LATVIA TOWARDS THE EUROPEAN MONETARY UNION: STABILIZATION AND PERSPECTIVES

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Abstract

This paper analyses the monetary history of Latvia and the current economic situation on the road to the European Monetary Union. The goal of this paper is to analyze economic development of Latvia over the last decade and answer the question, whether Latvia is ready to fulfill Maastricht criteria to join the EMU and introduce the euro. The tasks of this paper are as follows:

- to analyze the monetary history of Latvia;
- to analyze statistical data on main macroeconomic as well as monetary indicators of Latvia.

There are a lot of graphs and comparative tables, which reflect the dynamics of the main macroeconomic and monetary indicators so that the reader could better see the positive changes in Latvia's economy.

Keywords: economic development of Latvia, EMU, Monetary policy, Maastricht Criteria

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Introduction

The theme of this paper is "Latvia Towards the European Monetary Union". This issue becomes extremely important for Latvia, because after voting "Yes" in favor to join the European Union (EU), people simultaneously said "Yes" to euro on the referenda on September 20, 2003. This means, that Latvia is obliged to introduce the euro after joining the European Monetary Union (EMU). There are several preconditions for Latvia to join the EMU, namely Maastricht criteria, which Latvia must fulfill. This as well as other questions will be discussed in this paper further.

Author was involved in the student research assistant project at the Eurofaculty of the University of Latvia in the frames of this theme. Some empirical evidence is taken from the working paper "Fixed Exchange Rate: the Case of Latvia" written together with other authors.

The author of this paper participated in the research "The attitude of the Latvian Residents towards the Euro Introduction". Some tendencies of this recent research are described in this paper, too.

Monetary History of Latvia

To start analyzing the economic development of Latvia and answering the question, whether Latvia is ready to fulfill Maastricht criteria to join the European Monetary Union (EMU), author considers important to describe the monetary history of Latvia after gaining its independence in early 90s.

Latvia was incorporated into the Soviet financial system after World War II. The monetary system of the Latvian Soviet Socialist Republic was entirely controlled by the Bank of the USSR, which issued money and functioned as the State Treasury.

In the late 80s the reorganization of the banking system began and the Latvia Republican Office of the State Bank of the USSR was renamed into the Latvia Republican Bank of the State Bank of the USSR in 1987 (but still it did not become a central bank with the right to issue a national currency).

The Supreme Council of the Latvian SSR adopted the Law "On Banks" and the Resolution "On the Bank of Latvia" on March 2, 1990. It meant that a local independent state central bank, was restored in the Latvian SSR, which had the exclusive right to issue the national currency, organize fulfillment of the state budget treasury position, supervise commercial banks and control the economy by means of monetary policy instruments. However, it was only after the Declaration of Independence of the Republic of Latvia on May 4, 1990 and the collapse of the USSR that, in accordance with the Resolution of the Supreme Council of the Republic of Latvia "On Reorganization of Banks in the Territory of the Republic of Latvia," passed on September 3, 1991, the Bank of Latvia became a central bank with the right to issue the national currency.

Since the restoration of its independence, Latvia has consistently been moving from a planned economy to a market economy. The Law "On Taking over Rights of the Bank of Latvia Founded in 1922" was adopted by the Supreme Council on March 4, 1992. For the first time, the independence of the Central Bank from the Government's policy was ensured by two Republic of Latvia laws, "On Banks" and "On the Bank of Latvia" passed on May 19, 1992. The Board of Governors of the Bank of Latvia prepared the restoration of the currency in collaboration with advisors from Latvia and abroad. Later on, the Monetary Reform Committee of the Republic of Latvia was established, and on May 4, 1992, it passed a resolution introducing a temporary currency - the Latvian ruble (LVR). The denominations of the Latvian ruble were as follows: 1, 2, 5, 10, 20, 50, 200 and 500. In 1993 the national currency (the “lats”; LVL; Ls) was introduced in the following denominations: 1, 2, 5, 10, 20, 50 santims and 1 and 2 lats coins; 5, 10, 20, 50, 100 and 500 lats banknotes. A reform ended with the successful introduction of the lats provided for the accumulation and turnover of capital, and transition to a market economy.

Monetary policy

After regaining independence in 1991, Latvia initiated market-oriented reforms. The stabilization and structural reform programs were aimed at rapid price liberalization, elimination of subsidies, tightening of finances, and establishing a liberal trade and payments system. At an early stage of the adjustment process Latvia introduced its own currency, thus enabling the Bank of Latvia to pursue an independent monetary policy. The right to issue the national currency is vested with the Bank of Latvia. The Bank of Latvia has legal and practical independence in designing and implementing monetary policy.

Main principles of the Bank's Monetary Policy

- Free convertibility of the national currency (also for capital account transactions).
- No restrictions on capital movements to and from Latvia.
- External stability of national currency.
- Internal stability (domestic inflation as low as possible).
- Interest rate policy for additional liquidity management.

The Latvian lat became currently very strong and very secure with the property of full and free convertibility after it was pegged to the SDR. The achieved stability in foreign exchange markets as well as the potential loss of competitiveness due to the excessive real appreciation of the national currency stimulated the Bank of Latvia to introduce a fixed exchange rate at the beginning of 1994. This admitted to reduce risk of high volatility of the exchange rate, which was quite high in the rather "thin" Latvian foreign exchange market. The lat was pegged to the SDR[1] (Special Drawing Rights) basket of currencies (1SDR=0,7997LVL). There are following advantages of such arrangements:

- it is transparent to all economic agents and excludes uncertainty about the future value of the national currency,
- both the US dollar and the German mark were very important in the domestic market and foreign trade,
- the SDR basket is on average more stable and fluctuates less than any single currency,
- one can forecast changes of lat towards some other currencies,
- durable and credible fixed exchange rate reduces uncertainty, eliminates exchange rate risk and provides businesses with a solid basis for planning and pricing.

[1] SDR currency basket from January 1, 2001 consists of: the US dollar (44%), the euro (31%), the Japanese yen (14%) and the British pound (11%), [13]

The exchange rate of the lats against the SDR basket was based on the prevailing exchange rates of the lats against major trading currencies at the moment of pegging. There are two branches, which are dominant in the Latvian goods and service exports: export of wood is highly dependent from the lat exchange rate against euro and pound, but the profitable transit is dependent from the lat exchange rate against US dollar. Therefore, fixing lat to the SDR countervails the negative effect in one branch with the positive effect in another.

The advantages and disadvantages of the fixed exchange rate regime as well as comments are provided in the Table 1.

Table 1

Advantages and Disadvantages of the Fixed Exchange Rate System [4,37-38]

Fixed exchange rate system advantages	*Comments*
(1) If fixed exchange rate is durable and credible, it reduces uncertainty, eliminates exchange rate risk and provides businesses with a solid basis for planning and pricing, thereby fostering investment and international trade.	During the 10 years of fixed exchange rate maintenance the Bank of Latvia has won enough credibility to prove the society, that the lats have a stable exchange rate against SDR basket. This fact helped to abolish inflation expectations as well as motivated financial institutions to introduce favourable credit facilities, encouraging local business development and increasing exports.
(2) A stable exchange rate imposes a constraint on domestic monetary policy, and can thus be regarded as useful guard against unsound policies, which diverge significantly from those in the anchor countries.	The substantial differences in monetary policy with the country of a peg currency can end up with capital inflows or outflows, which can significantly affect either monetary stability indicators or foreign reserves. Since the monetary policy of the Bank of Latvia converges the SDR policy in its main points, it becomes difficult for any unpredictable speculative attack to take place.
(3) Fixed exchange rate can be favorable, when it is possible to determine the optimal exchange rate level as well as to undertake the economic policy introduction resulting in the exchange rate stability.	It is obvious, 10 years of the peg, that is considered to be one of the successful ones, stands by itself for tendency of making right decisions as well as for the overall competency of introduced monetary policy.
(4) Fixed exchange rate, that directly limits the monetary policy, can be preferable in situations, when financial instruments and markets are not enough developed to introduce the monetary policy based on market economy fundamentals.	After regaining the independence Latvian economy experienced a sudden transition from Soviet type centrally planned economy to a market one. Society was confused about any market reaction to internal or external disturbances. Fast changes had their reflection in excess exchange rate volatility and overall economic instability, that is why policy makers sacrificed part of their policy power in exchange for stability.

Table 1 continued

Fixed exchange rate system disadvantages	*Comments*
(1) If fixed exchange rate is not credible, it can take a huge amount of foreign reserves to defend it against speculative attacks.	It looks like Latvian central bankers from the very beginning had took into account this caution and insured the appropriate amount of foreign reserves, which covers almost all of the monetary base.
(2) There is no a certain possibility to evaluate, whether the selected exchange rate level is optimal and sustainable, since pegging of the nominal exchange rate, being important for reaching the monetary targets, cannot always solve the real exchange rate problem.	The exchange rate is a substantial factor in the scope of external competitiveness. Overvaluation of the exchange rate will have a negative impact on exports and can cause sharp decreases in the pace of export growth. It is extremely hard to estimate correctly the value of the exchange rate in developed countries. It is even harder to trace this process in transition economies, where the programs of macroeconomic stabilization start with undervaluation of the exchange rate, and a sharp increase in productivity due to reforms and structural changes. The real effective exchange rate of the lats in 2001 has appreciated by about 325% since the beginning of 1992. But the Bank of Latvia argues that the lats is still undervalued, presently, the nominal exchange rate of the lats is estimated to be about 1.8 times lower than in developed countries, using the PPP rate.
(3) There is a risk, that monetary policy co-ordination according to the country of a peg currency cannot be always beneficial for the home country.	By pegging the national currency to SDR the Bank of Latvia has made the lats more stable in regard to any individual currency of the basket than if it was pegged to any individual currency. Exchange rate fluctuations against individual currencies of the basket depend only on fluctuations in the world money market.

After positive economic and political reforms, Latvia was invited to open the negotiations with the EU in 1995. The main aspects of the European Monetary Union will be discussed in the next chapter of this paper. Maastricht criteria will be listed further as well. Then author will go on analyzing the economic development of Latvia.

European Monetary Union and Maastricht Criteria

The European Central Bank (ECB) defines three main stages of the development of the EMU, which are described in the Table 2 below.

Table 2

Three Stages of the Development of the EMU [9]

Stages	**Description**
First stage: July 1, 1990 – January 1, 1994 **Main points:** "Delors Report" "Intergovernmental Conference on EMU" "Treaty on EU"	On the basis of the Delors Report, the European Council decided in June 1989 that the first stage of the realization of economic and monetary union should begin on July 1, 1990 – the date on which, in principle, all restrictions on the movement of capital between Member States were abolished. At this time, the *Committee of Governors of the Central Banks of the Member States of the European Economic Community*, which had played an increasingly important role in monetary co-operation since its creation in May 1964, was given additional responsibilities. These were laid down in a Council Decision dated March 12, 1990 and included holding consultations on, and promoting the co-ordination of, the monetary policies of the Member States, with the aim of achieving price stability. For the realization of Stages Two and Three, it was necessary to revise the Treaty establishing the European Economic Community (the "Treaty of Rome") in order to establish the required institutional structure. To this end, an *Intergovernmental Conference on EMU* was convened, which was held in 1991 in parallel with the Intergovernmental Conference on political union. The negotiations resulted in the *Treaty on European Union*, which was agreed in December 1991 and signed in Maastricht on February 7, 1992. Due to some delays in the ratification process, the Treaty did not come into force until November 1, 1993.
Second stage: January 1, 1994 – January 1, 1999 **Main points:** Establishment of the EMI Exchange rate mechanism (ERMII) Stability and Growth Pact Establishment of the ECB	The establishment of the *European Monetary Institute (EMI)* on January 1, 1994 marked the start of the second stage of EMU. The two main tasks of the EMI were: 1. to strengthen central bank co-operation and monetary policy co-ordination and 2. to make the preparations required for the establishment of the European System of Central Banks (ESCB), for the conduct of the single monetary policy and for the creation of a single currency in the third stage. In December 1995 the European Council agreed to name the European currency unit – the *euro*. In December 1996 the EMI presented its report to the European Council, which formed the basis of a Resolution of the European Council on the principles and fundamental elements of the new exchange rate mechanism (ERM II), which was adopted in June 1997. Design of the euro banknotes was accepted. The European Council adopted the *Stability and Growth Pact* in June 1997. On May 2, 1998 the Council of the European Union – in the composition of Heads of State or Government – unanimously decided that 11 Member States (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland) had fulfilled the conditions necessary for the adoption of the single currency on January 1, 1999. These countries were therefore to participate in the third stage of EMU.

Table 2 continued

Stages	Description
	On May 25, 1998 the governments of the 11 participating Member States appointed the President, the Vice-President and the four other members of the Executive Board of the ECB. Their appointment took effect from June 1, 1998 and marked the *establishment of the ECB*. The ECB and the national central banks of the participating Member States constitute the *Eurosystem*, which formulates and defines the single monetary policy in Stage Three of EMU.
Third stage: January 1, 1999 **Main points:** Irrevocable fixing of the exchange rates Greece entered the EMU	On January 1, 1999 the third and final stage of EMU commenced with the irrevocable fixing of the exchange rates of the currencies of the 11 Member States initially participating in Monetary Union and with the conduct of a single monetary policy under the responsibility of the ECB. The number of participating Member States increased to 12 on January 1, 2001, when Greece entered the third stage of EMU.

In author's opinion the fourth stage of the EMU development will begin on January 1, 2008, when ten new accession countries plan to introduce the euro and join the EMU.

The Maastricht Treaty of 1992 laid down 5 convergence criteria (or Maastricht criteria). The Maastricht criteria are set in the Treaty establishing the European Community and are considered as the preconditions on joining the EMU:

- **Price stability**: a country's rate of inflation may not exceed the average inflation rate of three best performing member states by more than 1.5 percentage points.
- **Exchange rate stability**: the member state must have demonstrated exchange rate stability under the exchange mechanism of the EMS for at least two years, without having devalued its currency against the currencies of any other member state.
- **Convergence of long-term interest rates**: the long-term interest rate may not exceed the average long-term interest rate of the three best inflation performing member states by more than 2 percentage points.
- **Low budget deficit**: the member state must avoid excessive government deficits, defined as 3% of GDP.
- **Low public debt**: the public debt of the member state must not exceed 60% of GDP.

The main idea of the Maastricht criteria is to ensure solid economic fundamentals and durable convergence, which is also best safeguard against risk of destabilizing capital flows in the run-up to adopting the euro. This would be helped, in particular, by early and ambitious fiscal adjustment, which in some cases could well go beyond the requirements of the Maastricht criteria for public debt and deficits [12].

Further on the author of this paper will analyze the economic development of Latvia during the last decade, which is based mainly on the statistical data.

Economic Development of Latvia

This chapter will provide analysis of the economic development of Latvia during the last decade. Author analyzed statistical data available for the main macroeconomic and monetary indicators. This chapter is divided into two parts: macroeconomic development and monetary development. The main emphasize in this chapter was made on those indicators, which are important for joining the EMU according to Maastricht criteria (see the previous chapter), namely, inflation, exchange rate, long-term interest rates, budget deficit and public debt. Author will begin with the analysis of the macroeconomic indicators.

Macroeconomic development

The author analyzed Gross Domestic Product (GDP), current account and foreign trade, as well as fiscal policy and unemployment in the frames of the macroeconomic development.

Table 3 provides analysis of the key indicators of the economic development of Latvia.

Table 3

Key Indicators of the Economic Development of Latvia [3,8]

	2000	2001	2002	2003 e	2004 f
	(changes over the preceding year, %)				
GDP	6.8	7.9	6.1	7.5	7.0
Private consumption	7.4	7.8	6.9	9.0	8.0
Public consumption	-1.9	0.3	1.5	3.0	3.0
Total fixed capital formation	20.0	17.0	10.4	17.0	10.0
Exports	12.0	6.9	6.3	9.4	9.7
Imports	4.9	12.6	4.5	13.9	7.2
Consumer prices	2.6	2.5	1.9	2.9	3.8
	(in percent of GDP, unless indicated otherwise)				
General government budget fiscal balance	-2.8	-2.1	-2.5	-2.0	-2.0
Central government debt	13.1	14.8	14.6	14.7	14.8
Current account balance	-6.9	-9.6	-7.8	-9.0	-8.0
Foreign direct investment (flows)	5.7	2.1	4.6	4.0	5.0
Share of job seekers (% of economically active population)	14.4	13.1	12.0	10.5	10.0
Exchange rate of LVL against SDR (end of period)	0.7997	0.7997	0.7997	0.7997	0.7997

e – estimation of the Ministry of Economics
f – forecast of the Ministry of Economics

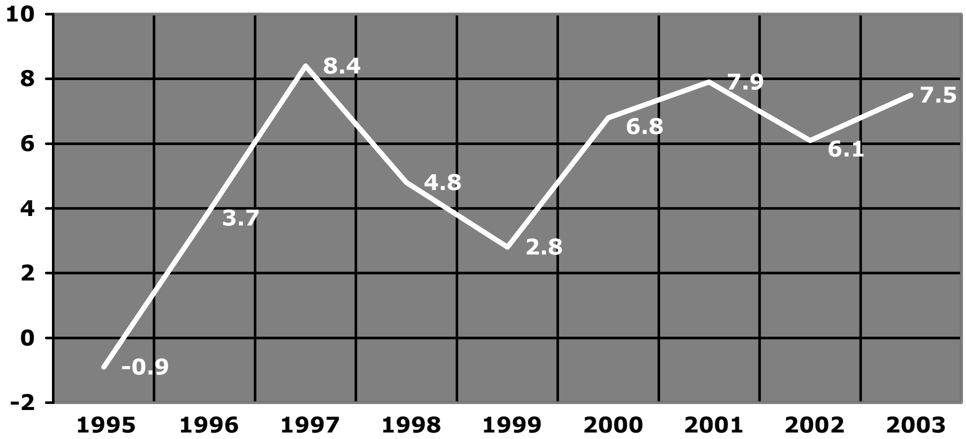
Gross Domestic Product (GDP)

The increase of the GDP in Latvia is one of the fastest in the world. The reason for that is growth of the personal income and domestic demand. As we can see from the Table 3 GDP in Latvia increased by 6.8% in 2000 comparing with the preceding year, by

7.9% in 2001, by 6.1% in 2002 and the estimation of the Ministry of Economics for the year 2003 is 7.5%. GDP increased by 7.5% in 2003 compared to 2002. The forecast of the Ministry of Economics for the year 2004 is 7%. Figure 1 shows the dynamics of the GDP growth by years.

Figure 1

Growth of the GDP of Latvia
(2000 average prices, % against the preceding year)



GDP in Latvia grew by 46.7% in 2002 comparing with 1994. As we see in the Figure 1, GDP in Latvia decreased by 0.9% in 1995. The decrease was caused by the banking crisis. After the banking crisis GDP in Latvia increased substantially. The year 1998 was not successful because of the Russian crisis and the increase of GDP in 1999 comparing to 1998 was only 2.8%. Stabilization of the GDP growth can be observed in the next years. The average GDP increase between 2000 and 2002 was 6.9%.

Current Account Deficit and Trade Balance

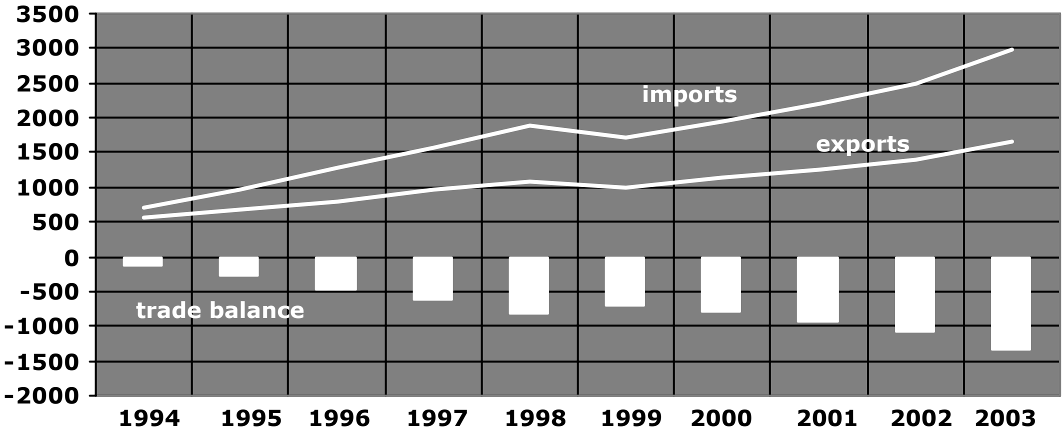
Current account deficit is considered to be one of the main economic problems in Latvia. High domestic demand and especially dynamic growth of investment cause the current account deficit. In 2003 the current account deficit was 8.6% of GDP. However, it is not considered as critical one, because current account is covered mainly by foreign direct investment and long-term credits.

Speaking about foreign trade, the main trade partner of Latvia is EU comprising 60% of total exports. After the EU enlargement the share of exports to the EU can rise to 80%. Exports to EU countries increased substantially after Russian crisis, when Latvian enterprises lost part of their market in CIS countries and had to search for new markets.

Negative trade balance is also considered as the economic problem of Latvia, because imports grow faster than exports. Figure 2 reflects Latvian total exports, imports and trade balance.

Figure 2

Exports, Imports and Trade Balance of Latvia
(million LVL)



Fiscal policy

The government of Latvia implements a fiscal policy aimed at balanced economic growth and stability of state finances. The goal of the government is to establish a budget deficit, which does not exceed 3% of GDP and to have a fully balanced budget in the medium term. Fiscal deficit of the general government budget since 1996 (except 1999) has been lower than the level identified in the Maastricht Treaty (3% of GDP). In 2002 the fiscal deficit of the general government consolidated budget was lower than projected and equaled to 130.5 million LVL or 2.5% of GDP [3,58]. Fiscal deficit for the year 2003 is estimated by the Ministry of Finance and it is 2.9% of GDP. The estimation of the Ministry of Economics for the fiscal deficit is 2% of GDP in 2003 (see Table 3).

Central government debt of Latvia in 2003 according to the estimation of the Ministry of Economics was 14.7% of GDP (see Table 3). Latvia fulfills the Maastricht criteria concerning public debt, which may not exceed 60% of GDP (see previous chapter).

Employment and Unemployment

Employment rate in Latvia in the 3rd quarter of 2003 was 63%, which is slightly lower than the average in EU member states [3,9]. Employment rate differs from region to region. The highest employment is observed in Riga and Riga district, the lowest in Latgale region. Real unemployment in the 3rd quarter of 2003 (share of job seekers) was 10.7%. In general, employment and unemployment indicators have improved in recent years.

Monetary development

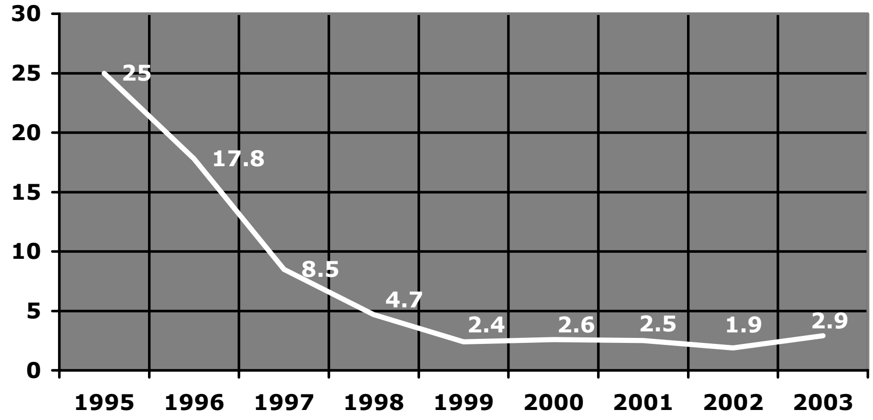
Here the author analyzed inflation and exchange rates, money growth and foreign reserves, as well as interest rates.

Inflation

Consumer price inflation is among the lowest in the countries of Central and Eastern Europe. The government has declared the goal to keep inflation within 2-4%. Figure 3 provides information on annual average inflation in Latvia.

Figure 3

Annual Average Inflation in Latvia (%)



According to inflation forecasts of the International Monetary Fund (IMF) for 2003, the lowest inflation is predicted in Germany (1%), Austria (1.3%) and Belgium (1.4%). Consequently according to the IMF forecast, the highest permissible rate in 2003 will be 2.7% (criteria). Average annual inflation in Latvia in 2003 (according to IMF forecast) is 3%, which is slightly higher (by 0.3 percentage points) than the limit.

Annual average inflation in Latvia in 2003 according to the data of the Central Statistical Bureau of Latvia (CSB) was 2.9%, which by 0.2% exceeds the permissible rate. However, annual average inflation rate in Latvia in 2002 was 1.9%, but permissible rate was 2.9% according to Maastricht criteria.

Inflation rate growth in 2003 was triggered by the increase of the administratively regulated prices (growth of rent payments, increase of the heating tariff at the beginning of the new heating season, more expensive waste disposal activities), medical services and products and some food prices and services. Also import prices increased because of the appreciation of the euro, which significantly affected inflation in Latvia in 2003.

Inflation in January 2004 increased by 3.9% comparing with the same month of the preceding year, or by 1.2% comparing with December 2003.

Average annual inflation will be between 2-4% in the coming years, because of the rise of some tariffs and excise tax, as well as imposing the value added tax on medicine products and other products and services. However, it will stabilize by the end of 2004 and the beginning of 2005 and will be lower than in the last months of 2003 and the beginning of 2004.

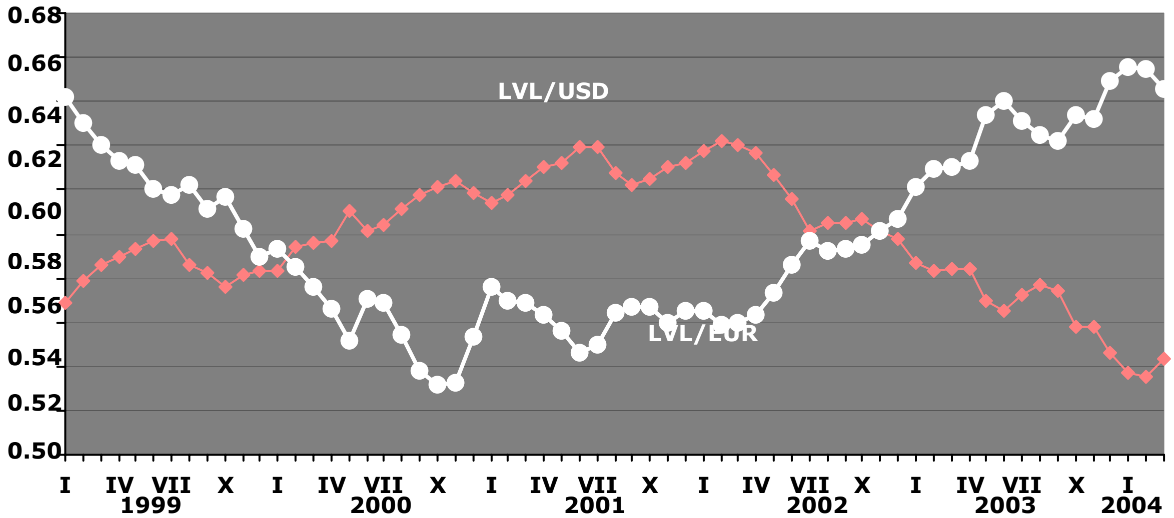
According to the last data on annual inflation, the best performing euro-zone countries in December 2003 were Germany (1.1%), Finland (1.2%) and Austria (1.3). So, the convergence criteria for inflation in December 2003 was 2.7%. Latvia's annual average inflation in December 2003 was 2.9% (by 0.2 percentage points more than allowed for joining EMU, if Latvia showed the willingness to join the EMU in December 2003).

Exchange rates

There were no fluctuations observed after lat was fixed to the SDR currency basket in February 1994 (see Table 3). Fluctuations of the lat were observed against other currencies represented in the basket. If there is a depreciation of the US dollar, the exchange rate of the lat against the US dollar decreases and the exchange rate of the lat against the euro increases. Figure 4 shows changes of the exchange rates.

Figure 4

Exchange Rates Set by the Bank of Latvia [3,56]
(average per month, in LVL)



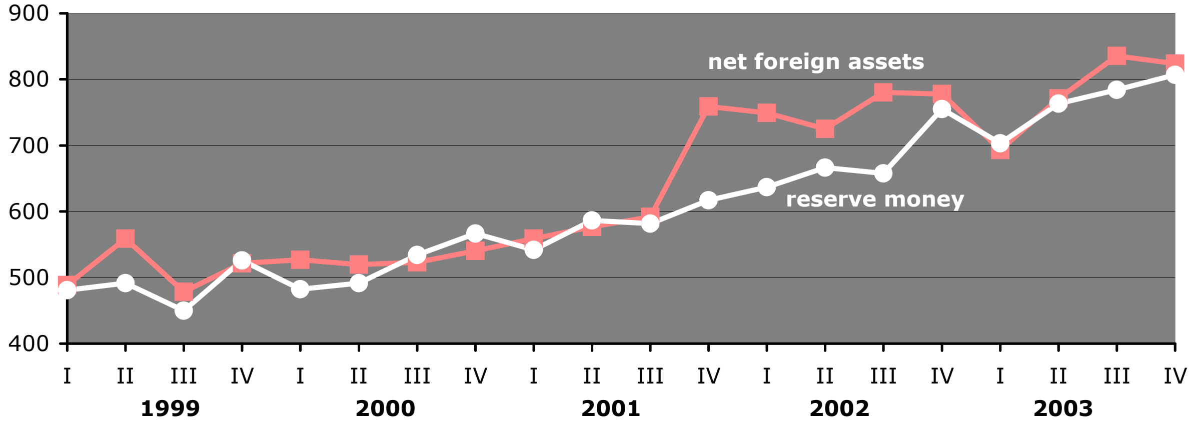
Latvia plans to fix lat to the euro on January 1, 2005 and introduce the euro as a single currency on January 1, 2008 according to the information of the Bank of Latvia. After lat is fixed to the euro, no lat depreciation is allowed according to Maastricht criteria (see previous chapter).

Money Growth and Foreign Reserves

At the end of December 2003 compared to the end of December of the preceding year the amount of the broad money M2X had gone up by 21.1%, money in circulation – by 10% and deposits – by 25%. Also credits to enterprises and legal persons grew by 37% over the same period of time [3,52]. Net foreign reserves of the Bank of Latvia constantly cover the reserve money in Latvia. It can be seen on the Figure 5 below.

Figure 5

Net Foreign Assets of the Bank of Latvia and Reserve Money [3,57]
(quarterly profile, million LVL, at the end of the period)

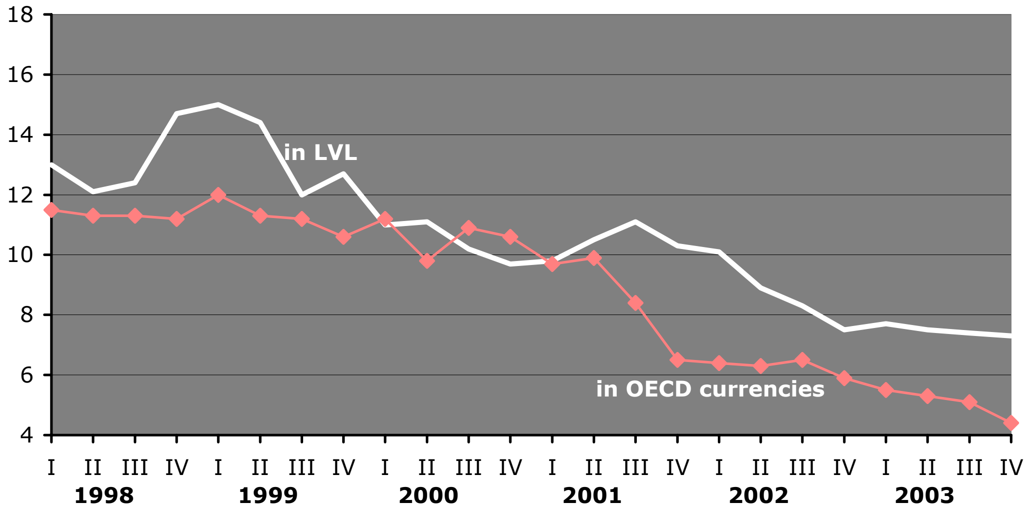


Interest Rates

Improvement of economic environment, low inflation and growing supply of credits, increasing competition in the banking sector promote gradual reduction of interest rates on credits and extension of crediting deadlines. Average weighted annual interest rate for short-term loans in LVL in December 2003 was 5.8%, for long-term – 7.4%. Interest rates on loans in OECD currencies were respectively 4.5% and 4.2% [3,55]. Figure 6 shows the fast decrease of the long-term interest rates from 1998 until 2003.

Figure 6

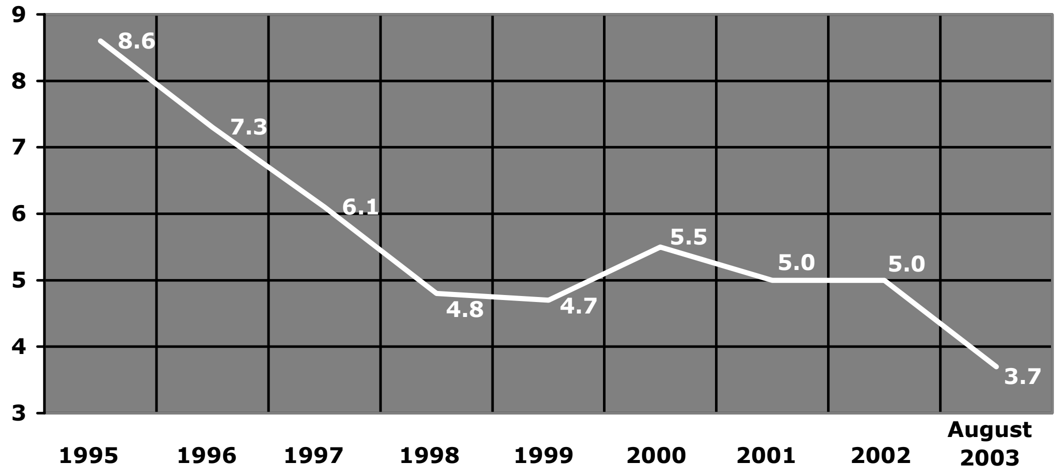
Average Weighted Quarterly Interest Rates on Credits in Credit Institutions
[3,55]
(long-term, in percent)



As we can see from the Figure 7, interest rates in the Euro area decreased substantially in the last decade as well.

Figure 7

Average Long-Term Interest Rate in Euro Area* [6,197]
(in percent)



* *Excluding Greece prior to 2001*

Summing up the abovementioned outlook of economic development of Latvia, one can say, that positive reforms in the country during the last decade have fostered rapid economic growth and development. Current macroeconomic and monetary indicators of Latvia prove that Latvia is almost ready to introduce euro and join the EMU in the nearest future.

Table 4 gives the general overview on the Euro area after ten new countries join the EMU as well as on the comparative statistics on population and GDP.

Table 4

Comparative Statistics on Population and GDP [11]
(2002)

	Population (millions)	%	GDP (EUR billions)	%
10 acceding countries	74.2	1.2	437.8	1.3
12-member Euro area	307.7	5.0	7065.7	20.7
22-member Euro area	**381.9**	**6.2**	**7503.5**	**22.0**
15-member EU	381.7	6.2	9164.5	26.9
25-member EU	**455.9**	**7.4**	**9602.3**	**28.2**
Japan	127.4	2.1	4234.9	12.4
Russian Federation	144.1	2.3	366.5	1.1
USA	288.6	4.7	11047.5	32.4
China	1281.0	20.7	1308.4	3.8
World	**6201.4**	**100**	**34108.9**	**100**

The GDP of the Euro area in 2002 was 7065.7 billion euro (see Table 4) and that of the acceding countries was 437.8 billion euro (around 6.2% of the Euro area's GDP). The Euro area had a population of 307.7 million people; the ten acceding countries had a total population of 74.2 million people (24.1% of the Euro area's). Summarizing data of the Table 4 the enlargement of the Euro area will not be economically significant (GDP will increase only by 6.2%), as it will be in terms of the size of the population (which will increase by 24.1%).

European Central Bank lists certain economic advantages for joining EMU and Euro zone enlargement: "The euro is a public good that brings many benefits to the participating countries. It eliminates exchange rate risks between countries that adopt it, thereby lowering interest rates, and ensures price stability, which is the primary objective of the ECB. It also paves the way for a deep, liquid and integrated capital market among countries that adopt it. Euro area enlargement means that a larger number of EU Member States can enjoy these benefits. Furthermore, some of the economic advantages of monetary union, such as the elimination of exchange rate uncertainties, increase with the size of the euro area. However, in order to be able to fully exploit the benefits, a country must be ready for the euro [10]."

The participation in the common currency area will provide a further significant boost to economic development through increased trade and financial flows by lowering transaction costs and eliminating market risks [12]. However, the euro adoption process may happen differently from country to country and can affect its economic development differently as well.

Despite the fact, that population of the most EU member states dislikes the euro according to the surveys of the Eurobarometer, in author's opinion it has become a strong economic symbol of Europe.

The introduction of the euro has significantly strengthened international financial system by eliminating disruptive currency crises among major trading nations in Europe. The low-inflation environment in Europe was achieved by the introduction of the euro. The European Central Bank earned credibility and trust in maintaining price stability. Economic analysis proves, that over the long term, the euro adoption could raise GDP by an additional 20-25% in most Central European countries [12].

Research on Public Opinion

As it was already mentioned in the introduction, the recent research of the author of this paper is "The Attitude of the Latvian Residents towards the Euro Introduction". The main goal of this research is to analyse the attitude of Latvian residents towards the euro introduction. The question of this research is to examine, whether the attitude of the Latvian residents towards the euro introduction depends significantly on the age, sex, nationality, citizenship, the level of education and income of the respondents. There was no research done in this field. All researches, which were done, were examining the attitude of the Latvian residents towards Latvia's accession to the EU. The author plans to examine the attitude of the Latvian residents towards the euro introduction with the help of questionnaires. Due to the fact that this research is in the process and author has not collected all the questionnaires yet, some tendencies will be mentioned only:

- the majority of respondents feel positive about the euro introduction.
- The majority of respondents of the Latvian nationality are not afraid of loosing sovereignty and national identity in comparison to non-latvians, who think, that after euro introduction Latvia will lose sovereignty and national identity.
- Some respondents are sure, that the lat is already fixed to the euro, however it is not true.
- Almost all respondents think, that the euro will be introduced in 2008, as it has been planned by the Bank of Latvia.
- Many respondents consider that the consumer prices will go up, moreover, they are sure, that the consumer prices will increase faster than their income. Respondents also think, that the ordinary inhabitants will suffer from the euro introduction.
- The only category, who will win in respondents' opinion is government and entrepreneurs.
- There is one more tendency, which should be mentioned: respondents from the same occupation category regardless even on age and nationality, for example, those respondents, who work in the education and culture or who are occupied in the health services, select the same answers in the questionnaire.

The author has noticed, that the respondents of Latvian nationality feel more positive about the forthcoming euro introduction in Latvia than the respondents of Russian nationality. It could be explained by the historically developed attitude of Russians towards the processes happening in Latvia: the same difference in opinions could be observed analyzing attitude of Latvians and Russians towards Latvia's accession to the EU and joining NATO.

Conclusions and Suggestions

1. Latvia was incorporated into the Soviet financial system after World War II. After the collapse of the USSR the Supreme Council of the Republic of Latvia passed Resolution "On Reorganization of Banks in the Territory of the Republic of Latvia" on September 3, 1991. According to this Resolution the bank of Latvia became a central bank with the right to issue the national currency.
2. The Latvian ruble (LVR) was introduced as a temporary currency in Latvia on May 4, 1992.
3. The national currency of Latvia – the lats (LVL) – was introduced in 1993, which became very strong and very secure with the property of full and free convertibility after it was pegged to the SDR currency basket in 1994.
4. The European Central Bank (ECB) defines three main stages of the EMU development: first stage is from July 1, 1990 till January 1, 1994; second stage is from January 1, 1994 till January 1, 1999; third stage is from January 1, 1999. In author's opinion the fourth stage of the EMU development will be when ten new accession countries join the EMU after January 1, 2008.
5. The Maastricht Treaty of 1992 laid down 5 convergence criteria (or Maastricht criteria), which are considered as the preconditions for joining the EMU. Convergence criteria define price stability, exchange rate stability, long-term interest rates, low budget deficit and low public debt. The main idea of the Maastricht criteria is to ensure solid economic fundamentals and durable convergence, which is also best safeguard against risk of destabilizing capital flows in the run-up to adopting the euro.
6. Author analyzed statistical data available for the main macroeconomic and monetary indicators. Author concludes, that the increase of the GDP in Latvia is one of the fastest in the world. The reason for that is growth of the personal income and domestic demand. GDP increased by 7.5% in 2003 compared to 2002.
7. Current account deficit is considered as one of the main economic problems in Latvia; however, it is not considered as critical one, because current account is covered mainly by foreign direct investment and long-term credits.
8. The main trade partner of Latvia is EU comprising 60% of total exports. After the EU enlargement the share of exports to the EU can rise to 80%. Negative trade balance is also considered as the economic problem of Latvia, because imports grow faster than exports.
9. Fiscal deficit of the general government budget since 1996 (except 1999) has been lower than the level identified in the Maastricht criteria (3% of GDP).

10. Central government debt of Latvia in 2003 according to the estimation of the Ministry of Economics was 14.7% of GDP, which is much lower than identified in the Maastricht criteria (60% of GDP).
11. Employment rate in Latvia in the 3rd quarter of 2003 was 63%, which is slightly lower than the average in EU member states. Real unemployment in the 3rd quarter of 2003 (share of job seekers) was 10.7%. In general, employment and unemployment indicators have improved in recent years.
12. The convergence criteria for inflation in December 2003 was 2.7%. Latvia's annual average inflation in December 2003 was 2.9% (by 0.2 percentage points more than allowed for joining EMU, if Latvia showed the willingness to join the EMU in December 2003).
13. There were no fluctuations observed after lat was fixed to the SDR currency basket in February 1994. Latvia plans to fix lat to the euro on January 1, 2005 and introduce the euro as a single currency on January 1, 2008.
14. Net foreign reserves of the Bank of Latvia constantly cover the reserve money in Latvia.
15. Improvement of economic environment, low inflation and growing supply of credits, increasing competition in the banking sector promote gradual reduction of interest rates on credits and extension of crediting deadlines.
16. The participation in the common currency area will provide a further significant boost to economic development through increased trade and financial flows by lowering transaction costs and eliminating market risks.
17. The euro has become a strong economic symbol of Europe. The introduction of the euro has significantly strengthened international financial system by eliminating disruptive currency crises among major trading nations in Europe. The low-inflation environment in Europe was achieved by the introduction of the euro.
18. 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.
19. Government and the Bank of Latvia should inform society more efficiently about the euro introduction in Latvia with the aim to raise the positive attitude of the population of Latvia towards the euro adoption by explaining all the advantages, disadvantages and benefits of euro introduction.

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