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Latvia's accession to the euro zone

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Abstract :

Five years after the start of a severe economic and financial crisis and the grant of international financial aid Latvia is to integrate the euro zone on 1st January 2014. It will become its 18th member. This accession will be the reward of an ambitious plan to bring public accounts up to speed and of an improvement in the country's competitiveness - even though there a few questions remain about the risk of renewed inflation and the weight of non-resident deposits in the local banking sector.

Latvia's entry into the European Union on 1st May 2004 was followed by a total overheating of the local economy. An annual GDP growth of 10% between 2004 and 2007 led to a sharp rise in real salaries (+20% over the same period) and encouraged the emergence of a real estate bubble, with prices rising by 60% between 2006 and 2007. The turbulence in the world economic situation led to an unprecedented contraction in the GDP (-18% in 2009) and a surge in unemployment that rose to 15% of the working population. A banking crisis came in addition to the economic crisis. The collapse of the housing market in 2008 (by 38 to 70%) further weakened the banks' financial situation, which was over exposed to mortgage loans.

Banca Parex, Latvia's leading bank with 4.9 billion lats in assets (6.95 billion €) suffered a devastating confidence crisis on the part of its depositors. The announcement by Stockholm of a guarantee plan to Swedish banks established in Latvia made clients wonder about *Parex's* ability to honour its commitments and leading to a vast wave of capital withdrawal. In October 2008 faced with a problem of refinancing the bank asked for State aid, which acquired 51% of its capital. The intervention did not however prevent capital flight, 457.4 million lats (648.5 million €), mainly of Russian origin, flowed out of the banks between 7th and 20th November 2008. A further public injection into the bank's accounts to a total of 1 billion lats (1.4 billion €) – i.e. nearly 19% of the national budget – forced the government to turn to international aid at the end of 2008 from the IMF, the EU and also directly from Sweden.

Set at 7.5 billion €, this bail-out was conditioned by the adoption of an austerity plan. This was not introduced immediately. Given this the international creditors decided to suspend the disbursement of the second tranche in March 2009. The Latvian government then faced an increase in the risk premium on its sovereign debt securities which prevented it from placing all of its bonds in tender in June and September 2009. Interest rates ranged from 10.5 to 14.3%.

It was in this context that the Latvian government decided to implement a so-called "internal devaluation" programme. This notably meant an estimated 30% reduction in remunerations in the public sector and a concomitant reduction of retirement pensions. Budgetary cuts ranging from 20 to 40%, depending on the ministry involved; were also undertaken. The healthcare system was reformed and the state education system rationalised: 10% of schools were closed, budgets devoted to universities were cut by 30 to 40%. Loans to state agencies were cut by half and except for a few, the boards of the major state businesses were dissolved. Public funds were redirected to structural investments. At the same time thought was given to how European loans could be used better and to foster various infrastructure projects. The enhancement of Latvia's attractiveness in the area of transport, and logistics then became a priority, with export companies also being the focus of aid.

This ambitious plan was implemented by Valdis Dombrovskis's government – whose Unity Party (centre-right) has comprised a pivot in the coalitions which have successively taken office since 2009. The rejection of the previous government, challenged for not having taken into account the observations of the Bank of Latvia and the international financial institutions in 2007 and 2008, culminated on 13th January 2009 with riots in Riga and demonstrations against the first austerity measures. It was in this context that the government coalition was extended and that Mr Dombrovskis, former Finance Minister from 2002 to 204 was called to lead it.

Results came rapidly, with Latvia recovering growth in 2011. The latter rose to 5.5% of the GDP. Revival in activity has been linked to a rise in exports (+12% in 2012) but also domestic demand, in spite of high unemployment (13.5% of the working population in 2012). Local businesses notably succeeded in positioning themselves on high value added markets,

creating the conditions to increase their margins and also to revive their investments.

Economic perspectives remain positive, since the European Commission's forecasts plan for increased activity of 3.8% in 2013 and 4.1% in 2014. Unemployment is due also to drop back below 10%.

In 2009 the public deficit lay at 9.8% of the GDP, but this has been brought back down to 1.2% over four years. In December the Latvian government made an early reimbursement of the rest of the international aid paid to it four years previously. Of the 7.5 billion € planned for in the programme it only used 4.5 billion between 2008 and December 2010. At the same time by 2011 economic recovery had helped Latvia reduce the budgetary consolidation measures planned for with the international creditors. The measures that it had adopted in 2011 did however lead to a certain degree of continuity: a rise in VAT from 21% to 22%, the suppression of reduced VAT rates on electricity, an increase in the reduced VAT rate from 10 to 12% in all sectors involved, a 100% increase in property tax, an increase of the rate on various products and the creation of a tax on credit institutions.

From an electoral point of view this austerity policy was not sanctioned in the ballot of October 2010 and then in October 2011 since Valdis Dombrovskis was re-elected to office. This stability in an extraordinarily sensitive context was totally unprecedented: 14 heads of government succeeded each other in Latvia from 1991, the year which the country regained its independence, to 2009.

Accession to Economic and Monetary Union

Latvia officially applied to become a member of the Economic and Monetary Union in March 2013, i.e. at the height of the crisis. Membership comprises a three-fold advantage:
- Eliminating speculative attacks against the lats;
- Reduction in the cost of refinancing the sovereign debt;
- Improvement in refinancing conditions of banks by enabling it access to the ECB.

Article 140 on the Treaty on the Functioning of the European Union (TFEU) specifies four criteria that have to be respected in view of accession to the euro zone, which are laid out in detail in Protocol 13 on the convergence criteria annexed to the Treaty:
- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which cannot be more than 1.5% higher than that of the three best performing Member States in terms of price stability,
- the sustainability of the government's financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive i.e. if the State witnesses a rise of its public deficit beyond 3% or its debt is higher than 60% of the GDP;
- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,
- the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels. The rate of the country in question cannot rise beyond the average rate of the three countries selected for the calculation of inflation of over 2%.
Article 140 of the TFEU also states that the reports by the Commission and the ECB take on board pertinent factors such as the development of labour costs, the development of the balance of payments and market integration.
In view of the convergence criteria the European Commission deemed that Latvia's integration was fully justified. In a report published on 5th June 2013 it recalls that inflation lay at 1.3% between May 2012 and April 2013[1]. At the end of February 2013 Latvia also became one of three reference countries for the price stability criteria. The excessive deficit procedure targeting Latvia was closed in 2011. Public debt lies at 40.7% of the GDP. The exchange rate with the euro has remained stable over the last two years. Finally as far as long term interest rates are concerned, their average value totalled 3.8% over the last 12 months which is below the reference rate of 5.5% calculated by the European Commission.

Illusory results?

The positive opinion on the part of the Commission could not mask the ECB's reservations about the Latvian economy. In its convergence report published on 5th June 2013, it notably insists on the impact of the international financial aid programme on the improvement of Latvia's financial situation. The international programme has reassured the interest rate and exchange markets.[2] Indeed can Latvia maintain its present level of convergence without the aid of the European Commission and the IMF?

The ECB especially fears a return of inflation when

1. http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee3_en.pdf
2. http://www.ecb.europa.eu/pub/pdf/conrep/cr201306fr.pdf

prices are converted to euro. Price volatility has been extremely acute in the country over the last ten years, with inflation oscillating between -1.3% and 15.3%. Inflation also increased on accession to the EU. The peak of 15.3% seen in 2008 was preceded by years marked by annual price increases of over 6%. Although they are well below these figures the forecasts for 2014 (between 2.1% and 2.7%) are still higher than the euro zone average. 2.7% represents a fifty percent rise in comparison with the rates retained for Latvia’s application to join the euro zone. Price increases on primary goods and also on labour costs – which are logical in part during recovery – may add to the rise in inflation. The long term nature of convergence in terms of inflation can therefore be contested.
As a result of this the ECB is really insisting on the need to continue the budgetary consolidation plan, to implement further structural reform designed to improve the functioning of the labour market and also to perpetuate the gains in competitiveness acquired over the last few years. The IMF expressed similar reservations in the report it published at the beginning of 2013[3]. Although this document does not challenge the success of budgetary recovery efforts it does point to a certain number of possible problems that may weigh long term on Latvian growth, notably insisting on the question of unemployment. The IMF notably recommended lower taxation on low skilled workers who are returning to the labour market and a reduction of post-natal parental aid. The improvement in the country’s competitiveness also means – in the IMF’s opinion – continued reform of university teaching and apprenticeship.

Beyond inflation the IMF wonders about the high level of short-term debt. To be able to honour reimbursement deadlines in 2014-2015 Latvia will have to borrow 3 billion € on the markets i.e. 14% of its GDP. This bail-out will come at a moment when the local financial establishments are limiting credit.

Overview of the Banking Sector

The stability of the banking sector also is also at the centre of the ECB’s doubts. Apart from the Latvian banks, Scandinavian and German establishments provide the main structure to the market. 60% of Latvian assets are held by foreign banks. The local banking system depends on the policy undertaken by non-Latvian establishments. The ECB’s concern especially concentrates on the share of non-resident deposits, which represent 33% of the local GDP. These mainly come from Russia and members of the Community of Independent States (CIS), and to a lesser degree from the UK. They represent 48.9% of the total deposits and total over 100,000€ for the most part. 80% of them are short term deposits which makes the Latvian banking sector extremely vulnerable to capital flight. This observation is also shared by the IMF in a context that is still marked by the Cypriot crisis.
However the situation is far from being the same in either country. The entire Latvian banking sector only represents 128% of the GDP which is well below the European average and far from the excesses seen in Nicosia where financial services represented 7.5 times the national wealth. Although the country has 29 banks for 2 million inhabitants their contribution to the GDP lies at 4.5%, with the European average being 6%. Latvia does not have the same "advantages" as Cyprus: corporate tax lies at 25% and the banks do not service remunerative rates. The reasons for the inflow of capital are to be found elsewhere: geographical proximity with Moscow, the size of the Russian speaking population (50% of the inhabitants of Riga) or the trade partnership with Russia (transport, storage, energy, property). The set pegging of the lats on the euro and the adoption of a legal and prudential framework also comprise advantages for foreign depositors.

Moreover the banks which host these deposits only play a limited role in the financing of the local economy. They do not try to attract local depositors and remain relatively inactive on the inter-bank market. Conversely the Scandinavian banks, which dominate the Latvian banking sector, limit the share of non-resident deposits to 5%, only the Swedbank goes beyond this ratio to total 8%. We should note that non-resident deposits are relatively stable over a long period. The average maximal fluctuation of these deposits has never risen beyond 15% over one month. The most important withdrawals were witnessed in 2008 and 2009 when *Parex* went into bankruptcy.

The stress tests undertaken in 2012 also showed that the Latvian financial establishments could withstand the withdrawal of 50% of their deposits. The banks concerned by inflows of foreign capital are moreover relatively well capitalised, with their solvency ratio rising beyond 16%. Only the *Nordik* Banka has a lower ratio: an additional capital injection was requested in 2012. The banking sector is also continuing to recover as seen by the significant reduction in non-performing loans: 12.5% outstanding at the end of 2012 against 19.5% two years ago. At the same time the financial establishments have made drastic reductions in their liabilities (*deleveraging*). The ratio of loans over deposits set at 260 at the height of the crisis now lies at 176. The loans portfolio was still contracted in 2012

3. http://www.imf.org/external/pubs/ft/scr/2013/cr1328.pdf

even though the granting of loans recovered last year: + 28% for businesses and +18 % for households.

The bankruptcy of *Krajbanka* in 2011 also indicated the strength of the local banking system. This liquidation, the second in three years after that of *Parex*, highlights however the shortfalls in financial supervision in Latvia. The authorities were unable to detect the criminal activities of this establishment, who reference shareholder was Russian. We should note that in addition to this the Deposit Guarantee Fund was found to be inadequate to guarantee deposits below 100,000€. A state loan was then granted.

These difficulties are not preventing Riga from strengthening its role as a regional financial platform. Non-resident deposits increased by 17% in 2012, against 1.3% in terms of residents. Long term Riga might become a sanctuary for Russian capital previously placed in Cyprus, even though the deposits from the island only represent 600 million € at present, i.e. 3% of the GDP. The Latvian authorities are also implicitly encouraging this development. Regulations concerning residence permits which entered into force in July 2010 foster this kind of deposit: citizens of third countries can obtain a temporary residence permit as soon as they have invested 150,000€ in Riga's real estate sector or 75 000 € in other regions, or if they have invested 300,000€ in a credit institute or abounded the social capital of a Latvian business with at least 37,500€. This enables real estate investments to a total of 360 million €. The banking sector has enjoyed a windfall of 76 million €. In exchange 2,366 investors received a residence permit including nearly 1,900 after a property purchase.

In regard to these factors the ECB wants Latvia to implement rapidly a range of measures designed to rise to the risks that weigh over financial stability. It is inviting the Latvian authorities to limit its banking sector's dependency on non-resident deposits. Latvia has therefore created a tool in this domain: local banks are indeed obliged to increase their capital as soon as these deposits rise above 20% of their assets. The growth rate of these non-resident deposits in their assets can also lead to an obligation to inject fresh capital. It remains that this assessment is undertaken on an annual basis whilst deposit volatility is gauged over a shorter period. The insurance premium requested of banks by the Latvian Deposit Guarantee Fund for non-resident deposits is also three times that demanded on local deposits. These instruments are all the more important since the future Banking Union will only enable the supervision of the country's biggest three banks.

In addition to this the ECB, just like the European Commission is insisting that the Latvian government quite resolutely implements anti-laundering regulations. The Council of Europe's Committee of experts on the assessment of measures to counter the laundering of capital and the financing of terrorism (MONEYVAL) deemed in July 2012 that Latvia was indeed implementing international recommendations in this domain.

Public Opinion and the Euro

The adoption of the single currency has not been accepted by all of the political parties as shown by two votes in Parliament on the bill concerning how the transfer over to the euro was to take place. The emergency procedure required for the examination of this text planned for two readings. The two votes highlighted a real split over the issue: 53 votes in support 35 against in December 2012 then 52 votes in support, 40 against and 2 abstentions a month later. However MPs did not turn to the procedure planned for in article 72 of the Constitution whereby 34 MPs can ask for the adjournment of the promulgation of the bill. This reticence was echoed within the population. A survey published at the beginning of June 2013 indicated that only 36% of Latvians supported the euro. The government has expected a great deal of an information campaign on the introduction of the European currency which started mid-July. Some NGOs for their part have vainly tried, with the launch of several petitions, to push for a national referendum on the matter.

Conclusion

Accession to the Economic and Monetary Union seems automatic as soon the convergence criteria have been met by a candidate country. The adoption of the euro is the logical goal of every EU Member State, except if it enjoys dispensation like Denmark and the UK. The major crises that have affected five of the 17 countries in the EMU are however causing for a certain amount of caution. In this regard Latvia might prove to be a case study and now the effectiveness of the supervision mechanisms that the zone has created over the last two years can be put to the test.

The *six-pack*, adopted in December 2011, notably includes an excessive imbalance procedure designed to pinpoint a certain number of risks that weigh over a Member State's economy: competitiveness deficit, speculative bubble, private debt etc. 10 indicators have been selected for this purpose. The Council can

then address recommendations to the States involved and implement sanctions if these are not respected. If the trends seen in Latvia regarding inflation and especially the share taken up by non-residents in the banking system become a reality then it would be time to implement these measures.

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