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What Could Go Wrong on the Way to EMU? The Case of Latvia

Possible Development Scenarios

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Abstract

In May 2004, the Republic of Latvia joined the EU, so now the next step towards full European integration is to become a member of EMU, which involves adopting the Euro. Currently, Latvia has a 'country with derogation' status and the earliest possible year to join EMU is 2008. In order to be able to converge with the existing EU Member states and to become a full-fledged member of EMU, Latvia and the other new EU Member states have to comply with the Maastricht criteria and with the norms of the Stability and Growth Pact. This study aims at analyzing possible future development directions for Latvia prior to actual entry into EMU by identifying leading areas of flaws that could hold back Latvia from joining EMU in 2008. To answer this question, the study utilizes scenario-planning methodology for identifying key forces for change. The results demonstrate that the most ambiguous factors on the way to EMU are the level of inflation rate and the government budget deficit. Consequently, based on these findings four future state scenarios are developed and their implications are analyzed.

Keywords: EMU, Euro, scenarios, Maastricht criteria, inflation, government budget deficit

1. Introduction

In May 2004, ten Central and Eastern European countries[1] (CEEC), including the Republic of Latvia, joined the European Union (EU). The Treaty establishing the European Community, Article 122 (2002) states that the new EU Member states will not have the right to remain outside the Economic and Monetary Union[2] (EMU), unlike the cases of Great Britain, Sweden, and Denmark. For Latvia this implies that the next step towards full European integration is to fix the Latvian national currency (the Lat) to the Euro in accordance with the exchange rate EUR/LVL as at 30 December 2004[3], to be followed by entry into the Exchange Rate Mechanism II[4] (ERM II) at the beginning of 2005. This implies that Latvia will inevitably, sooner or later, become a member of the EMU, which involves adoption of the Euro as the national currency.

The Treaty on European Union[5], Article 109k (1992), points out that in the initial stage the new EU Member states, which remain outside the Eurozone have "countries with derogation" status. Before becoming full-fledged members of the EMU, Latvia and other new EU Member states have to comply with the Maastricht criteria[6] and with provisions of the Stability and Growth Pact[7], in order to be able to converge with the existing EU Member states in a united monetary union.

1.1 Relevance of the Study

Since Latvia has become a member of the EU, much discussion is taking place regarding the costs and benefits associated with the common currency and the consequences of having it on the economy of Latvia. At the same time one can observe obscurity and confusion in the society of Latvia about what the process of adopting the Euro is going to look like in the next

[1] The Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia, and Slovenia. Mediterranean countries Cyprus and Malta are added to this sample for convenience.
[2] An agreement by participating European Union Member countries that includes protocols for the pooling of currency reserves and the introduction of a common currency (Answers.com, *European Monetary*, 2005).
[3] The rate according to which the Latvian national currency (the Lat) was fixed to the Euro on 30 December 2004 –0.702804 EUR/LVL.
[4] The European Exchange Rate Mechanism (or ERM) was a system introduced by the European Community in March 1979, as part of the European Monetary System (EMS), to reduce exchange-rate variability and achieve monetary stability in Europe, in preparation for Economic and Monetary Union and the introduction of a single currency. In 1999, ERM II replaced the original ERM (Answers.com, *European Exchange*, 2005).
[5] The Treaty on European Union (formal name for the Maastricht treaty,) was signed on 7 February 1992 in Maastricht between the members of the European Community and entered into force on 1 November 1993. It led to the creation of the European Union and was the result of separate negotiations on monetary union and on political union (Answers.com, *Maastricht*, 2005).
[6] The four nominal convergence criteria – price stability, government finances, exchange rate and long-term interest rates - are presented in Article 121(1) of the Treaty establishing the European Community (EC Treaty). They are set out in the Protocol on the convergence criteria referred to in Article 121 of the EC Treaty and reflect the degree of economic convergence that Member States must achieve (Europa.eu.int., 2003).
[7] The Stability and Growth Pact is an a agreement by the European Union member states related to their conduct of fiscal policy following Economic and Monetary Union (Answers.com, *Stability*, 2005).

years prior to EMU membership. One of the latest studies made by EOS Gallup Europe upon the request of the European Commission (2004) indicates that Latvians are the least eager to adopt the Euro, mainly because they do not have any interest in this issue, due to lack of knowledge.

Preliminary interviews and presence in the meeting of the Economic Council in the Ministry of Economics (2004) revealed that even among high-level officials uncertainty was present about the process of adopting the Euro. One of the key institutions involved in the process – the Central Bank of Latvia (further the Bank of Latvia) - is striving to provide information; however, it has rather a general nature as there are still many unclear issues about the events that are going to take place in the next few years. Despite the fact that there is ambiguity about what could happen in the next two years, analyzing possible future directions helps to identify the major areas of flaws and allows policies to be designed in a more grounded way. This study is vital in the Latvian context for several reasons. Firstly, it is inevitable and only a matter of time, when Latvia will become a member of EMU. Secondly, this paper helps to identify areas that are most problematic for Latvia in the convergence process and that could prevent successful adoption of the Euro in 2008. It also takes a wider look at future development trends without concentrating on one single plan and helps to prepare for diverse events that could possibly occur.

1.2 Research Question

The research concentrates on identifying possible obstacles and developing most likely scenarios for the events that could occur in the period prior to 2008, which is the year when the Bank of Latvia has provisionally planned to substitute the Lat with the Euro. The main aim of this study is to develop and analyze possible future development directions for Latvia by identifying leading areas of flaws that could hold back Latvia from joining EMU in 2008.

Consequently, the main value added of this paper is the exploration of four possible future developments based on Schwartz's scenario building steps by taking into account current economic conditions and views of experts in the field. The authors identify major concern areas and determine the most likely implications for Latvia on the way to EMU.

The situation of the new EU Member states is not comparable with the experience of the current EMU Member states on their way to membership due to the economic and political circumstances; therefore no comparison with these countries will be presented. Besides, the authors also delimit themselves from presenting analysis on the potential consequences of the introduction of structural and cohesion funds in Latvia as this lies

beyond the scope of this study. Moreover, in this research the analysis of future developments is prepared for the whole country without focusing on distinct sectors.

The outline of the paper is as follows: section 2 presents the literature overview on the subject under investigation. The strategy of Euro-adoption prepared by the Bank of Latvia and arguments why it would be valuable for Latvia to join EMU in 2008 are also presented in this section. Section 3 takes a look at the methodology and data collection methods applied in this research. Next, in section 4 the analysis using Schwartz' scenario-building steps is presented: this includes identification of the major issue, isolation of key drivers, as well as exploration of four possible future development directions. Section 5 comprises a presentation of the leading indicators and signposts in relation to the scenarios developed. Finally, section 6 makes concluding remarks and provides suggestions for further investigation.

2. Review of Literature

When making secondary data research the authors discovered that in the course of the last few years the number of studies on EMU has been steadily increasing. Different authors have taken diverse approaches to researching EMU and issues concerning it. This section provides brief background information on EMU, as well as the classification from global view to Latvian case of research done in this field and justification of the chosen approach to this paper (see Appendix A).

One group of researchers uses the Optimum Currency Area (OCA) theory and attempts to evaluate how much EMU complies with the criteria for being an OCA. The founder of this theory is Mr. Mundell, who published his work "A Theory of Optimum Currency Area" back in 1961. In the paper he argued that if there is perfect internal and external factor mobility, then a common currency area can perform inflation control and stabilization of growth for the region (Afxentiou, 2000).

The OCA theory was further elaborated by McKinnon and Kenen. Their researches are important pertaining to their helpfulness in determining whether the Maastricht criteria, which are the measures for nominal convergence[8], are effective rules for monetary and fiscal stability. They emphasize that the Maastricht criteria must operate within an environment characterized by economic homogeneity, not by internal or external economic disparities and disequilibria or, in other words, fulfill conditions of the OCA (Afxentiou, 2000). In the

[8] Compliance with the Maastricht criteria.

majority of papers it is argued that EMU is on the way to become an OCA; however, at present it does not fulfill all necessary criteria for being one (Blejer et al., 1997).

Other researchers use diverse tools to determine the costs and benefits for countries that are already members of unions with a single currency or are just about to become members. These researchers can be classified into several clusters according to the scope of countries under investigation. These researches range from investigations on global market performance such as the paper "One Money, One Market: Estimating the Effect of Common Currency on Trade" written by Rose (2000) to researches written specifically about Latvia and the Baltic States – "Impact of the Euro adoption on the Economy of Latvia" by Kaužēns and Bitāns (2004). "Convergence Programme of the Republic of Latvia 2004 – 2007" (Republic of Latvia, Ministry of Finance, 2004) and report on "Economic Development of Latvia" (Republic of Latvia, Ministry of Economics, 2004) prepared in December 2004 were used, because the authors recognized the importance of the current state of Latvia's economy and provisions made by the Latvian government and the Bank of Latvia. The papers were very helpful in preparing the most likely future development projections and identifying the most variable macro economic factors.

In addition, valuable researches for this paper are those written about the CEEC countries on the way to EMU. An important asset was the research "European Monetary Integration after EU Enlargement" conducted by Gern, Hammermann, Schweickert and Vinhas de Souza (2004). This paper describes and analyzes the situation in the EU after enlargement. In addition, it gives a thorough background overview about the achievements of the potential EMU Member states, as well as dealing with implications for the exchange rate regimes in different countries and their suitability.

Besides, the authors have come across a paper that offers an alternative strategy to joining the EMU, a paper written by two Polish professors Bratkowski and Rostowski "The EU attitude to Unilateral Euroization: misunderstandings, real concerns and ill-designed admission criteria" (2001). The paper presents a grounded critique of the current accession procedure and offers an alternative strategy, the so-called unilateral euroization[9], which means that the Euro is introduced in a country before the actual decision power in the European Central Bank (ECB) is given to an individual country. Thus the professors argue that this way a country can enjoy the benefits of the common currency and can converge better and faster than through participation in ERM II. However, further in this paper the

[9] As proposed by Rostowski, "unilateral euroization" means that euroization would be implemented by buying the necessary euros using a country's international reserves and before the country becomes a member of Economic and Monetary Union (2005).

authors do not consider this strategy for the Latvian case, as the European Commission has clearly stated, it will not be offered for any of the potential EMU Member states (2001).

During the preliminary research phase, the authors discovered that there are few working papers written about the period between ERM II and full EMU membership. Those relating to this period attempt to determine what currency regimes should be employed (fixed vs. floating). The authors could not find any paper that would attempt to answer the "what if" question and would suggest strategies for avoiding possible obstacles.

2.2. Strategy of Euro Adoption: Bank of Latvia

Euro introduction strategies are rather similar for all ten new EU Member states, because the main aim is to converge with the level of the existing EMU countries, and this is determined by using nominal and real convergence criteria[10]. In this section, the authors present the Euro adoption strategy prepared by the Bank of Latvia, in order to identify and explain the most important phases on the way to EMU.

The Bank of Latvia has adopted a strategy that takes into account both the requirements set out in the EU treaties and wishes expressed by domestic entrepreneurs and financial specialists. In the research carried out by the Bank of Latvia in 2003, it was discovered that Latvian entrepreneurs would like to have at least one year from the date of referendum (20th September, 2003) to prepare for the upcoming changes when the Lat is untied from the SDR currency basket and fixed to the Euro (Bērziņa, *Personal interview*, 2004). The option of pegging the Lat to the Euro was not considered before the referendum, because this 'vote' was crucial to determine if any further negotiations on EMU are meaningful to be carried out (Rimšēvičs, *Kas notiek Latvijā?*, 2005). This meant that for Latvia the closest date when the Lat could be fixed to the Euro was the 1st of January 2005. Initially it was planned that Latvia would enter ERM II in the same month, indicating that in 2007 the Convergence report on Latvia's compliance with the Maastricht criteria could be prepared. January 2008 is the closest date that Euro introduction could be started (see Appendix B).

On the 1st of January 2005 the Lat was fixed to the Euro according to the exchange rate as at December 30th 2004, which was 0.702804 LVL for 1 Euro. Vigorous debate took place immediately after the fixing, arguing whether this was the appropriate time for Latvia to fix its currency to the Euro. Some of the proponents for revaluation of the Lat argued that pegging at this value could be an additional drive for further inflation growth (Grostiņš, 2005). However, as the president of the Bank of Latvia Mr. Rimšēvičs (*Kas notiek Latvijā?*,

[10] Also referred to as the Copenhagen criteria. These principles of the European Union are formally described as Membership criteria of the European Union. Any European country that respects the principles of the European Union (democracy, human rights, rule of law, market economy, minority protection) may apply to join.

2005) stated, there is never a right time for fixing a currency, because at different times the peg is favorable for different players in the domestic and foreign markets. The major advantage achieved with the fixing is that from year 2005 the exchange rate risk in deals with Euro countries is eliminated.

Each country has to participate in ERM II at least for two years and during this period the domestic currency of a country cannot exceed a ±15% fluctuation limit against the Euro (Focus group discussion, 2004). The Bank of Latvia has decided to keep the previous fluctuation corridor for the currency, which is ±1% instead of the ±15% as required by the ECB (Bitāns, *Latvijas Bankas*, 2004). Thus, Latvia continues to pursue its policy of fixed exchange rate that has been employed for many years and has proved to be appropriate for such a small and open economy as Latvia (Bitāns, *Latvijas Bankas*, 2004).

2.3. Benefits of Timely Entry into EMU

It is essential to understand the positive aspects about joining EMU as early as possible to justify the goal of the Bank of Latvia and the government of Latvia to join EMU in 2008. The main argument for having a single currency that is mentioned by the majority of researchers involves abolishing the national currency, which ought to lower all costs associated with changing and trading with different currencies (Baimbridge et al., 2000). For Latvia this would imply that there would be no transaction costs when trading with Euro countries, which constitute at the moment 61.8 % of Latvian exports (Dombrovsky, 2005). The exchange rate risk with the Euro countries was eliminated when the Lat was pegged to the Euro; however, there are still slight transaction costs involved that could be fully abolished once the Euro is introduced in Latvia.

Greater price transparency (Healey, 2000) is another benefit mentioned in the debate on Euro adoption. Having the Euro in the majority of European countries will allow producers and end consumers to make easier comparison of prices for different goods, identify unjustified price differences and when possible switch to more competitive suppliers (Healey, 2000).

Moreover, a common currency is one of the instruments to ensure stable and low inflation in a particular region. The ECB is one of the most independent banks in Europe and its main task is to ensure that inflation within the region is stable and around two percent (Alm, 2004). In Appendix C it can be observed that the ECB has been rather successful in ensuring stable inflation over the last two years.

Besides, participation in EMU leads to lower long-term interest rates because of eliminated exchange rate risk and lower average inflation. This in turn should boost investment and development of the country (Baimbridge et al., 2000). At the moment Latvia is already receiving considerable investment especially from the current EU counterparts (Republic of Latvia, Ministry of Economics, 2004). This facilitates modernization of production and introduction of new and more productive technologies (2004).

In case Latvia postpones membership in EMU for a longer period than the foreseen two years from now, this might lead to unwanted consequences such as outflow of investments and loss of potential markets to more successful countries like Slovenia, Lithuania, and Estonia, if they manage to join EMU much earlier than Latvia (EastCapital.com, 2004).

The ability of policy makers in a particular country is tested by applying the same criteria as were used for other EMU Member states on their way to full membership to see whether they can ensure balance of the government budget, along with stable inflation. This means that the sooner the requirements of the Maastricht criteria are achieved and fulfilled, the sooner Latvia proves its ability to participate as a full-fledged member in monetary union and to take part in the decision-making process in the ECB.

3. Methodology

This paper demands from the authors to take a long-term view on the policies developed and to take into consideration possible future developments, indicating that the research has to be qualitative (Schwartz, 1996). In order to ensure that a country is not caught by surprise once an unexpected development occurs, the Scenario – planning methodology can be employed. The Scenario – planning methodology is an appropriate tool because it helps to identify critical factors and contemplate diverse possibilities for the future, while combining experiences from other countries and events of the past. As pointed out by Peterson et al., the strongest aspect of scenario-planning methodology is "increased understanding of key uncertainties, incorporation of alternative perspectives into conservation planning, and greater resilience of decisions to surprise" (2002, 358). Moreover, this methodology does not try to predict the future, but instead, attempts to develop possible future trends and patterns of environment by manipulating critical forces in diverse future directions (Nakicenovic, 2004). By considering different directions in the future, scenario-building helps to anticipate the future via recognizing possible areas of flaws and suggesting necessary action to overcome them. As proposed by Schwartz (1996), it is optimal for a research to develop four different scenarios to overcome the "golden midway" scenario bias. The scenarios developed should

be descriptive, meaning "evolutionary and open-ended, exploring paths into the future" (Nakicenovic, 2004) (see Appendix D).

4. Scenario-Building Steps

In the next section, scenarios are built with the help of the Scenario – planning steps developed by Schwartz. Initially, the major issue of this research is specified, and the key drivers identified. This is followed by an analysis of the most uncertain, but at the same time the most important forces of change, and exploration of four possible future development directions. Finally, implications are developed and sign points identified for all scenarios.

4.1 Specify the Major Issue or Decision

After secondary data research, focus group discussion and interviews, the authors recognized that the fundamental issue in this research was analysis of possible future development directions for Latvia prior to the actual entry into EMU by identifying leading areas of flaws that could prevent Latvia from joining EMU in 2008.

4.2 Isolate the Key Drivers

The scenario development process began by determining key variables on which will depend whether Latvia will become a member of EMU in the next two years or not. The authors identified these factors with the help of the secondary data review, the experts from the focus group, and the e-mail survey. The situation in regard to these factors is described as of January 2005 with the latest data available.

The most obvious variables that must be accounted for are the Maastricht criteria that are measures for nominal convergence.

Inflation – change in consumer price index over a certain period (usually one year)– is a convergence criterion that is rather hard to sustain low for a long time. According to the Maastricht Treaty, inflation in a potential EMU candidate country cannot exceed the average of the three EMU Member states with the lowest inflation by more than 1.5 % (Ledrut et al., 1999). In 2004, the inflation rate in Latvia reached 7.2% (Republic of Latvia, Ministry of Economics, 2004), which far exceeded the required level (reliable data for 2004 are not available yet; in 2003 the required level was 2.7 %, see Figure 6), indicating that this criterion could present a certain concern. Several components make up the inflation rate: price of raw materials, price of fuel, administrative prices, level of the EU countries prices, exchange rate, price of imports, and other nondescript variables (Bēziņa, *Eiro ieviešana*, 2004).

Fiscal budget deficit – excess of government expenditure over government revenue in a given year (Weerapana, 2002) – is not allowed to exceed 3 % of the Gross Domestic Product

(GDP) in the corresponding country. This criterion has crucial meaning in ensuring the long-term stability of the Euro, which is why EMU applicant countries have to prove they can limit the budget deficit of the country; this criterion has been strongly emphasized in the Stability and Growth Pact. For the long-term prosperity of the Eurozone, countries are encouraged to limit their fiscal budget, because an extensive budget deficit could lead to inevitable increase in demand for printed money and in the longer run to increased inflation (Ofmanis, 2002). At present the projections for Latvia are that the government will be able to keep its budget deficit balance at the required level. However, this criterion is easily influenced by unexpected events and policies chosen by parties in power (Focus group discussion, 2004).

Long-term interest rate convergence: this criterion indicates that the average long-term nominal interest rate should not exceed 2 % of the average interest rate of the three EMU Member states with the lowest inflation. It is essential to ensure that investment in all EMU Member states increases at a similar rate, so that the Euro can be kept as an actable currency (Ofmanis, 2002). The representative from Unibanka, Mr. Krūmiņš, indicated that for Latvia, interest rates would emulate those of EMU countries in the first half of 2005 (2005). In addition, also specialists from the Bank of Latvia did not envisage any difficulties in complying with this criterion after the Lat had been fixed to the Euro (Focus group discussion, 2004). Appendix E shows the trend of interest rate developments for Latvia over the past eight years.

Government debt is “the total amount of outstanding loans owed by the government” (Weerapana, 2002, 4). The excessive debt criterion states that “the stock of the outstanding debt should not exceed 60% of the GDP” (Ledrut et al., 1999, 17). The criterion is also crucial for the financial stability of EMU. In recent years the government debt of Latvia has not exceeded 14 % of GDP (see Appendix F). Soon Latvia will have to start repaying the debt; however, as pointed out by Mr. Krūmiņš, there should be no threats to compliance with this criterion (2005).

Exchange rate fluctuation: this criterion postulates that the currency of future EMU Member states has to be in ERM II without revaluation or devaluation for at least two years (Ledrut et al., 1999). The average fluctuation of a domestic currency in the two years prior to membership in EMU must be within ±15% limits. The Bank of Latvia has decided to continue the fixed exchange rate policy that was employed previously, which means that the Lat will be allowed to fluctuate against the Euro by no more than ±1 % (Focus group discussion, 2004).

Current account balance is a significant real convergence factor that must be taken into account when evaluating Latvia's prospects for joining EMU. At present the current account deficit is rather large for Latvia "due to high domestic demand and steep growth of investments in particular" (Republic of Latvia, Ministry of Economics, 2004, 10). In the first half of 2004 it exceeded 13.6 % of GDP (2004). In recent years Latvia has faced a strongly negative current account balance due to a negative trade balance constituting 20.7 % of the GDP in the first half of 2004 (2004). These developments can be largely explained by rapidly growing internal demand that stimulates the growth of imports. This deficit is partly covered by a positive balance of services of which 57.7 % must be attributed to transportation services (2004). Another phenomenon that can be observed in Latvia is that domestic savings have not been changing very much over the last few years, while investments have been rapidly growing, thus this has served as an additional reason for an increased current account deficit.

Euro/dollar fluctuations is one of the factors that could influence the Latvian economy, but it cannot be influenced anyhow by Latvian internal policies. From the beginning of January 2005, the Latvian Lat is fixed to the Euro, indicating that now the Lat will fluctuate against the US dollar exactly by the same level as the US dollar will fluctuate against the Euro (see Appendix G). In the next two years the Euro/dollar interrelationship will mainly affect those industries that will continue trade with dollar-countries and other non-Euro countries without hedging their deals and insuring against the exchange rate risk. This has been proved by the weakening of the US dollar that took place at the end of 2004 and the influence it left on the timber industry, which was benefiting in the short-run from cheap imports from Russia and expensive exports to Great Britain (Jordāns, 2005).

Additionally, the fuel price is another factor that could indirectly influence Latvia's prospect for joining EMU in 2008, but cannot anyhow be affected by Latvian governmental parties, as the fuel price is dependent on Euro/dollar exchange rate fluctuations (Weller, 2004). Higher fuel prices can lead to increase in price of other goods and cause problems in the logistics industry.

GDP growth – Latvia has the highest economic growth rate in the EU; in 2004 the annual GDP growth reached a striking 8.5 % (Republic of Latvia, Ministry of Economics, 2004) (see Appendix H). High growth was mainly attained "due to stable domestic demand dynamics and ability of Latvian companies to expand their export markets" (2004, 8). Although increased growth of the country's economy is desirable, at the same time it involves certain risks. For instance, it can lead to 'overheating of the economy', thus influencing not only the inflation rate, but also the financial stability of the country.

4.3 Select Several Drivers that are Both Important and the Most Uncertain

During the research process, the chosen research methods were applied with the aim of identifying the key drivers for change in the Latvian economy prior to full EMU membership. The focus group participants and e-mail survey respondents named different powerful and influencing factors, such as the EUR/USD exchange rate, oil prices, economic development in the new EU Member states, GDP growth and other factors as presented above. Despite the fact that different key drivers were identified, all experts involved in this research agreed that the most significant, but at the same time the least predictable key drivers in the Latvian economy in the next few years are going to be the inflation rate and the government budget deficit.

Looking at the historical development of the inflation rate, one can observe that after fixing the Latvian Lat to the SDR currency basket the very rapidly growing consumer price index slowed down. Since 1999 the inflation rate was rather stable and low, amounting to less than 3%; however, in 2004 a significant increase was observed, reaching its peak of 7.2% in November (see Appendix I).

In order to understand the fluctuations of the inflation rate in Latvia, one has to recognize the components and factors that constitute inflation level. The backbone of inflation is consumer price core inflation, which characterizes the overall inflation pattern excluding short-term supply side shocks. Fluctuations in basic-inflation may arise due to exchange rate fluctuations, import amplitude, the inflation rate in major trading partner-countries, changes in production costs, inflation expectations, as well as internal demand (Bērziņa, *Factors influencing*, 2004). Other important factors that influence the inflation rate are unprocessed food prices, administratively regulated prices, and fuel prices. The importance of these factors depends on overall trends both globally and locally such as bad harvest and local tax policies (see Appendix J).

Looking at the historical development of the government budget deficit in Latvia, it is clear that over the last decade Latvia has been able to hold the level of budget deficit within acceptable boundaries. There have been years, for instance 1999, when Latvia's fiscal position had worsened due to the budget deficit exceeding 3% of GDP. In 2003 the situation regarding the budget deficit improved and fell to 1.6%; in 2004 government expenditures exceeded revenues by more than 2%, indicating that the fiscal position in Latvia is rather volatile. However, the Ministry of Finance envisages and promises to keep the budget deficit within 2% for the next two years (see Appendix K).

In periods when the economy is experiencing recession and budget revenues decrease, worsening of the budget deficit would be acceptable. Budget deficit is influenced by cyclical and structural factors, which is why during a growth period, the country should follow tighter fiscal policy, in order to be able to stimulate growth and compensate for periods of recession. In the case of Latvia, the budget deficit should be more affected by structural or discretionary components; however, in recent years Latvia has been experiencing sharp economic growth, thus large cyclical fluctuations have been dominant (Republic of Latvia, Ministru Kabinets, 2003). Cyclical factors are mainly unemployment allowances, tax revenue, and other components that influence budget income and expenses, but structural factors are related to discretionary policy employed by a government in normal economic surroundings (2003).

4.4 Scenarios – Exploration of Possible Future States

In the previous section, two of the most important, but at the same time the most uncertain forces of change on Latvia's way to EMU, meaning inflation and the government budget deficit, were identified. The authors would like to point out that they do not intend to manipulate with different positioning of drivers in each of the quadrants, but instead define thresholds for each of them. Both of the key drivers will be set based on the Maastricht criteria requirements, so the threshold for budget deficit is set below or above 3% of GDP, similarly for inflation – this will be set below or above the average of the three EU Member states with the lowest inflation plus 1.5% (see Appendix L).

Depending on the quadrant in which the scenario is depicted, possible global development trends in the world economy that could affect Latvia's way to EMU are illustrated and analyzed. The authors look at possible economic developments in the U.S.A, as it has been stressed in the report "Economic development of Latvia" prepared by the Ministry of Economics, that "the guide of the world's economic growth and development is the U.S.A." (2004, 13). Moreover, at the beginning of every scenario, an overall picture of the situation in the EU and Latvia is portrayed, and depending on its intricacy, an inherent name to each scenario is given. Looking at how inflation and the budget deficit are positioned in Figure 9, analysis of possible causes for these key drivers is presented. Additionally, this is followed by analysis of other key forces of change identified in the previous section in relation to the assumptions made in each of the scenarios (see Appendix D). The analysis is based on relationships and tendencies regarding the key factors stemming from the current situation in the global economy, the EU, and Latvia. The authors would like to underline that time effect as well as volume effect of events are not elaborated in the scenarios, as this is usually the purpose of quantitative research that uses econometric models. Implications of

every scenario, possible solutions of how to timely overcome the problems identified, while the likelihood of a particular scenario's occurrence is discussed further in the paper.

Current Situation

The current situation in the U.S.A. and the EU is briefly presented, to get a better understanding of relationships and tendencies depicted in the scenarios.

The U.S.A.

In late 2004, the Financial Times reporter, Mr. Wolf, presented his analysis of the current situation in the U.S.A., pointing out that the country is experiencing rising deficits and debt, both external and fiscal, which may endanger its credit in the world, as well as the global role of its currency (2004). Currently, the U.S.A., the impeller of the world economy, continues to experience steadily increasing problems with its current account deficit, despite recent trends with respect to US dollar depreciation against the Euro. Recent depreciation of the US dollar has been the first step towards "returning the current account balance of the U.S.A. to a reasonable level" (Bivens, 2004). As stated by Mr. Bivens (2004), "the current U.S.A. international debt path is damaging to future U.S.A. living standards". This has not yet happened only because interest rates in the U.S.A. historically have been low and borrowing has been cheap, but as soon as interest rates begin to rise, the consequences might be unpredictable. So far the economic development and growth rate has been steadily increasing, amounting to 3-4% per year (Rosenberg, 2004).

The EU

During recent years, the pace of economic development in the EU has been rather low at around 1-2% per year and has mainly been based on external demand (Republic of Latvia, Ministry of Economics, 2004). As notified by DekaBank, "the Euro zone is currently suffering from an economic slump that is the direct result of the weak economic stimuli from the global economy" (2004, 1). Many articles suggest that most likely growth in the EU will remain rather weak; however, currently existing high purchasing power would serve as a basis for the prosperity of the EU's economy in the future (Parais, 2005).

Scenario – 'S.O.S.'

This scenario comprises steadily increasing growth and improving economic development in the U.S.A. Regarding the US dollar, one can observe a continuing decrease in its value against the major world's currencies. As stated by Wolf, high growth in the U.S.A. will most

likely magnify imports even further in comparison to exports, despite the fact that the US dollar has become weaker (2004). This scenario indicates further problems with the current account balance and government debt in the U.S.A.

In the past few years, the old Member States of the EU[11] have continued to experience a rather low pace of economic development. The development of the EUR/USD implies that the US dollar is becoming slightly weaker, but the Euro is becoming indistinctively stronger, around 1.36-1.40 EUR/USD; such a situation may cause problems for the EU in regard to competitiveness, as a stronger Euro makes exports from the EU comparably more expensive.

Since 1999 Latvia has been growing at a quite remarkable pace, reaching 8.5% of GDP growth in the third quarter of 2004 (Statistical Bureau of Latvia, 2004). Following the four phases of a cycle of economic development proposed by Schumpeter, after a period of extrinsic growth, it would be coherent for Latvia to experience recession in its economic development (Cycles: some empirical issues, 2004). Also, World Bank analysts have indicated that starting from 2005 growth in Latvia might decrease, initially to 6%, and then even further (Republic of Latvia, Ministry of Foreign Affairs, 2005).

Despite many investigations carried out, still considerable discussion regarding the relationship between growth and inflation is present, but as pointed out by Khan and Senhadji, "the empirical results strongly suggest the existence of a threshold beyond which inflation exerts a negative effect on growth, the threshold for developing countries is 11–12 percent" (2001, 19). In the case of a slowdown in the Latvian economy, the inflation rate most probably will not diminish and will still exceed the average of the three EU Member states with the lowest inflation by more than 1.5%. Moreover, as the revenues of the Latvian government cannot be increased so fast, especially if the economy is experiencing recession, but the government keeps on spending inexpediently, then the budget deficit is going to exceed the preset Maastricht criteria - 3% of the GDP.

As this scenario comprises problems of compliance with these two Maastricht criteria (inflation and budget deficit), the name 'S.O.S.' was given.

Government Budget Deficit

As noted above, development of any economy is exposed to periods of growth and recession. In this scenario the Latvian economy after a period of remarkable growth is experiencing a slowdown. Saleh performed thorough studies about the relationships between budget deficit and macroeconomic variables; he stresses that there are many empirical studies that detect

[11] UK, Germany, France, Spain, Italy, the Netherlands, Belgium, Ireland, Greece, Luxemburg, Portugal, Austria, Sweden, Finland, Denmark

"significantly negative effect of public consumption expenditure on growth" (2003, 40). Indicating that such a slowdown most probably will leave a negative impact on the government budget of Latvia. Besides, due to frequent changes in government, Latvia employs a somewhat short-term fiscal policy, and it lacks a long-term view on policies being developed. Ruling coalitions within the Latvian government change too often, political parties come and go, all this portrays a rather instable political situation. During the period of economic growth (1999-2004), the Latvian government tried but did not succeed in improving budget deficit, and continued to spend its revenues on the usual expenditures. Basically, the Latvian government was employing a short-term strategy; although it knew that economic slowdown could be faced at any moment putting even higher pressure on the budget. One should not forget that soon (in October 2006) the 9th Latvian parliamentary elections are coming. As previous experience shows, political parties that hold office tend to make popular decisions in the last months before elections, promising higher salaries, pensions, and other social allowances. Such a situation might worsen the first months of a newly established government in 2007, just when the Convergence Report is to be prepared.

Consequently, economic slowdown combined with an unstable political situation in Latvia could worsen the government budget, because government revenues cannot be increased as much as during a growth period and at the same time expenditures cannot be cut down so strictly, which means the budget deficit is probably going to exceed 3% of GDP.

Inflation

In 2004, inflation in Latvia increased unexpectedly, fast reaching its peak in November. This was caused by many imponderable factors, such as the increase in administrative regulated prices, higher price of natural gas, increase in excise tax due to higher oil prices, as well as increase in prices of unprocessed food due to a poor harvest (Bērziņa, *Factors influencing*, 2004). Nevertheless, the Bank of Latvia and the Latvian government are very optimistic and have declared that inflation in 2005 will decrease to 4.5% (2004).

As pointed out by Khan et al. (2001), the slowdown in the Latvian economy should not affect the inflation rate, as growth is not going to exceed 11-12% per annum, so inflation should continue to be rather high. In the next two years prior to joining EMU, high inflation can be attributed to an increase in consumer price core inflation, which in turn is caused by higher expectations of inhabitants regarding inflation, the EU price level, and EUR/USD exchange rate fluctuations. To note, if there are high expectations for inflation in a society, meaning that people expect increase in prices, but at the same time realize that their salaries remain at the same level, then overall dissatisfaction is observed. Moreover, in such a

situation there exists a possibility of internal crises, which in turn might leave a negative impact on the government budget. As the prosperity level in Latvia is rather low compared to other EU countries, society in Latvia is more sensitive towards increases in the inflation rate. Past experience shows the most sensitive sectors with respect to increased prices are health, education, and agriculture.

Weller and Lilly (2004) have performed calculations of correlation coefficient between oil and the US dollar (-0.7), indicating that most of the time when the US dollar fell against the Euro, oil prices rose. As this scenario suggests, the EUR/USD exchange rate continues to lower, indicating that increase in fuel prices is unavoidable, which puts even higher pressure on the inflation rate.

Other Key Factors

Currently, around 55% of imports to Latvia come from EU countries, and as the Euro continues to be strong against the US dollar, importing from Eurozone countries is becoming more expensive (Bērziņa, *Lata piesaiste*, 2004). In addition, if fuel prices rise, then one should expect increase in transport costs and further this could leave an impact on import prices, worsening the current account balance even further.

With respect to government debt, one can observe a rather optimistic picture so far, but in order to be able to solve internal problems that arise from economic slowdown, the Latvian government might need to borrow from the International Bank for Reconstruction and Development or Eurobonds; however, it still should not exceed the Maastricht criteria, which is 60% of GDP.

Implications

The convergence report prepared about Latvia in 2007 concludes that Latvia has not been able to maintain low inflation and employ tight fiscal policy, meaning it does not comply with the Maastricht criteria, thus continuing to have ‘country with derogation’ status. Latvia is forced to wait at least one more year, when the next convergence report is to be prepared by the Council of Ministers of Finance.

While experiencing a growth period, Latvia should employ tighter fiscal policy and try not to spend so much, but instead save something for the “bad” times. Moreover, it would be essential for the government and the Bank of Latvia to communicate clearly to the general public the downsides of inflation expectations, and be careful when making key decisions.

Scenario – 'Overheating'

This scenario implies that the EUR/USD exchange rate is becoming stable at around 1.2 EUR/USD, meaning that the U.S.A faces continuing problems with its current account deficit. As the US dollar becomes stable, oil prices return to the usual level around 30 USD per barrel (Lafayette Economic Development Authority, 2003). The scenario comprises continuing problems in the U.S.A. with current account deficit level and probable threats of increasing interest rates.

Growth of the Eurozone countries is going to be around 1.5-2% per year, but still with no signs of rapid future economic development (Banka Paritāte, 2004). Domestic demand and especially private consumption still continues to be relatively weak, and the main driving force of the EU growth is going to be exports (Banka Paritāte, 2004). This means that in regard to imports and exports the situation in the EU is becoming more stable; although the U.S.A. is still more competitive, it does not have such a large impact on the EU as when the EUR/USD exchange rate has been incommensurably high.

Despite the slow pace of growth in the EU, Latvia continues to experience very rapid economic development reaching 9-10% in 2005. As explained by Mr. Rimšēvičs, quite clearly a slowdown in pace of industrial production development had been observed in 2004, but at the same time such fields as construction, business and commercial services were growing faster than GDP (*Press conference*, 2005). This kind of disproportionate development indicates existence of high internal demand that in the short-term ensures rapid growth. At times when the economy is growing very fast, high internal demand is nothing unusual; however, one should be careful as it also brings some risks to the economy. One of the measures of high internal demand is that the amount of credits handed out substantially exceeds deposit volume (Bitāns, *Bez pieprasījuma*, 2004). In the last few years in Latvia, a constitutive increase in crediting has been observed, so during 2004, the overall increase in credit issuance has been 40%, but credits handed out to private persons has increased even more rapidly, hitting 70% (Rudzītis, 2004).

The president of the Bank of Latvia, Mr. Rimšēvičs, has pointed out that if the economy of Latvia grows by more than 8% per year, then the government, banks and entrepreneurs should start worrying about possible 'overheating of the economy' (Leitāne, 2004). The reasoning behind so-called 'economic overheating' is that if borrowing is easy and cheap, many people start taking credits from banks and buying more goods, which they otherwise would not be able to afford. What happens is that purchasing power becomes so high that producers and sellers start increasing prices and producing more products. As a

result, the economy grows disproportionately fast in the short-run; however, such growth is not sustainable in the long-run. Furthermore, the Bank of Latvia has expressed concern that such a high amount of credits handed out indicates that many inhabitants of Latvia live with debt commitments (Leitāne, 2004). Such a situation implies that if there is some internal or external shock to the economy, due to which interest rates or unemployment may rise, then the borrowers will not be able to cover their liabilities to banks. Consequently, banks will suffer loses and in such a situation a crisis in the banking system is highly probable.

One should remember that 'economic overheating' in a country can happen due to a combinations of different factors, as mentioned by Mr. Rimšēvičs, "inflation rate of 5%, large current account deficit, budget deficit of 2%, high issuance of private usage credits, the situation in the real estate market, existing high growth" (Leitāne, 2004). A combination of these factors anticipates the possibility of 'economic overheating' in Latvia.

If looking at the two main drivers, the scenario comprises inflation rate exceeding the average of the three EU Member states with the lowest inflation by more than 1.5%, but the rapidly growing economy helps to retain a stable budget deficit around 1% of GDP, which is below the Maastricht criteria requirements. As this scenario includes the possibility of 'economic overheating' due to high internal demand and very rapid growth, the name 'Overheating' was given.

Government Budget Deficit

Due to the high growth level, planned revenues for the 2005 budget are by 26.3% more than in the previous year, but at the same time expenditures are planned to increase by 23.2%. (Republic of Latvia, Ministru Kabinets, 2005). As pointed out by J. Paiders (2004), Latvia was distinguished among the other EU countries as the country having one of the highest unemployment levels of 8.7% in the third quarter of 2004. The basis for unemployment reduction is creation of new work places, and as emphasized by J. Paiders (2004) in EU practice this is usually done within the framework of the government budget. That is why it would not be suggested to reduce government expenditures substantially during the next years, because this would increase the unemployment level even further, instead keeping the budget deficit in borders of 1-2 % of GDP would be advisable. The government budget for 2005 involves the potential budget deficit in the next year possibly remaining within 2% of GDP. In addition, new parliamentary elections are coming, thus the current Latvian government will not be able to reduce the budget deficit to 1% of GDP, as changes in political power indicate modifications in budget spending and other adjustments that lead to increasing costs.

Moreover, during 2003 the price of natural gas increased, tariffs for water supply and drainage rose, while charges for heat energy grew, all these factors adding to inflation (Rudzītis, 2004). The same happened in 2004, after joining the EU, drugs were additionally taxed with a value added tax of 5%, as well as excise tax for fuel increased. In the next few years, the same can be expected, for instance, excise tax for fuel and cigarettes will be increased even further bringing additional revenues into thegovernment budget (Hansabanka, 2004). With concurrent increases in tariffs and taxes, starting from 2004 the minimal wage level was raised from 70LVL to 80LVL per month, indicating a slight sign of increased prosperity of Latvia's inhabitants (Rudzītis, 2004).

Inflation

In 2004, Latvia was in 1st place among EU countries, as governmen country having the highest inflation (Paiders J., 2004). Despite optimistic statements made by the government of Latvia and the Bank of Latvia that the inflation rate in 2005 would decrease to 4.5% (Bitāns, *Bez pieprasījuma*, 2004), high internal demand seems to impose a potential threat on their optimism. As stated in the quarterly periodical "Averss&Reverss" by Bitāns (2004), if internal demand grows quickly and unregulated, it may generate increases in inflation, a large current account deficit, or even a crisis in the banking sector. During 2004, the inflation rate followed the increasing trend of internal demand, creating a very high inflation rate even for such a rapidly growing economy as Latvia (Rimšēvičs, *Press conference*, 2005)

As mentioned previously in the scenario, the EUR/USD exchange rate is becoming stable, implying steady oil prices. As a result, minimal or no effect from fuel prices is expected to be reflected in the inflation rate in the next few years. As mentioned when analyzing the government budget, in the next year it is expected that prices for administratively regulated services will rise, which will put even more pressure on the inflation rate. Starting from 1st January 2005, excise tax increase for cigarettes will come into force, and from 1st July 2005 it is expected that the tariff for heat energy will be taxed with value added tax, besides a planned increase in gas tariffs (Rimšēvičs, *Press conference*, 2005). These increases in administratively regulated prices will put pressure on the inflation rate, so the government of Latvia should reconsider carefully their policies and try to minimize the possible effect of those changes on the inflation rate. In this scenario, the inflation rate will not be as high as in November 2004, but still will exceed the Maastricht criteria.

Other Key Factors

The potential for increase in exports has been very optimistic so far due to increasing productivity; further, in the next few years it could lead to a 15% increase per annum, (Hansabank Markets, 2004). However, some anxiety is present regarding increasing import volumes, which from one side is acceptable as a rapidly growing country has high demand for new technologies and wellhead equipment, but on the other side it worsens the current account deficit. Another pressure on the current account balance is rapidly growing internal demand, which stimulates and encourages new importers to enter the Latvian market. In regard to EUR/USD exchange rate fluctuations, there is going to be a minimal effect regarding competitiveness of EU exports, which should not affect substantially the current account balance of Latvia.

In the case of 'economic overheating' in the Latvian economy, long-term interest rates should not be affected, because convergence to Euro short-term interest rates has already been observed after the Lat was fixed to the Euro. The more time passes, the greater convergence will be present with respect to long-term interest rates, which are expected to become more stable after a few years (Hansabanka, 2004).

As to government debt, no major problems should be expected, as this Maastricht criterion does not seem to be problematic for Latvia to comply with. Currently, Latvia's government debt represents 13.4% of GDP. A probable banking crisis may impose some needed help from the government side, but in no case would this exceed 60% of GDP.

Implications

Before becoming an EMU member state, Latvia must comply with all Maastricht criteria; however, this scenario indicates that due to the high inflation rate in the Convergence Report prepared in 2007, Latvia has not been invited to join EMU in 2008.

As stated by J. Paiders (2004), in order to be able to exercise a common policy regarding inflation, budget deficit and unemployment, the government of Latvia, the Bank of Latvia and the elite of Latvia should work together for a common goal. So, cooperation between governing institutions in Latvia is crucial to achieve the goal of entering EMU. Currently, it is possible to observe rather weak collaboration, although, as stressed by a representative of the Bank of Latvia, there is some cooperation between them and the government of Latvia (Focus group discussion, 2004). However, they doubt that stronger cooperation would solve anything, as political power shifts between different parties too often (Bērziņa, Personal interview, 2004).

It is crucial to determine what kind of governmental policy will be employed in Latvia during the next few years – divert the existing budget surplus to usual expenditure, or save for times when the economy experiences recession (Paiders J., 2004). One should not forget that the fiscal policy carried out by the government of Latvia, after the Lat was fixed to the Euro, has become the main tool of eliminating risks associated with high internal demand, inflation, and other macro economic variables.

The Bank of Latvia has already taken action towards slowing down exalted amounts of credits handed out. In March 2004, the Bank of Latvia increased the interest rate for commercial bank borrowings (Paiders J., 2004). Moreover, in July 2004, the Bank of Latvia also increased the compulsory reserve norm for commercial banks, from 3% to 4% (Hansabanka, 2004). This helped for a while; however, the intended effect was erased in months and interest rates fell again, because many borrowers preferred the Euro to the Lat, in which situation the Bank of Latvia became powerless (2004).

Scenario – 'Crisis'

The following scenario implies that the U.S. market continues experiencing problems with its current account balance due to the fact that the Euro/dollar exchange rate is stabilizing and the US dollar is not any more as cheap as it was at the end of 2004 (Focus group discussion, 2004). This implies problems for U.S. exports, which are now not as cheap as before. Internal demand in the U.S.A. is still very high, and thus it continues to grow steadily.

In the EU the situation is stable, and no major crises that could affect development substantially are expected. The average inflation in the old EU Member states is stable and rather low; at the same time, the internal demand of EU Member states has not been improving (Republic of Latvia, Ministry of Finance, 2004). Lithuania and Estonia should have complied with the Maastricht criteria in 2006, which means that both of them should become members of the EMU in early 2007 (EastCapital, 2004).

In Latvia after the elections in October 2006 an expansionary fiscal policy has been realized. The newly elected government is very optimistic about revenues, and the majority of money is planned to come from EU funds (Hansabanka, 2004). In the preceding year the government tried to address some of the most complicated social issues by trying to implement Health Care System Reform, however, little success was achieved. The new government is under pressure from society to solve not only the problems of the medical sector, but also to increase teachers' salaries as well as maternity and childcare benefits (2004).

At the same time a major crisis in the textile industry can be observed, which can be attributed to the fact that real wages increased in 2005 – 2006 (Republic of Latvia, Ministry of Economics, 2004). At the beginning these changes were seen as a positive development by society; however, in the subsequent year the implications of these changes became obvious and the textile sector in particular got hurt. This happened because the salaries and real wages of the workers constitute part of production costs and cheap costs were the main competitive advantage of exported textile production. Production had to be decreased and employees had to be laid off. These problems put additional pressure on the government as budget resources had to be transferred to solve these problems. By the end of 2007 unemployment has increased, thus downwards pressure is put on internal demand. In turn this puts downward pressure on inflation.

This scenario comprises a low inflation rate combined with a level of government deficit that does not comply with the 3% required by the Maastricht criteria. Due to the fact that this is triggered by a crisis in one of industries, the name for the scenario is “Crisis”.

Government Budget Deficit

The government budget deficit in 2007 exceeded the limit of 3% of GDP, as government expenditure has exceeded income by far. This has happened mainly due to two reasons, one of which being the expansionary fiscal policy employed by the new government. After the elections, the government decided to increase spending for social allowances. The one thing that the government is not prepared for is an increase in unemployment in the textile industry.

The government expected that its revenues would grow in year 2007 .The income from taxes during that year is unexpectedly low and as the government continues to spend money at the same level, the level of loans is rising. Special programs are being developed to reduce the rate of unemployment, but apart from that quite a lot of money has to be spent also on other social programs, because medical personnel continue to be dissatisfied with salaries. All these problems that the new government has to face imply that the government budget deficit criterion is not satisfied.

Inflation

In this scenario the Latvian government in cooperation with the Bank of Latvia has managed to limit inflation. After year 2004 when inflation reached a worrying 7.2%, all efforts were made to limit inflation, thus achieving a substantial decrease in the next year to the projected 2 –2.5 % (Republic of Latvia, Ministry of Finance, 2004, 10), and by year 2007 the level of the inflation has reached the intended level. To achieve that all the major changes in administrative expenses have been made in years 2004-2005 and no “unpopular” decisions

such as raising prices for electricity or gas were made in 2006, because of the upcoming elections.

Moreover, the crisis in the textile industry has created an increase in the unemployment rate, which in turn has put downward pressure on inflation. The Maastricht criteria of inflation that created the biggest concern to policy shapers are satisfied in this case.

Other Key Factors

The current account balance is worsening even more due to the fact that the budget deficit has increased, thus making the trade balance even more negative (Saleh, 2003). Also the fact that real wages have risen leaves a negative influence on the export of goods. The rate of unemployment has risen drastically, creating many problems for the government. At the same time oil prices in the world have stabilized, which for Latvia implies that there are no major increases in oil prices in that period.

To solve the problem in the textile industry, additional loans are taken thus increasing general government debt. The level of debt increases to 20%, which is still satisfactory according to the Maastricht criteria.

Implications

At the time when the Convergence Report for Latvia is prepared in 2007, the Latvian government is facing a problem of a budget deficit that exceeds the necessary 3 % of GDP. At the same time the level of inflation has been limited, which is a very positive development for Latvia. Latvia continues to have 'country with derogation' status, as the Commission report reflects that Latvia is still lagging behind in development from the other EMU Member states. The Bank of Latvia encourages the Latvian government to search for possible solutions to improve the situation and prevent industry from getting into even deeper crisis.

Scenario – 'Too Good to be True (?)'

In this scenario the U.S.A. continues to face problems with its current account balance and budget deficit. The current account deficit increases even more, because the US dollar becomes stronger compared to the Euro as proposed by some specialists (E-mail survey, 2005). For the U.S.A. this implies that its trade balance becomes worse. Although internal demand is still very high, the growth of the country slows down somewhat.

In the EU the period from 2005 to 2007 is characterized by low, but stable growth, at the same time economists observe the first signs of slow recovery (Republic of Latvia, Ministry of Finance, 2004). All the new Member states are rather successful in their

convergence process, and there are no major events within the EU that interrupt their development. The average level of inflation among the EU countries is stable (2004).

During 2002-2005 Latvia experienced a very rapid growth rate, but at the same time inflation reached an unexpectedly high level (7.2 % in November 2004). On the one hand, the growth rate of 8.5% in 2004 was a positive development for Latvia in the convergence process (Republic of Latvia, Ministry of Economics, 2004). On the other hand, however, productivity was growing faster than real wages and salaries (Republic of Latvia, Ministry of Finance, 2004) thus, the average level of welfare of Latvian inhabitants remained unsatisfactory – in 2004, Latvia was among the poorest EU member states with 8,950$ per head (Dombrovsky, 2005). This data on welfare combined with the rising rate of inflation created concerns for policy makers. To limit inflation, the government of Latvia employed a strategy where administrative expenses were put under control. After the first rise in 2004, they were further increased in 2005, thus leading to a 6 % rise in inflation in that year, but in the year after no administrative costs were raised (Focus group discussion, 2004). People regained the belief in stability of prices and the expectations for inflation were decreased.

The government in cooperation with the Bank of Latvia is successful at implementing the convergence strategy prepared at the end of 2004. The strategy was specially prepared to specify the aims that are to be reached in the next few years and projections whether they can be reached. A very important factor in this strategy was ensuring that the budget of the country is in balance for the next few years – medium term planning (3-5 years) is introduced to ensure targeted funding and effective spending (Republic of Latvia, Ministry of Finance, 2004).

In the scenario both most uncertain variables that could influence Latvia's prospects for joining the EMU are set to be within the required boundaries. The name that has been given to this scenario is "Too Good to be True (?)".

Government Budget Deficit

In the scenario, the budget deficit does not exceed the preset 3 % of GDP, because the institutions involved in the process of Latvia entering EMU closely follow that the government expenditures are held within appropriate limits and do not exceed government income by more than the required level. At the end of 2004 several important development documents were prepared by the Ministry of Finance and the Ministry of Economics to ensure that the idea of stable development and convergence with the rest of the EU is clearly communicated.

The most important task for the government in 2005-2007 was ensuring sufficient funds for co-financing EU-supported projects (Republic of Latvia, Ministry of Finance, 2004); additionally some funds were channeled to health care system reform. All these expenditures were balanced against increased revenues from exports of services to EU countries.

Inflation

Inflation in this scenario has slowed down and reached the average level of the three EU countries with the lowest inflation rate. One of the reasons for slowdown is that core inflation that stems from changes in administrative expenses has decreased. In 2006 – 2007 no major changes in prices of electricity, utilities and natural gas have been introduced as all the necessary changes have been made in 2004-2005.

Another reason for the slowdown in inflation is that the Lat has been pegged to the Euro since the beginning of 2005, thus the influence of the exchange rate on the Lat has been diminished (Republic of Latvia, Ministry of Finance, 2004). Also the fact that average inflation has been rather low among the old EU Member states leaves its positive influence on the level of inflation in Latvia.

Price developments will be also positively affected by raising competition among domestic producers and closer integration with EU markets (Republic of Latvia, Ministry of Finance, 2004). Inhabitants' expectations towards inflation should decrease as there is going to be a certain period of time over which there will be no major turmoil that could serve as a possible hint for increased expectations.

Other Key Factors

Latvia continues to grow at a rapid path of 4 – 5% of GDP until year 2008. This is mainly because of increased productivity, which is accelerated by investments made in 2004 – 2005. The competitiveness and quality of products for exports should also grow considerably (Republic of Latvia, Ministry of Finance, 2004). In this scenario, it is envisaged that by 2008 exports comprise 8% of GDP while imports constitute 7.2% of GDP; this way the current account balance should improve.

No problems with government debt are faced in this scenario as it is still kept well below the required 60% of GDP level. In the world market there are no major changes in oil prices and overall the situation in the European and global markets is rather stable allowing for no major crises that could influence the economy of Latvia.

Implications

This scenario is very close to the strategy scenario envisaged by the Bank of Latvia and the government of Latvia. It implies that Latvia complies with the two most uncertain Maastricht criteria and also the other three criteria are satisfied. When preparing this scenario a good deal of information was retrieved from the "Convergence Program of the Republic of Latvia 2004 – 2007" prepared by the Ministry of Finance (2004).

Nominally these projections imply that Latvia can become a member of EMU in 2008. However, there are several concerns that made the authors give the 'Too Good to be True (?)' name to this scenario. The first concern is the fact that the European Commission itself has concluded that the program prepared by the Ministry of Finance needs revision, as some of the data create doubts about its validity (Official Journal of the European Union, 2004). Besides, the process of entering ERM II has been prolonged for almost three months, which proves that there are still many internal problems to be solved.

Apart from that, if one of the current EMU member countries decides that it does not want Latvia to be in the EMU, it can require prolonging of the test period for several more years. However, experts from Latvia and abroad evaluated this option as rather unlikely.

6. Concluding Remarks

At the beginning of the research the authors of this paper formulated that the main aim they wanted to achieve with this study was exploring the leading flaws that could prevent Latvia from joining EMU in 2008 and identifying possible future trends in the convergence process. Scenario planning steps were employed to accomplish this task – the authors not only conducted interviews with representatives from Latvian government institutions and the Bank of Latvia, but they also carried out a focus group discussion and an e-mail survey to gather opinions of foreign specialists who have done research in the field of European monetary integration. Apart from that, extensive literature was used to gain understanding of the background of the issue under investigation.

The main results that can be acknowledged at this stage is identification of the two most important and most uncertain key drivers – the inflation rate and the government budget balance – that can substantially influence Latvia's prospects for joining EMU along with the four scenarios that take into consideration variations in the key drivers. The implications for three out of four scenarios are that there are certain concerns that it might be problematic for Latvia to enter EMU in 2008. One of the scenarios indicates that there is a possibility that Latvia might converge at least nominally with the current EMU Member states; however, policy shapers should take into account certain signposts to exercise that. For each of the scenarios the authors developed a possible causal background based on statistical data and

previous research; these should be considered if the government of Latvia is to pursue its goal of integrating Latvia into EMU as soon as possible.

The study carried out is qualitative, thus meaning that no quantifiable results were retrieved; however, the authors believe that at this stage it was more important to summarize the available information and identify possible pitfalls than to run any econometrical regressions.

Suggestions for future studies include a more thorough analysis of the strategies chosen by Lithuania and Estonia on their way to EMU, and what is being done in these countries to ensure a smooth path of the convergence process. Additionally, a study on the impact of introduction of structural and cohesion funds could be carried out.

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Appendixes

Appendix A: Review of Literature

Working Papers

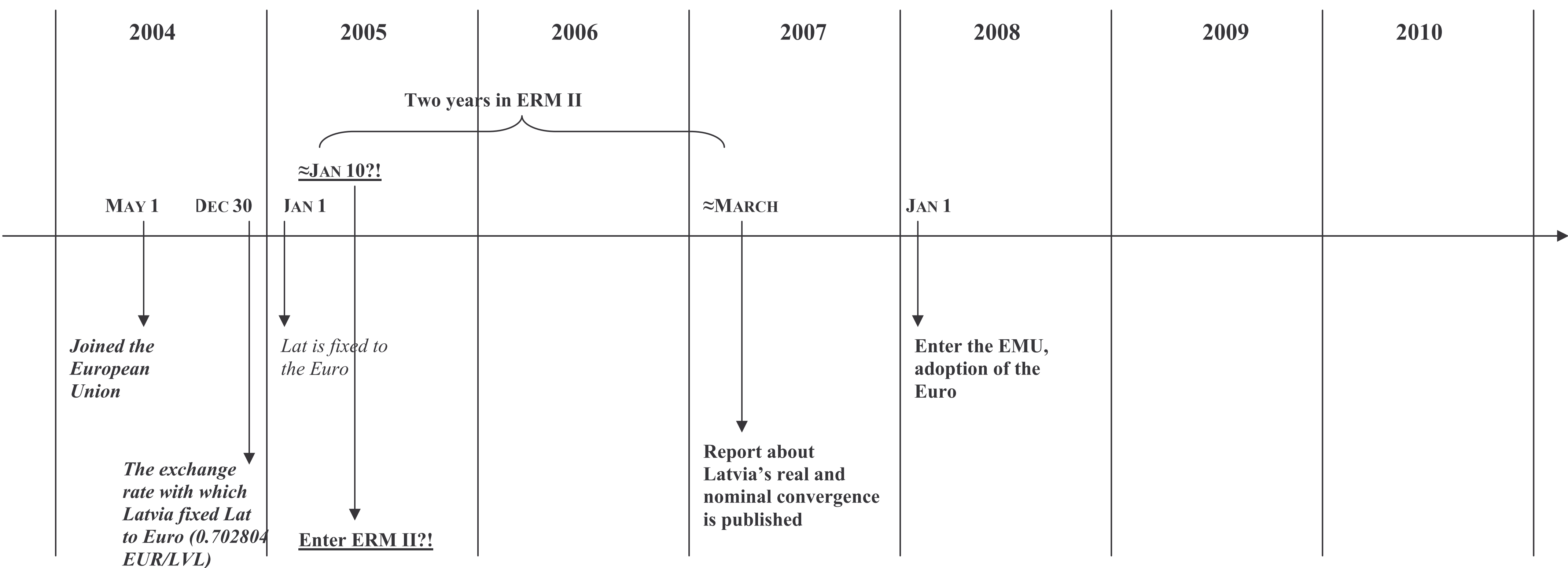
Author	Title of the paper	Countries	Research question	Results & Conclusions
Mārtiņš Bitāns, Egils Kaužēns	"Impact of the Euro Adoption on the Economy of Latvia" (2004)	Latvia	Analysis of the consequences associated with the introduction of the euro in Latvia.	# The adoption of the euro in Latvia would not generate immediate and sizable gains, due to the current exchange rate regime that limits fluctuations of the national currency against the euro to a great extent.
Česlavs Gržibovskis	"Latvia towards the European Monetary Union: Stabilization and Perspectives" (2004)	Latvia	Analysis of economic development of Latvia over the last decade; answer the question, whether Latvia is ready to fulfill Maastricht criteria to join the EMU.	# One of the author's suggestions is as follows: the government of Latvia should implement strict macroeconomic policy also in the future to keep low inflation, low fiscal deficit and public debt. Bank of Latvia should implement also further strict monetary policy, which is directed to low inflation and flexible long-term interest rates.
Mārtiņš Bitāns, Dainis Stikuts, Ivars Tillers	"The Monetary Transmission Mechanism in Latvia" (2004)	Latvia	Identification of the monetary transmission channels in Latvia.	# This research publication gives an overview of the Latvian financial system in the context of the functioning of monetary transmission. It presents evidence of increasing capital mobility and the influence of global developments on domestic monetary conditions.
Raoul Lättemäe	"EMU accession issues in Baltic Countries" (2003)	Estonia, Latvia, Lithuania	Analysis of EMU accession issues in Baltic countries; formal inspection of the OCA criteria in Baltic countries.	# The existing symmetries in structural shocks are smaller in accession countries than in current EMU members according to structural VAR estimates.
Pekka Sutela	"Managing capital flows in Estonia and Latvia" (2001)	Estonia and Latvia, episodically Lithuania	Answers how Latvia and Estonia managed to maintain stable capital flows while having fixed exchange rate, liberalized capital accounts and very large current account deficits.	# Small open economies tend to pursue more flexible exchange rate, the three Baltic States paradox in this respect # Baltic Countries was actually protected by their smallness from the speculations. # Would continue the same pass until accession to EMU would abolish all external threats.
Jerome Trotignon	"EMU enlargement towards CEECs: risk of sector-based and geographic asymmetric shocks" (2003)	Central European States, Turkey	Classify the 10 new member states and Turkey according to the sector based diversification criterion as well geographic variety of sales	# Estonia and Latvia present such sensitivity to trade shocks that it should dissuade them from hastening to join the EMU, even if they are about to meet the nominal convergence criteria # National stabilization funds (like in Finland) should be created, so that they can be activated in case of a shock before joining the EMU.
Ian Babetskii	"EU Enlargement and Endogeneity of some OCA Criteria: Evidence from the CEECs" (2004)	Central Eastern European Countries	Cost aspects of joining the euro zone, namely on the degree of shock asymmetry between the EU and the candidate countries	# Supports the view about demand shock convergence and divergence of supply shocks between the candidate countries, the EU-15 and Germany as alternative benchmark
Lucio Mauro	"Beyond Transition: Essays on	10 new member	Describes the process of	# The Accession Countries might not form ex-ante an Optimal

Vinhas de Souza	the monetary integration of the Accession Countries in Eastern Europe" (2003)	states	enlargement, current exchange rate arrangement and political business cycles in the Accession Countries	Currency Area with the EU
Klaus-Jurgen Gern, et al	"European Monetary Integration after EU Enlargement" (2004)	10 new member countries	Focus on the implications of European monetary integration for the NMS	#Expectations about additional short-term gains from joining EMU should not be too optimistic # With respect to the Maastricht criteria NMS have already made considerable progress
The Ezoneplus Research Consortium	"Euro zone Enlargement – Exchange- Rate Choices and Adjusting Markets" (Summary Report)	Eight Central and Eastern European countries	Presents major findings in the areas of capital and labor markets, trade and FDI	# Set of transmission mechanisms affecting the markets is still to be determined # Neither migration nor labor market flexibility are strong enough to reduce the inevitable adjustment burden of most of the accession countries once they join EMU
Andrzej Bratkowski, Jacek Rostowski	"The EU attitude to Unilateral Euroization: misunderstandings, real concerns and ill-designed admission criteria" (2001)	Accession countries to EMU	Aim is to try to understand and to analyze the arguments against euroization (in terms of interest of current EMU members)	# EU opposition to unilateral euroization mainly stems from intellectual confusion between UE and admission to EMU # Maastricht criteria could be softened for the countries adopting UE, however, this should be done only if hardened fiscal deficit criterion is satisfied # It might be the case, however, that suspicion that EU is not ready for the role of a global currency supplier is true at the moment
Marco Weimann	"OCA theory and EMU Eastern enlargement – An empirical application" (2002)	10 Central and Eastern European Countries (CEEC)	Assess whether these candidates are better or worse suitable for EMU membership than the current participants	# From today's point of view one cannot judge the CEECs as worse accession candidates than present EMU members # The results of the convergence analysis point to endogeneity of the analyzed criterion.
Holger van Eden, Albert de Groot, Elisabeth Ledrut, Gerbert Romijn, Lucio Vinhas de Souza	"EMU and Enlargement: a review of policy issues" (1999)	10 Central and Eastern European Countries, Cyprus and Malta.	Six key issues will be discussed: *What is the likely phasing and timing of accession into the EU and into the Euro area? *What are the prospects of the applicant countries meeting the Maastricht criteria for Euro area membership? *What are the present exchange rate linkages to the Euro area and how will these evolve as first EU membership and then full integration into EMU approach? *What will be the economic and institutional consequences for the accession countries and the EU itself if countries decide against or for early entry into the Euro area? *What will be the impact of an	# Only a few of the accession countries have a clear Euro area entry strategy. It would seem a good idea that accession countries develop with the European Commission and the ECB medium- to long-term EMU entry strategies (and exit strategies from their present arrangements), which are attuned to the individual needs and possibilities of the accession country in question.

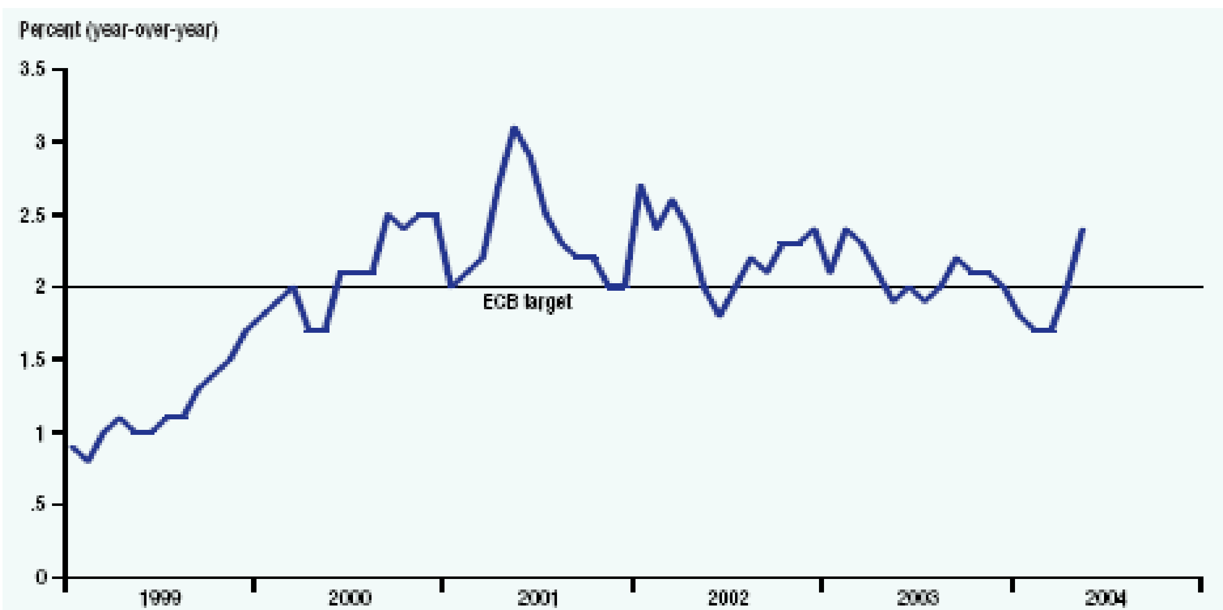
			expanding Euro area on the international monetary system and on neighboring country groups remaining outside the EU?	
Jarko Fidrmuc, Iikka Korhonen	“The Euro goes East. Implications of the 2000-2002 economic slowdown for synchronization of business cycles between the euro area and CEECs” (2003)	Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia	Assess whether the EU acceding countries belong to the same optimum currency area as current members of the monetary union.	# The authors found that the slowdown in 2000-2002 has increased the heterogeneity within the EU, as well as within CEECs, this is particularly true for demand shocks.
Iikka Korhonen	“Some Empirical Tests on the Integration of Economic Activity between the Euro Area and the Accession Countries” (2001)	The Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia	The purpose of the study is to investigate the degree of economic integration the EU accession countries have achieved with the euro area economy.	# No very strong results emerge from the analysis, the results do confirm a priori beliefs that the advanced accession countries, which were chosen by the EU Commission to begin membership negotiations first, are also generally the most integrated with the business cycle of the euro area.
Jarko Fidrmuc, Iikka Korhonen	“Similarity of supply and demand shocks between the euro are and the CEECs” (2001)	Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia	Assess whether the accession countries belong to the same optimum currency area as the current members of the monetary union.	# The authors found that some accession countries have a quite high correlation of the underlying shocks with the euro area. However, even for many advanced accession countries, the shocks remain significantly more idiosyncratic.
Iain Begg	“Quick EMU entry for the new members – a good or bad thing?” (2001)	Bulgaria, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia, Slovakia	Assess whether quick entry in the EMU for the new members is a good or a bad thing.	# Three options: *Entry into stage 3 of EMU as rapidly as possible, i.e. a form of big bang; *An extended period in ERM II to assist acclimatization, but with the corollary that monetary policy would remain with the Member State; *Retaining flexibility in the exchange rate in order to deal with possible shocks or problems associated with transition both to EU membership and more comprehensive market economy structures.
	“Modeling Alternative Paths to EMU for the Accession Countries” (Chapter 5)	Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia	Focus of this study is on the effects of two types of exchange rate strategies: fixed and flexible exchange rates.	# The results from a formal modeling exercise of alternative exchange rate regimes seem to indicate that a float regime would bring about a greater degree of aggregate welfare and would also be a better shock absorber for temporary shocks -if all shocks are weighted equally- for most of the countries.
Prof. Dr. Sylvester C.W. Eijffinger	“Accession Countries and ERM II” (2003)	The Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia	Discuss the implications of the upcoming enlargement of the EU for EMU.	# The enlargement reinforces our argument for reform of the decision-making process of the ECB. # A currency board with a peg to the euro may be the proper exchange rate regime for accession countries on their road to full EMU membership. # Due to the Balassa-Samuelson effect, the accession countries may experience higher inflation than the euro area in case of a nominal fixed exchange rate.

Guergana Stanoeva	"The Theory of Optimum Currency Areas: an Application to Ten Central and East European Countries"	Ten Central and East European Countries:	Study about the degree of exchange rate variability of the CEE countries	# Found that there is a strong relationship between asymmetric real and monetary shocks and the behavior of the nominal exchange rate of these countries as predicted by the theory. # Real shocks are more pronounced than monetary shocks for each of the countries in the sample. A possible explanation can be the fact that the CEE countries have managed to attenuate their nominal differences with the EMU more rapidly than their differences in the real sphere.
Lucjan T. Orlowski	"Monetary Convergence of the EU candidates to the Euro: A Theoretical Framework and Policy Implication" (2001)	Transition economies, special focus on Poland, Hungary and the Czech Republic	The focal point of the investigation is the assessment of whether monetary policies in these countries are backward or forward-looking	# Conclude that monetary convergence process is best served with policies based on flexible inflation targeting and it should end, perhaps a bit abruptly, with a leap to euroization.
Michael B. Devereux	"Monetary Policy Strategies for Emerging Market Countries: The Case of the East European Accession Countries"	Eastern European Accession Countries	Develops a framework for the evaluation of monetary and exchange rate policy in emerging market economies with special emphasis of the situation of the EMU accession economies of Eastern Europe	# Monetary policy must recognize the importance of capital flows, productivity and terms of trade shocks, an attempt to stabilize the economy around a smooth trend path of GDP is not appropriate #The adjustment to some shocks may entail an important trade-off between inflation and output that would not exist in a closed economy # Stabilizing the exchange rate may not be consistent with stabilizing the domestic inflation rate, because of the required adjustment in the real exchange rate.
Willem H. Buiter, Clemens Grafe	"Central Banking and the Choice of Currency Regime in Accession Countries" (2001)	New EU member states, excluding Malta and Cyprus, but including Bulgaria and Romania	The design of appropriate Central Banking arrangements and exchange rate regimes for those former centrally planned Central and East European countries	#Because of Balassa- Samuelson effect, a currency board arrangement may fail to produce an inflation rate below the Maastricht ceiling without an unnecessary recession # Inflation targeting can, unless the exchange rate becomes very volatile, deliver the inflation and exchange rate stability conditions for EMU membership if the exchange rate criterion is interpreted asymmetrically, and permits appreciations or revaluations of the exchange rate.
Andrew K. Rose	"One Money, One Market: Estimating the Effect of Common Currency on Trade" (1999)	186 countries, includes countries that have had trade with same currency units, EU & NAFTA	Assess the separate effects of exchange rate volatility and currency unions on international trade	# The gravity model was used to show that two countries with a common currency trade more, three times more #The most important consequence of increased trade is increased gains from trade

Appendix B: Time Schedule of the Euro Adoption in Latvia

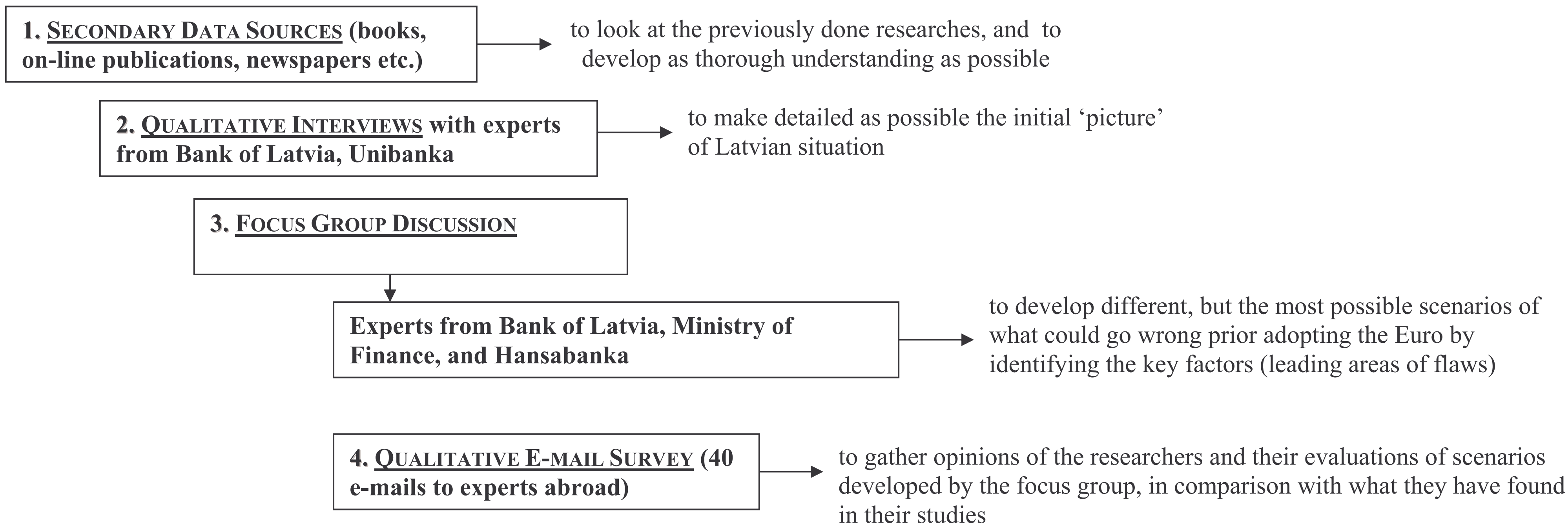


Appendix C: Inflation during the EMU

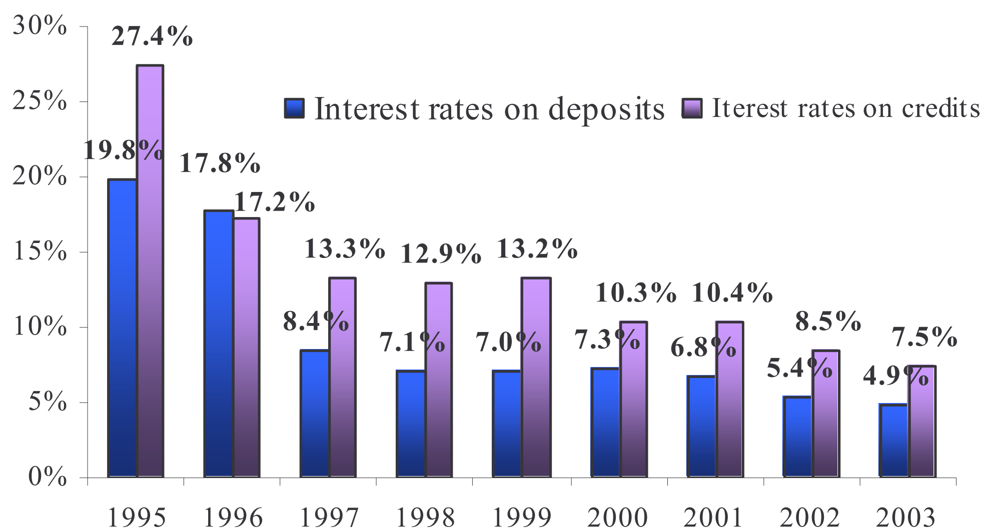


Source: Alm, Richard. Five Years of the Euro: Successes and New Challenges. Beyond the Border. Federal Reserve Bank of Dallas. Aug. 2004. 12 Feb. 2005 < http://www.dallasfed.org/research/swe/2004/swe0404c.pdf>.

Appendix D: Graphical Representation of the Research Design

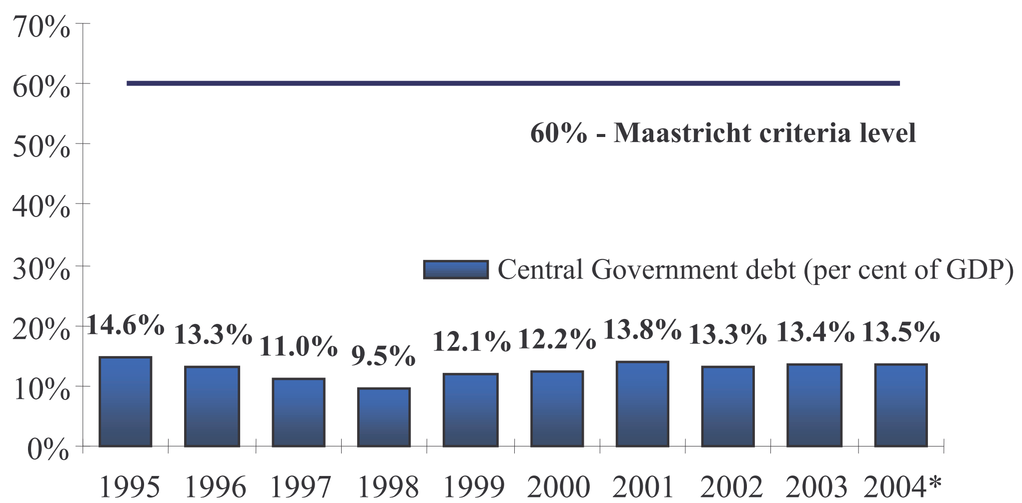


Appendix E: Long-term interest rates on deposits and credits (percent)



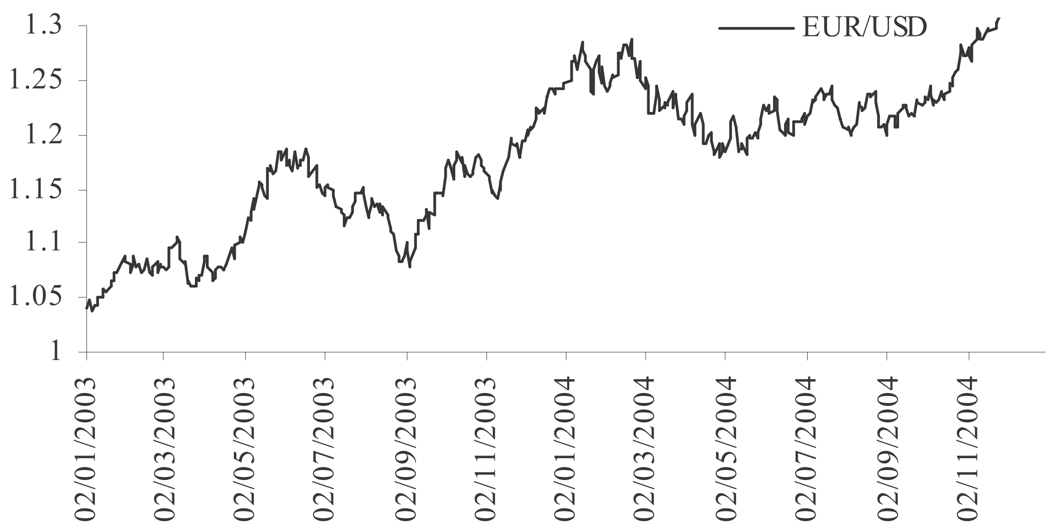
Source: *Statistical Buf Latvia, 2004*
** For 2004 no reliable data available*

Appendix F: Central Government Debt of Latvia (1995-2004)



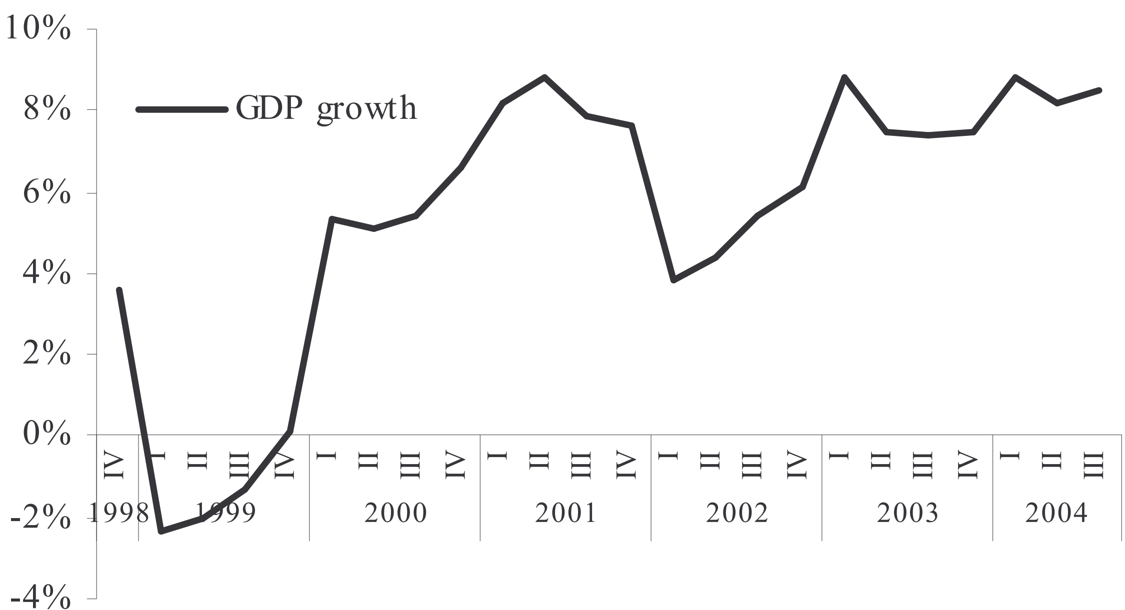
* Source: *Ministry of Economics, 2004*
Source: *Statistical Bureau of Latvia, 2004*

Appendix G: EUR/USD exchange rate development (2003-2004)



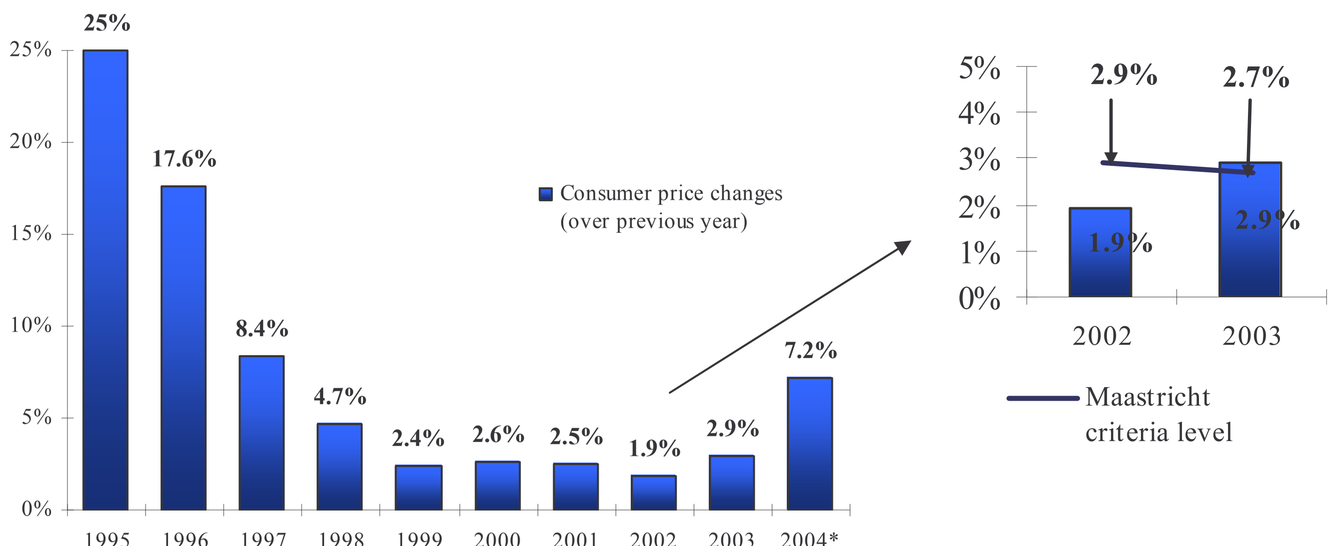
Source: *Statistical Bureau of Latvia, 2004*

Appendix H: GDP growth in Latvia (1998-2004)



Source: *Statistical Bureau of Latvia, 2004*

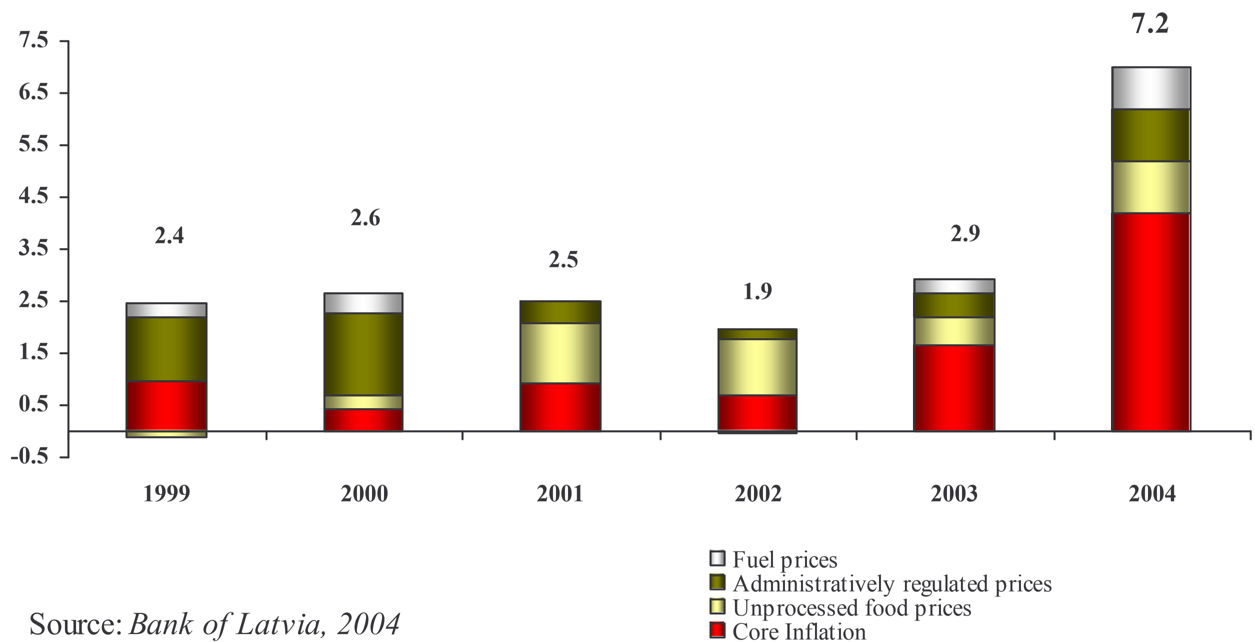
Appendix I: Consumer price changes (over previous year)



* Inflation in November 2004 as compared to November 2003. Source: *Ministry of Finance, 2004*

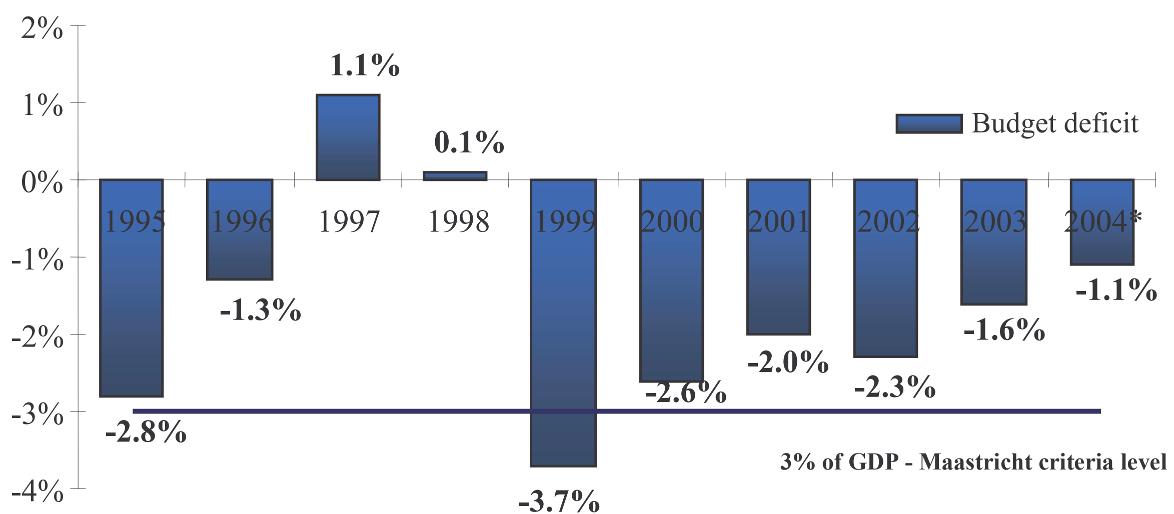
Source: *Statistical Bureau of Latvia, 2004*

Appendix J: Components of Inflation rate (1999-2004)



Source: *Bank of Latvia, 2004*

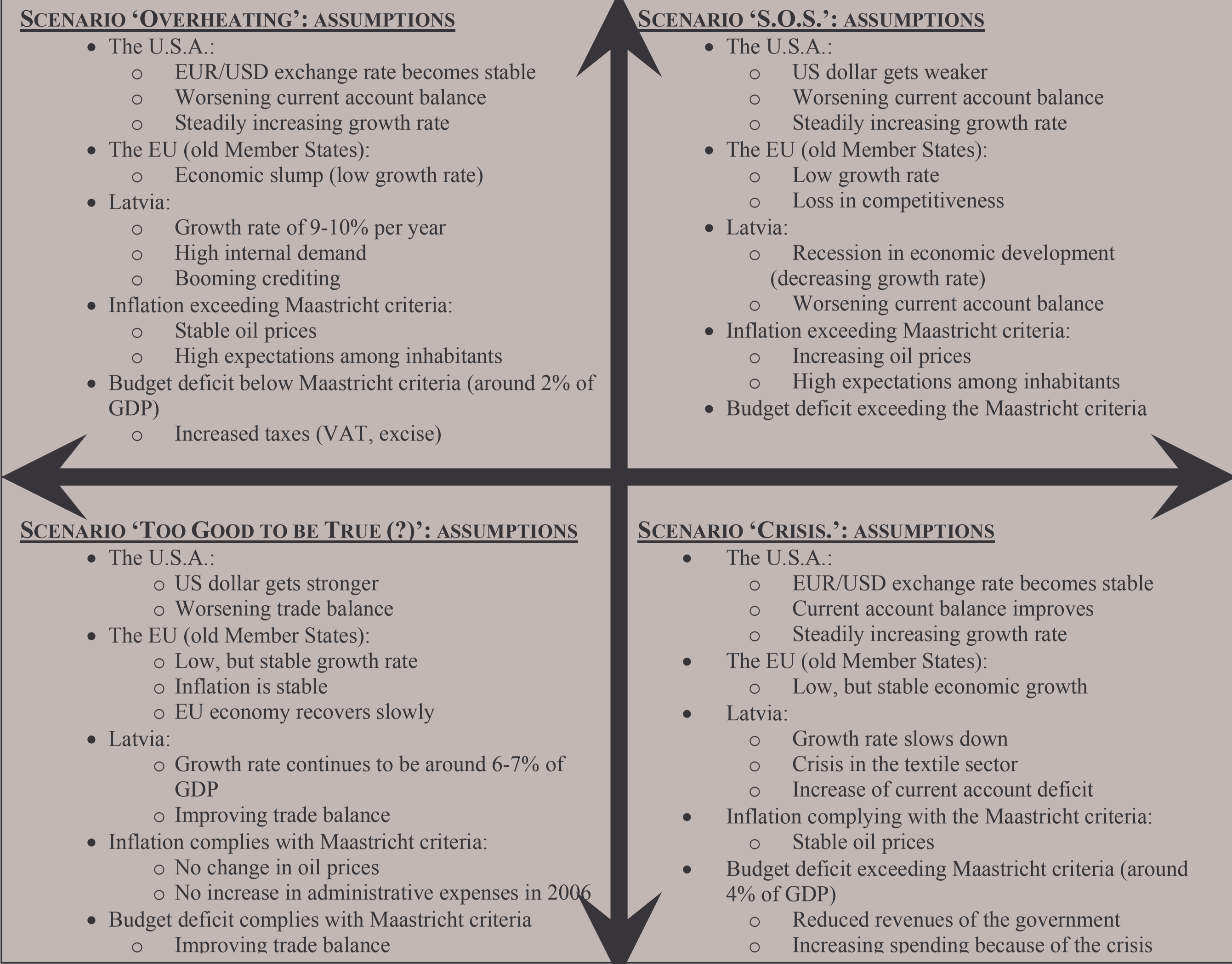
Appendix K: Budget deficit (1995-2004*)



* Source: *Latvian Ministry of Finance, 2004*

Source: *Statistical Bureau of Latvia, 2004*

Appendix L: Scenario Assumptions



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