EuPI European Policies Initiative

Open Society Institute – Sofia

Country Report LATVIA

Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers' World

Jānis Bērziņš,
Institute of Economics
of the Latvian Academy of
Sciences and Riga Stradins University

Sofia, October 2009

The publication is a product of the Open Society Institute – Sofia within the European Policies Initiative (EuPI) and the project "Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers' World".

The publication comprised of nine Country Reports and a Summary Report is available on the website of the European Policies Initiative: www.eupi.eu

About EuPI

The European Policy Initiative (EuPI) aims at stimulating and assisting the New Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society level. As a new priority area of the European Policies and Civic Participation Program of Open Society Institute – Sofia, EuPI will contribute to improving the capacity of New Member States to effectively impact common European policies through quality research, policy recommendations, networking and advocacy.

Address:
Open Society Institute – Sofia
European Policies Initiative (EuPI)
56 Solunska Str.
Sofia 1000
Tel.: (+359 2) 930 66 19
Fax: (+359 2) 951 63 48
E-mail: eupi@osi.bg
Web EuPI: www.eupi.eu
Web OSI-Sofia: www.osi.bg

About the publication

The publication is a product of the Open Society Institute – Sofia within the European Policies Initiative (EuPI) and the project "Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers' World".

EuPI aims at stimulating and assisting new Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society levels (www.eupi.eu).

The project was implemented from September 2008 to September 2009. The main outcome of the project is a publication comprised of nine Country Reports and a Summary Report.

Following a uniform structure, and addressing a set of similar questions, the nine Country Reports (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovenia) present stylized facts about the patterns of real and nominal convergence with the euro area in nine new EU members, outline the setting and the implementation of the accession policies in those countries and emphasize the incidence of the current crisis on the strategy to adopt the common currency.

Comments are relevant to policy developments until 20 May, 2009 – the cut-off date for the submission of the last revised version of the Country Reports.

The Summary Report reviews the results of the Country Reports and systematizes some of the dominant trends they reveal. The Summary Report checks the countries' experience in dealing with the complicated concentric monetary structure inside the EU (euro area; ERM II; non ERM II countries) and pays particular attention to the evidence gathered about the political economy of the procedures in the different countries.

Each Country Report and the Summary Report include an Appendix, containing Tables that summarize significant data provided in accordance with a standardized set of indicators.

The results of the Project are correctly intelligible only if all its pieces (ToR, Summary Report, Country Reports, Appendix) are considered together.

Advisory Board
The project was able to benefit from the insights of a distinguished Advisory Board. As the Boards' mandate was limited to advice and comments on the methodology and the Summary report, responsibility for the findings and statements rests solely with the authors of the Country and the Summary reports.

Advisory Board Members:

Roumen Avramov, Program Director for Economic Research at the Centre for Liberal Strategies in Sofia

Marek Dąbrowski, Professor of Economics, President of the CASE – Center for Social and Economic Research in Warsaw and Chairman of the Supervisory Board of the CASE-Ukraine.

Luděk Niedermayer, Director at Deloitte Czech Repiublic, responsible for the area of financial institutions in Central Europe.

Karsten Staehr, Professor of economics at Tallinn University of Technology, Estonia, and a part-time research advisor at Eesti Pank, the Estonian Central Bank.

György Szapáry is a visiting professor at the Economic Faculty of the Central European University in Budapest and member of the Board of Directors of the OTP Bank

Authors of the Reports

Summary Report:	Roumen Avramov, Program Director, Center for Liberal Strategies Sofia
Bulgaria:	George Angelov, Senior Economist, Open Society Institute-Sofia
Czech Republic:	Ondrej Schneider, Associate Professor, Institute of Economic Studies, Charles University, Prague, Czech Republic
Estonia:	Hardo Pajula, OÜ Monadero
Latvia:	Jānis Bērziņš, Institute of Economics of the Latvian Academy of Sciences and Riga Stradins University
Lithuania:	Ramunas Vilpisauskas, Associate Professor at the Institute of International Relations and Political Science, Vilnius University.
Hungary:	Gabor Bekes, Research Fellow at the Institute of Economics of the Hungarian Academy of Sciences
Poland:	Dr. Przemyslaw Wozniak, Research Economist and Member of the Council, CASE - Center for Social and Economic Research, Warsaw, Poland
Romania:	Liviu Voinea, Associate Professor National School for Political and Administrative Studies, Executive Director Group of Applied Economics
Slovenia:	Vladimir Lavrac, Senior Research Fellow, Institute for Economic Research

Project Team
Assya Kavrakova, EuPI, Open Society Institute – Sofia
Georgi Stoytchev, Executive director, Open Society Institute – Sofia
Boryana Klimentova, EuPI, Open Society Institute – Sofia

Copy Editor
Courtney Lobel

CONTENTS

EXECUTIVE SUMMARY

Latvia's authorities have always assumed that the adoption of the euro was the main goal to be achieved after joining the European Union (EU). Until 2007, Latvia was fulfilling all the Maastricht criteria except for inflation. Although facing a process of unsustainable development that could be characterised as underdevelopment, if the Latvian authorities had taken measures to slow the inflationary process of the last years, most probably Latvia's currency would now be the euro. After joining the EU, Latvia faced a restructurisation of its economy, due to changes of strategies of the actors of the financial sector, mainly Scandinavian banks. This fact, in conjunction with the low level of indebtedness of the private economic agents, forced Latvia to start to finance its economic growth with external savings. The lack of appropriated regulation by the Financial and Capital Market Commission, in conjunction with an imprudent tax policy imposed by the Ministry of Finance and the timid regulation of the monetary base by the Bank of Latvia, resulted in the development of a speculative bubble in real estate assets and an increase of the consumption of durable goods. As Latvia is a small country, the result was the restructurisation of the economy in such a way that nearly 60% of GDP became dependent on these sectors, together with financial intermediation and transports, four non-sustainable sectors in the medium and long term.

The result of the economic policies of the last years shows that they weren't effective and well-directed enough to ensure sustainable integration into the European Monetary Union (EMU). This may be explained by the lack of competence among politicians and the authorities to deal with macroeconomic issues, which is explained by the lack of pragmatism and the lack of knowledge of economics as discipline. Considering that the process of economic decision became subordinated to the rules of the request for standby arrangements determined by the International Monetary Fund (IMF), the European Commission (EC) and the European Central Bank (ECB), the policies leading to the fulfilment of the Maastricht criteria are determined independently of the internal political process. Albeit the politicians tried to not take into full consideration some points, the pressures of the external agents are guaranteeing their fulfilment.

It's clear that the best for Latvia would be an early adoption of the euro, with a depreciation of about 15 to 20%. As this idea lacks political support from the EU, the best solution for Latvia, in realistic terms, would be widening the bands between the ERM II limits of ± 15%. This would boost the competitiveness of the industrial and service sectors, helping the economy to recover and develop following the crisis. However, to avoid a general default, this must be done in collaboration with the banking sector. There are two ways to achieve this: to extend the terms of the loans or to establish a special exchange rate to convert euro into Latvian lat. Naturally, losses are implied in this scheme in the short run. It's the only way to guarantee sustainable development in the short term, assuring that the losses may be recovered in the medium run.

Naturally, the EC and the ECB could relax the requirements for Latvia to adopt the euro. In the case of such a small country, even if Latvia doesn't fulfil any of the Maastricht criteria, the impact of inflation or any other disequilibrium in Latvia to the EMU is completely irrelevant. At the same time, the benefits to the country are enormous. That's why, if the euro was seen as a strictly economic matter until now, it turned to be a matter of diplomacy and politics. The individual discussion about the possibility of each individual country to adopt the euro resonates in Latvia's political environment right now, and it's to be expected that the Latvia's delegation in Brussels are going to work in this sense.

I. Latvia's Economic Convergence

The adoption of the euro was a goal of the Latvian authorities, even before the joining the EU. When Latvia became a member of the EU, it automatically committed to implement the euro as its national currency. However, only on 2 May of 2005 were Latvian lats was included in the ERM II. This is explained by the fact that the decision for Latvia to join the EU was made after the referendum of 20 September 2003, making January 2005 the earliest possible date for joining the ERM II. The rhetoric of the authorities was that the best chance for the country would be to adopt the euro as soon as possible, thus the criteria of the Maastricht Treaty shaped the economic policy of the last years in order to reach economic convergence.[1] The process of catching-up to the living standards of the old members of a monetary union is fundamental to determine if a country may be a member of a monetary union or not, because catching-up in income levels is usually followed by a rise in prices.[2] In addition, there is a process of general economic convergence, usually resulting from the Balassa-Samuelson effect.[3] In other words, the process of real convergence may result in inflation. This increases the spread in relation to the inflation of the euro area, what complicates the process of monetary policy making. Real convergence in Latvia has been increasing, as reflected by the growth of the GDP per capita in relation to the EU. Between 2004 and 2008 the GDP per capita in relation to the EU increased from 45,7% to 57,9% in 2007, although decreasing to 55,3% in 2008 because of the economic contraction that began during the summer of 2008.

Price stability

The difference between Latvia's 12-month average inflation and the reference value to the ERM II has been increasing since Latvia's accession to the EU in May 2004, from 2,94% in 2003 to 15,25% in 2008.[4] Although it decreased in 2006, from the spring of 2007 onwards it has accelerated, resulting in the resumption of a wider gap between both indicators. As the reference value was 3,2%, as in March 2008, currently there is a difference of 12,05 percentage points between both indicators. Although in the period between 1999 and 2003 inflation remained within a 2-3% range, since 2004 it increased significantly as consequence of several factors, and headline core HICP inflation increased sharply to 10,08% on average in 2007 to a peak of 17,50% in June 2008.

The mainstream vision is that inflation in Latvia is the result of increasing wage costs and profits margins, fuel, food, indirect taxes and administered prices, higher energy prices, the lagged effective depreciation of the lat, and buoyant domestic demand associated with rapid credit growth. Accordingly to the Convergence Report issued by the ECB, the very rapid growth of Latvia's GDP in recent years resulted in increased capacity constraints and strong demand pressures feeding into inflation. However, if the inflation of the period 2004-2006 may be explained by external factors and that the inflation of the subsequent period became more entrenched amidst signs of a wage-price spiral and upward adjustments in inflation expectations, inflation after 2007 has been determined by domestic sources and by the huge increase in prices for imported commodities. On the side of non-energy industrial goods, the impact came from the segments of

1 Although the countries currently using the euro as national currency don't fully meet all conditions and terms in monetary integration theory, as there are still deep differences in their economic structure, real economic convergence is a central presupposition to monetary unions. See Bayoumi, T. & Eichengreen, B. (1997)."Ever closer to heaven? An optimum-currency-area index for European countries." *European Economic Review*, vol. 41, no. 3-5, pp. 761-77; Ghosh, A. R. & Wolf, H. C. (1994)."How many monies? A genetic approach to finding optimum currency areas." *NBER Working paper*, no. 4805.

2 Rogoff, K. (1996)."The purchasing power parity puzzle." *Journal of Economic Literature*, vol. 34, no. 2, pp. 647-66.

3 Accordingly to the Balassa-Samuelson effect, a catching up economy with high rates of productivity growth is expected to experience more rapid convergence of productivity levels in the tradable goods sector than in non-tradable goods sector. As higher productivity in the trade goods pushes up wages in this sector, under the presupposition of perfect labour mobility across sectors, wages rise in all sectors.

4 The reference value to the period never surpassed the barrier of 3,2%.

communications and electrical household appliances, while from the autumn of 2007, food and energy prices in combination with domestic factors resulted in higher prices for motor fuels, gas and heating, and electricity. However, the upwardly trending price increases in the services sector were the major driver of increasing core inflation, as a consequence of buoyant demand conditions and wage growth. In 2008, until the mid-summer, inflation was still growing, reaching a peak of 17,50% in June. However, since September there has been a process of deflation as a result of the economic contraction.

Although this analysis issues all the factors contributing to the increase of inflation in Latvia in recent years, it is limited due to its singular focus on the appearance of the problem and not on its essence. Inflation associated with accession-related price increases has been occurring and Latvia's prices were still 65% of the EU average in 2007, showing that still there is room for increases in the prices of some goods and services. At the same time, although the influence of the increase of the prices of energy and commodities is undeniable, the main factor explaining both the high level of economic growth and inflation in recent years is the economic structure and lack of effective regulation of the financial sector. It's a direct consequence of the economic model adopted since independence and strengthened by joining the EU, which resulted in the consequent process of de-industrialisation and speculation.

Joining the EU and the ERM II resulted in almost the complete loss of regulatory power for the Bank of Latvia, as the combination of a completely open financial and capital account with fixed exchange rate results in the impossibility to implement monetary policy. The adoption of this model was based, mainly, in the presupposition that a monetary policy wasn't necessary, because the deficits of the budget of the government were acceptable; together with the fact the Bank of Latvia is independent. In both cases, this would mean that an increase of the monetary base would not be possible, resulting in low inflationary levels. Although theoretically correct, in practice this is the main cause not only of the inflationary process of the last years, but of the economic crisis as discussed in section 2.

Government Budgetary Position

The general government budgetary position has increased from a deficit of 3,9% of GDP in 1999 to a small surplus of 0,1% in 2007. This is the result of expenditure policy, which has aimed at moderating the domestic boom of the last years. From the year 2000 until the 2007, the deficit-to-GDP ratio was consistently below the 3% reference. Although in the first three quarters of 2008 the deficit of the budget was less than -1,3%, still comfortably below the reference, the 2009's budget was already being calculated with a deficit of around -7% of the GDP, as there was already a perception that the crisis would reduce the amount of collected taxes.

In the beginning of September of 2008, ministries and other central government budget authorities were instructed to reduce their planned central government funding to 2009, taking into consideration a contraction of the economic activity resulting in a GDP growth between 1-5% in 2009. The objective was to guarantee a deficit of about -1,25% of GDP. The exceptions were the following areas: implementation of the EU structural funds and other policy instrument projects, contribution to the EU budget, central government debt management and interest payments, social benefits, expenditure financed from service charge incomes and their balances, state pension budget, special employment budget, special employment accident budget, special disability, and maternity and sickness budget. This resulted in the first version of the 2009 budget to have a deficit of more than 10% of GDP.

At the end of October, the prognosis turned to a deficit of -1,85% of GDP, as the statistic data of the level of economic activity divulged in the beginning of October has shown a reduction of more than 10% in consumption in the month of September.[5] The EC had divulged that the Latvian GDP was expected to decrease -2,7%, while the Chamber of Commerce and Industry of Latvia had predicted a decrease of -4 - -5% one week before. If until this point the Latvian government was still waiting for the economy to grow, the prognosis for 2009's GDP changed from growth to a contraction of -1%. In the country's plan for economic stabilisation, the Finance Ministry declared that the expected result of the economic recession would be the decrease of inflation and the increase of household confidence in the economy in the first semester of 2009. Economic recovery was expected for the second semester of 2009, in addition to a strong reduction of the deficit of the current account, as the labour market to experience changes in the competitiveness level as well. In the medium term, a growth of 4-6% was expected.[6]

Although these were optimistic predictions, four points were already visible in the middle of October 2008. First, according to the National Treasury, tax collection was already much less than the reference used to calculate the budget; secondly, that the level of 1,85% was considered an ideal and that the real deficit was expected to be -3%;[7] third, that the so-called reduction of salaries at the state level was in reality only to not increase wages in 2009; and fourth, that although there was the intention to restructure the distribution of the European Structural Funds and to reduce taxes related to profit reinvestment, there wasn't a clear strategy to stabilise the economy.

When adjusting the draft for the second reading at the Saeima (Latvian Parliament) in November,[8] it was already clear that the calculations were too optimistic and that additional spending cuts were necessary. A decision was made to reduce the spending in wages by 5% and in goods and services by 3%. In addition, the budget of some special programmes of the Ministry of Transport and the Ministry of Defence were reduced. To reduce the wage fund, the ministries and their dependent institutions would have to carry out redundancy measures by at least 5% by 31 December 2008 and by at least 10% by 30 June 2009. In 14 November 2008, the Saeima approved the 2009 budget.

With the deterioration of the economic situation, in the beginning of December the government concluded that urgent amendments were needed, implicating an additional expenditure decrease. These amendments were approved by the Saeima on 12 December 2008; the main points were the reduction of 15% of the previously planned expenses on wages, and of 25% of the expenses on goods, services and subsidies and endowments as compared to the previously adopted 2009 budget. There weren't expense cuts for finances destined to help facilitate the absorption of EU funds. To ensure the decrease of the expenses with salaries, a Law on Remuneration of governmental and local government institutions' was also approved. It defined that in 2009 premium wages and bonuses, as vacation pay as well, won't be paid, and that new managerial agreements won't be signed, although the already valid managerial agreements are considered closed. In the same way, any constraint on additional benefits defined by law is forbidden.

After the agreement was forged with the IMF, some modifications were made to the budget as, according to the 'Request for standby arrangement', the GDP contraction projection for 2009 would be -5%. As indirect tax revenues and corporate income tax revenues are expected to collapse as profits fall, the budget approved in November would include a 12% of GDP fiscal deficit. With the substantial contingent fiscal liabilities from the financial sector, this deficit would have been extremely difficult to finance. As the IMF imposed a deficit of 4,9% of GDP as target for 2009, the authorities were still

5 In relation to September 2007.

6 Accordingly to Latvia's Finance Ministry "Vidēja termiņa makroekonomiskās attīstības un fiskālās politikas ietvars 2009. - 2011. gadam" (Macroeconomic development and fiscal policies principles in the medium term, 2009-2011).

7 Interview of the author with a high level actor from the Finance Ministry, who wants to not be identified.

8 Saeima is the Latvia's Parliament.

trying to find a way through amendments in the budget, while avoiding the necessary structural reforms.

Exchange rate

The Bank of Latvia set the exchange rate of the lat against the euro at 1 EUR = 0.702804 LVL in 30 December 2004. The relation was calculated according to the market exchange rates that were fixed by the ECB on 30 December 2004 using the Special Drawing Rights (SDR) valuation formula – as it had been daily practice since the beginning of 1994 when the lat was pegged to the SDR of the IMF at 1 XDR = 0.7997 LVL. Since 1 January 2005, the Bank of Latvia has been unilaterally maintaining the fluctuation band of the lat against the euro of ±1% around the central rate, meaning that in reality the lat is practically fixed to the euro.[9] The Latvian lat entered the ERM II on 2 May 2005 and until mid-February 2007 fluctuations against the central band of 1% remained limited.[10] The agreement on participation in ERM II was based on a number of policy compromises, relating to pursuing sound fiscal policies, promoting wage moderating, reducing inflation, containing credit growth, reducing current account deficit and implementing structural reforms. Under ERM II, the Bank of Latvia hasn't devaluated the lat against the euro on its own initiative.[11] However, within the unilateral fluctuation band, some changes have occurred.

After remaining near to the upper limit of the 1% fluctuation band for most of 2005 and 2006, the lat moved to its weaker side in mid-February and September 2007. The first episode was due to a rumour about the imminent devaluation of the lat, spread through SMS by an unidentified person. On 19 February, rumours about the weakness of the Latvian economy and inevitable crisis resulted in a sudden increase of the demand for foreign currencies, triggering a sharp downturn in the value of the lat in relation to the euro. To compensate the weakness of the lat, the Bank of Latvia intervened in mid-March 2007 in the foreign exchange market to increase the refinancing rate. By end-March 2007, the lat was near the lower end of the fluctuation band, having weakened around 1,8 percentage point in comparison to mid-February. In April 2007, tensions on the foreign exchange market gradually subsided following the government's decision to implement an economic plan to deal with inflation. With the lat reaching the stronger side of the fluctuation band in May 2007, the Bank of Latvia had to intervene to avoid further appreciation. In the beginning of the global crisis and the consequent concern of investors about the sustainability of the Latvian Economy, the lat weakened during the summer and moved to the lower side of the band again. This was also a consequence of the renewed concerns about the macro imbalances of the Latvian economy.

The second one is connected to the downgrade of Latvia's future outlook by a grading agency from stable to negative in September 2007, as consequence of the concerns over further increases of the current account deficit and inflation. Besides other external developments, Latvia has been experiencing widening deficits in its Balance of Payment's current account. Since 2001 the deficit in relation to the GDP has been growing, reaching a peak in 2006 when it totalled 27,62%, while -26,8 in 2007 and -19,5% in 2008. The last indicator reflects the reduction of the consumption of durable goods by households, as this sector was already losing its dynamics since mid-2007. The deficit is also a result of a process of de-industrialisation and restructurisation of the economy to sectors related to consumption - mainly durable goods - as result of the credit boom of the last years, and is expected to soften as a result of the economic crisis. From late-September 2007 onwards, the lat gradually recovered, becoming relatively stable. In May 2008, it reached a peak of 0,6967, turning back to around 0,7056 in February 2009.

9 There was no imposition by the ECB to Latvia adopt the 1% band. It was a free choice of the Latvian authorities. Since joining the ERM 2, the lats never has deviated from the 1% band.

10 As explained before, the earliest possibility to Latvia to join the ERM II was january 2005. The fact it's happened only in may was result of the bureaucracy of the process.

11 ECB Convergence Report, May 2008.

Long-term interest rates

Since 2001, the long-term interest rates of Latvia have been behaving erratically, reaching its lowest point in the period 2001-2009 in 2005 (3,88%). In 2006, the spread in relation to the long-term interest rate of the euro area reached its minimum (2,49%). However, from June 2006 onwards, the long-term interest rate trended upwards, while the spread to the euro area has increased considerably. Long-term interest differentials peaked in May 2007 because of the already cited downgrade of the Latvian economy by a rating agency. As market conditions eased onward, the differentials have experienced a reduction, although remaining positive in relation to the benchmark of the euro area until mid-2008 as result of the illiquidity of the market for Latvian government bonds. From this period, the long term interest rate has been increasing, reflecting the interaction of two factors: by the internal side, the worsening of the macroeconomic conditions and the consequent increase of the risk of lending, which was expressed in higher interest rates; on the external side, the change in strategy of foreign banks operating in Latvia as result of the global crisis.
The capital market in Latvia is smaller and less developed than other euro area countries, and corporate sector market-based indebtedness is lower than other countries that are at a similar stage of economic development. The value of outstanding fixed-income securities issued by corporations was equal to 2,5% of the GDP in 2007.[12] At the same time, the capitalisation of the stock market, which reached a peak in 2005 of 7,47% of GDP, had experienced a reduction to 3,11% of GDP by mid-2008.[13] This level is very low compared with the euro area and other EU members from Central and Eastern Europe. This is a consequence of the policies of both local and foreign banks operating in Latvia, which issued banking credit that was easy to obtain and cheap to pay. On the other side, it also reflects the structure of the Latvian economy, which suffers a lack of real and sustainable development. The number of firms with the scale to necessary to leverage the operations of the capital market isn't sufficient. At the same time, the biggest Latvian companies are already participating and operating in the Rīgas Fondu Biržа.[14]

Since December 2008, Latvia doesn't fulfil this criteria as in January the long term interest rate has reached 10,64%, resulting in a spread of 6,21 percentage points in relation to the euro area. However, as 85% of the credit lent in Latvia is in euro, the most important long-term interest rate is the one determined by the ECB. In this sense, although the Bank of Latvia is able to determine the long-term interest rate of the lat, its effect as instrument to deal with inflationary questions is practically irrelevant. Therefore, this indicator isn't important to determine if Latvia is ready to adopt the euro or not.

Additional factors

Real convergence implies the reduction of the differences between the levels of price and productivity between catching-up countries and those already in a monetary union. The idea is to avoid the transmission of inflationary effects from one country to the union, what would make the monetary policy difficult to perform. The indicators chosen by the ERM II to define if a country is ready or not to join the EMU, although based in the most advanced monetary theory, aren't adequate to deal with the Baltic Countries, especially with Latvia. As these indicators' base are econometrics models explaining the reality of relatively big and well developed economies, their dynamic doesn't reflect the impact of the economic reality of such small and underdeveloped countries to a monetary union of the significance of the EMU.

Besides, these models presuppose that the economic conditions they are trying to reflect have some level of 'normality'. In other words, that the economy in question presents at

12 ECB Convergence Report, May 2008.

13 Author's estimations.

14 The Riga's stock market.

least an economic structure compatible with an ongoing process of sustainable socioeconomic development. These standards, which should be viewed as guidelines and not as dogmas, may not apply to some countries due to their specific economic idiosyncrasies. At the same time, they may fool a careless observer, as they concentrate on the external aspects of the phenomena, avoiding a deeper analysis that could show a counter-tendency. In the case of the ERM II, this results in a narrow understanding of the economic environment of the Baltic countries, especially of Latvia. That's why, besides the consideration of these main indicators, a deeper analysis is necessary to determine if the Latvian economy is really developing in a sustainable way, avoiding future inflationary shocks to the EMU. If some normality in economic structural conditions is necessary to the Maastricht criteria to reflect the economic conditions of a particular country, Latvia isn't the case. The Latvian economic performance lasting recent years is characterised by an abnormal lack of sustainability resulting from the process of economic involution of the last years.

In Latvia's case, the most significant issue after joining the EU was the complete openness of the financial and capital accounts, together with the increase of the positive sentiment of investors about the future of the economy. This changed the strategy of the banks operating in the country, which were directed to expand the credit market. All schools of economic thought, even Marxism, agree that credit is fundamental to determine both the level of economic activity and the structure of the economy. In this way, as a consequence of the strategy of the banks operating in Latvia, the structure of credit market has been altered; changing the way the country (under)develops. Besides a process of deterioration of the national accounts, what the Latvian economy has been facing since joining the EU is a process of economic restructurisation, resulting in the establishment of an economy based on non-dynamic sectors and speculation, what's been reflected in the deterioration of the basic indicators to access the euro.

This is the result of the lack of effective conduction of macroeconomic policies by the Latvian authorities, which exhausted a non-sustainable model of economic growth. Although also determined by the actions of foreign actors, the lack of congruent internal policies that, at a minimum, guarantee economic growth will translate into development is the main determinant. The actions of foreign actors weren't determined by the international financial system, but by the regional strategies of expansion and market conquer. In this sense, the crisis isn't directly related to the global financial crisis of the post-Leman Brothers world, although it's prejudicing the performance of the few exporting companies. As economic sustainable development is the key issue to a successful monetary integration, in Latvia's case it's necessary to go beyond these indicators, as national economic bankruptcy followed by deep recession may result in indicators compatible with monetary integration. Integration in this stage may be problematic, as all the indicators may deteriorate with the beginning of a new cycle of economic expansion.

II. National Goals and strategies for Euro adoption

The main strategy to guarantee the process of convergence has been mainly the administrative determination of the long-term interest and exchange rates, and budget planning aimed at avoiding huge deficits. Inflation, which isn't determined administratively, had been the main impediment to the adoption of the euro prior to the crisis. As it's the only indicator free to show the real conditions of the economy, to understand the inflationary process in Latvia is fundamental to determining the country's real prospects for adopting the euro in the next years. It is the expression of the process of economic restructurisation Latvia has been passing through, showing how the policies chosen by the government don't reflect the adoption of the euro as a concrete and real objective.

The inflationary process is directly connected to the expansion of the credit market in recent years. In the last quarter of 2008, the loans issued to residents amounted Ls 14.737,4 million, or 90,1% of the GDP. In comparison with the end of 2003, there is a significant change in the structure of the loans issued, because of the strategy of the banking sector and the demand of the public. While in 2003 the most privileged sectors were individual services (23,11%), wholesale (16,09%) financial intermediation (12,5%) and manufacture (11,73%), in the end of 2008 the situation had changed drastically. Since 2004, the banks started to lend relatively cheap money to finance operations in the real estate sector and consumption of durable goods. Besides, because of the process of increasing financial needs, the availability of credit for financial intermediation also rose. In this way, the money lent to non-banks in the recent years was mainly directed to finance operations with real estate actives (56%), consumption (10%) and financial intermediation (7%), while all other sectors experienced a relative reduction.

As result of the availability of credit, the Latvian economy was growing strongly, resulting in inflationary pressures. However, it was occurring in an unsustainable way. As a deeper analysis of the GDP shows, its structure is based on sectors whose dynamism is not sustainable. In 1995, the most dynamic sectors the Latvian economy were manufacturing (17,69%), transportation (12,59%), operations with real estate actives (8,94%) and wholesale (8,93%). However, in the first quarter of 2008, the most dynamic sectors of the economy were commerce (22,8%), mainly of durable goods, real estate (16,8%), transports (13,5%) and financial intermediation, totalling 58,1% if the GDP. At the same time, manufacturing (11,8%), construction (6,5%) and agriculture (2,4%) accounted to 20,70% of the GDP. This performance of the real sector would be acceptable, if the service sector had a strong dynamic and a solid capacity to export, which is not the case.

This process of restructurisation is the main determinant of current economic crises. First, because the demand for durable goods has a natural limit. Due to the past huge repressed demand for these goods because people wanted to get rid of the old soviet stuff, with the sudden availability of credit the consumption of durable goods experienced a boom. However, when this demand is fulfilled, the sectors associated with it tend to experience a strong reduction in their level of economic activity. Second, as economic history shows, artificially inflated prices of real estate always go down - in other words, bubbles always deflate. Third, and most relevant, people's capacity to borrow is directly related to the amount of disposable money they have to pay back the credit.

Also, the transportation and storage sector depends of the production of goods, which by its time is dependent on their demand. With a crisis, both on the internal external sides, this sector tends to suffer a reduction in its performance. As Latvia's manufacturing sector has been shrinking, besides the inevitable decrease in the commerce of durable goods, the transportation and storage sector has also been experiencing a slow down. In this way, nearly 60% of the Latvian GDP has remained in an unsustainable basis, showing that a crisis would occur with or without the current financial crisis. If the GDP was growing fast, in reality the structure of the Latvian economy was debasing and becoming increasingly dependent on four sectors that, by their own idiosyncrasy, weren't sufficiently dynamic to push the economy in the medium and long terms. In other words, the failure of the internal model was a natural consequence of its own structure.

Even with the signs indicating that this process was unsustainable, as the structure of the loans appeared to be very sound – mainly mortgage loans and commercial pawn, in the beginning of 2008 the banks were still considered secure enough to continue lending.[15] Also, there was a strong component of moral hazard. Accordingly to Sommers, 2008, when the question of why they were knowingly inflating the real estate market with credit was posed to the head of the real estate division of one of the top three banks in Latvia, he remarked that "(...) *it is unsustainable, but everyone's annual bonus depends on making more money. We know it will crash, but we are all making to much money now to stop it*".[16] Although appetite for risk by large foreign banks was particularly strong given the modest exposure of their portfolios to the Latvian market and the very high returns on equity invested there, international experience shows that perceptions of loan quality are notoriously procylical-positive during economic upswings, but deteriorate rapidly when conditions turn less favourable.

The consequences at the end of the speculative cycle in the real estate market in Latvia were two-fold. Concerning the banks, (a) the soundness of the loan portfolio experimented in a reduction of its quality, in other words, the material guarantee of the issued loans was considerably less than the amount they stood to receive, implicating in losses and (b) the assets of the banks suffered a reduction that may affect the profitability of banks. As foreign-owned institutions dominate most of the banking system in Latvia, this result in the exporting of losses to the mothers, what is already suggested by the IMF in the last "Request for standby arrangement". On the part of the general population, the main problem has been the psychological impact affecting consumption and thus credit and the general level of savings. As buying a real estate property is seen as an investment and a method of saving money, a decrease in the price of property makes people feel as if they've lost part of their savings. This negatively affects their level of confidence in the national economy, causing consumption levels to fall in addition to the future expectations of the economic agents. This translated into a lower level of economic activity and employment. This effect has been magnified in Latvia.

Latvia must be considered a sub-developed country integrating into the EU while in a subordinate position. This means that Latvia's insertion into the international economic system has such a structural dynamic that the paths of dependence are strengthened instead of eased. The structure of foreign trade indicates that Latvia exports mainly primary products or products of the paradigm of the Second Industrial Revolution, while imports are comprised of machinery and equipment for the fragile real sector of the economy, together with imports of high technology goods, durable goods, combustible minerals and their derivates. Besides, Latvia also imports a considerable share of prepared foodstuff, showing that the agricultural sector is not capable of satisfying internal demand and that agribusiness in the country is not quite developed. The conclusion to be drawn is that the Latvian economy is poorly developed and dependent on both technology and material products, which relegated the country to assuming an underdeveloped and subordinated position inside the EU and the world.

In the specific case of Latvia and the EU, although there was a huge opportunity for promoting economic growth and development through European structural funds, Latvia until now has been unable to achieve it. As Latvia is a liberal economy, adopting the regulations of the EU, the way the country develops should be the result of the interaction of the economic forces of the market. However, business can only flourish if there are propitious conditions. The state's fundamental role is regulating the economy, assuring an environment conducive to sustainable economic development. Besides, although the state should not intervene directly in the economy, it may define which sectors are strategic to the overall goal of promoting development.

---

15 Although not as profitable of other services, mortgage guarantee that the client will stay with the bank for a long period and that he/she will buy other products as, for example, insurance.

16 Sommers, J. (2008)."Latvia living at the extremes: seeking equilibrium between central planning and financialization." *Humanities and Social Sciences Latvia*, vol. 3, no. 56, p. 48.

In recent years, these sectors are those related to high technology and to those where there is a high level of aggregated-value. At the same time, the social structure of the country must be taken into consideration and the state must work to avoid deepening the social gap and thus achieve development in sustainable terms. In this way, as banks will direct credit to the most profitable sectors – maybe not the most worth to development, only the state may help to develop the sectors of the economy that can led Latvia to develop. In other words, it's a political decision. The European Structural Funds were a key agent for it, however they have not been used with this objective in mind.

Besides the question of credit, one significant problem facing the Latvian economy is not only the way the country is growing but not developing, but also other macroeconomic aspects such as the persistent deficits of the Balance of Payments, the External Debt and the way these deficits have been financed. The first thing to be considered is the chronic deficit of the Current Account. This occurs due the very profound disequilibrium of the Current Account, consequence of the negative results of the Commercial Balance. The results of both Current Account and Commercial Balance are presenting deepening deficits in the last years, resulting from the process of deindustrialisation. As this process has been ongoing since the beginning of the 1990s, most of the non-durable goods consumed internally are imported. In this way, as the economy was growing fast but developing slow, what could be seen in the results of the components of the Payment Balance - first, the increasing deficit of the commercial account shows that although the exports are growing, the imports also and more intensively, second, the Service Account is stagnated since 2001, showing this sector could develop faster and, third, the growing deficits of the Income Account, and forth the Current Transfer Account's erratic behaviour – there was a tendency of the deficits of the Current Account to go deeper and deeper, until the limit of the capacity of the economic agents to borrow and the burst of the bubble of the real estate sector.

The way the deficit of the Payment Balance has been financed is a special matter per se. In 2007, the sum of the positive results of the Balance of Payments was only nearly 18,4% of the negative results, meaning that the deficit has been financed by the influx of external capital. If this external capital influx was mainly foreign direct investment (FDI) directed to competitive sectors, it would help to promote economic development. Instead of that, the influx of FDI, which could be financing the deficit of the Balance of Payments, is nearly at the same level today as it was in 2000 in absolute terms and, in relation to both the GDP and the deficits of the Payment Balance, is exhibiting completely erratic behaviour with negative tendencies. If Latvia was not financing its external deficit with FDI, it has been doing it in another way. The answer to this question may be found in the passive of the Financial Account, precisely in the loans of banks item. Due to the lack of internal savings in Latvia and the high spread level, the development of the credit market resulted in a growing influx of foreign capital to be offered as credit to the public.

The result is the well-known inflationary process, resulting from the increasing of the monetary base. When Keynes debated inflation, especially in his 1920s texts *The Economic Consequences of the Peace* and *How to Pay for the War*, there is an obvious conclusion: if an economy is growing fast, it's impossible to avoid inflation. Policymakers must choose which option they prefer: a) to grow and continue to improve the living conditions of the population or b) to provoke a recession and, probably, an economic crisis, penalising real people who will lose their jobs and, in the case of Latvia, will not be able to pay back the credit they borrowed. Chicago Monetary Tradition's answer to this question is clear and gives the basis to the way the IMF shapes the policies in these countries: people aren't important; only the monetary and macroeconomic aggregates have value. In other words, recessive policies are always the solution.

What developing countries must take into consideration is that 13% annual rate of inflation isn't so bad if there is economic growth and, more importantly, development.[17] Inflation is a problem when it's 13% a month. A yearly inflation of about 2-3% is the case of developing countries in recession or of developed countries approaching stagnation and starting to face problems like unemployment. Before achieving an inflation rate of 2-3%, a country first must develop. On the contrary, such a low inflation rate is going to occur at the expense of small economic growth/development. In this sense, a country must develop first, to reach a consolidated and sustainable inflationary behaviour. The EC's Latvian convergence reports usually attribute the country's inflation to five factors: a) a wage spiral that forces a reduction in profits; b) growing demand pressures; c) growing oil prices; d) precautionary corrections of prices based on future expectations; and e) the growing price of imported commodities.

All these factors certainly have been exacerbating inflation in Latvia lasting recent months. However, they are the external appearance of another problem. Certainly, it isn't the increasing wages in the sense that if workers receive higher wages, an increase of the costs of production will result, thus abetting inflation. This analysis is naïve. The fact that Latvia has a very big deficit in the trade balance shows that most of what is consumed in the country is imported. In this way, a wage increase may affect the costs of circulation and internal transport resulting in inflationary pressures, but in Latvia's case these costs aren't the most relevant. At the same time, as there is a virtually infinite supply of goods and services from the EU and the rest of the world through imports, the argument that the demand is surpassing supply is false and only valid when it comes to distribution and retail, where a few big supermarkets dominate the sector. Instead, there are five factors: a) the increase of the monetary basis, b) the positive expectations about the future as result of the perception of the increase of personal wealth, consequence of the availability of cheap credit, c) inertial movements and d) the alignment of prices with the level of the EU and e) the increasing of the price of energy and some commodities. The first three has been the most relevant, with items "b" and "c" being the result of "a", while "d" and "e" are minor variables.

From 2003 to 2007, the monetary basis of Latvia increased 181%, mostly the M2. From May 2004 to June 2008, the increase was 163%. By the side of M1, the largest growth was registered in overnight deposits, leading one to conclude that the issuance of money by the Bank of Latvia hasn't been the main cause of the increase of the monetary basis. Rather, this is the result of the strategies of the private banks operating in Latvia. If on one side they may naturally create money, on the other the increase of their activities have been financed by external remittances of money. As at least a half of all investments in the country continue to be in lats, this means that part of the foreign currencies received by the foreign banks operating in Latvia has been converted to lats, increasing the monetary base.

Although in the last months there has been a tendency among common people to say that the banks are guilty for the current crisis, no one can say that the banks are guilty. Banks are private institutions looking for profits – they are not charitable foundations. In reality, the problem is to be found in the ineffective regulation of the market by the Financial and Capital Market Commission and the inability of the Bank of Latvia to deal firmly with the increases of the monetary base. On one side, the Financial and Capital Market Commission assumed a position of not intervening in the market, rather becoming an observer. It wasn't able to perform its basic function of regulating the financial system to guarantee its stability, controlling the explosion of the market credit and therefore protecting both banks and clients from overexposing to risk.

The case of the Bank of Latvia is different. As Latvia's exchange rate is practically fixed to the euro and the capital and financial accounts of the Balance of Payments are

17 Economic development here must be understood in a Schumpeterian way.

opened, following the rationality of the "impossible trinity", it's impossible to form monetary policy. By the same token, as the currency of more than 85% of the credit lent in Latvia is the euro, this means that the Bank of Latvia cannot use the interest rate as an instrument to control inflation.[18] This is the official discourse of the institution, which assumed also a passive attitude in fighting inflation. The Bank of Latvia considers its main task to protect the exchange rate from going beyond the fluctuation band, and to maintain the long-term interest rate in accordance to the Maastricht criteria. It has been performing most administratively than through active interventions disciplining the market, and therefore, although aware of it, has been ignoring the role of the monetary base as determinant of inflation in Latvia.

A working paper of the Bank of Latvia even discussed the change of expectations among economic agents as determining inflation, but the authors didn't go to the monetary aggregates, what would be logical to try to explain why the expectations are changing.[19] Although mostly of the sectors of the Latvian economy were developing based on unreal positive expectations, people have been feeling they were getting richer and richer and that this was occurring in a sustainable way. The result was a distortion of the apprehension of reality by the majority of economic agents. Even in 2008, some international consulting companies were still defending the idea of Latvia becoming an international financial centre, when a superficial analysis of basic macroeconomic indicators already clearly showed that the Latvian economy was starting to face a structural crisis.

To reduce inflation and avoid the economic structural changes it is necessary to impose some regulations. This is a delicate issue in Latvia, as the concepts of 'economic freedom' and 'economic liberalism' are understood by the Latvian authorities, politicians, and a significant part of private economic agents as synonyms for complete anarchical freedom. Anything more than the regulations imposed from the outside, for example, the regulatory framework of the EU, is considered to be communism or populism.[20] This cultural specificity helps to explain the lack of initiative on the part of regulators to perform their basic function of regulating efficiently. In addition, there is a lack of effective cooperation between the Bank of Latvia, the Financial and Capital Market Commission, and the central government, as they tend to act independently from each other. The Bank of Latvia was the singular institution that alerted other stakeholders several times about the structural problems the Latvian economy was going to face. The central government generally did not take these alerts into consideration, often discrediting them, while the Financial and Capital Market Commission ignored the macroeconomic aspects of its chosen regulatory model.[21] In this sense, the passiveness of the Financial and Capital Market Commission, combined with the self-interested attitude of politicians is an important component of the formation of the structural crisis.

As it was clear that a process of restructurisation was occurring at least since 2006, some measures could be taken to avoid it and to soften the inflationary process of the last years. In this case, the Bank of Latvia could at a minimum have taken one significant measure. Although the possibilities for performing a comprehensive monetary policy are limited, in this specific case one instrument was available: the compulsory reserves. As the monetary base was increasing mainly as consequence of the remittance of capital from foreign banks to their subsidiaries to be issued as credit, together with the endogenous creation of money by banks operating locally, a more strict increase of the

18 About the impossibility of the Bank of Latvia to deal with monetary policy, see Beņkovskis, K. (2008)."Banku aizdevumu kanāls Latvijas monetārās politikas transmisijā." *Latvijas Banka Pētījumi*, 1/2008.

19 Beņkovskis, K. & Paula, D. (2007)."Inflācija gaidas Latvijā: patērētāju apsekojuma rezultāti." *Latvijas Banka Pētījumi*, 1/2007

20 The word 'populism' has a lot of concurrent uses by the Latvian politicians and authorities. Usually, it is used to criticise any idea or action from opposition groups, even if the idea isn't really populist.

21 Is a known fact the governor of the Bank of Latvia Ilmārs Rimšēvičs was often ridiculed by the politicians of the central government, principally when Aigars Kalvītis as prime-ministry, when trying to alert about the structural problems of the Latvian economy.

compulsory reserves would be sufficient to dry up the liquidity of M2.[22] Combined with stricter regulations for lending by the Financial and Capital Market Commission and a more prudent tax policy by the Ministry of Finance, the process of economic restructurisation would be completely different.[23] The result is that the prospects for adopting the euro became more distant, although it's viewed by the political elite as the only chance to give back to the country the opportunity to grow and to develop.

1. The impact of the global crisis

As previously mentioned, with or without the global crisis, Latvia would still be facing a huge structural crisis. It might have been delayed, but there would certainly be a similar negative impact on the Latvian economy. In this sense, the impact of the global crisis must be understood as a booster rather than the main cause of the current crisis. Since the end of August, a run on Parex Bank - the largest domestically owned bank and the second largest overall - resulted in loses of more than a quarter of its deposits, and ten percent of the deposits of the commercial banking sector. This is the result of the combination of the effects of the crisis in the Commonwealth of Independent States region, with foreign investors losing their confidence both in the bank and in the Latvian economy.[24] Although the government negotiated a partial takeover of the bank, while retaining the major controlling shareholders, this measure wasn't sufficient to restore confidence.[25] From the end of August until late November, the official reserves fell to €3,4 billion or almost 20% - one-third of short-term external debt and over 100% of base money in comparison with 127% in September - as the Bank of Latvia started to sell currency to sustain the peg of the lat to the euro. In spite of the interventions of the Bank of Latvia, the exchange rate has remained in its upper band, and interbank spreads have substantially increased. Therefore, the concerns about the sustainability of the external debt, the exchange rate peg and financial system as a hole became strongly unfavourable.[26]

The government was incapable of gaining access to credit due to lack of confidence in the Latvian economy on the part of outside private capital markets, and in this way to obtain the foreign currency to bolster the banking system to restore confidence. Therefore, the only alternative the government was to ask for help to the IMF and the EU. With international reserves falling and barely covering the base money, the authorities also requested support from the balance of payments facility of the EU (consistent with commitments of under Article 119 of the European Community treaty), and from other sources as well. Besides the IMF, the EC, with representatives from the ECB - in line with

---

22 The Bank of Latvia increased the compulsory reserves three times since 2005: in the beginning of 2005 from 4% to 6%; in december 2005 from 6% to 8%; and in 2006 through the inclusion of the financial liabilities due in more than two year, in order to limit the Scandinavian banks, which were able to attain long-term financing and were playing the major role in the sector. It's not clear why the bank of Latvia didn't use all the potential of this instrument to control

23 Until now, there are no taxes on capital gains, as very low taxes on real estate as well. Taking in consideration that other sectors are much more labour intensive, resulting in more taxes to be paid, there was a natural tendency to the development of the real estate sector.

24 Although there are 27 banks operating in Latvia, more than 55% of the banking market is divided between four Scandinavian banks. These explains the fact that the run on Parex wasn't a very serious treaty to the stability of the economy. Until now, there are no signs that other banks may face similar problems.

25 Unofficially, the maintainsnce of the main shareholders in the control of the institution is viewed as the main reason to explaining the incapacity of the action of the government to restore confidence in the market.

26 International Monetary Fund. (2009).Republic of Latvia: Request for Stand-By Arrangement - Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia. IMF Country Report, no. 09/3.

Latvia's ERM II membership - Sweden, as other Nordic countries as well, the World Bank and the European Bank for Reconstruction and Development.[27]

Accordingly to the IMF, the main objective of the program is "to maintain Latvia's exchange rate peg through strong domestic policies and substantial international finance assistance".[28] The idea is that the plan will allow the economy to emerge from a period of slow growth with less disequilibrium on corporate and households balance sheets. The plan is centred in four key elements:[29]

a) immediate measures to stem the loss of bank deposits and international reserves;

b) steps to restore confidence in the banking system in the medium-term;

c) fiscal measures to limit the substantial widening in the budget deficit, and **prepare for early fulfilment of the Maastricht criteria**;[30]

d) incomes policies and structural reforms to rebuild competitiveness under the fixed exchange rate regime.

The fulfilment of the Maastricht criteria is one of the main objectives of the stabilisation plan, meaning that the Latvian authorities don't have any choice, whether to do all to fulfil all criteria or not. This isn't a political problem, as the adoption of the euro has been always seen, at least, as unavoidable and something to be done. As the strategy to adopt the euro from now on is determined by the IMF in the Request by Standby Arrangement with the accordance of the EC and ECB, the government's strategies adjustments are well defined. As Latvia has already adopted the functioning and regulations of the EU to its financial market, there is practically no space to changes. The general practical aspects of the plan are:[31]

a) to maintain the peg of the lat to the euro it's necessary to fence and to solve the immediate problems in Parex Bank, to prevent contamination of the entire system, drawing substantial outside international financial assistance to attend to the demand for foreign exchange;

b) strong fiscal policy and income policies to reduce inflation and improve competitiveness or - in simple terms - deep recession, together with structural policies to boost productivity growth and help to generate the shift from production of non-tradables to tradables;

c) private sector debt restructuring;

d) because of the exchange rate peg, a real depreciation by factor price adjustment through a recession in the short run and slow growth for several years;

e) change in the regulatory approach towards banks dealing primarily with non-residents, to reflect the higher liquidity and market risks, This is expected to occur through the reduction of the maturity mismatches created by these deposits and the request for additional capital to ensure that they have sufficient and liquid foreign assets to meet potential depositors withdrawals;

f) commitment from foreign banks to maintain their presence to solve the collective action problem and discourage individuals to withdraw credit lines;

27 Ibid..

28 Ibid., p. 4.

29 Ibid..

30 My emphasis.

31 Ibid..

g) enhancement of the Financial and Capital Market Commission's capacity for monitoring banks, and improvement of information sharing with the Bank of Latvia - principally on amounts of liquidity support - and home supervisors of foreign banks;

h) restructurisation of private debt by amending the insolvency law to facilitate workouts between viable enterprises and their creditors, the improvement of the personal bankruptcy framework to help the rehabilitation of households debtors and by strengthening banks so they can restructure their debts;

i) tightening of the budget to the target of 4,9% of GDP deficit. Near one third of the adjustment of the budget approved by the Saeima in December 2009 comes from revenue measures (increase of VAT and excises), while two thirds comes from cutting expenditure (reduction public sector nominal wages - see item 'l', and a 25% real cut for most current spending);

j) adoption of fiscal rules, especially with embedded expenditure targets, introducing a medium-term budget framework and strengthening public fiscal management. Besides, a fiscal responsibility law, focusing on increased transparency and accountability;

k) implementation of the National Lisbon Program to boost competitiveness and productivity to reduce external imbalances, monitored by the EC;

l) reduction of public sector wages and bonuses in 2009 in comparison with 2008. Although the central government has direct control only over its wages, there will be wage reductions to state-owned enterprises and, by reducing transfers, to local governments also;

Usually, the conditions imposed by the IMF are very strict and wrest control from the central governments over internal questions and reducing the political game to a detail. While most the countries might consider this a problem, in the case of Latvia this may be very positive. As there is a general problem of competence in economic issues in Latvia, mainly in macroeconomics, to take away the power to decide from the politicians and the technicians of the government is to guarantee that, at a minimum, the main points of the plan are going to be fulfilled. As the Maastricht criteria are a key element of the IMF's program, it's to be expected that everything possible will be done to guarantee an early fulfilment of the Maastricht criteria.

III. Institutional and policy environment regarding the Euro adoption

Euro adoption is considered a critical issue for Latvia to guarantee financial stability or at least reduce the vulnerability, risks and transaction costs of the lat in relation to the EU. As discussed before, crucial decisions were already determined by the IMF, the EC and the ECB. Other actors, such as the Ministry of Finance and the national banks, have insufficient power to influence the process of decision-making. The procedures to deal with the adoption of the euro by now are those described in section 3.1. However, some remarks must be done about the trade-off between quantitative and qualitative criteria and the role of fuzzy judgements, such as the role of politics and diplomacy.

Although it is the conditionality of the IMF, the EC and the ECB, until the end of March the authorities weren't completely fulfilling the restructurisation of the national budget. Instead, in the beginning of March it was announced that the deficit of the budget would reach 7% of GDP instead of the 4,9% imposed by the IMF. This is primarily because of the wages of the public sector were not reduced by 25% but rather by 20%, and also because the taxes collected were much less than predicted. The government is expected to present a new budget by June 2009, fulfilling all requirements as to promote reform of the health and educational systems.

This will be a very difficult political task, as a wave of protests is expected to happen over the next months and the coalition in force may fall. Besides, as the result of such reforms led by the World Bank and the IMF in Latin America are well known as, to be gentle, not the most effective, people are afraid of the future of the basic services, increasing the political instability. Although the euro is an important objective, political problems may prevent the fulfilment of the conditionality of the multilateral agencies and therefore indefinitely postpone adoption of the euro.

The definition of the Maastricht criteria indicators are based on the presupposition that countries fulfil them are less vulnerable to structural problems and, most important to a monetary union, to inflation. In addition, only very stable countries may have the four indicators fulfilling the criteria at the same time. As their theoretical base is the neoclassic orthodoxy transformed by the Chicago School, these indicators reflect rather the external appearance of the phenomena in question rather than its essence. Therefore, the main point is that a country facing a process of unsustainable economic development may be able to join the EMU, without having the solid economic base for doing so. Latvia is a good example. If Latvia was unable to join the EMU in 2008 due to inflation, it was because of the negligence of the authorities to impose more strict controls to regulate the expansion of the monetary base, rather than because of real and sustainable economic convergence.

There is a fundamental difference between the idea/meaning of the Maastricht criteria and the indicators used to determine if a country is ready to join the EMU. The essence of Maastricht is that countries joining a monetary union must have a sufficiently stable economy to avoid inflationary pressures/contagion, which makes monetary policy difficult to implement. "Stability" also means "sustainable convergence", here understood as socio-economic development. So, what really matters is the ability of a country to catch up to the same level of economic development and stability of the other members of the EMU to avoid inflation dissemination. This is the real Maastricht criteria. The problem is that the indicators of nominal convergence became an autonomised expression of the essence of the Maastricht criteria, turning to be an objective per se.

As nominal convergence results from sustainable real converge, in reality the indicators of the Maastricht criteria are trying to reflect a situation of real economic convergence through those four indicators. The first problem is that they can be falsified.

a) Stable exchange rate: the original idea is that it reflects the fact that a country hasn’t had any structural disequilibrium in relation to the other members of the monetary union, both of terms of trade and financial capital flux. At the same time, that the economy of the country in question is solid and shielded against monetary disturbances, in other words, that there aren’t inflationary pressures resulting from devaluation. A stable exchange rate can be achieved administratively; most of the countries of the EMR II are doing this now. So, this indicator is useless.

b) Positive government budget: the idea again is inflation. Traditionally, the idea is that deficits are financed by printing money or borrowing from external sources. In both cases, the result is the expansion of the monetary base resulting in inflation. However, an equilibrated budget must also reflect that the administrative routines and apparatus of the state, as well as general expenses, are efficient. An equilibrated budget may be artificially achieved by cuts, not guaranteeing that future budgets won’t have deficits. At the same time, a very important question to be answered is the inflationary impact of the deficit. In the case of independent central banks, as in Latvia, the decision of printing money is independent from the central government. In Latvia’s case, the increase of the monetary base as a consequence of the activity of foreign banks with a lack of efficient policies of the authorities in 2006 was about 14% of the GDP. The result was huge inflation. At least in Latvia’s case (but certainly in other countries also), this indicator is useless.

c) Long term interest rates: the fundamental point here is that in fully integrated international capital markets, investors are indifferent to the margin between any two activities to which they allocate capital, independent of national location. Equal national real interest rates in the long run tend to drive a rapid convergence process for national production possibilities. More important in the case of the EMU is that convergence of long term interest rates means that monetary policy has generally become more synchronised across countries. Also, that the government doesn't have a high degree of indebtedness, as it tends to be associated with high long-term real interest rates. The Japanese experience of low real rates and very high debt provides a counter-example. Besides, in small underdeveloped countries, when investors' euphoria turns into pessimism or even if a change in the investment grade of some agency occurs, it may result in deep changes in the long term interest rates. On one side, the combination of fixed exchange rate with opened capital and financial accounts result in the impossibility to perform monetary policy. By the other, as the biggest share of credits in Latvia is in euro, the interest rate is already determined by the ECB. I would say that for Latvia this indicator is not relevant.

d) Inflation: price stability may be achieved artificially by freezing prices (this was discussed here in Latvia) or through a recessive policy, usually the choice of the IMF. This means to postpone real convergence for years. Without real convergence there isn't real price stability and sooner or later inflation will come back. It's a fundamental indicator, but alone it's useless.

The set of indicators of the Maastricht criteria aren't only inadequate for the Baltic countries, especially Latvia, but for underdeveloped countries in general. Besides the fact that they may not reflect the real economic conditions of a country, they have an implicit presupposition common to the neoclassic orthodoxy that different levels of socio-economic development does not matter and that one fits all. For an underdeveloped country to achieve the Maastricht criteria in a sustainable way, real development is necessary. In other words, it's a very long process and it would be very difficult for a country to achieve the real objective of the Maastricht criteria.

Buiter (2004) and Mundell (2000) defended the idea that achieving fiscal sustainability is the unique necessary condition for euro adoption. This idea is more realistic and pragmatic. However, deeper structural analysis is necessary. Latvia's inflationary episode in recent years is due mainly to the influx of euros into the country. This wouldn't have any influence on inflationary pressures/contagion of other countries if Latvia were a member of the EMU. Objectively, a plausible alternative to these indicators is the adoption of the notion that one doesn't fit all and that deep individual structural macroeconomic analysis is necessary. As I said before, the main objective of the traditional Maastricht indicators is to show that a country isn't going to spread inflation in the union, making monetary policy difficult to implement. To some countries, some indicators are relevant; to others they aren't. The case is to really understand the economic conditions of each country and avoid generalisations.

The IMF considers the idea of a radical acceleration of the adoption of the euro at a depreciated exchange rate to be the best option for Latvia. The benefits would be that the entry would not be subject to speculation, boosting confidence and being associated with less of an output decline. However, the Latvian authorities don't take this possibility too seriously and the Bank of Latvia itself is against it, supporting the vision of the ECB, whatever it is. Besides, the authorities don't think that the IMF itself is convinced that it's something actual possible. Aside from the adoption of the euro at a depreciated exchange rate, the IMF considers three additional options:[32]

a) to widen the bands: although it would correct the problem of overvaluation, the fall in output would be deeper because of balance sheet effects, and the economy would incur bank restructuring costs upfront, as loans defaults by unhedged firms and households would reduce bank capital. Besides, a sudden stop in capital flows, which could follow depreciation, may boost the credit crunch.

b) to free the exchange rate: the IMF considers the problem rather related to the popular and political support than with macroeconomic aspects. Most probably, a free exchange rate would result in a strong depreciation of the lat, increasing the loans defaults as well.

c) Euroisation with EU and ECB concurrence: if Latvian banks could access ECB facilities, then those that are both solvent and hold adequate collateral could access sufficient liquidity. The increase in confidence would dampen concerns of resident depositors and also help stem non-resident deposit outflows.

In all cases, the IMF expects a devaluation/depreciation of the exchange rate. As the Latvian authorities are not giving up in the case of nominal depreciation, the IMF is expecting domestic policies to be "radically strengthened" (sic). This must "(…) be addressed through a prolonged factor price adjustment" that "(…) will likely require a recession in the short run, and slow growth for several years to come".[33] This resulted in a trap: make the exchange rate freer; most probably results in a general default, as the biggest share of the loans were issued in Euros. This would impose too much loss on Scandinavian banks, resulting in the collapse of the banking system and of the economy; maintaining the fixed exchange rate (assuming a band of 1%), real depreciation through recession and slow growth for several years is expected. None of them is adequate for Latvia.

It's clear that the best option for Latvia would be early adoption of the euro, with a depreciation of about 15 to 20%. As this idea lacks of political support from EU authorities, the best solution for Latvia, in realistic terms, would be widening the bands between the ERM II limits of ± 15%. This would boost the competitiveness of the industrial and service sectors, helping to develop and to recover the economy from the crisis. However, to avoid a general default, this must be done in collaboration with the banking sector. There are two ways: to extend the terms of the loans or to establish a special exchange rate to convert euro to lat. Naturally, losses are implied in this scheme in the short run. It's the only way to guarantee a sustained development in the short term, assuring that the losses may be recovered in the medium run.

Naturally, the EC and the ECB could relax the requirements for Latvia to adopt the euro. In the case of such a small country, whose GDP is equivalent to 27,5% of the GDP of the city of Munich,[34] even if Latvia doesn't fulfil any of the Maastricht criteria, the impact of inflation or any other disequilibrium in Latvia to the EMU is completely irrelevant. At the same time, the benefits to the country would be enormous. That's why the adoption of the euro must be seen as an instrument to promote stability, this economic development.

---

32 International Monetary Fund. (2009).Republic of Latvia: Request for Stand-By Arrangement - Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia. IMF Country Report, no. 09/3.

33 International Monetary Fund. (2009).Republic of Latvia: Request for Stand-By Arrangement - Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia. IMF Country Report, no. 09/3, p. 11.

34 Data for 2007 from the Bank of Latvia and the Municipality of Munich, author's calculations.

Conclusion: progress, perspectives, recommendations

Until 2007 Latvia was fulfilling all the Maastricht criteria except inflation. Although facing a process of unsustainable development that could be characterised as underdevelopment, if the Latvian authorities had regulated the expansion of the monetary base, most probably Latvia's currency would be the euro by now. After joining the EU, Latvia's faced a restructurisation of its economy, due to changes of strategies of the actors of the financial sector, mostly Scandinavian banks. This process, in conjunction with the low level of indebtedness of the private economic agents, resulted in Latvia having to finance its economic growth with external savings. Economic literature shows that this usually results in the development of speculative bubbles in real estate assets and in an increase of the consumption of durable goods. As Latvia is a small country, this resulted in nearly 60% of the GDP becoming dependent on speculation with real estate actives, consumption of durable goods, financial intermediation and transports, four non-sustainable sectors in the medium and long run.

Although the euro always has been an objective of Latvia's authorities, and the rhetoric of its adoption was always present in official statements, the result of the economic policies of the last years proves that these policies weren't effective. This may be explained by the lack of competence and pragmatism of the authorities to deal with macroeconomic issues, which is a result of the lack of knowledge of economics as a discipline. Consequently, Latvia had to ask for help from the IMF and the EC just as European countries like Estonia, Poland and the Czech Republic. In order to concede the help, the consortium formed by the institutions and countries asked for some conditions, which are now dictating Latvia's economic policies. Fulfilment of the Maastricht criteria - the sooner the better - is considered one of the main presuppositions to the success of the process of adjustment.

Although politicians tried to not fulfil the target of a budget deficit of -4,9%, instead trying to negotiate with the IMF for a budget deficit of about 7,0% of GDP, the result of the negotiations that ended on 30 March 2009 was a public expression of dissatisfaction by the IMF. The Ministry of Finance promised to make a new budget by June 2009. Considering that the collection of taxes is smaller than predicted when forecasting the budget, more cuts are expected, chiefly in wages and in social guarantees. As result, a period of political instability is expected over the course of the next several months. This may interfere with the plan's fulfilment and in the adoption of the euro.

The definition of the Maastricht criteria indicators are based on the presupposition that countries fulfilling then are less vulnerable to structural problems and, most important to a monetary union, to inflation. However, although the criteria have turned into a dogma somehow, the analysis of other indicators, as well of other subjective factors is necessary. Latvia, a small country in economic terms, presents no risk to the stability of the EMU. Even if Latvia doesn't fulfil any of the Maastricht criteria, the impact of inflation or any other disequilibrium in Latvia to the EMU is completely irrelevant, while at the same time, the benefits Latvia stands to gain from the euro adoption are enormous. The

ECB and the EC should go beyond the idea that one model is applicable to all countries. These institutions should also take into consideration the costs of political and economic instability to the union, and the risk that is posed to the union if some countries interminably suffer from chronic underdevelopment.

Literature

Bayoumi, T. & Eichengreen, B. (1997)."Ever closer to heaven? An optimum-currency-area index for European countries." *European Economic Review*, vol. 41, no. 3-5, pp. 761-770.

Beņkovskis, K. (2008)."Banku aizdevumu kanāls Latvijas monetārās politikas transmisijā." *Latvijas Banka Pētījumi*, 1/2008.

Beņkovskis, K. & Paula, D. (2007)."Inflācija gaidas Latvijā: patērētāju apsekojuma rezultāti." *Latvijas Banka Pētījumi*, 1/2007.

Ghosh, A. R. & Wolf, H. C. (1994)."How many monies? A genetic approach to finding optimum currency areas." *NBER Working paper*, no. 4805.

International Monetary Fund. (2009). *Republic of Latvia: Request for Stand-By Arrangement - Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia.* IMF Country Report, no. 09/3.

Rogoff, K. (1996)."The purchasing power parity puzzle." *Journal of Economic Literature*, vol. 34, no. 2, pp. 647-668.

Sommers, J. (2008)."Latvia living at the extremes: seeking equilibrium between central planning and financialization." *Humanities and Social Sciences Latvia*, vol. 3, no. 56, pp. 34-54.

Appendix

Yearly data, 1999-2008 (for countries that joined EU in 2004); 2002-2008 (for countries that joined EU in 2007)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
HICP (EU harmonized inflation index)	2.13	2.64	2.52	1.95	2.94	6.19	6.9	6.57	10.08	15.25	
Budget deficit/surplus - % of GDP (General Government Budget Balance)	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.1		
General Government Gross debt, % of GDP	12,5	12,3	14,0	13,5	14,6	14,9	12,4	10,7	9,5		
Long-term interest rates (10-year government bonds) – end of year			7.57	5.41	4.90	4.86	3.88	4.13	5.28	6.43	
Exchange rate - % change against the Euro	-5.25	-10.6	0.16	3.73	10.28	3.82	4.66	0	0.56	0.37	
Price level compared to the EU average (Eurostat)	52.1	58.8	59	57	54.4	56.1	57	60.5	65.8		
GDP per capita at PPS as % of EU average (Eurostat)	36	36.7	38.7	41.2	43.3	45.7	48.6	52.5	57.9	55.3	
GDP growth	3.25	6.92	8.05	6.47	7.19	8.68	10.60	12.23	9.98	-4.58	
Export growth	-6%	12%	11%	12%	17%	30%	34%	14%	23%		
Current account - % of GDP		-4,8	-7,6	-6,6	-8,2	-12,8	-12,5	-22,5	-22,5	-12.6	
FDI - % of GDP (+ % of FDI coming from EU countries, if data exist)		5.3	1.6	2.7	2.7	4.6	4.4	8.3	8.3		
FDI from EU countries - % of GDP		2.2%	1.6%	1.4%	1.6%	2.8%	2.0%	5.9%	6.5%		
External debt (private + public) - % of GDP (+ net external debt, if data exist)	52%	61%	68%	73%	80%	93%	99%	114%	135%		
Bank credit growth (% change)	16.1%	27.8%	50.5%	29.9%	41.2%	46.0%	58.9%	56.2%	37.2%	11.2%	
M2 (% change)						26.9%	38.7%	39.7%	14.4%	-6.2%	
Interbank interest rates, monthly averagesfor the corrersponding year	4.73	2.96	5.23	3.01	2.88	3.25	2.49	3.25	5.06	4.09	
Share of deposits denominated in Euro				8.5%	10.2%	21.2%	25.0%	30.6%	38.0%	43.4%	
Share of credits denominated in Euro				16.3%	19.0%	31.9%	58.6%	73.0%	83.4%	85.2%	

EU banks ownership of local banks, % of total assets				37.77	39.29	39.1	45.9	49.31	48.3	51.71	
Stock market index			46.9%	-14.3%	47.0%	43.5%	63.5%	-3.1%	-9.2%		
World bank doing business ranking										26	29

Monthly (sarting from June 2008) and quarterly (starting from IQ 2008) data. According to the frequency (monthly; quarterly) of their issue

2008	Q1	Q2	Q3	Q4						
GDP growth, % change from the same quarter of the previous year	0.52	-1.87	-5.20	-10.34						
	June	**July**	**August**	**Sept.**	**Oct.**	**Nov.**	**Dec.**	**January**	**Febr.**	
Industrial production, % change from the same period of the previous year	-0.70%	-3.80%	-7.80%	-3.60%	-6.00%	-11.40%	-13.50%			
Unemployment rate	6.8	6.6	7.5	10.1						
HICP (EU harmonized inflation index), % change from the same month of the previous year	17.5	16.5	15.6	14.7	13.7	11.6	10.4	9.7	9.4	
Exchange rate - % change against the Euro, monthly	0.64	0.04	0.06	0.30	0.47	-0.01	-0.11	-0.58	-3.09	
Export growth – monthly data compared to the same period of the previous year	4%	13%	8%	25%	7%	-18%	-11%	-31%		
Current account - % change yearly	-17%	-30%	-49%	-55%						
FDI - % change compared to the same month of the previous year	22%	-63%	-32%							
External debt (government +										

private) - % of GDP										
Bank credit growth, % change from the same period of the previous year	21.1%	20.3%	19.5%	17.8%	16.0%	14.6%	11.2%	11.5%	9.8%	
M2, % change from the same period of the previous year	6.1%	5.9%	5.5%	5.2%	3.0%	0.5%	-4.4%	-5.4%		
Interbank interest rates	3.40	3.30	3.30	3.60	6.40	5.00	5.40			
Stock market index	-0.24%	-0.86%	-1.87%	-23.34%	-2.25%	-14.90%	-15.72%	-11.54%	-10.62%	-0.50%