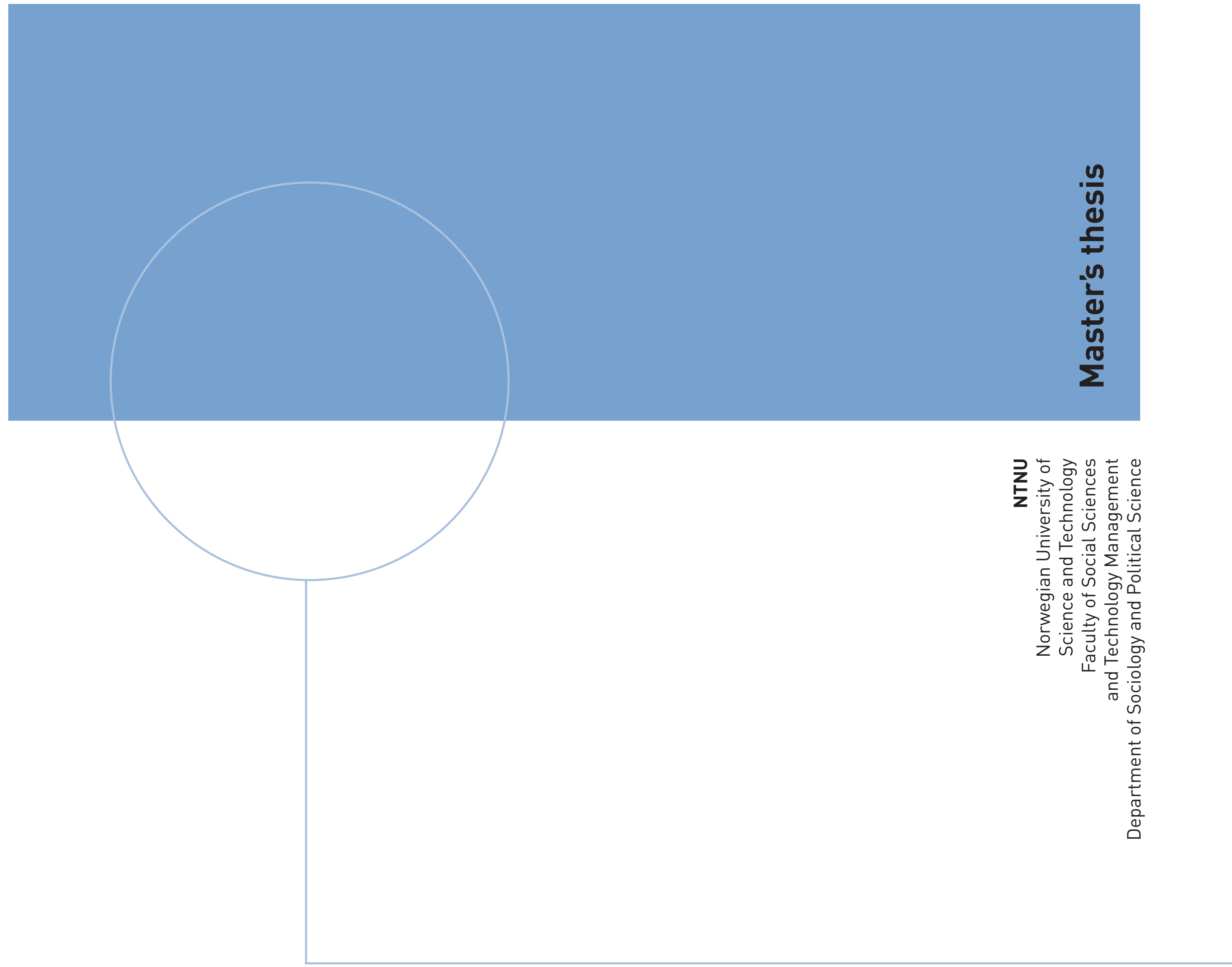

Magnus Utseth Christoffersen

The Financial Crisis in Europe:

A Comparative Analysis of Latvia and Cyprus

Master's thesis in Political Science

Trondheim, fall 2013

NTNU – Trondheim
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The financial crisis in Europe

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Abstract

The financial crisis in Latvia and Cyprus shared many important characteristics and they both underwent similar crisis with significant help from international partners. Latvia underwent internal devaluation while Cyprus employed capital controls, as a strategy for dealing with the crisis. This paper analyses these two countries and the strategies they employed in a comparative perspective. A central conclusion is that while internal devaluation is possible in principle, it is very hard to achieve in the real economy and entails huge social consequences. Capital controls can provide governments with breathing space but has to be followed by comprehensive reforms to correct the macroeconomic imbalances that have accumulated in the economy.

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1. Introduction

Milton Friedman (1953) contended that the argument for flexible exchange rates is similar to the argument for changing the clock to save time in response to changing daylight patterns. He noted, "it is much simpler to change the clock that guides all than to have each individual separately change his pattern of reaction to the clock, even though all want to do so. The situation is exactly the same in the exchange market. It is far simpler to allow one price to change, namely, the price of foreign exchange, than to rely upon changes in the multitude of prices that together constitute the internal price structure" (Friedman 1953: 173). Despite this parsimonious defense more than half a century ago for flexible exchange rate regimes[1], 18 of the largest economies in the world as of January 1. 2014, have for various reasons decided to enter into an Economic and Monetary Union (EMU), each member thus forsaking its ability to pursue an autonomous monetary policy.

When the Bretton Woods system was started after WWII with the currencies pegged to the dollar, which in turn was linked to gold, countries recognized the need to have control over their monetary policy, but were thus also obliged to keep capital controls[2]. Today, most countries in the EU have opted for a fixed exchange rate with the free flow of capital, thus forsaking their independence in the sphere of monetary autonomy. This is consistent with the recognized argument originally put forth by Mundell-Fleming, which I shall henceforth refer to as the policy trilemma.

The policy trilemma states that countries fundamentally can choose between two of three options when deciding international macroeconomic policy, in which each one is beneficial in its own right. These are capital mobility, fixed exchange-rates and an autonomous monetary policy. Given the choice made by European policy-makers when the common currency area was established to opt

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[1] In general, three broad criticisms, or some variations thereof, have been charged at the argument in favor of flexible exchange rate regimes. (1) it may decrease certainty in the economic scene, (2) it will not work because it would offset changes in domestic prices and (3) it would not produce the best attainable timing or pace of adjustment.

[2] Quote by John Stuart Mill on favoring a world currency, "so much of barbarism, however, still remains in the transactions of most civilised nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbours, a peculiar currency of their own" (Mill 2009 [1885]: 479).

for the decision to have free capita flows, fixed exchange-rate and no autonomy in monetary policy decision-making – this paper asks, which strategy is best for handling financial crises in the eurozone?

Thus, the problem with the financial crisis in Europe is that euro-area countries (or those aspiring to become one) do not have control over their monetary policy. Many of the countries hit hard by the crisis also have unsustainable debt, in large part fueled by a credit-led growth in the years prior to the crisis, and default of sovereign bonds is strongly discouraged by the EU. Furthermore, devaluation as an option of handling the crisis is impossible, meaning that the two real options on the table are internal devaluation and capital controls[3]. This paper compares the financial crises in Latvia and Cyprus, in which the first employed internal devaluation and the latter used capital controls, to see which strategy provided the best outcome and how the institutions of the European Union and the International Monetary Fund responded differently to these crises.

In this paper, I argue that these two countries had a similar crisis, but the principal difference separating these two were the strategies employed. Furthermore, I find that while internal devaluation is possible in principle, it is extremely hard to achieve in the real economy. Although Latvia has accomplished some benefits from its strategy such as return to growth and fulfillment of the convergence criteria, thus ensuring euro adoption – the social consequences of the strategy on employment and social benefits programmes are immense and likely to be adverse in the following years. On the other hand, I find that although the legalities surrounding the use of capital controls in the EU is contested, the strategy of capital controls as it was employed in Cyprus allowed the authorities in Cyprus to gain some breathing space. With capital controls, they could obtain some level of independence with respect to their monetary policy to stabilize the fragile banking system and bring the balance sheets back on track. More far-reaching reforms, however, are needed to address

[3] There are, in fact, some other options available, but the level of realism and effectiveness of these are questioned. Following Snider (1964), alternative strategies could be: Quantitative limitations of imports or increased tariffs, export subsidies or other measures to directly stimulate exports, reduction in foreign aid and military expenditures.

the macro economic imbalances in the Cypriot economy while the controls are in place. The best outcome is determined in terms of whether the capital controls in Cyprus actually resulted in monetary autonomy, and whether internal devaluation in Latvia corrected the imbalances in the economy and fully took into consideration the social impact of the measures implemented.

The paper proceeds as follows. First, various strategies for managing crises as well as general considerations on capital controls and internal devaluation, are taken into consideration. In addition, the legal framework of the EU and the Troika are also examined. Second, a brief background to the crises in Latvia and Cyprus is given, along with comparisons of the two crises and the role that the EU and IMF played. Third, methodological concerns and rationale for case selection is provided. Fourth, and last, alternative approaches in Latvia and the degree to which capital controls resulted in monetary independence in Cyprus is discussed.

2. Strategies for management of crises

This section delineates various strategies to deal with financial crises as they have occurred in Latvia and Cyprus. It focuses on the aforementioned policy trilemma in which governments face a trade off between two of three policy options and considerations on the use of capital controls and internal devaluation. In addition, the role of the legal framework in the EU and the configuration of the Troika are taken into account.

2.1 The Policy Trilemma

When choosing international macroeconomic policy, policy-makers face a fundamental trade-off. This is embedded in the concept of the "policy trilemma", which stipulates that governments must decide between two of three policies: capital mobility, autonomous monetary policy and fixed exchange rates. This trilemma is depicted below in the triangle and the logic is fairly easy to grasp. If, for instance, a country has a credible fixed exchange rate and unrestricted movement of cross-border capital, it follows logically that the domestic interest

rate must follow the international interest rate[4]. This implies loss of monetary policy autonomy because a higher domestic interest rate than the international interest rate results in investors shifting their funds in the country with the highest denominated interest rate, thus making the exchange rate depreciate. Hence, countries must either allow the exchange rate to depreciate or impose restrictions on capital.

In the triangle below, each corner represents one of the three possible policy options. A government can choose either of the three variations. (1) A floating exchange rate with capital mobility and monetary policy autonomy, (2) a fixed exchange-rate and unrestricted movement of capital, but with no autonomy in monetary policy or (3) a fixed exchange rate and monetary policy autonomy but with capital controls. Each of these options has its own benefits and costs, and as previously mentioned, governments can only choose two of three. The possibility of a middle ground policy, in which some restrictions on capital can give certain degrees of monetary policy autonomy, is beyond the scope of this paper. The next section expands on this policy trilemma and discusses some of the considerations governments face when employing capital controls.

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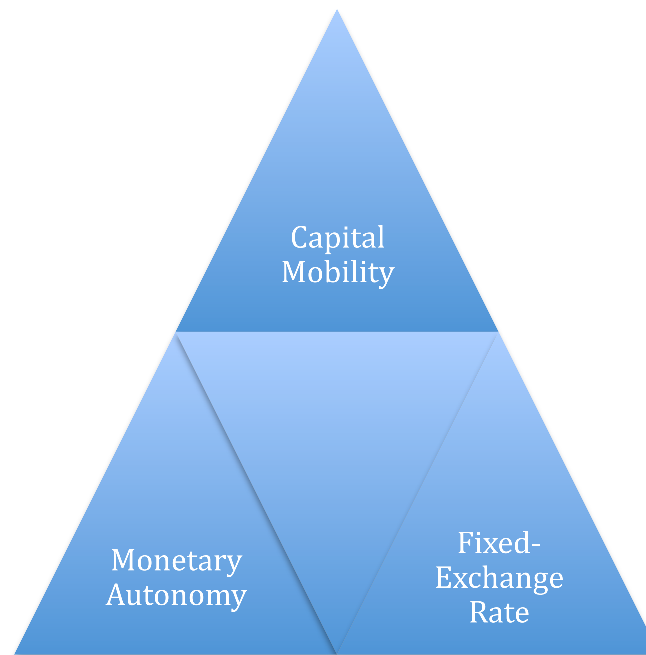
[4] Mundell noted some of the risks of contagion in currency areas: "Under the gold standard depression in one country would be transmitted, through the foreign-trade multiplier, to foreign countries. Similarly, under a common currency, depression in one region would be transmitted to other regions for precisely the same reasons. If the gold standard imposed a harsh discipline on the national economy and induced the transmission of economic fluctuations, then a common currency would be guilty of the same charges; inter regional balance-of-payments problems are invisible, so to speak, precisely because there is no escape from the self-adjusting effects of inter regional money flows" (Mundell 1961: 660).

Figure 1. The policy trilemma



2.2 Considerations on the use of capital controls

There are many arguments concerning the employment of capital controls, both in terms of its perceived negative and positive impacts on the economy. In times of crisis, restrictions on the movement of capital can create conditions in which improvement upon the general economic welfare is achievable[5], most commonly to compensate for existing or reoccurring market imperfections. One makes the arbitrary distinction between administrative controls (direct), and market-based controls (indirect) (Ariyoshi et. al. 2000). Direct controls typically seek to reduce the flow of capital thorough outright prohibition on capital, explicit quantitative limits or an approval procedure, which may be rule-based or discretionary. These measures attempt to reduce the direct volume of the cross-border financial transactions. The indirect controls seek to reduce capital movements by making them more costly to undertake. These controls may take various forms such as taxation on cross-border financial flows or other price-based measures.

[5] The use of capital restrictions as a way of maintaining stability has perhaps been long recognized. The member states of the Organization for Economic Cooperation and Development (OECD) formally agreed to abolish restrictions that might prevent the free movement of capital. The agreement, however, left significant scope for member states to make certain exceptions for certain capital transfers for the "maintenance of public order or… the protection of security interests" (OECD Code of liberalization of Capital Movements 1986)

One of the most common arguments in favor of capital controls is the maintenance of domestic monetary policy autonomy[6]. Supposing the measures to restrict capital are fully implemented, governments can regain control of their monetary policy and adjust the interest-rate towards suitable domestic conditions. In addition, capital controls have been employed to preserve monetary and financial stability in times of consistent and severe financial flows. This is particularly when concerns of the (1) inflationary consequences of financial inflows and (2) inadequate assessments by the banks and corporate sector about the consequences of large capital outflows, are prevalent (Ariyoshi et. al. 2000). The effectiveness of capital controls is frequently assessed based on its ability to maintain exchange rate stability, provide greater monetary policy autonomy or preserving domestic macroeconomic and financial stability. There has been much attention given to differentials between domestic and international interest rates, as capital controls tend to create a discrepancy between these two. If implemented fully, capital controls can ensure that financial flows are less sensitive to domestic interest rates, which can then be used towards domestic economic goals.

Associated costs with the use of capital restrictions are considerable. First, comprehensive capital controls may interfere with desirable capital and current transactions along with less desirable ones. Second, controls may entail administrative burdens to ensure the controls are effective, which is particularly prominent when the measures have to be broadened to close existing loopholes. Third, there is an existing risk that imposing capital controls may interfere with necessary structural reforms to correct existing macroeconomic imbalances and reduce the private sector's ability to adjust to changing international market conditions. Fourth, and lastly, capital controls may give rise to negative market perceptions, which may create difficulties in countries' ability to access international funds (Ariyoshi et. al. 2000). As previously mentioned, the EU

[6] Members of monetary unions do not have independent monetary policy. According to the theory of fiscal federalism, for stabilization policy to be effective, it has to be exercised at the federal level (Oates 1968). Furthermore, allocation of resources at the central level is crucial, "the existence of spill-over benefits and costs between communities indicate a need for central-government policies to correct for the resulting inefficiencies in resource allocation" (Oates 1968: 54).

treaties firmly prohibit any restrictions on the movement of capital. Although the treaties stipulate conditions where temporary measures to restrict the movement of capital is allowed, there is considerable disagreement whether the conditions in Cyprus are applicable to the conditions stipulated in the treaties.

When considering the effects of capital restrictions, it is worth noting that governments face a dilemma between efficiency and stability (Brakman et al 2006: Oatley 2010). The unrestricted movement of international capital flows enhances the benefits that capital movement can provide, for example giving investors the opportunity to diversify their risk and the international allocation of savings and investments. When evaluating the costs and benefits of capital mobility it is important to take into consideration that although governments face the dilemma between stability and efficiency, there are no easy way to measure the exact costs and benefits of capital mobility. Most economists argue that the trade-off is significant and that governments have to make a deliberate choice between efficiency and stability. The costs of unrestricted international capital mobility are most commonly portrayed fairly simple. Capital mobility reduces governments' ability to maintain an autonomous monetary policy, in that the domestic interest rate is highly sensitive to international interest rates. If a government lowers the interest rate – for example in response to domestic conditions – capital typically flows out of the country to where interest rates are higher. The second important cost that comes with capital mobility is increased financial fragility. In a world where capital flows are liberalized, imbalances arise more rapidly following a change in monetary policy. If the flow of capital is restricted, imbalances occur slowly as the current account deteriorates and moves into deficit. In a world with liberalized capital flows, however, serious imbalances can happen very fast. In a world with capital mobility, the imbalance constitutes the differences between large capital outflows and capital inflows. This balance can be billions each day. On the other hand, with capital fully restricted, the imbalance is the gap between exports and imports. Although this gap can become large in a given period of time, it can never be as large and destabilizing as the imbalances that may occur in a world where capital moves unhindered.

Thus, when capital mobility is high, governments' foreign reserves last shorter, the financial system is more fragile and prone to destabilizing capital movements. These can in turn have a very negative impact on the current account. Indeed, when faced with destabilizing capital movements, governments can deplete its foreign reserves in only a few days. Without capital mobility, countries can sustain a current account deficit longer (albeit not indefinitely). Hence, prohibiting capital flows does not vanquish the trade-off between stability and efficiency, but it relaxes it substantially (Oatley 2010: 242).

When considering the effect of crisis handling has on employment, it is generally true that internal devaluation has an adverse effect and devaluation has a favorable effect, while capital controls fall in between. Reduction in capital outflow could likely result in lower employment in the export-led industry, but could potentially switch foreign direct investment to domestic investment expenditure (Snider 1964: 353). The next section discusses internal devaluation.

2.3 Considerations on the use of internal devaluation

Financial crises typically entail some form of reduction in the value of a currency. Given that the euro-area countries have chosen to abandon their monetary policy, this devaluation of the real-exchange rate can happen through internal devaluation, which can be defined as regaining competitiveness through lowering wage costs and increasing productivity while maintaining the nominal value of the exchange rate.

When faced with a worsening trade or current balance, a country can in principle adjust the economy through economic contraction. Because imports rely on domestic demand, and exports rely on the demands of other countries, if the economy shrinks fast enough relative to its trading partners, the argument goes, the trade balance will consequently improve (Weisbrot and Ray 2010: 7). It is generally true that Latvia has set the current account balance back in track with the use of internal devaluation through the collapse of its imports. It is worth noting, however, that the process has also entailed a sharp decline in exports because of the recessionary situation in the neighboring countries. The problem with an over-valued currency remains, nevertheless. This has serious problems

with respect to the export-led sector of the economy. Once the economy returns to growth, the danger is that current account problems will reemerge.

Regarding the general nature of internal devaluation, some consequences are widely held to be representative. Cutting wages and public spending while increasing taxes leads to lower growth and higher unemployment. The process is consequently very slow and painful and it may take a long time before real competitiveness in the economy reoccurs. Furthermore, as Keynesian economic theory suggests, adjustment through wage reduction is particularly tough and people have an inherent resistance to wage cuts since the effects are so hardly felt. Unions often deter such wage cuts making them harder to achieve politically. As was true in Latvia, the strategy of internal devaluation often relies on public sector wage cuts and some sectors typically manage to avoid the wage cuts. This results in rising inequality, in which the effects of the austerity measures are unequally felt and a rising feeling of dissatisfaction may emerge. Although debt levels has been within the Maastricht criteria in Latvia, the burdens of the debt-servicing are harder. Internal devaluation often entails reducing inflation and possibly causing deflation, the real value of the debt thus increases and makes it difficult to reduce debt/GDP ratios. Increases in debt can result in investor nervousness.

2.4 The Lisbon Treaty

When understanding the crisis that occurred in Latvia and Cyprus, it is important that one understands the legal framework that exists within the EU for these types of events. Article 143 of the Lisbon Treaty explains member states' right of financial assistance in the face of balance of payment crises.

> Where a Member State with a derogation is in difficulties or is seriously threatened with difficulties as regards its balance of payments either as a result of an overall disequilibrium in its balance of payments, or as a result of the type of currency at its disposal, and where such difficulties are liable in particular to jeopardise the functioning of the internal market or the implementation of the common commercial policy, the Commission shall immediately investigate the position of the State in question and the action which, making use of all the

> means at its disposal, that State has taken or may take in accordance with the provisions of the Treaties.
>
> Source: Article 143 of the Lisbon Treaty (2007)

Article 143 explicitly gives the right of financial assistance only to member countries outside of the euro-area. When the financial crisis hit Greece in 2008, it could not apply for a medium-term financial assistance (MTFA) from the European Commission. Latvia being outside of the euro-area, on the other hand, applied for MTFA in December 2011 and received financial assistance of 7.5 billion euros. In obvious contrast to Article 143 of the Lisbon Treaty, Cyprus applied for financial assistance in June 2012, which was formally agreed in May 2013.

There are different views on why member states that are part of the euro-area should not be eligible of financial assistance. One, which is often put forward in Germany, is that it is the logical consequence of Article 125, which is often referred to as the "no-bailout clause" (Pisani-Ferry, Sapir and Wolff 2013: 16). This clause expresses the view that the Union or any member state should not be liable for the budgetary actions of any member state. It was regarded as a central pillar of the common currency and as a precondition for euro membership. When the financial crisis hit in the eurozone, it was obvious that the EU did not have any legal framework by which to provide financial assistance to its member states.

Regardless of the exact motivation of excluding euro-area countries from the MTFA- programme, opinions differ with respect to the reason of exclusion of euro-area countries from the MTFA. For instance, Marzinotto et al (2010) argue that the short and correct answer to why euro-area countries were excluded from the MTFA was that the MTFA deals with BOP problems and it was supposed that these problems would disappear when the EMU was created. The configuration of the troika is also important to understand when looking at the crises in Latvia and Cyprus.

2.5 The Troika

The Troika came into existence on 25 March 2010 and consists of the International Monetary Fund (IMF), the European Commission (EC) and the European Central Bank (ECB), as a decision to coordinate bilateral loans to Greece as a part of a package with European majority funding, and the IMF as a junior partner. The disbursement of the bilateral loans would be given with unanimity among euro-area members. Based on assessments by the ECB and the EC, the financing programmes to receiving countries would be subject to strong conditionality.

The creation of the European Stability Mechanism (ESM) in October 2012 and the following Treaty on Stability, Coordination and Governance (TSCG) in January 2013, resulted in a number of decisions to formalize the division of labor within the Troika, and the role and responsibilities of its mandate. Access to ESM assistance is reserved for countries that have ratified the TSCG, while IMF lending is available for all EU countries as a result of their membership in the IMF. In order to understand the workings of the Troika it is important to have a firm conception of the role of the ESM.

First, the ESM is now the formal organization to have the responsibility for deciding on financial assistance for the euro-area (ESM treaty 2012). The Board of Governors decide whether it is feasible to provide assistance to countries, and the Board consists of the financing ministers of the euro-area, which means the Eurogroup only in a different name. Second, decisions on assistance are taken based on unanimity by the ESM Board, thus giving each Board member a veto in effect (ESM Treaty 2012). If, on the other hand, the EC or ECB judge that failure to decide would have destabilizing effects on the euro-area, votes are taken on the basis of 85 percent majority. Third, the EC is charged by the ESM to provide an assessment of the economic and financial situation and its implication for the euro-area as a whole. If assistance is provided, the EC has the responsibility along with the IMF to negotiate the terms and conditions for financial assistance, "in laison with the ECB". In addition, the EC is given the role of signing the Memorandum of Understanding (MoU) with the recipient country. Formally, the

EC acts on behalf of the ESM and thus on behalf of the member states (ESM Treaty 2012).

Representatives from the Troika jointly take part in meetings with representatives from the national authorities. The different parties of the Troika prepare assessments, which in principle are common, although the IMF and EC prepare separate reports. Negotiations with the national authorities are held jointly and agreements about the conditions for financial assistance are agreed upon simultaneously. The resulting strategy, as is expressed in the letter of intent, is then addressed by the IMF, EC, ECB, the president of the Eurogroup and the finance minister of the country that holds the rotating EU-Council presidency (Pisani-Ferry et al 2013: 21).

It is important to emphasize that the Troika is not a lender, nor a decision-making institution. This role is reserved for the IMF and the ESM (Pisani-Ferry et al 2013). Lending decisions are not taken by the EC or the ECB. The IMF and the ESM provide lending with different terms of agreement, although these are coordinated. Hence, recipient countries enter into separate lending activities with these two institutions.

In addition, it is worth noting that the EC has a more restricted role when it comes to financial assistance with euro-area member countries, in comparison with assistance to non-euro area EU countries. This is in line with what is stipulated in the aforementioned Article 143 of the Treaty on the Functioning of the European Union (TFEU). The EC thus had a much larger role in assisting Latvia than it did in Cyprus because Latvia is not a member of the eurozone, while Cyprus is a member of the euro-area. For non-euro countries the EC participates alongside the IMF in negotiation and the actual lending. On the other hand, for eurozone countries such as Cyprus, the EC has no authority to provide loans only to negotiate the terms on behalf of the Eurogroup.

This means that the EC merely acts on behalf of the member states when dealing with financial assistance to euro-area countries, as opposed to representing the general community interest which is its normal function (Pisani-Ferry et al 2013). In non-euro countries such as Latvia, the decision to provide financial

assistance is taken by the Council based on a proposal by the EC, which comes from the College of Commissioners. It has no formal role in assistance to euro countries. In addition, the EC's role as an agent of the member states and as a EU institution is a role that is often filled with tensions. With respect to the ECB, it has a much less clear role in the Troika. It is referred to as "in laison with the ECB" (ESM Treaty 2012).

3. Methodology

This paper employs a comparative design. This design exploits the advantages of few cases, but lacks the ability to generalize beyond the cases. The cases are studied qualitatively, to discover the differences and similarities between the two. The chosen cases are Latvia and Cyprus. These are chosen among others because they have certain similarities: EU-membership, a strong relationship with the euro, the existence of a credit-led growth in the years before the crisis, consistent and persistent current account deficits, a fragile and risky banking system, small economies with a favorable tax system to attract foreign investment and flexible labor force. The financial crisis that struck these two countries were both significant and the social costs were adverse. The particular nature of these two countries makes them prone to the adverse effects of capital flights, which can potentially deplete foreign reserves in a short period of time. This paper attempts to compare how the strategies envisaged to cope with the financial crisis have affected these two countries. In addition, although Latvia is not a member of the eurozone, it will be in 2014, while Cyprus has maintained its membership since 2008. Moreover, both countries became members of the EU in 2004.

The comparative method has been used extensively in political science (Przeworski and Teune 1970; Landman 2000; Ragin 1987). There are both positive and negative aspects of this methodology. As the experimental and statistical method choose their cases on a random basis, and are thus also capable of generalizing to a much broader extent, the comparative method puts a heavy emphasis on case selection on the basis of the dependent variable. These study designs are thus less able to generalize.

The dependent variable for this study is: outcome of the financial crisis. The two independent variables of principal interest are the two different strategies Latvia and Cyprus employed, internal devaluation in the former and capital controls in the latter. The existence of two crises where both had rigid exchange rate regimes combined with full capital mobility and no autonomous monetary policy, who nonetheless employed different strategies for managing the crisis, provides an interesting vantage point for a study of crisis management. By choosing two cases that have important similarities and the same placement in the policy trilemma, one can with some level of confidence control for other possible explanations. Although inferences about causality are always prone to uncertainty because one can never be certain that one has controlled for all the other possible variables that may influence the dependent variable, by choosing two similar cases one can hope to control for some variation. All else equal, observed difference in outcome between the two cases may be attributed to the policy instruments employed.

One aspect to also take into consideration is how one can determine what is the best outcome? There are several ways one can evaluate the outcome of a policy instrument. I argue that with respect to Cyprus, the outcome of the crisis in large depended upon whether the authorities were able to achieve autonomous monetary policy, which would give it breathing space to pursue further reform of its economy. With regard to Latvia, the evaluation of the outcome depends on which variables one chooses to look at. If one solely looks at the effects of the internal devaluation on growth, current account balance and other economic variables, the picture might look like the success story that many have preferred to portray. On the other hand, if one looks at social indicators such as unemployment, wage cuts, social spending and so forth, the impression emerges that although austerity offered some benefits in the country, the social consequences of the measures are likely very adverse. In this paper, I attempt to consolidate both points of view and paint a nuanced picture of the crisis in Latvia.

Thus, the method employed in this paper most resembles what Mill termed the method of difference. In this method, one looks for important differences in

systems, which share many of the same similarities. With these similarities one attempts to control for variation and to arrive at the conclusion that the observed difference in a system that is otherwise similar may significantly influence the dependent variable, upon which the investigation relies. Latvia and Cyprus were chosen because both have important similarities as mentioned above; they both underwent a financial crisis that were of similar nature and both relied upon the IMF and the EU for financial assistance. Thus the systems were similar, but the principal difference separating the two were the strategies employed and thus also the difference in outcome between these two countries can with some level of confidence be attributed to the chosen policy instrument. This logic is evident in Mill's own words:

> If two or more instances in which the phenomenon occurs have only one circumstance in common, while two or more instances in which it does not occur have nothing in common save the absence of that circumstance, the circumstance in which alone the two sets of instances differ, is the effect, or the cause, or an indispensable part of the cause, of the phenomenon. (Mill 1891: 489)

One challenge with social science is to control for unwarranted variation. How can one be certain that the variation in outcome one observes can be attributed to the variable the researcher has in his model? Furthermore, the selection bias is a significant problem with the comparative approach, as well. In statistical studies, this problem occurs when cases are not chosen randomly, but rather on the basis of some common characteristics. This may lead researchers to erroneous conclusions and create spurious correlations. Because case selection is conducted non-randomly in comparative designs, this problem is particularly salient in the comparative method.

3.1 Rationale for Case Selection

Latvia and Cyprus are both small and open economies situated at the outskirts of Europe, one in the north close to the giant Russia and the other in the south close to Africa and the Middle East. Each country has a relatively small population, in which Latvia has approximately 2 million and Cyprus with a little over one million if one includes the northern Turkish dominated part. Exports contribute roughly one third of Latvia's GDP and because of its geographical position, it has a highly developed transit services along with timber and wood-processing, agriculture and manufacturing of machinery and electronics industries.

Furthermore, Cyprus is an open market economy heavily dominated by the service sector, which amounts to four-fifths of GDP. Tourism, financial services and real estate are the most important sectors. The country has also discovered reserves of natural gas, which it intends to exploit (Indexmundi 2013).

The two countries were chosen because they share common characteristics. Their financial openness make them dependent on the goodwill of foreign investors and capital flows. In addition, they have a strong relationship with the euro, where Cyprus has been a member of the euro area since 2008 and Latvia has pegged its currency to the euro. Although similar in respect to their experiences with crisis, they choose different strategies to handle the crisis. Latvia embarked on a tough path of internal devaluation, in which the economy contracted heavily and unemployment reached massive levels. In Cyprus, however, restrictions on capital were employed to ensure the banking system would not fail. Moreover, the legal issues concerning restrictions on capital are contested in the EU.

Both countries have banking systems of considerable size and a strong relationship with the euro. The two countries entered the EU in 2004, and Cyprus entered the eurozone in 2008. Latvia intends to join the eurozone in 1. January 2014 and had pegged its currency (the Lat) to the euro. A favorable tax regime for the establishment of international corporations and a flexible labor force – in particular in Latvia – are prominent features of both countries.

At the outset of each crisis, both countries enjoyed free movement of capital and both lacked independent monetary policy, with a fixed exchange rate regime. Latvia could have opted for devaluation because it was not a member of the eurozone, but choose to maintain the peg, with a relatively small margin of fluctuation. Restructuring of the banking system was crucial for both countries and the strategies employed were roughly similar.

In all likelihood, the existence of a rigid system of fixed exchange rates and full movement of cross-border capital, proved a challenge not only to Latvia and Cyprus, but also for the management of the financial crisis of the eurozone in general. The fundamental lack of independent monetary policy in Latvia and

Cyprus consequently meant that traditional tools for handling financial crises were no longer on the table. In addition, volatile capital flows, which could quickly deplete foreign reserves, posed serious risks for policy-makers. Thus, the two cases were chosen because they had similar characteristics but choose different strategies for managing the financial crises.

4. The financial crises in Latvia and Cyprus

This section starts with a background of the crises in Latvia and Cyprus, and then compares these two crises. It also considers the role played by the European Union and the International Monetary Fund, and how these differed.

4.1 Background: The accumulation of economic imbalances

In the 2000s Latvia commenced a boom that gained momentum with the country's accession in the EU in 2004, which wa unsustainable. Between 2000-07 annual real growth averaged 8.5 percent and entry into the EU boosted confidence in its economic and financial institutions. Private capital inflow fueled a rapid economic growth driven mainly by domestic demand in the non-tradable sector. Inflation began to reach high levels and a real estate bubble continued growing. In addition, a current account deficit of 23 percent of GDP in 2007 created serious problems for the Latvian economy (IMF 2013a: 4).

The financial crisis in Cyprus commenced after Greece defaulted on their debt in 2012, which hit the country the year after and created insolvencies in the Cyprot government. Cyprus is divided between a Turkish minority in the north and a Greek minority in the south. The country has strong cultural and financial ties with Greece. By the end of 2011, bank loans to Greek residents reached 130 percent of GDP, and Cypriot holdings of Greek bonds reached 30 percent of GDP (IMF 2013b). As the magnitude of the Greek crisis became apparent to the world, the crisis spread to Cyprus. Thus, the Cypriot authorities requested external financial assistance from the IMF and ESM.

Similar to Latvia, Cyprus' entry in the EU in 2004, and adoption of the euro in 2008, gave Cyprus confidence in the international financial markets. This also meant that it had accumulated large imbalances in the real economy. A favorable lenient tax regime gave rise to increased non-resident financial inflows, which at the highest point constituted over eight times of GDP (IMF 2013b). Similar to Latvia, these financial inflows helped sustain significant current account deficits, which peaked at 15 percent of GDP in 2008. Furthermore, the housing boom and rapidly growing domestic credit growth was one of the largest in the euro area. With Cyprus' entry into the euro area, fiscal policies were notably loosened resulting in a rapid rise in budget deficits and public debt.

Table 2. Timetable of key events during the financial crisis in Cyprus

Year	Month	Event
2012	June	Cyprus seeks financial assistance from the eurozone to restrict the risks to its economy from the financial sector. The request was motivated by an estimated loss of 4.5 billions from the two major banks in Cyprus, which was a result from the debt restructuring in Greece.
	October	The EU urges Cyprus to accept a rescue plan constructed by the "Troika" - the International Monetary Fund, the European Commission and the European Central Bank – which calls for a 15 percent salary decrease in the public sector and increases in the Value Added Tax.
2013	January	Moody's downgrades Cyprus' government bond rating, allegedly because of coming increases in the government's debt burden. German Chancellor Angela Merkel urges Cyprus to follow economic reforms. The credit ratings agency Standard and Poor's lowers the island's long-term debt rating by two notches to BB+ and puts it in the speculative category.
	February	The newly elected president Nicos Anastasiades claims that his first priority is to restore the credibility of Cyprus.
	March	The country agrees to submit its financial sector to independent scrutiny over allegations of large scale money laundering. A delegation from the Troika visits Cyprus to gather data on semi-governmental organisations as part of a deal to finalize the bailout package. Moody's downgrades Cyprus ratings to Baa3, the equivalent to Standard and Poor's BB+. In addition, the third largest credit rating agency, Fitch, too downgrades Cyprus to the lowest possible rating for a borrower. Eurozone finance ministers and the IMF agree on a 10-billion-euro bailout deal for Cyprus, which is the fifth eurozone member to be rescued. Cyprus postpones an emergency debate in parliament on the EU bailout. The government is pushing for a vote before banks reopen Tuesday, after a three-day holiday weekend. Media reports say the president may have to to declare an additional bank holiday on Tuesday to get the MPs to ratify the deal.

Source: EUbusiness

In Latvia, the economic expansion was financed with large credit growth from Latvian banks. In the mid- 2000s, bank credit grew at over 50 percent per year, fueled largely by external borrowing. By the end of 2007, the household debt-to-GDP ratio exceeded 40 percent, up from 11 percent in 2003, in which the majority was mortgage debt (IMF 2013a: 4). According to IMF-staff calculations, it was becoming clear that in 2006 Latvia suffered from a noteworthy loss in competitiveness, with a depreciation of the real exchange-rate. Wage and price pressures together with limited productivity gains during the last decade had vanquished much of the competitiveness gains Latvia enjoyed earlier in the decade. With a trade deficit that rose sharply and reached critical levels of almost 24 percent of GDP in 2007, it appeared to be a difficult situation for Latvia.

This credit-led growth was also highly visible in Cyprus. In the first decade of 2000, Cyprus enjoyed some of the highest levels of GDP-growth in the euro area, consisting annually of 3.0 percent in real terms. This was twice the average of the euro area (EC 2013). Cyprus enjoyed a clear increase in GDP in the 2003-08 period. When compared with Latvia, Cyprus is a rich country. It enjoyed prosperity in this period, likely boosted by EU-membership and the introduction of a stable international currency in 2008. From 2008, however, the country started loosing some of its growth, in particular between 2008 and 2009. From 2009 and until 2012 GDP-levels were flat or negative. Although data for 2013 in Cyprus is not available from Eurostat at present, it is fair to assume that 2013 would be another tough year for the Cypriot economy.

Problems with insolvent banks were significant in Cyprus, in which some banks had assets up to 400 percent of GDP. The Cypriot authorities passed a bank resolution in March 2013, where three major steps were taken: (1) the Greek branches of Cypriot were sold to a Greek bank, (2) Cyprus Popular Bank (CPB) was intervened and its insured deposits were transferred to Bank of Cyprus (BoC), while uninsured deposits and other assets were left in a run off unit and (3) BoC was intervened and recapitalized with participation of bank creditors, including uninsured depositors to attain regulatory limits (IMF 2013b). The Cypriot authorities protected all insured deposits and the result was that the banking sector shrank by 200 percent of GDP.

Moreover, the period of growth before he crisis hit took place with almost full employment, high job creation annually, low inflation and rising real disposable income. The inflow of foreign workers supported the Cypriot economy and convergence of nominal interest rates with the EU before the introduction of the euro, created very favorable conditions. Moreover, people in Cyprus enjoyed wage increases significantly higher than most of the eurozone. This economic expansion was in large fueled by rising domestic demand. Private consumption was supplemented by strong private investment particularly in construction, whereas net exports contributed negatively to GDP growth. Financial integration, capital liberalization and large levels of liquidity in the banking sector, linked to very large inflows of foreign deposits, further escalated the boom in Cyprus and were symptoms of an unnatural economic expansion. The confidence building measures of EU accession and euro adoption were considerable.

The initial response to the economic imbalances was slow in Latvia. The Article IV[7] consultation with the IMF in 2006 noted a significant overheating of the Latvian economy and the Latvian authorities responded lightly to these developments. It was believed that the expansion of the Latvian economy in the 2000s was a part of the convergence at the EU-level. Hence, policy action to contain the crisis was limited and not in proportion to the existing macro vulnerabilities and imbalances at the time. In early 2008, the economy was coming to a halt as global liquidity came to a stop with the collapse of Lehman Brothers in September 2008. The second largest and domestically owned bank – Parex Bank – had severe liabilities and there were huge concerns as to its financial condition, which led to a deposit run (IMF 2013a).

Economic contraction of GDP was considerable in Latvia, with a 25 percent decrease between 2008-10 (IMF 2013a: 3). Throughout the crisis, the authorities in Latvia maintained a strong conviction of maintaining the currency peg to the euro. Latvia carried on with an "internal devaluation" consisting of large cuts in wages, pensions and other public expenditures and strategic reforms in public

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[7] The IMF regularly conducts surveillance of each member state, usually annually. It is called Article IV consultation because of its requirement in IMF's Articles of Agreement. During these consultations, an IMF-team visits the country to assess and discuss the financial situation in the country with relevant partners.

services. In addition, Latvia carried out extensive structural reforms to give the country a more efficient and sustainable economic outlook.

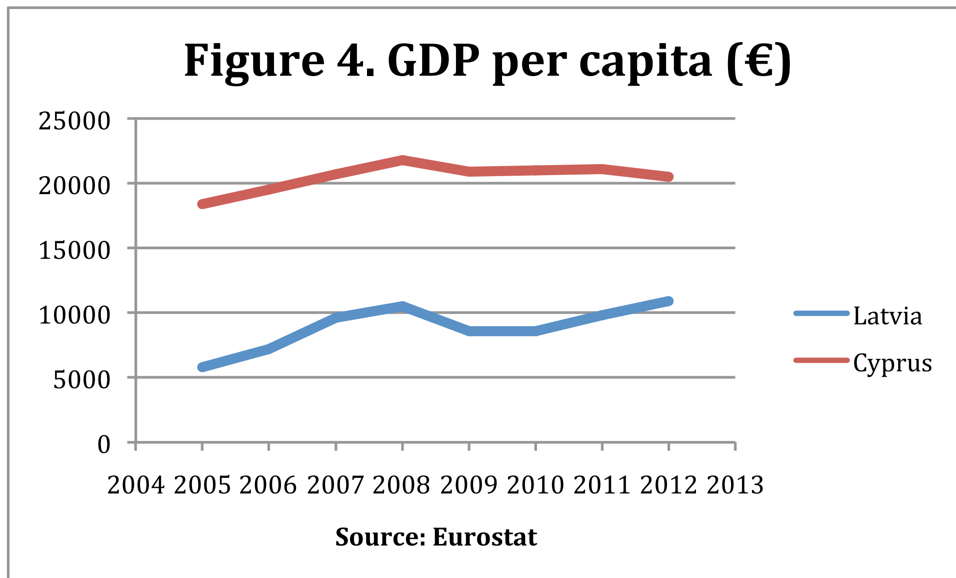
With respect to Cyprus, financial assistance was significant. The IMF's Extended Fund Facility of about one billion euro (563 percent of quota), was initiated to be spread over three years (IMF 2013b: 1). In addition, the European Stability Mechanism (ESM), the emergency financial assistance fund for euro area countries, provided assistance of 9 billion euro. The European Commission, the European Central Bank and the International Monetary Fund monitor the progress of the program and make sure that Cyprus complies with programme conditionality, as stipulated in the Memorandum of Economic and Financial Policies and Memorandum of Understanding (MoU).

Table 3. Timetable of important events in Latvia 2004-10		
2004		Latvia joins the EU
2008	March	Quarterly GDP growth turns negative
	June	Consumer spending and fiscal revenues contract in the first half of the year
	September	Lehman Brothers collapses
		Real estate prices decline 31 percent
	October	5-year CDS spread reaches 1,000 basis points
		Fitch and Standard & Poors downgrade Latvia
		Interbank overnight rates double in one month and reach 8 percent
	November	ParexBank partially nationalized
		Foreign reserves drop by € 800 million
	December	Partial freeze imposed on deposits at ParexBank
		ParexBank nationalized
		IMF approves SBA and disburses SDR 535 million
2009	January	EC approves € 3.1 billion loan to Latvia
	February	Prime Minister Godmanis resigns
	March	Net foreign reserves fall by € 0.8 billion in 30 days, consultation clause triggered
		Output contracts further
		New coalition formed
	June	Local elections take place
		Revised supplementary budget 2009 approved
	July	EC completes first review and disburses € 1.2 billion
		Net foreign reserves stabilize
	August	IMF completes first review and disburses €1.2 billion
		Overnight rates return to single digits
	September	Non-residents deposits stabilize, having contracted by 16 percent in 2009
	October	Non-residents deposit inflow resume
	November	World Bank disburses € 200 million
	December	Parliament approves 2010 budget with adjustment of 4.2 percent of GDP
		Constitutional Court reverses mid-2009 pension cuts
2010	February	IMF completes second SBA review and disburses SDR 178 million
Source: International Monetary Fund		

4.2 Comparative views on the two crises

The crisis in Latvia and Cyprus both involved significant expansion of the economy during the period leading up to the crisis. During the period leading up to the crisis, both countries enjoyed a high GDP growth. Latvia almost doubled its output from 2005-08, while Cyprus also experienced high levels of growth (IMF 2013a: IMF 2013b). Closer integration with the Nordic countries for Latvia and easy access to international investment in Cyprus helped fuel this growth. The accession into the EU in 2004 for both countries helped boost confidence in these two countries, and entry into the euro-area for Cyprus in 2008 further strengthened business confidence. Both Latvia and Cyprus are small countries with open economies, often dependent upon capital and investment from the outside, and thus more reliant on support from international partners. Latvia particularly suffered from losses in competitiveness, with a considerable increase in inflation and unit labor costs. This period also saw a notable increase in public expenditures, which proved to be out of line with the tax base. Fiscal imbalances were high in both countries and both countries had significant current account deficits.

Latvia and Cyprus both experienced strong credit booms, along with many of the other countries of the European periphery. For the eurozone in general, adopting the euro meant that their banks could raise funds from international sources in their own currency - rather than borrowing from a currency other than their own and hoping the exchange rates would not move against them (Lane 2012: 52). For Latvia in particular, EU ascension increased easier access to loans and profitable investment opportunities from international companies. Easier access to credit and artificially low interest-rates, resulted in consumption-related borrowing in both Latvia and Cyprus, although Latvia had not yet joined the euro-area.



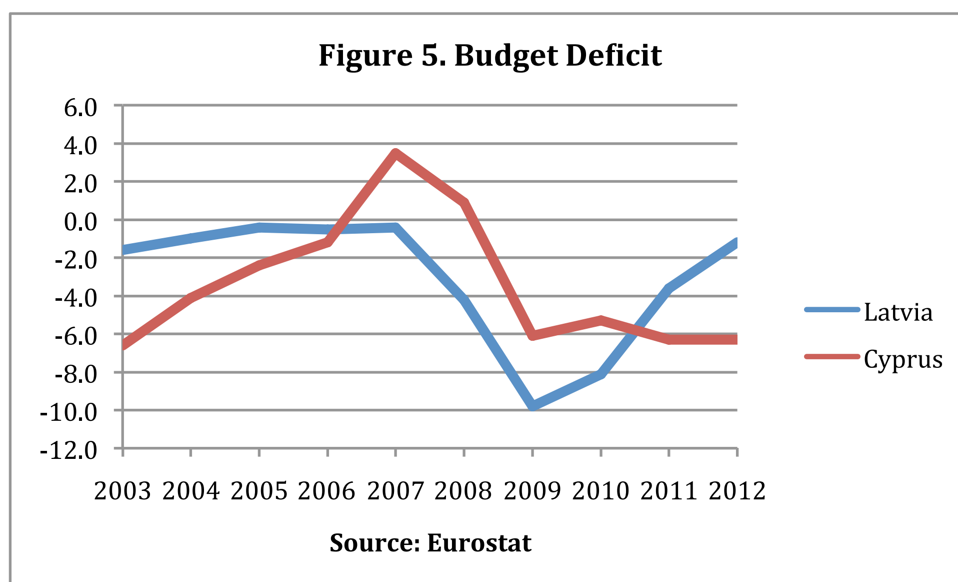
The graph portrays the development of GDP over the ten last years for Latvia and Cyprus. Although Cyprus is notably richer in terms of GDP than Latvia, the trend is similar for both countries. Both enjoyed significant growth, which was exacerbated by entry into the EU. After the crisis hit, however, both countries experienced noteworthy flattening or deteriorating growth in terms of GDP.

In the years prior to Latvia joining the eurozone, it had rigidly pegged its currency to the euro, allowing only a fluctuation of 1 percent above or below. While Cyprus obviously would not be able to adjust its exchange rate, Latvia could have opted for this strategy. The interesting question becomes, why did not Latvia want to go for the strategy of adjusting its exchange rate?

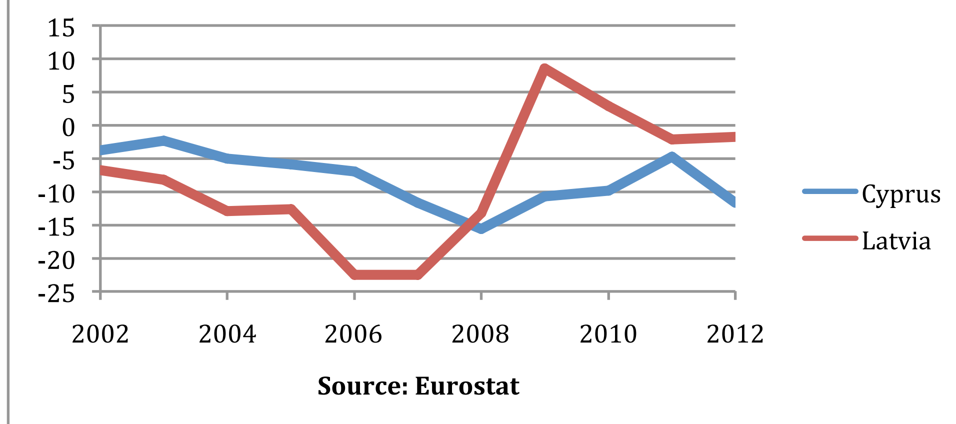
There were many arguments for and against maintaining the peg[8], but Latvian authorities had a strong conviction that doing so until the adoption of the euro would be the most feasible option. In all likelihood, such a policy would not have been possible had had the Latvian authorities not been so firmly committed to the peg.

[8] Although famous for the theory of optimum currency areas, Mundell (1961) noted some of the benefits of a floating exchange rate: "The existence of more than one currency area in the world implies (by definition) variable exchange rates. In the international trade example, if demand shifts from the products of country B to the products of country A, a depreciation by country B or an appreciation by country A would correct the external imbalance and also relieve unemployment in country B and restrain inflation in country A. This is the most favorable case for flexible rates based on national currencies" (Mundell 1961: 659).

With a considerable majority of bank loans to corporations and households in euros, a weaker exchange rate would result in a significantly lower private sector net worth (Purfield & Rosenberg 2010: 12). Furthermore, the Latvians contended that it would lead to massive insolvencies and non-performing loans, resulting in a negative feedback loop and increased economic problems in the country. It was also believed that devaluation would lead to small gains in competitiveness only, and contextual factors such as the global financial crisis vanquished any ideas of a quickly export-driven recovery.



The Latvian economy, along with its Baltic sisters, proved to be extremely flexible, as was evident during previous times of distress such as the Russian crisis. Hence, the strategy of internal devaluation was achievable. It is not obvious whether the same strategy would be feasible in Cyprus, which has a significant different composition of the country. The exchange rate peg had also been a symbol of economic prosperity and an anchor of macroeconomic stability for the last 20 years in Latvia (Purfield & Rosenberg 2010). Altering that policy would have been a challenge and creating support for an alternative policy would have proved difficult. The graph below shows that Latvia was able to correct its current account deficit, which at its worst year was close to -25 percent.



While debt was never a serious problem with Latvia and Cyprus when compared with other countries hard hit by the euro crisis, such as Greece and Ireland, the current account proved to be a considerable problem. With record lows of -22.5 percent of GDP in Latvia and -15 in Cyprus, it is clear that the external deficit was a problem of paramount importance. The handling and strategy of dealing with such large deficits on the current account was central to the Commission and IMF. Scholars have identified significant risks with running large external deficits over time. Blanchard (2007), for instance, contended that deficits on the current account can be very harmful if increased expenditure on non-tradables squeezes the tradable sector by driving up wages and sucking resources away from those industries which have more prospects for competitive gains. This risks are more evident in currency unions because the necessary adjustment that needs to take place once the deficit episode has occurred can only be achieved with a persistent increase in unemployment. This was very pronounced in Latvia, in which unemployment reached massive levels and the extent of internal devaluation was very considerable.

In the short-term, current account deficits are problematic if there is a sudden stop in the funding markets such that the deficit must be narrowed quickly. The Latvian case particularly illustrates this point, where capital flow reversals were very costly with respect to contraction of output, high unemployment and the

decline of asset prices. This further exacerbated the crisis and resulted in increased risk of banking crisis.

The crises in Latvia and Cyprus were both connected to the global financial crisis that started in the US. The failure of adjustment is well-known ever since Mundell's (1961) classic analysis of what constitutes a sensible currency union. Many economists worried that the lack of labor mobility[9] and fiscal policy had dramatic consequences since when asymmetric shocks hit the currency area, there was no policy levers available to offset them[10]. With the absence of an autonomous monetary policy, as is the case in Latvia because of the peg and in Cyprus because of membership in the euro area, the inability to manipulate the exchange rate possibly had the consequence of leaving one part of the union with high growth and another part mired in unemployment. Simultaneously, states were left with no real policy tool to offset shocks. The result is austerity or internal devaluation must be employed as a tool to handle the crisis.

Although the idea that countries that have been undergoing fiscally irresponsible policies have to resort to austerity for a time before the economy can become healthy again has an unmistakable appeal, the fact remains that internal devaluation is a slow and tedious process, which might take many years before results emerge. According to Friedman (1953), internal devaluation is likely more difficult to achieve than a simple change in the exchange rate. This is because changing thousand of wage and price contracts can be understood as much more demanding and burdensome than simply changing the exchange rate.

In addition, Keynesian economic theory explains why internal devaluation might be difficult to obtain, it is often more difficult and costly to adjust prices and wages down than up (Shambaugh 2012: 180). Many contend that in macroeconomics, wages are difficult to adjust downwards (Akerlof, Dickens, and

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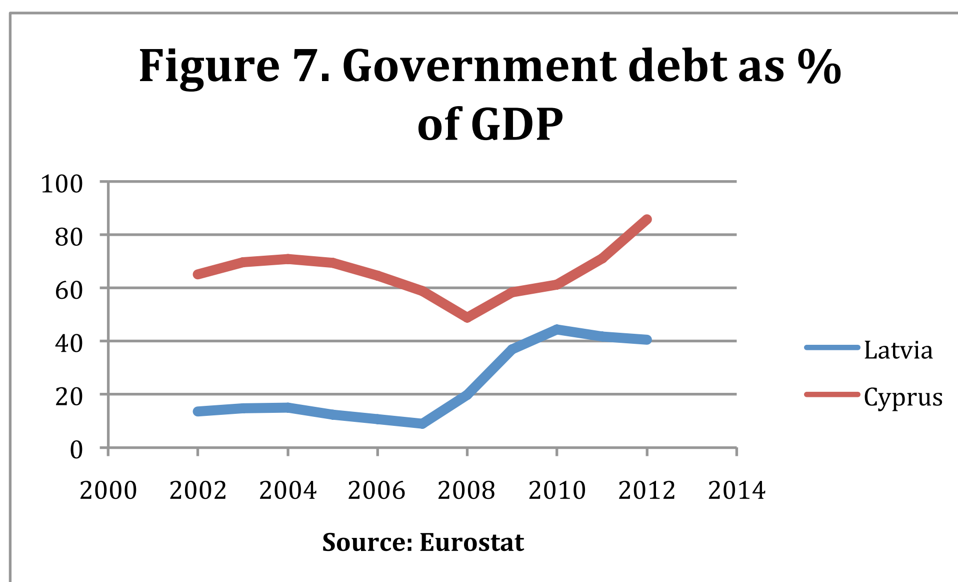
[9] Mundell (1961: 661) observed that, "if factor mobility is high internally and low internationally a system of flexible exchange rates based on national currencies might work effectively enough", but contended that is argument is only valid if currencies are reorganized on a regional basis.
[10] Meade (1957) contended that conditions of a currency union in Western Europe did not exist at the time because of the lack of labor mobility, and therefore a system of flexible exchange rates would be most suited to alleviate balance of payments disequilibria.

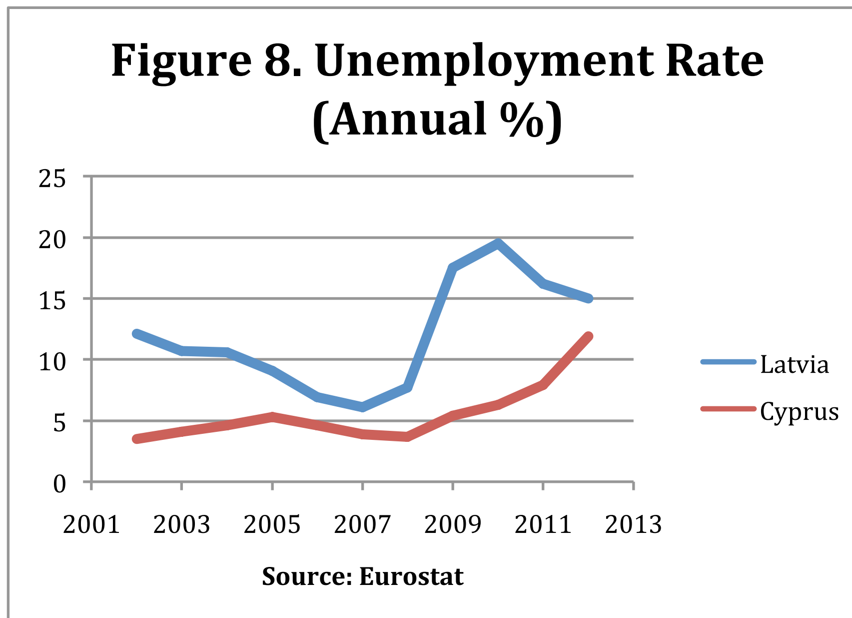
Perry 1996; Barattieri, Basu, and Gottschalk 2010), and thus the process of internal devaluation is slow and costly to achieve. Latvia's experience of a real depreciation of 7 percent between 2009 and 2010, where the currency fell in nominal terms of just 3 percent is often used as an example of a successful attempt at internal devaluation (the only one in the EU). However, there is very little evidence of successful internal devaluations in the EU and much points to the fact that in Latvia, country-specific characteristics played a big part. It is highly unlikely that the experiences in Latvia can be replicated elsewhere and even though the fiscal austerity in Latvia brought the deficits back in order, the social costs of the policies were significant.

Albeit it worked in Latvia, the policy of austerity has proved to be disastrous for the EU as a whole. There are four ways out of a crisis; (1) inflate, (2) devalue, (3) austerity and (4) add liquidity (Blyth 2013). In a currency union, the option of creating inflation is not possible since each member of the EMU has no independent monetary policy and the same goes with the devaluation strategy. While adding liquidity is an option for EU countries, it is only a limited one. The option that has been chosen by the IMF and European Commission is the one of austerity. Through cutting budgets, it is believed that countries should in some way save themselves to growth. According to Blyth (2013), this policy is built on several fallacies. First, if all members of a currency area enforce austerity and reduce their budgets, the only option can be a contraction in GDP. Countries create wealth by trading with one another, and within the euro area countries trade significantly with each other. This means that it is not possible to create growth while all countries are undergoing austerity. Moreover, the policies of austerity have not reduced debt levels, quite the contrary. Although Latvia never had deep problems with high debt levels, when compared other countries hard hit from the European financial crisis such as Greece and Ireland, the graph demonstrates that Latvia increased its debt level four times during the period in which it implemented the policies of austerity. Second, there are still significant problems with the banking system in Europe, in which some banks have assets that are above and beyond national GDP. It is important to recognize that budget cuts cannot solve the problems with the banking system in Europe. In addition,

the "no-bailout" clause makes sure that banks will not be bailed out if a large deposit run would happen. Moreover, the ECB does not have the role as lender of last resort, it is oriented toward one goal, which is fighting inflation. Its predetermined goal is to make sure that inflation does not run higher than two percent, which many argue is in the principal interest of the mainly export-led German economy, where maintaining competitiveness is the key.



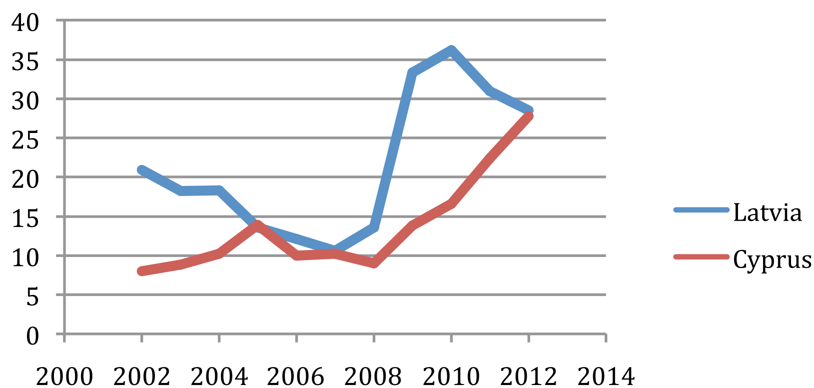
The graph of government debt over the ten-year period between 2002 and 2012 shows that debt was never a serious problem prior to the crisis. Cyprus had debt levels in line with the Maastricht criteria of no more than 60 percent of GDP, with just above that level from 2003 to 2005. Quite interestingly, however, Cyprus saw a noteworthy increase in their debt levels after euro adaption in 2008. In this period, Cyprus gained debt levels close to 90 percent of GDP in 2012. Latvia, on the other hand, had low levels of debt from 2002 until 2007. With the onset of the crisis, debt levels increased drastically to over 40 percent in 2010, with a flattening out or a small decline in the following two years. Although this increase in debt levels was significant, the level of debt is low when compared with Cyprus and the other countries that were hardest hit by the financial crisis in Europe.



With respect to employment, the graph clearly shows that the financial crisis has had a disastrous effect on employment, in both countries. The most adverse effects are observed in Latvia, with unemployment levels reaching 20 percent, at the most in 2010. Although unemployment levels are declining in Latvia, levels are still very high with 15 percent in the latest year in which data are available in 2012. According to data from Eurostat, the youth are hardest hit from the financial crisis both in Latvia and Cyprus, with 35 percent at the most for Latvia in 2010. This figure is also declining, albeit on high and likely adverse levels still. With respect to Cyprus, unemployment levels are on the rise ever since euro adaption in 2008, with well above ten percent in the latest year of the data 2012. Unemployment among youth has been rising drastically since 2008 in Cyprus, with close to 30 percent in 2012.

The empirical observations are also evidence of the brutal impacts of austerity measures in the work force in Latvia. An increase in unemployment on national levels from a little over five percent in 2007 to 20 percent three years later, is very dramatic. This level of massive increase in unemployment likely happened as a direct result of the internal devaluation measures, and probably had very negative social consequences that will continue to influence the country for many years to come.

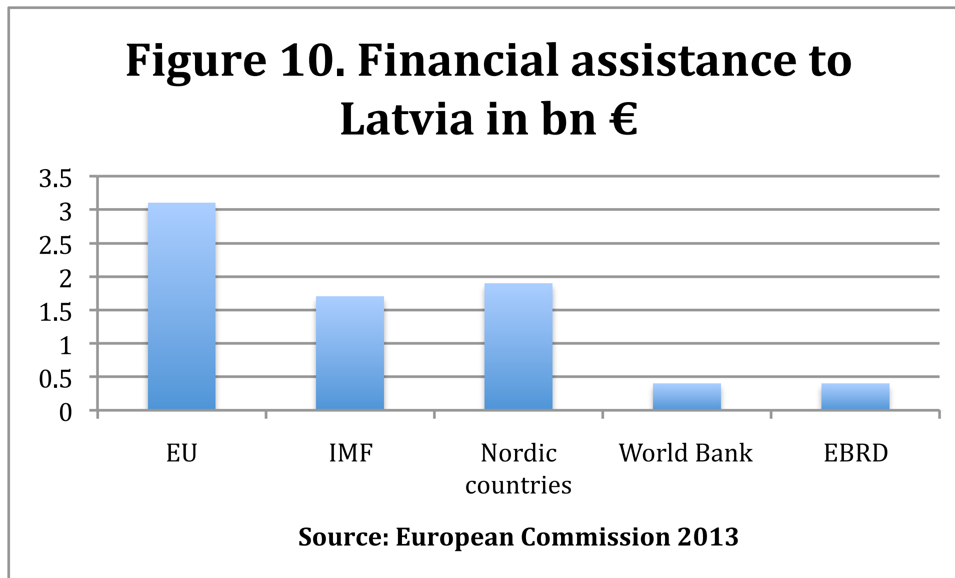
Figure 9. Youth Unemployment Age 18-25 (Annual Average %)



Source: Eurostat

4.3 The Role of The International Monetary Fund in Latvia

In Decembers 2008, IMF announced a financial assistance programme consisting of 1.7 billion euro going to Latvia. Managing director at the time, Dominique Strauss-Kahn, said "under the program the Latvian authorities are implementing a strong package of policy measures aimed at stabilizing the economy. In assembling the financial support for the authorities' program, the IMF coordinated closely with the European Union, the World Bank and several Nordic countries" (IMF press release 2008). This quote shows the multilateral effort of attempting to get Latvia on its feet again.



The immediate objective of the programme was to provide liquidity and to ensure long-term external stability. The maintenance of the exchange rate peg was also of critical importance for Latvia (IMF 2013a). While there were some initial uncertainties regarding the continuation of the peg, the Latvian authorities were firm in their conviction that the peg should be maintained. The immediate measures included in Latvia's SBA program were to stabilize the financial sector, and restoring depositor confidence. This was achieved partly by bolstering liquidity and maintaining foreign reserves. In the medium term, measures were included to bring real depreciation through income policies and fiscal consolidation. The exit strategy was the fulfillment of the Maastricht criteria and entry into the euro.

With respect to the financial sector, the advice from the IMF focused on resolving the crisis of the Parex bank, which was experiencing a deposit run (IMF 2013; IMF 2009). The authorities took over 85 percent of the bank's professional management, developed a new strategy for the way forward and appointed new staff. The recommendation from the Fund was that the authorities err on the side of overcapitalization of banks, by raising its capital adequacy ratio to at least 12 percent. The banks and the authorities responded quickly to the strains caused by the downturn in the economy. In addition, the Nordic-owned banks responded decisively and ensured adequate capital and liquidity (IMF 2013; IMF 2009; IMF 2010).

Domestically, state-owned banks posed the highest risk. Supervision of domestic banks' liquidity continued on IMF's advice, especially taken into consideration that these were strained by non-resident deposit outflows. In the event of systemic threats, the authorities were granted greater ability to supervise and intervene in these risk-banks. The Swedish and other Nordic partners issued public statements of support for their investments in Latvia. In addition, with respect to long-term external viability, measures were taken that focused on fiscal and income policies. The original program from the Fund included considerable measures to reduce aggregate demand, bring fiscal consolidation, promote real devaluation and correct the current account. Wage cuts were taken for public employees with around 25 percent to increase competitiveness.

Latvian authorities unanimously supported the exchange-rate peg, although many expressed doubts whether it was a sustainable policy for the economy[11]. Among others, these concerns included the ability to implement the necessary fiscal adjustment and controversial income policies (IMF 2013a). The latter part about income policies is so controversial because a decline in people's wages is so hard felt, and the results are typically unequally distributed. Wage cuts to create fiscal consolidation are often started in the public sector and then implemented in the rest of the economy. When some sectors have to take significant haircuts, while other sectors manage to avoid the wage cuts, it creates feelings of unfairness for those sectors hardly hit.

On the other hand, an exchange rate adjustment could have resulted in "a quick correction of Latvia's real exchange rate misalignment, which staff had assessed to be significant in the 2008 Article IV consultation report" (IMF 2013: 11). Although considered a preferred option for Latvia by many outside observers, it also entailed considerable risks.

[11] Although having noted that if internal prices were as flexible as exchange rates, Friedman (1953) observed that it would have made little difference if a country were to adjust through internal prices or with changes in the exchange rate. However, he insistently rejected that this condition existed, "the exchange rate is potentially flexible in the absence of administrative action to freeze it. At least in the modern world, internal prices are highly inflexible. They are more flexible upward than downward, but even on the upswing all prices are not equally flexible" (Friedman 1953: 165).

First, a change in the peg was strongly discouraged by the authorities and would seriously hampered ownership of the program. The peg was seen as a national symbol of success and prosperity, and had been an anchor of the country's macroeconomic policy for the last 15 years. Second, devaluation would have created immediate large balance sheets effects, with the possibility of a negative feedback loop. At the time, 70 percent of bank deposits and 90 percent of loans were foreign currency denominated. Exchange-rate devaluation would have resulted in deterioration of private sector net worth, increasing the real value of the debt and the bank deposits. Third, external financing-needs might not have been significantly reduced. While devaluation would have resulted in a decreased current account deficit, it would also increase external debt-to-GDP ratio. In addition, the economic situation at the time was severe and even though devaluation would have resulted in a competitiveness advantage for Latvia's exports, it is not altogether clear whether the precarious economic situation in Europe would have allowed Latvia to benefit from export competitiveness. Fourth, given the fragile global funding environment at the time, the spillover risks may have been higher for other emerging European countries in the Baltics and South-Eastern Europe (IMF 2013a; IMF 2009).

On the other hand, the IMF proposed measures that Latvia could have taken to shorten its financial troubles. First, a widening of the exchange rate band to -/+ 15 percent, as permitted under ERM2[12]. Latvia had an exchange rate band of 1 percent currently. A larger fluctuation in the Latvian currency would have resulted in larger initial output decline, but would arguably have restored competitiveness more quickly, reduced the current account deficit and fostered a more rapid economic recovery. Second, the Fund argued that this policy implementation would be more solid if it were to be followed by immediate euro adoption, which would address many of the risks described and give Latvia deeper access to capital markets. This option, however, was firmly ruled out by

[12] The Exchange Rate Mechanism was set up in 1999 to ensure that exchange rate fluctuations between the euro and other EU-currencies do not disrupt economic stability within the single market. In addition, it was envisaged that the ERM2 would help non-euro area countries prepare themselves for entry into the eurozone.

EU-authorities because of its inconsistency with the Maastricht Treaty and the signal it would send to other potential euro candidates.

The strategy of relying on the exchange rate peg came at a significant risk (IMF 2013). IMF-staff emphasized the importance of fiscal consolidation, and the likely heavy output loss that would result from this strategy. Wage restraint was also considered an important strategy.

There were also considerable difficulties in the design of the IMF-program for Latvia. In the initial programme, it was assumed that the Latvian economy would contract five percent for the first year. Instead, the economic output contracted by 18 percent, which led to significant fiscal underperformance (IMF 2009). Hence, after the first review the Fund reconsidered its strategy to take into consideration the unexpected economic downturn, and it took measures to limit exposure to vulnerable groups in Latvian society, while at the same time maintaining the exit strategy. Whether enough was done to limit exposure to socially vulnerable groups was done remains an open question.

When a country requests financial assistance it can draw money from its quota, which is determined by the country's share in the Fund. These are resources that a country has immediate access to. However, for countries in significant economic trouble, it usually needs more for financial assistance. Under such circumstances, a country can apply for exceptional access from the IMF. The Fund has four conditions which have to be satisfied in order for a country to get exceptional access. These conditions are: 1. Exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within normal limits. 2. High probability that debt will remain sustainable. 3. The member has good prospects of regaining market access within the time frame that Fund resources would be outstanding. 4. The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plan, but also its institutional and political capacity to deliver that adjustment (IMF 2013). Latvia was judged to be in line with the conditions set in the exceptional access criteria, although more

attention could have been given to the role of domestic factors in assessing prospects for regaining market access (IMF 2013), criteria 3.

Program conditionality was judged to appropriately aimed to stop the immediate liquidity crisis and then to ensure long-term external stability (IMF 2009; IMF 2010; IMF 2011; IMF 2013a). These structural measures were in particular pointed at the financial and fiscal sector. Quantitative performance criteria were set, and on a number of key financial variables, to closely monitor the macroeconomic performance in light of the program. In the context of the fixed exchange rate regime, it was important to achieve structural reforms in order to improve competitiveness. In comparison with other programs, the program in Latvia had more structural conditions, which in part was a result of the severity of the situation in the financial and fiscal sectors. It can be asked whether the program in Latvia did have too many structural conditions, given that program ownership was so high.

The Fund approved an exceptional access to Latvia, consisting of 1.7 billion euro, 1200 percent of quota, in a 27-month arrangement. Although Latvia suffered severe deficits in its current account and a crisis in its capital account, it appears in retrospect that the program was over financed (IMF 2013a). Even though this over financing may have occurred, it is likely that it had a strong effect in building confidence for the country, as well as to outside observers and investors. When judged in hindsight, it is even possible that the IMF had learned something from its earlier EU involvement. If one compares Greece and Latvia, it appears that in Greece the aid that was given was too little too late. While in Latvia it seems that too much was given just in time.

4.4 The Role of the International Monetary Fund in Cyprus

IMF's assistance programme to Cyprus was considerably smaller than it was for Latvia, despite Cyprus being a richer country. One aspect that is particularly disastrous in monetary unions experiencing financial crises is the risk of contagion, that crisis in one region can spread to another. This typically happens in the periphery and then spreads inwards to the centre. There are various

strategies, which can be employed to prohibit contagion. In the case of Cyprus, it is relevant to ask: What were the chances of the crisis spreading to other parts of the eurozone?

According to assessments by the IMF, the crisis in Cyprus has not triggered an adverse market reaction, although deposit flights and sell-offs in some euro stocks occurred. Notable spillover effects from Cyprus include Greek government bonds, Greek and Russian bond stocks, some debt in periphery country banks and to a lesser extent Slovenian government bonds (IMF 2013b). Although the spill-over effects have not been of a special volatile nature, long-term effects of these spill-overs remain a possibility. The circumstances of the crisis in Cyprus are considered by many as unique. The existence of an abnormally large banking sector when taking into consideration the country's fiscal capacity, combined with large amounts of uninsured non-resident financial deposits, is unlike most other euro area countries. Moreover, the combination of an outsized banking sector and many uninsured non-resident deposits became the focus of criticism by the IMF (IMF 2013b).

The liquidity of the banking sector was of critical importance during the financial crisis in Cyprus. To ensure financial stability, the authorities along with IMF and EU imposed capital controls and restrictions on deposit withdrawals (IMF 2013b)[13]. While a restructuring and recapitalizing strategy was being formed, the authorities enforced a 6-day bank holiday. It became evident, however, that once this "holiday" was over, a deposit run would result from the deposit holders. Responding to this challenge, a decision by the Cypriot government, endorsed by the EU and IMF, was set in motion to freeze all uninsured deposits in the Bank of Cyprus, and restrictions on all bank cash withdrawals within the country and transfers across the country.

In addition to being the first eurozone country to impose capital controls, the IMF and the EU imposed a tax on holders of bank deposits of all sizes. These

[13] On governments ability to impose controls, Friedman (1953: 169) noted, "whatever the desirability of direct controls, there are political and administrative limits to the extent to which it is possible to impose and enforce such controls… Given sufficient incentive to do so, ways will be found to evade or avoid the controls".

included a 9.9 percent levy on deposits over 100 000 and 6.75 percent on deposits under this threshold. This meant that even small deposit holders would be subjected to a tax (Eurogroup 2013; Véron 2013). The crisis hit Cyprus when Greece defaulted on their loans. Greece's sovereign debt restructuring in 2012 hit holders of those bonds the year after and raised questions about the government of Cyprus' solvency. Negotiations on a possible EU bailout were pushed into the election year of Germany, which is the recognized leader of the Eurogroup and the most important economic actor in the eurozone (Proissl 2010). This led many to conclude that the most viable strategy would be to force losses on big deposits in Cypriot banks, in which many were Russian. Furthermore, Cypriot president Anastasiades pushed for a decision to incur losses on small depositors, as well. Albeit strange, this decision would ensure that financial stability in Cyprus would continue to exist, while upholding the country's reputation as a safe-heaven for financial investors.

It is reasonable to ask whether the authorities' decision to impose a levy on small deposits constituted a smart strategy, when understanding the various policy responses to the crisis. One thing that is evident is that it lacked a consideration on the lessons of international financial history (Véron 2013). The global depression, which started in 1930s in the US, shows how important it is to protect the small depositors and thus ensure the welfare of the middle class. It is understood that a breach on deposit insurance will generally hit down on the holders of small capital and deposits, and being of particular detrimental nature.

Central Features of the Strategy

When creating the strategy for Cyprus' financial assistance, there were two main objectives that were instrumental for achieving long-run sustainable growth. First, restoring financial sector stability. It was recognized that bringing the banking sector on a secure and sustainable footing was paramount, if Cyprus were to regain its economic vigor. Among others, this aspect of the strategy sought to complete the recapitalization process and reform the supervision and regulation process. Second, achieving sustainable public finances, which entailed "an ambitious and well-paced fiscal adjustment that balances short-run cyclical

concerns and long-run sustainability objectives, while protecting vulnerable groups" (IMF 2013b: 3).

As previously mentioned, reducing the size of the banking sector was critical in Cyprus. It had a very large banking sector, in which some banks had assets up to 400 percent of GDP. Agreement between the troika and the authorities in Cyprus was reached on correcting the imbalances and prohibiting bankruptcy. By 2018, it is envisaged that the banking sector will be decreased to the EU average (Eurogroup statement 2013). The EU and IMF demand that Cyprus acquire 5.8 billion euro, and receive 10 billions in financial assistance. While the first agreement on March 16 stated that the two banks in Cyprus were to be continued, the Troika-leaders and Cypriot authorities concurred that the agreement on March 25 would involve the splitting up of Cyprus' second largest bank, Laiki. The division entailed the separation of Laiki into two parts, a "good bank" and a "bad bank". The "bad bank" is closed down and the "good bank" with all deposits under 100 000 € were transferred to the largest bank in the country, Bank of Cyprus. This bank survived the restructuring process, but depositors with more than 100 000 euro lost a significant portion of their deposits, which is in line with the Deposit Guarantee Scheme as laid out by the European Commission (EC 2010).

4.5 The Role of The European Union in Latvia

As previously mentioned, the EC has a much larger role in dealing with countries outside the euro. While the EC acts on behalf of the ESM in countries belonging to the euro-area, the College of Commissioners proposes a law, which is then set into effect by the Council. Thus, since Latvia is not yet a member of the euro, the EC participated alongside the IMF in the negotiations of the lending arrangements.

The Council decided on 20. January 2009 that mutual assistance to Latvia should be provided, in light of the economic and financial troubles observed in the country. Among others, it underscored that "There is a serious threat to the Latvian balance of payments which justifies the urgent granting of mutual assistance by the Community in conjunction with the IMF and other

contributors" (Council 2009). It specifically noted the importance of "a strong commitment from the Latvian authorities to implement an ambitious fiscal, financial system and structural reform programme to facilitate the necessary external and internal adjustments, to stabilize the economy and to restore economic policy credibility" (Council 2009).

The first memorandum of understanding (MoU) between the European Community and Latvia, and the following addendums, laid the foundations of financial assistance from the EC. The size of the financial assistance was up to 3.1 billion euro, with a maximum maturity of seven years (MoU 2009). It sought to support the Latvian authorities' Economic Stabilization and Growth Programme, and maintain domestic and international confidence in the financial system. Furthermore, it attempted to reverse the adverse effects of competitive loss and inflation by decreasing wages and to improve growth projections by structural reforms. However, whether the effects on the weaker groups in society were correctly taken into account when the fiscal consolidation measures were implemented, is not altogether clear. By implementing the measures proposed by the EC and Council, the goal was to reduce the macro imbalances, the current account deficit would be adjusted and inflation tackled. It would lay the groundwork of a sustainable convergence and secure Latvia's entry into the euro.

The EU-financial assistance would be set for six disbursements, with the amount of the first installment of one billion euro. It was also an explicit goal that by 2011, the general government deficit would be reduced to the Treaty reference level of 3 percent of GDP. To achieve this, the EC set tough fiscal conditions to reduce the budget deficit within the Maastricht criteria. These conditions, among others, included: (1) significant reductions in employments in central government with at least a 10 percent reduction of employment in June 2009, (2) the elimination of general bonuses, performance bonuses, vacation bonuses, management contracts, addition payments for work in high intensity conditions, and similar payments, (3) reduction of subsidies, excluding social support, and expenditure on goods and services, (4) implementation of EU-funded projects at the planned level, (5) on the revenue side, increases in the Value Added Tax

(VAT) from 18 to 21 percent, along with increased taxes on tobacco, alcohol, petrol, and other beverages (MoU 2009: 2). Thus, the conditions the EU set were tough and resulted in massive unemployment and a contraction in the economy rarely seen in Europe. It is, however, obvious that these measures had a significant detrimental impact on the country, and even though Latvia is back on a different track today.

To avoid "inappropriate expansionary policies" (MoU 2009: 3), measures were conducted with respect to fiscal governance, increased transparency and improved public financial management. In addition, financial sector conditionality was determined by the EU to be oriented towards the medium- to long-term by ensuring banking sector stability and restoring confidence to banking system. Among others, these measures included a resolution plan for the Parex bank, which experienced a deposit run and severe liquidity troubles.

With respect to the institutional set up of the Troika, notably the EC and the IMF, provided both some problems and advantages for the road to Latvia's economic recovery. Initially, the financial fund the EC provided was not in proportion to the hardships Latvia was undergoing. The European Stabilization Fund (ESF), the balance-of-payment facility for non euro-area members, had already reached its maximum capacity when the IMF and the EC were called in to help Latvia (Dahan 2012). The fund had already been used up to help Romania and Hungary and with limited financial resources it was little the EC could do to help Latvia. Therefore, the EC negotiated at the internal level and increased the capacity of the ESM upwards to 25 billion euro to provide it with better leverage in the following negotiations.

At the outset of the programme, it is noteworthy to mention that the EU did not have substantial administrative capacity and institutional resources to monitor and overlook a bail-out process (Sjöstedt 1999). It had limited resources at its disposal and was lacking in experience in dealing with these types of situations. The IMF, on the other hand, had substantial experience in these matters, which it has been doing for several decades throughout the world. Thus it was very clear

that at the start of the programme, it was the IMF that sat in the "driver's seat" vis-à-vis the Latvian authorities (Dahan 2012: 197).

Although the EC's and the IMF's role typically were identical during the management of the Latvian crisis, there were instances where the role of these two came in conflict. The IMF is more short- to medium-term oriented, where loans are usually paid back within three to five years. The EU, on the other hand, is involved with the member state on a long-term basis and is more influenced by solidarity principles, risk of contagion and other member states' view (Dahan 2012). Thus, in some instances the IMF's short-term vision was in conflict with the long-term (Henning 2011). Moreover, the IMF was often ignorant of EU-legal framework and the complexities of its institutional system and regulations, and at times devoted little resources to growth-enhancing structural reforms.

With respect to the institutional lending facilities provided to Latvia, the agreed formula had three dimensions that the lending partners agreed to: (1) the lending facility, or the balance of payment; (2) the amount of money required which was determined to be 7.5 billion euro; and (3) the programme's overall adjustment strategy, which was joining the euro (thus maintaining the exchange-rate peg) and adjusting through internal devaluation (Dahan 2012: 197). The lending facility was foreseen by the 143 Treaty, and was thus unproblematic to agree upon by the lending partners. Deciding upon the exact amount of money required and the adjustment strategy, was more difficult since it depended in part on the changing economic circumstances. Because of unforeseen changes in the economy – for example a much larger than anticipated contraction in GDP – the lenders were forced to reevaluate their readjustment formula. The problem was that the IMF and the EC had different perspectives on how to achieve this.

Debt restructuring was also a vital part of the plan from the EU (MoU 2009). It noted the importance of creating insolvency procedures and quick implementation of rehabilitation plans. In addition, the EU was firm in its conviction that maintaining the exchange rate peg was of principal importance in keeping a credible monetary policy. Furthermore, a solid backing of international reserves was advised to be continued and the strategy of adjusting the reserve

ratio based on inflationary forecasts and credit growth trends were supported by the EC.

When looking at the Latvian case, the speed of the country's recovery along with the efficiency of the implementation of its austerity measures and the success the country experienced in steering out of the financial crisis was quite astonishing. In reviewing the performance of the Latvian economy, the EC noted that in November 2011 it had the best economic performance in the EU with GDP growth, 5.7 percent in the last quarter of 2011 and 6.8 percent in the first quarter of 2012 (EC 2010). Along with impressive growth results, the budget deficit was also reduced from 8.2 percent of GDP in 2010 to 3.5 percent of GDP in 2011, just in line with the Treaty criteria.

Although the numbers were quite good, the EC was still concerned with increasing complacency among the Latvian authorities, which in turn will pose significant risks. This was especially taken in relation with the end of the surveillance under the BoP (EC 2010). The EC noted that the authorities still needed to prove their capacity to implement prudent policies and to resist pressures arising from the improved economic outlook after the end of the programme. The Latvian authorities had suggested tax cuts, which the EU was very opposed to, arguing that it would entail a worse fiscal policy framework and would endanger the convergence strategy of the 2012 programme, which would be considered in the context of the Maastricht Treaty. In addition, the Commission recommended that the Latvian government intensified the pace and ambition of its structural reforms.

4.6 The Role of The European Union in Cyprus

The EU provided the largest part of the financial assistance to Cyprus. In particular, the European Commission negotiated with Cypriot authorities on the terms and conditions of the programme, on behalf of the European Stability Mechanism, which is the emergency fund for euro-area countries. According to its own assessment, the EC claimed its aim was to restore financial market confidence, re-establishing sound macroeconomic balances and enabling the economy to return to sustainable growth (EC 2013).

Moreover, the programme from the EC rested on three pillars to achieve these goals. First, it had ambitious measures to address the deep banking crisis, with particular attention to capital and liquidity shortfalls. The EC noted the Cypriot authorities' efforts to handle the oversized banks in Cyprus, particularly in the two largest banks, without using taxpayers' money. Furthermore, attention was given to the restructuring process of these banks and the programme's goal was to return to free movement of transactions. Second, the EC builds its financial assistance programme on the assumption that fiscal consolidation is continuing on a determined track in Cyprus. This fiscal consolidation builds on the work already started in 2012, and aims to reduce current primary expenditure, enhancing the revenues of the country, improving the functioning of the public sector, and maintaining fiscal consolidation in the medium-term. The most important purpose of this programme from the EC was to reduce the general government deficit with efficiency and bringing public debt levels at a more sustainable level in the medium term. There is still a long way to go, however, with improving the functioning of the public sector. Reforming the tax system to optimize the collection of taxes, along with battling money laundering processes in the country, remains a priority the EC and IMF should focus more closely on. Third, the programme built on structural reforms to enhance competitiveness, along with sustainable growth. There was an explicit ambition from the European partners to overcome the macroeconomic imbalances that had been created before and after the crisis, and to bring forth the foundations for a sustainable growth path (EC 2013).

At the same time, the measures included in the programme had the important aim to mitigate adverse social effects of these austerity measures. Whether the structural conditions initiated by the European institutions and IMF correctly and adequately addressed the impacts these measures had on weak social groups, is a question that merits further research. It is apparent that when a country takes a heavy cure to restore its balance sheets, the weakest groups in society are hit first and strongest. It might be true that while the EC might have sectorial knowledge of European countries, and the IMF were sitting in the "driver's seat" when it came to crisis management, none of these institutions

really had competence and knowledge of the social impacts of the measures implemented. More coordination and knowledge transfer from other international organization should have been included in the programme to Cyprus.

The EC and ECB recognized the importance of ensuring the stability of the financial sector and improving its capacity to contribute to economic growth (EC 2013: 66). Because of the crisis in Greece, the financial sector in Cyprus suffered significant losses due to exposure to bonds and because of poor risk management and the overexpansion of credit. The proposed reform that the EC conducted covered three broad strategies. The first strategy aimed at improving regulation and supervision. Concrete steps in this direction included the improvement of bank liquidity, supervision of credit institutions, addressing private indebtedness and increased financial transparency.

The second strategy included measures to ensure the viability of the banks and sufficient capital buffers. The measures implemented to ensure this goal were the introduction of adequate capital buffers, the restructuring of the two principal banks in Cyprus, restructuring and recapitalization of the other commercial banks, and the restructuring and recapitalization of the cooperative credit institutions. Finally, the EC included efforts to limit the time that the measures to restrict capital would be upheld.

While the unhindered movement of capital is a long recognized principle of the EU, the EC is aware of the legal issues regarding capital restrictions in the eurozone and the illegality of this policy. In a report of the adjustment process in Cyprus it noted:

> While freedom of capital movement is the one of the key principles on which the Internal Market and the European Union are based according to article 63 of the Treaty, restrictions are possible in exceptional circumstances. They must be justified on the grounds of public order and security that could be threatened if uncertainty in the financial sector risked destabilising public life. A monitoring committee oversees that the measures taken are proportional to the problems to be tackled, cause the least damage to economic activity and looks for ways to end them as soon as possible (EC 2013: 75).

Hence, the EU treaties state that there are instances where restrictions of capital are justified, although there is no consensus whether the conditions in Cyprus fit the criteria stipulated in the treaties. The disastrous effects of a deposit rush on the Cypriot banks, had capital restrictions not been implemented, are well recognized. One can wonder, however, why capital controls were never considered a policy tool in the previous crises the eurozone has been experiencing. In all likelihood, more liquidity from the ESM or any other Fund would likely have produced a different outcome in Cyprus.

The fiscal consolidation measures that the EC proposed were significant, albeit small when compared with Latvia. First, it covered the compensation of public sector employees. Progressive scale of wage cuts in 2012 and streamlining of allowances in 2013 with a full year effect of 1.2 percent of GDP (European Commission 2013). In 2014, there will be a 3 percent horizontal wage decrease. Second, fiscal consolidation is expected to target social benefits and discretionary spending. The idea is that social benefits should be targeted more efficiently to those groups that have actual need for it, instead of going to the higher social strata. At the same time, the EC recognized the need to protect disadvantaged people by abolishing or streamlining certain schemes or tightening of means testing criteria. These reforms on social benefits are expected to save considerable funds and limit the fiscal deficit. Third, the fiscal consolidation process included important steps to reform the pension system. This is both for the public servants and for the pension system as a whole. With these measures, significant fiscal benefit is expected in the long run, according to evaluations by the EC. For the general pension system, the systemic changes including linking the statutory retirement age to life expectancy, the introduction of early retirement age penalty and the calculation of the pension benefit on a pro-rata basis taking into account life-term service. The EC expects that this reform will contribute to the fiscal consolidation with 0.5 percent of GDP in 2016. Fourth, on the revenue side, the Commission expected that several taxation increases would benefit the fiscal consolidation process in Cyprus. Increases in property taxation was assumes to yield 0.4 percent of GDP in 2013, and increases in duties on alcohol, tobacco and petrol were supposed to yield 0.7

percent of GDP in 2012-14. In addition, increases in the value added tax provided opportunities to increase revenues in Cyprus. Increases in government fees and corporate tax were also measures the EC recommended (EC 2013).

Fiscal-structural reform is another important stet the EC is taking to improve the sustainability of public finances in Cyprus. It seeks to provide the economy with the diversification it needs along with diminishing the country's special exposure to external shocks. In its own words, the fiscal-structural measures were designed to:

> (1) further reforms of the pension system to address the high projected increase in pension spending; (2) rapid implementation of measures to contain the growth of health expenditure; (3a) a comprehensive reform of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (3b) additional measures to strengthen the effectiveness of the revenue administration, with the particular aim of improving tax collection; (4) adoption of a Medium-Term Budgetary Framework; (5) targeted reform of the overall social benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (6) establishment of a legal framework for PPPs and initiation of a programme for improving the efficiency of state-owned and semi- public enterprises (EC 2013: 81).

The measures included also took into account the presence and exploitation of natural gas. It was advised that the revenues gathered from these resources be set into a fund and backed by solid rules. This is not unlike the case of Norway, in which the revenue from petroleum activities is set into a fund, and then used to finance the budget deficit through a strict rule of how much the government can spend each year. This alleviates the mixed blessings of natural resources, which often can amplify boom and bust cycles, encourage poor investment and lead to deteriorating fiscal policies. A resource fund creates incentives for transparency, accountability and effectiveness, and serves to mitigate the adverse effects of the "resource curse" – the phenomenon where higher levels of natural resources creates a boom that inflates the country and creates losses in competitiveness, which in the longer run can be detrimental for growth. Further exploitation of the natural resources would reduce dependency on imported oil, and thus

decrease the trade deficit. The Commission stated its desire for Cyprus to implement the Third Energy Package and notify the EC after successful implementation.

Structural reforms were also a crucial advice from the EC and ECB. As laid out in the Memorandum of Understanding, these consisted of measures to support a recovery of competitiveness and the return to a sustainable and balanced growth path (MoU 2012; EC 2013). These reforms are particularly targeted at high-value added sectors, such as tourism and financial services. There are also issues concerning the organization of the public sector, which among others include, (1) obstacles to staff mobility between departments (2) the large share of overtime and shift payments in the wage bill, which is indicative of suboptimal organization of the labor system (3) the large range of allowances and (4) the weak link between the staff appraisal system and wages and promotions.

These restrictions on capital were among others:

- **Cash**: Aimed to manage withdrawals of funds from banks and uncontrolled export of capital. Withdrawals of cash were limited to maximum 9 000 euro per person, and 2000 euro per person per journey when going abroad.
- **Checks, credit and debit cards**: Payment with checks was allowed inside Cyprus, but with certain limits. The usage of credit and debit cards was allowed for domestic purposes, and limited to 5000 euro abroad each month per accountholder.
- **Wire transfers**: Restrictions were put in place to prevent large outflows of capital that might destabilize the financial system or create imbalances in the liquidity of the banks. Payments over 300 000 euro domestic and 20 000 euro abroad were restricted and amounts larger were subjected to approval by a national committee.
- **Prohibition to open new accounts**: To reduce the risks of deposit migration, banks were not allowed to open new accounts for new customers.

- **Extension of term deposits**: To further stabilize banks' liquidity, maturing term deposits are extended for one month, except for an amount of 5 000 euro or 20 percent of the deposit.

The decision to restrict the movement of capital in Cyprus was decided on March 22 and endorsed by the ECB and the European institutions. It was decided that simple transfers of capital from Cyprus to any country in the eurozone would be prohibited, without an approval of the authorities, with the ECB playing a role in the approval. The most important characteristic of a monetary union is the ability to move capital unrestricted within the currency area (Wolf 2013). With this restriction, the ECB and EU have in reality made the Cypriot euro inferior to a euro elsewhere. By employing this measure, the EU has in effect introduced a new currency in Cyprus.

The Treaty on the Functioning of the European Union clearly prohibits the restriction of capital movement in the euro area, "Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited" (EU Treaty 2008). While the Treaties allow certain "measures which are justified on grounds of public policy or public security" (EU Treaty 2008), it is not altogether clear that the situation in Cyprus constituted an example of this incident. The right to restrict capital in the face of economic hardship can be maintained by a non-euro area country, and for a euro-area country in exceptional circumstances.

Once the closure of the Cypriot banks was lifted, it was clear that a significant portion of the depositors would want to take their money and ship it to another part of the eurozone, such as predicted by the policy trilemma. In such a situation, where the Cypriot banks would be in need of adequate liquidity, the EU has clearly defined rules and procedures. The Eurosystem can provide liquidity if the bank is judged solvent to the bank in case. One can argue that had the EU taken a more active role as the "lender of last resorts", a policy option of capital controls may not have been needed.

The capital controls Cyprus enforced during the financial crisis that started in 2012 and developed into systemic proportions in 2013, were indeed significant. It was the first time that a member of the euro area had imposed capital restrictions and critics alleged that once in place, such restrictions would be hard to lift again.

5. Alternative strategies

The aim of this section is to evaluate outcomes and alterative outcomes in Cyprus and Latvia. It explores whether the Cypriot authorities in fact managed to achieve autonomous monetary policy and what other options the authorities in Latvia had on the table. A central conclusion with respect to Cyprus is that although autonomy in monetary policy is a difficult concept to measure, and no doubt many will disagree regarding the operational measurements employed, I find that the measures taken in Cyprus created temporary stability which in large prevented a perilous bank run that would have had devastating consequences not only for the Cypriot economy, but also for the euro area in general. However, the steps taken to create monetary independence are of no use unless followed by comprehensive and long reaching reforms to mitigate the imbalances created previously in the Cypriot economy. On the other hand, I find that in Latvia it is not altogether clear whether alternative strategies would have created a better outcome. Devaluation of the currency could potentially have boosted competitiveness and corrected the current account deficit likely with less social costs than the strategy than austerity. However, because of the recessionary nature of the world economy, it is unclear whether it would have resulted in increased competitiveness. It is also a question to pose why the EU and IMF along with the Cypriot authorities never considered capital controls in Latvia.

5.1 Did Capital Controls Create Autonomous Monetary Policy in Cyprus?

Monetary policy is the ability to control the supply of money by increasing or decreasing it, which in turn affects the interest rate. Conventional theory expects that without exchange rate flexibility, there can be no independence of monetary

policy. With a fixed exchange rate regime such as in Cyprus, monetary outcomes will be determined by its exchange rate commitment. Accordingly, domestic interest rates will be similar to that country (or group of countries) that the currency has been pegged to. The fixed exchange rate regime implies that monetary policy has been imported from the country that it has pegged to (Hausman et. Al. 1999: 4). As the theory behind the policy trilemma (Mundell 1961) recognized, one negative consequence of this may be that the monetary policy of the given country may be wrong given the business cycle of that country. For example, the country one has pegged to may be going through a recession and wants to reduce the interest rate to stimulate aggregate demand, while the other country is going through a boom and wants to keep interest rates high to reduce aggregate demand. Thus, for countries with similar outlooks may have no problem with having the same kind of monetary policy, countries with different profiles may importing the wrong kind of monetary policies.

Concerning Cyprus and the other countries of the eurozone, these countries are 'importing' the monetary policies of Germany, which controls the money supply. When the financial crisis hit Cyprus in 2013 because of vulnerability to Greek debt after Greece defaulted on its debt in 2012, the absence of autonomous monetary policy meant that some form of strategy was needed. The strategy chosen was capital controls. The question to determine, however, is whether capital controls gave the Cypriot authorities monetary independence to handle the crisis that was unfolding?

Monetary policy can be a difficult concept to measure, especially when it comes to determining the degrees of autonomy. There are many variables to take into consideration: The exchange rate regime, liquidity in the system, access to capital, control of capital flights, short- and long-term interest rates, controls and regulations, bank oversight, financial openness, etc.

Euro area participation implies loss of monetary independence per se, since the control of the supply of money is conducted in Germany and interest rates are particularly sensitive to international interest rates in fixed exchange rate regimes. However, capital controls allowed the Cypriot authorities some

breathing space upon which far-reaching reforms could be undertaken. In one sense, this is a form of monetary autonomy. In all likelihood, the capital controls undertaken in Cyprus reduced the risks of a bank-run, which would likely have happened in the absence of such measures. Furthermore, a bank-run would have resulted in very negative consequences not only in Cyprus, but also for the eurozone in general. The collapse of a large bank in Cyprus would likely have entailed contagion to other members of the euro area, thus creating systemic risk and further contagion to other members of the euro area again, eventually having the potential to bring down the whole common currency area. In this way, the capital controls were successful in that they prevented a bank run. It is important to emphasize, however, that capital controls are no long-term solution for the economy in Cyprus. They can only give the government a temporary relief from acute financial trouble. The effectiveness and the level to one which can determine the degree of successfulness of the measures, relies upon whether the government has the ability to implement reforms to correct the fundamental imbalances that have occurred during a period of unsustainable public finances in the years prior to the crisis.

As with all policy instruments, there are costs and benefits. As mentioned, capital controls helped give the Cypriot authorities stability, even though this was temporary. The costs of this strategy are efficiency losses and reduced business confidence. It could entail a loss of investment in the years to come because of investors' perceived increase in risk for a second crisis. The table below shows data from the Central Bank of Cyprus. It depicts the activity of financial transactions in 2013. It clearly shows how the total amount of financial transactions have been reduced from March 2013, but gradually increasing again.

Financial transactions 2013 in Cyprus (€ millions)				
	Domestic residents	Other euro area residents	Residents of rest of the world	Total
Jan.	-533.1	-576.1	-627.7	-1,736.9
Feb.	-178.2	-862.8	88.2	-952.8
Mar.	-1,305.8	-496.3	-1,949.5	-3,751.6
Apr.	-1,672.5	-112.8	-1,770.2	-3,555.5
May	-794.0	237.3	-793.9	-1,350.6
June	-783.1	-95.6	-622.1	-1,500.8
July	-809.7	-85.0	-61.4	-956.2
Aug.	11.5	-89.6	-380.4	-458.6
Sep.	-308.9	-76.0	-539.2	-924.0
Oct.	-461.8	-107.8	406.6	-163.0
Nov.	373.9	-44.1	-468.4	-138.5

Source: Central Bank of Cyprus

5.2 How could Latvia have handled the crisis differently?

Although considered by many as one of the few examples of "successful" implementation of austerity measures, the effects of internal devaluation in Latvia were likely severe in terms of social consequences. As previously mentioned, unemployment reached massive levels in the country as a direct result of the measures, and wage cuts were significant in particular in the public sector.

The Latvian authorities considered using currency devaluation but never opted for this strategy likely because it would have entailed non-fulfillment of the convergence criteria, thus forsaking euro adaption. Commonly, the various benefits of currency devaluation can normally be ascribed to the following: Correction of the current account deficit, increased competitiveness in the export-led sector, reduction in the real debt value and less severity of implemented austerity measures.

Granted, reducing the current account deficit – which in Latvia was significant – can be achieved through internal devaluation, as was proven in Latvia. The process of reducing the deficit, however, is much more demanding and time-consuming than it is with currency devaluation. The effects are hard felt, especially for those who experience a wage decline. It reduces aggregate consumption in which a contraction of output is the most immediate consequence, a process that may take several years to overcome. One other consequence, which is severely felt, is the increased real value of debt resulting from a general deflation or decrease in inflation. This was particularly visible in Latvia where debt levels rose four times in the years of the crisis.

Capital controls could have been an option for the Latvian authorities, but were never employed. While the reasons for this may be many, one interpretation was that Latvia was concerned about the reputational costs of introducing capital controls. An open economy such as Latvia is dependent upon the goodwill of investors and capital restrictions would likely have created reduced investor confidence. It would also have set back the convergence criteria, thus increasing the time before euro adaption, which was always Latvia's preferred exit strategy.

The recovery from the crisis in Latvia depended in some part upon cooperation from international partners. These were among others the Swedish and Norwegians who owned much of the Latvian banking system. Instead of fleeing and leaving the banking system on its own, these partners were willing to inject liquidity in the fragile Latvian banking system thus helping to avoid the worst consequences of the crisis. In all likelihood, the support and help of international partners in Latvia helped mitigate the crisis.

Although internal devaluation had some success in terms of economic growth and correction of the current account balance, the existence of contextual factors may have influenced the outcome differently in Latvia than what would otherwise hold true for the same strategy in a different country. For instance, the Latvian people have a particular psychological mindset that gave the people resilience in the face of economic hardship (Dahan 2012). The country's experience with the post-Soviet crisis and the Siberian prison camps earlier

instilled upon the people a special ability to cope and tackle economic hardship. Thus, the financial crisis in 2008 was a continuation of a series of events that the Latvian people have had to handle.

Flexibility of the labor force was also a significant contextual factor, which may have helped Latvia's wage and employment process. In Latvia, unionization is very low and weak, private labor law governs public administration contracts, and the rules of dismissals in the labor market are favorable towards the employer (Kohl 2004; Eamets 2004). These particular contextual factors may have helped the government in its tough adjustment process, with a relatively low risk of riots from the workers. Moreover, favorable institutional conditions such as high caliber civil service staff, capable planning institutions and a centralized decision-making apparatus created credibility in the eyes of EU and the IMF.

6. Conclusion

The crisis that started in the United States with the collapse of Lehman Brothers had a profound and long lasting effect on the global economy. This crisis was, perhaps even more than the U.S., very evident in Europe where unemployment and low economic growth continue to plague the European countries. This thesis has compared how the crisis unfolded in the two countries Latvia and Cyprus. It has asked the question, which strategy is the best for handling crises in fixed exchange rate regimes?

The crisis that unfolded in Latvia and Cyprus shared many similar features of which the existence of a large banking sector, small and open economies, EU-membership, a strong relationship with the euro, credit led growth in a period before the crisis hit – were some of the most important. Although so similar in nature of the crisis, different strategies were employed to cope with the crisis. Latvia embarked on a tough path of internal devaluation while Cyprus – as the first time in the history of the eurozone – used capital controls.

The central argument of this paper has been that the process of internal devaluation – deflating the general level of prices of goods and wages – until the

imbalances in the real economy have been corrected, is possible in principle yet unlikely to be successful in reality. The success of Latvia's austerity, in the eyes of many, were more the result of contextual factors specific to Latvia, with questionable odds of being replicated elsewhere. On the other hand, while the legalities of the capital controls in Cyprus are contested, the measures allowed the Cypriot authorities to regain some autonomy with respect to its monetary policy and for the country to gain breathing-space in large to prevent a highly destabilising bank-run that would have had grave consequences for Cyprus and the eurozone as a whole. The measures to restrict capital movements, however, must be accompanied with far-reaching reforms to correct the fundamental macro economic imbalances in the Cypriot economy.

Section two described the policy trilemma, which has been a central theoretical framework which this paper has relied upon. This argument states that governments can chose two of three macro economic policy choices, each of which has various costs and benefits. Both Latvia and Cyprus are situated in the same place within the policy trilemma, with a fixed exchange rate, capital mobility and non-autonomy in monetary policy. Considerations on capital controls and internal devaluation have also been discussed. In general, capital mobility may provide efficiency gains in the normal transactions between economic agents, while it renders the system more fragile and prone to destabilising capital movements. This is particularly visible in countries that have fixed exchange rate regimes, in which capital movements potentially can deplete foreign reserves in a matter of days. Internal devaluation has also been considered in this thesis where a central conclusion is that although possible in principle, it is very hard to achieve in reality and the social costs are extensive. The legal framework and the configuration of the Troika has also been considered.

Section three dealt with the methodology of this study, in which strengths and weaknesses of the comparative method have been discussed, along with some elaboration of Mill's famous method of difference of which this paper most closely resembles. A justification for why the cases were chosen and how the

choice of these cases may help to control for some variables in order determine causality were also taken into consideration.

Section four dealt with some background to the crisis and described in some detail how fundamental macro economic imbalances have been developing in the years prior to the crisis, both in Latvia and Cyprus. The section further compared the crisis in these two countries and focused in on a key number of variables such as economic growth, unemployment, youth unemployment and the current account. The roles played by the IMF and the EU in Latvia and Cyprus were also taken into consideration. Central from the IMF and the EU with respect to Latvia was the implementation of the austerity measures and the discussion which surrounded the exchange rate peg, where the discussion ended with Latvia continuing the rigid peg and choosing not to devalue the currency. With respect to the IMF's and EU's role in Cyprus, these sections focused on the importance of economic reforms and restructuring of the largest bank in Cyprus, which faced a bank-run and had huge assets thus being very unstable. The introduction of capital controls, and the nature of these, was also elaborated on.

Section five dealt with alternative responses and how the outcomes in Latvia were likely more the result of contextual factors specific to Latvia, rather than proof of an efficient policy that may be used uncritically elsewhere. The use of a questionable instrument in Cyprus, capital controls, was also analysed. It was found that the measures introduced allowed the Cypriot authorities some form of autonomy in monetary policy in that a perilous bank run was prevented, but further reform is also needed.

The crisis that hit Latvia and Cyprus were both tough and involved significant financial assistance from international partners. The experience was also a novel one for the common currency area and the results are likely to be studied in the years to come. It is not altogether clear whether the national authorities or the international partners sufficiently took into account the social impact of the financial assistance programmes. In all likelihood, there is a further need to assess the impact of these financial assistance programmes on vulnerable groups, to ensure that cuts in social spending are not disproportionately affecting the poor and vulnerable. The conditionality of these programmes are

often very tough and it is my suspicion that oftentimes, they do not take fully into consideration the effect it has on the vulnerable groups in society.

Following Shambaugh's (2012), one option is for the eurogroup leaders to focus on different monetary policies to foster growth in the long run. Instead of – or in addition to - policies that address the structural conditions of each country and internal devaluation to correct balance of payment problems, the ECB could take a more active stance. Quantitative easing, which has been done by the Federal Reserves when the financial crisis hit the U.S., could stimulate the economy and increase the money supply. Also, less rigidity in inflation targeting by the ECB, in other words allowing for a higher inflation than the conventional 2 per cent, could help debt sustainability and increase overall GDP levels.

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