monetary policy (which is maintaining price level stability) is the exchange rate peg to the Euro. Hence, at the beginning of our analysis of this element, we can argue that the monetary policy of the central bank has been very much restricted by the attempts to keep the exchange rate within the ±1% margins.

[13] The average wage declined by almost 13% in 2009 and 6% in 2010 (author's calculation based on Ameco, 2012).

Table 6

Monetary policy indicators, selected years

	2000	2007	2008	2010	1995-07	2008-10
Nominal refinancing interest rate	3.5	6.0	6.0	3.5	4.0	4.2
Convergence to the Euro area[1]	-1.2	2.0	3.5	2.5	0.9	2.9
RRIR minus GDP growth (%)[2]	-5.3	-13.7	-6.0	5.1	-10.7	-0.5
RLIR minus GDP growth (%)[3]	...	-13.8	-5.1	11.2	-14.3	3.0
RLIR minus productivity growth (%)	...	-10.0	-4.2	7.3	-11.5	1.6

* Note: [1]Convergence to the Euro area is calculated as the difference between the refinancing interest rate of the Bank of Latvia and the one of the ECB. [2] RRIR stands for real short term refinancing interest rate. [3] RLIR stands for real long-term interest rate.

Source: author's calculation based on Ameco, 2012.

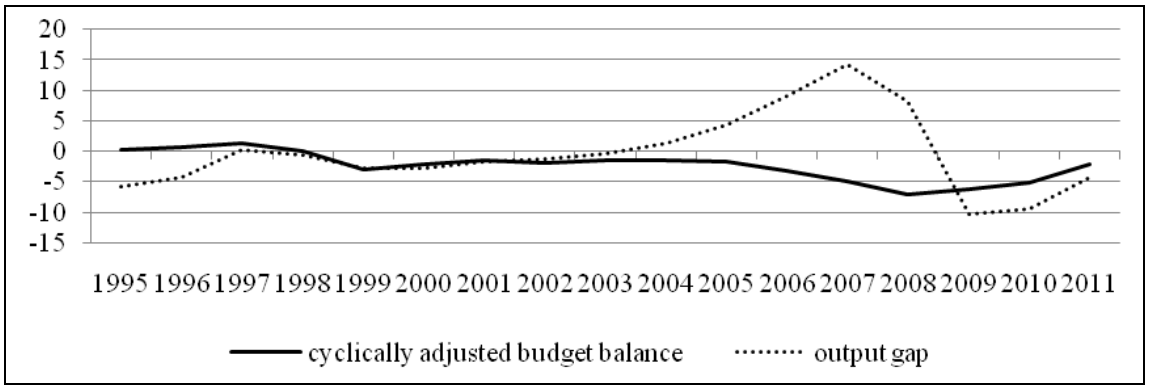
In Table 6 we can see the development related to the monetary policy in Latvia. The nominal interest rate development until 2002 was closely connected to the interest rates of the ECB. In the years that followed the central bank was put in a dilemma to fight the inflationary development or prevent a further increase in capital flows. It increased the refinancing interest rate to fight the inflationary development, which on the other handled to ever-increasing capital inflows. On average, the real interest rate was negative during the boom period which was conducive for investment and credit-driven consumption. The negative real interest rates contributed even more to the creation of the bubble. That monetary policy during this period was expansionary is additionally proven by the fact that the difference between real short term interest rates and real GDP growth and real long-term interest rates and productivity growth was negative (Table 6). In 2009 and 2010 as a result of the decreasing inflation rate in 2009 and deflation in 2010, real interest rates turned positive, which curbed investment and prolonged the recessionary period.

For the reason that the monetary policy was too expansionary in boom and too restrictive in the bust period, we can argue that monetary policy has been dysfunctional.

3.7.Fiscal policy

Fiscal policy has been given the task of fulfilling the Maastricht criteria. Except in 1999, the budget deficit stayed below the 3% limit and the public debt/GDP was also below the 60% margin set by the Maastricht Treaty. However, due to the financial and economic crisis in 2008, there has been an increase in budget deficits relative to GDP over the 3% limit, which the government already in 2009 attempted to reduce in spite of the fact that the slowdown has not been overcome. In order to be able to assess if the fiscal policy was procyclical, we need to look at the structural budget deficit[14]. Figure 3 shows that in the periods 2005-2007 and 2009-2010 the fiscal policy was moving in a pro-cyclical direction. Therefore, we can say that the fiscal policy in these periods has been dysfunctional.

[14] Structural budget deficit is cyclically adjusted budget deficit (Eurostat, 2012).



Source: Ameco, 2012.

Fig. 3. **Structural budget balance and output gap, 1995-2011**

As a response to the financial and economic crisis, the government of Latvia implemented a series of cuts in public spending including reduction in public sector wages. The VAT has been increased from 18% to 22% in 2012 (Ministry of Finance of the Republic of Latvia, MoF, 2012). The reduced VAT was increased from 5% to 12%. The government also stated that it is committed to keep the structural budget deficits below 0.5% of GDP in the coming years (The Government of Latvia, 2012:4). With regards to the Gini coefficient before and after taxes, due to the restricted data (only available for 2007), we cannot draw a straightforward conclusion. However, taking into account that in Latvia there is a flat tax rate for personal income we can argue that the redistributive policies have not been functional.

4. Conclusions

In this paper, the contours of a MPR for an emerging country, candidate for a currency union was sketched. Then on the basis of this normative model, the functionality of the MPR in Latvia was assessed. Starting in the mid 1990s Latvia experienced a boom period supported by high capital inflows especially in the real estate and financial intermediation sector. These inflows were due to several institutional changes which marked the way in which macroeconomic policies were to be applied. Firstly, the deregulation of goods and financial markets which was almost completed in the mid 1990s increased the presence of foreign banks and opened up the opportunities for companies to receive funding in the capital markets. Secondly, the process of accession in the EU in 2004 increased the confidence of foreign investors. However, these capital inflows caused an increase in current account deficits and even more importantly, the level of external debt, as most of them were in the form of credits. The macroeconomic policy mix applied in Latvia can be summarised along these lines: monetary policy has been constrained by the aim to keep the exchange rate peg to the euro within ±1% fluctuation margins and the high level of euroization and currency mismatch (especially of the household sector, non-exporting companies and the government). The current account deficits and open capital account made Latvia vulnerable to capital flows and the exchange rate was put under depreciation pressure amidst the financial crisis. Deregulated financial markets and expansionary monetary policy allowed for the creation of asset bubbles. Fiscal policy has been given passive role of meeting the Maastricht criteria. Wage and industrial policy have not been given any significant role. In a nutshell, the analysis of the elements of a macroeconomic policy regime provided in this paper points towards a dysfunctional development, leading to ever rising current account deficits, high euroization, overvalued currency and capital flow volatility.

This paper thus suggests an alternative model in which the foreign economic policy plays a paramount role for reducing the external balances of the economy and achieving more sustainable economic growth based on exports of high value-added products and reduced income elasticity of imports. Moreover, foreign economic policy is given a role of capital management so to prevent high foreign currency exposure of the financial system. Providing a stable exchange rate anchor through intervention in the foreign exchange market is also an important part of foreign economic policy. The role of the industrial policy will be to support foreign economic policy by stimulating investment in R&D. Investment in R&D, especially in the infant industries and experimentation in know-how and technology is of great importance, thus the government's involvement (via subsidies, tax reliefs, patents, etc.) can stimulate creation of new and diversified knowledge, which is one of the main factors for sustainable growth in the emerging economies (Chang H.J., 1994:67-68). The financial system's main task is to provide sufficient, affordable finance for the manufacturing sector and securing stability in the financial system through defining conditions for bank's exposure to foreign capital, setting reserve requirements for different types of assets, and separating banks from other financial institutions. Labour market institutions also need to be considered. For the wage policy to be able to provide a stable wage anchor, wage coordination needs to be strengthened and the collective bargaining process, if necessary, needs to be supported by the government. In Latvia where collective bargaining is weak and the extension of collective agreements is possible only under very limited conditions and is rare, minimum wages policy should be applied (Herr H., Kazandziska M., 2011a).[15]

A more general recommendation for monetary policy would be to keep the long run real interest rates positive at a low level, with low, but positive nominal interest rates, at a given inflation rate maintained by the wage policy, so as to stabilize expectations, to promote investment and prevent the occurrence of speculative flows (Priewe J., Herr H., 2005:52). Fiscal policy should take care of real stabilisation of the economy, reducing income inequality and securing a high level of employment. In the emerging countries, the government needs to undertake large public investments in order to increase not only productivity and economic growth, but also to provide social programs to reduce poverty and the income inequality.

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