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Euro newcomer Latvia

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On 1st January 2014 the euro zone welcomes its 18th member. Latvia's adoption of the euro sends a strong signal about the currency’s appeal. This is particularly the case given that, during the crisis, the country chose the painful path of internal devaluation rather than currency devaluation, in order not to jeopardize its accession.

Latvia in figures

The newcomer will be one of the smallest members of the euro zone, with a population of just over two million (0.6 % of the euro zone's total population, about as many as Thuringia) and a GDP of EUR 14.4 billion forecast for 2013 (0.17 % of the euro zone's GDP). Thus Latvia's per capita GDP is just under 60 % of that of the euro zone overall.

For the last two years, the Latvian economy has grown by more than 5 %, with growth of 4 % annually forecast for 2013–2015. This makes the country one of the fastest growing economies in the EU. Its growth is broadly based, with equal contributions coming from private consumption, investment and exports. The country has a small current account deficit (-1.7 % of GDP) due to high imports of goods, particularly mineral products and machines.

Total assets in the Latvian banking sector are a healthy size, standing at 130 % of GDP. The loan-to-deposit ratio of the country's 15 banks mainly operating domestically is high at 154 %, but the trend is sharply downwards. In 2008 the ratio was 241 % – with devastating consequences for the Latvian economy.

Phoenix rising from the ashes of the crisis

Starting around 2005, the Latvian economy began to overheat, driven, in part, by capital inflows from abroad. Real growth was 10 %, with inflation reaching 15 % and the current account deficit at 22.4 %.

Capital inflows ceased abruptly in 2008 with the outbreak of the financial crisis. This made bank refinancing difficult, leading to the collapse of the country's second-largest bank. Its bailout, in turn, meant that the Latvian government itself lost access to the financial markets, and it, too, had to be rescued.

The financial support programme for Latvia began in 2009. It comprised EUR 7.5 billion in loans, of which EUR 4.5 billion was actually disbursed. Besides the IMF and the EU, other participants in the assistance programme included the World Bank, the European Bank for Reconstruction and Development (EBRD) as well as several neighbouring east European and Scandinavian countries. In return, the Latvian government implemented a strict consolidation and reform programme, with massive layoffs and wage cuts in the public sector. One source of heated debate at the time was the Latvian government's decision not to facilitate the reforms in the short term through a devaluation of the currency.

The course the country chose proved to be successful, enabling Latvia to forgo further aid since October 2010 and start growing again from 2011. At the same time inflation has declined considerably, wages are growing in line with productivity and the current account is nearly in balance. There has been a decline in unemployment (2013: 11.7 %), although part of the reduction is due to a 10 % decrease in the population in the last ten years, primarily as a result of crisis-related emigration.

Convergence criteria fulfilled – sustainability not assured

The rapid recovery that followed the severe crisis and the early repayment of IMF aid enabled Latvia to fulfil the five convergence criteria for the introduction of the euro by a comfortable margin (see table). Nevertheless, there are risks concerning future adherence to the criteria, so there is an urgent need to continue with recent reforms. Particular causes of concern are the highly volatile inflation rate and the continued heavy reliance of Latvian banks on foreign deposits for refinancing.

A good sign for the euro

The majority of the Latvian population is sceptical of the introduction of the euro, fearing it will lead to hidden price increases. On the other hand, the overwhelming majority of the political class supports accession, not least because they see the euro as a further shield against Russia.

Latvia's adoption of the euro will have no meaningful effect on the euro zone. Nevertheless, accession at this time is a strong vote of confidence in the future of the currency. ■

Table: Convergence criteria

Criterion	Actual	Threshold
Inflation rate	1.2 %	2.7 %
Deficit	1.2 % of GDP	3 % of GDP
National debt	40.7 % of GDP	60 % of GDP
Exchange rate	within +/- 1 % of reference rate	within +/- 15 % of reference rate
Yield on 10-year bonds	3.8 %	5.5 %

Source: EU Commission

Note: This paper contains the opinion of the authors and does not necessarily represent the position of the KfW.