Banks brace for Latvia's collapse

The Baltic states are once again in the eye of the storm after leaked reports that Sweden is bracing for a full-blown economic and political "breakdown" in Latvia.

By Ambrose Evans-Pritchard, International Business Editor
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Latvia's currency peg is back on the agenda

The *Svenska Dagbladet* newspaper said Sweden's finance minister Anders Borg had told banks secretly that Latvia's political order was unravelling, advising them to prepare for the collapse of Latvia's rescue talks.

Latvia has failed to deliver draconian spending cuts agreed to secure the next tranche of its €7.5bn (£6.85bn) bail-out from the EU, the International Monetary Fund, and Sweden, balking at 20pc cuts in pensions and a further 15pc cut in public wages.

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The People's Party, the largest group in the coalition, voted against austerity measures last month, raising concerns that the country is ungovernable.

Mr Borg said the world's patience is running out. "It will be very hard to continue with these international programmes if they don't fulfill the spirit and the content in the agreements they have signed."

Latvia's economy contracted by 18.2pc in the twelve months to June, trumped only by Lithuania at 20.4pc. "Latvia's currency peg is back on the agenda, " said Hans Redeker from BNP Paribas. "The government has to relax policy for social reasons. The hardship this winter is going to be unbelievable."

Youth unemployment in Latvia is already 31pc, and concentrated among ethnic Russians. Premier Valdis Dombrovskis said his chief task is to "preserve social peace".

Neil Shearing from Capital Economics said the appetite for austerity has been exhausted. Latvia is "more likely than not" to devalue, toppling pegs in Estonia and Lithuania. "Financial markets elsewhere in the region are likely to be hit by contagion, with Hungary, Romania, and Ukraine most vulnerable."

The area is better able to cope with shocks than during the panic this Spring. The G20 tripled the IMF's fire-fighting fund to $750bn in April, chiefly as an insurance for Eastern Europe. This has greatly reduced risk of a liquidity crisis. It does not alter the slow-burn damage of rising defaults.

The Baltic trio financed property booms in euros (and swiss francs) because rates were lower. It was taken for granted that eventual euro entry had eliminated the exchange risk. This has become a trap. They need to devalue to break the cycle of depression, but cannot do so because of euro mortgages. Instead they hope to claw back lost competitiveness through wage deflation. This takes years, and discipline.

Mr Shearing said Latvia's economy would shink by 30pc whether it devalues or not. The peg merely draws out the agony, and slows the pace of inevitable defaults.

Washington's Center for Economic and Policy Research said the IMF is enforcing a"pro-cyclical contractionary policy" in Latvia. Foreign banks (mostly Swedish) are being rescued at the cost of local taxpayers. The IMF deal equals 34pc of GDP. Latvia is piling up debt to defend its peg. The policy may backfire in any case. Fiscal contraction is causing tax revenues to implode, feeding a vicious circle.

Lars Christensen from Danske Bank said Latvia's political class is chiefly responsible for clinging to the peg. "It's their choice, but if they want the bail-out money, they must do what they promised. They don't seem to understand that the IMF and EU are willing to walk away now that the global economy has improved and spill-over risks have been reduced," he said.

Prospects are grim whatever happens "There is absolutely no sign of stabilisation. The economy is still contracting. It's paralysis," he said.

http://www.telegraph.co.uk/finance/financetopics/financialcrisis/6263039/Banks-brace-for-Latvias-collapse.html