74th East Jour Fixe: Latvia Joining the Euro Area

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The OeNB's 74th East Jour Fixe was organized in cooperation with the Austrian Society for European Politics and took place on October 21, 2013. It focused on Latvia, which on January 1, 2014, will be the 18th EU Member State to introduce the euro. While the discussion centered on Latvia's experience of coping with the economic and financial crisis by internal adjustment (i.e. without changing its long-standing exchange rate peg to the euro), substantial attention was also paid to the country's economic outlook and to challenges awaiting Latvia following euro adoption.

After an introductory statement by *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department, who sketched the evolution of Latvia's plans of euro introduction, *Paul Kutos,* Head of Unit in the European Commission's DG ECFIN, delivered a keynote address on "Latvia's Accession to EMU: Macroeconomic Background and Remaining Challenges." He provided an overview of the Latvian transition process, the country's economic performance in the run-up to the crisis and the subsequent adjustment program. Kutos stressed that after euro adoption, it will be crucial for Latvia to ensure sustainable convergence and to maintain its commitment to sound policies, in particular in the areas of public finances, the labor market and in the financial sector.

The next session, entitled "Strengthening Macrofinancial Stability and Competitiveness in Latvia," was chaired by *Helene Schuberth,* Head of the OeNB's Foreign Research Division, and opened by *Daniel Hardy,* Expert at the Austrian Financial Market Authority, with his presentation on "Non-Resident Deposits and Financial Market Stability." He explained the role of nonresidents' deposits in Latvia and how they became a problem during the crisis. Hardy analyzed the recent resurgence of nonresidents' deposits in Latvia and sketched the differences between Latvia and genuine offshore financial centers. He discussed measures the Latvian government took to tackle possible risks as well as areas which might need further policy attention, such as the country's deposit guarantee scheme.

Plamen Iossifov, Senior Economist at the European Central Bank, discussed "Newly Rising House Prices against the Backdrop of Overleveraged Balance Sheets: A Cause for Concern?" He provided an overview of the latest house price boom-bust episode in the Baltic countries, which had been fueled by rapid credit growth. After the crisis, Latvian households started repairing their overleveraged balance sheets and house prices started to recover, although they remain well below their pre-crisis peaks. According to Iossifov, potentially long-lasting low real interest rates pose a risk to the sustainability of this recovery process.

Anders Paalzow, Rector of the Stockholm School of Economics in Riga, discussed "Price and Non-Price Competitiveness: A Key Factor for a Small Open Economy." He stressed that the internal devaluation Latvia undertook during the crisis, which had resulted in significant export growth, was just a necessary price adjustment. According to Paalzow, this was the "easy part," however, as fundamentals have not yet been addressed. The adoption of the euro is thus just the "end of the beginning." Against this background, Paalzow called upon the Latvian authorities to pay increased attention to non-price competitiveness, which is of essential importance for small and open economies like Latvia. In particular, Paalzow considers a sound fiscal policy and effective investment in physical infrastructure and education the most important drivers bolstering non-price competitiveness.

The workshop continued with a panel discussion featuring the governors of the Latvian and Austrian central banks, *Ilmārs Rimšēvičs* and *Ewald Nowotny,* respectively. This high-level debate was moderated by *Paul Schmidt,* Secretary-General of the Austrian Society for European Politics. Governor Rimšēvičs started the discussion by walking the audience through Latvia's experience with the crisis and the euro adoption process, pointing out that despite ex-ante warnings of protracted recession risks under an internal adjustment scenario, internal adjustment in fact was followed by a strong V-shaped recovery. For the last three years, Latvia has been the fastest-growing EU economy and, according to the European Commission's forecast, it is expected to remain the EU growth leader over the next three years. Rimšēvičs stressed that this impressive economic performance has only been possible because of Latvia's sizeable fiscal consolidation, which is underpinned by structural reforms, as well as its unique combination of specific factors, namely speed, ownership, commitment and solidarity. With respect to the country's upcoming introduction of the euro, Rimšēvičs pointed out that Latvia will benefit from the common currency in many ways. As a euro area country, Latvia will be able to participate in crucial decision-making processes; moreover, the common currency is also expected to spur exports, investment and growth, reduce debt servicing costs and risk premiums and save transaction costs. According to Latvijas Banka's estimates, the long-term advantages will clearly outweigh short-term costs, and the net benefit for Latvia will amount to some EUR 9 billion, cumulatively, over the next ten years. Rimšēvičs wrapped up by presenting survey evidence suggesting that public support for the euro in Latvia is steadily increasing and that, in general, the Latvian population implicitly welcomes the benefits the introduction of the euro will entail.

OeNB Governor Nowotny added that while in Austria public opinion in favor of EU membership has always been rather high and stable, public support for the euro increased significantly only after the introduction of the common currency. He then went on to recall Austria's experience with its hard currency policy, which – given the small size and the openness of the Austrian economy – had proved very successful and had also served as an instrument to promote deeper structural changes. Nowotny then took up Paalzow's notion that for Latvia, euro adoption was just "the end of the beginning" and warned against reform fatigue. While acknowledging that every policy measure comes at some cost, political and public willingness to accept these costs is essential. Nowotny then opened the general discussion by raising the question whether within the future banking union we should pursue the same, pan-European standards despite different perspectives and interests of home and host countries. The subsequent discussion centered on the challenges the Latvian banking sector in Latvia is facing, in particular on its relatively high share of nonresidents' deposits, and on the differences in the extent of such deposits in Latvia and Cyprus. Another issue was Latvia's need to find a new convergence model that is not based on capital inflows but geared to addressing labor market challenges, in particular emigration.