



Baltic-German
Strategic
Engagement:

Realignment after
the Eurocrisis?

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“Baltic-German Strategic Engagement: Realignment after the Eurocrisis?” is a research publication focusing on the potential changes to the relationship between Germany and the Baltic States in the context of the financial and economic problems in the Eurozone and Latvia’s planned accession into the Eurozone in 2014. The policy paper also addresses the economic, political and institutional implications of Latvia’s accession into the Eurozone, with the aim of addressing the main concerns and strategic reasoning of the Baltic state. The publication was prepared for the German – Baltic Strategy Talks 2013 (Overcoming the Eurocrisis: Baltic-German Strategic Engagement), which is taking place in Riga, May 16-17, 2013. The conference and the policy paper are yet another example of fruitful collaboration between the Latvian Institute of International Affairs and the Friedrich Ebert Stiftung.

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Introductory Remarks

by Andris Sprūds

The Baltic countries and Germany have engaged in a constructive dialogue and cooperated extensively over the last two decades. Germany supported and contributed to the Baltics' Euro-Atlantic integration and the eventual Europeanization of the new member states. Although somencing mutual understanding led to a gradual convergence of positions on issues such as transatlantic relations, the Eastern Partnership and Russia, and energy security. Economic asymmetry notwithstanding, the Baltic countries welcomed the foreign direct investments and business management experiences of Germany. Moreover, the intensification of mutual trade relations facilitated the more recent recovery after the considerable economic downturn in the Baltic countries. Access to Germany's market was instrumental for the export oriented countries, especially in the neighbourhood, to pull their economies out of the recession. Europe's economic decline and accompanying Eurocrisis, however, has led to wider and more fundamental repercussions. The Eurocrisis essentially transformed the community's internal and regional configuration and mutual perceptions. Germany has turned into an indispensable European nation, both economically and politically. Germany has remained relatively competitive, and even experienced modest growth in economic terms that partially offset the unfavorable economic trends in the EU. Moreover, the major European economy has also retained its role as the major net contributing nation to the overall EU budget and the Financial Stability Mechanism, which was established to support the crisis-hit Eurozone members. As a result, Germany has inevitably become the dominant player in EU debates on further economic, fiscal, monetary and political integration. Initially by default rather than by design, the economic crisis has impelled Germany to transform from a large economic but reluctant political player to an instrumental stabilizing power and increasingly important political leader.

The Baltic countries, alongside the other Nordic and Visegrad countries, forged a diversity of economic and political partnerships with Germany to constrain the crisis. These countries largely demonstrated like-mindedness in the economic philosophy of accepting austerity measures and tightening fiscal controls. Germany's comparative economic competitiveness and modest economic growth served as a role model for the new EU members in the Baltic Sea region. Actually, the (somewhat) previously existing division between the developing new and developed old member states was substituted by categorization into the fiscally disciplined Northern and rhetorically growth oriented Southern states. Some realignment of interests, perceptions and partnerships has apparently taken place among member states within the European Union. However, the question must be raised as to whether the significant changes and new challenges and partnerships in the context of the Eurocrisis have led to fundamentally transformed and permanent engagement patterns among the states. Hence, the major objective of this publication is to assess the scope, character and determinants of the current and potential realignment of the Baltic-German strategic engagement after the Eurocrisis.

The successful completion of this publication under the auspices of the German-Baltic Strategy Talks was enabled by a number of joint efforts. The Friedrich Ebert Foundation in the Baltic countries has been continuously instrumental in generously supporting the research endeavors

related to thoroughly assessing bilateral and regional economic and political developments, and promoting an informed dialogue between German and Baltic partners. The very idea of a regular dialogue was launched as early as 2001 in close cooperation with the Friedrich Ebert Foundation, as well as German and Baltic think tanks. The current joint research project and German-Baltic Strategy Talks also takes full advantage of the opportunities of a long tradition of a prolific cooperation between the Latvian Institute of International Affairs and its partner institutions in the other Baltic countries and Germany, especially the German Institute for International and Security Affairs. Back in 2001, the Dialogue was aimed at addressing the issue of Baltic integration into the broader process of European political, security and economic developments. More than 10 years later, the Baltic countries are full-fledged members of the Euro-Atlantic organizations and the aim of the current Strategy Talks is to address the issue of the potential for joint Baltic-German economic and political endeavors within and beyond the EU. The new scope and quality of the dialogue has been itself the manifestation of successful bilateral and regional engagement and development. Last but not least, this publication and the whole German-Baltic Strategy Talks effort would be void without the participation of a wider public interested in the constraints and opportunities for a mutually beneficial political and economic engagement and the potential for a further mutually beneficial realignment between Germany and the Baltic countries.

The Crisis and Germany's Challenges in the EU: Stabilizing the Eurozone and Looking for Partners

by Kai-Olaf Lang

The sovereign debt crisis and its implications have caused serious problems for the functioning and the acceptance of the European project. Most notably, the difficulties of some Eurozone members have led to considerable instability of what has always been the firm ground of integration, i.e. mutually beneficial economic, commercial and trade relations between the economies of the member states. What is more, even the problems of smaller economies seemed to have “systemic” potential: according to the prevailing opinion, the financial or fiscal failure of a single Eurozone state could cause the end of the Eurozone and the European project altogether. As opposed to the various crises Europe went through in the past, for the first time European integration now stares into the abyss.

No wonder that soon after its outbreak, the sovereign debt crisis and problems in the Eurozone have also had political effects. Governments have fallen victim to dissatisfaction caused by the economic downturn, problems in the banking sector and rising unemployment. In some EU countries, the hardships of economic reforms, cuts in public spending and a downsizing of welfare systems have sparked social unrest and protest movements. But the crisis has not only caused complications in domestic policy. The difficulties in the Eurozone and the complicated politics of handling the crisis have also impacted the political dimension of European integration. For many, the euro has been regarded as a key political project and a driver towards an “ever closer Union”. The problems in the Economic and Monetary Union (EMU) have endangered this flagship project and could have the potential to slow down or even reverse the intensification of Europe’s integration. This possibility is particularly challenging because the crisis might act as a catalyst for tendencies towards re-nationalization and “de-Europeanization”, which had gained ground even before state budgets and banks got stuck in a debt quagmire. At the same time, clashing interests between member states reinvigorated tensions in bilateral relations and reanimated traditional stereotypes between societies.

Moreover, uncertainties about the euro’s future and the success of stabilization efforts have caused increasing doubts about the effectiveness of the EU’s response to the crisis. At the same time, decisions taken by non-elected institutions and through nontransparent procedures (like for example the Frankfurt Group, consisting of the presidents of the European Commission and the European Council, the president of the European Central Bank, the heads of the IMF and the Eurogroup, the German chancellor and the French president) have brought about a feeling of the EU as an increasingly “technocratic” and “post-democratic” entity, lacking appropriate democratic legitimacy¹.

¹ Cf. Jürgen Habermas, *The Crisis of the European Union: A Response*, Cambridge; Malden, 2012; Mark Leonard/Jan Zielonka, *A Europe of incentives: how to regain the trust of citizens and the markets*, European Council on Foreign Relations, Policy Brief, June 2012, http://ecfr.eu/page/-/ECFR58_EUROPE_INCENTIVES_REPORT_AW.pdf; EU democracy in crisis: mired in a perfect storm or rebounding?, Article by Kirsty Hughes published on OpenDemocracy, 16.1.2012, www.opendemocracy.net; on the traditional problems of the EU’s democratic deficit: Føllesdal, Andreas/Hix, Simon (2006): *Why There is a Democratic Deficit in the EU. A Response to Majone and Moravcsik*, in: *Journal of Common Market Studies*, 2006, Volume 44, Number 3, pp. 533–62.

The crisis and attempts to overcome it are a common challenge for all member states. However, those countries with a big political, economic and financial potential have a special role to play. That is why Germany, the heavyweight among EU and Eurozone members, is a key player in the process of re-stabilizing the Economic and Monetary Union (EMU). Even though in the EU there is no consensus on the German way to tackle the crisis, both supporters and opponents of Berlin's concepts attach major relevance to Germany. Looking at Germany's role in the crisis and the ongoing reforms in the EU, at least four questions have to be asked:

- What is Germany's approach to crisis management and the reform debate in the EU, and what are Berlin's key objectives?
- Who are Germany's partners?
- What are the basic challenges in the nearest future?
- How could Germany and the Baltic states reinforce cooperation?

1. Germany's interests in the context of the crisis

As the biggest EU and Eurozone economy, as a country that is heavily dependent on exports and intensively intertwined with the economies of other Eurozone and EU states, Germany has a vital interest in the swift and sustainable stabilization of the EMU and the Euro-area. Moreover, as Germany is traditionally one of the standard bearers of European integration as a political endeavor, a breakdown of the euro with all the associated political consequences would be a severe blow to one of the pillars of Germany's Post-World War II identity. That is why Germany has clearly stated that it is an overarching objective that it will do everything to support the euro and that the Eurozone has to survive. Hence, it came as no surprise that the German chancellor declared, "if the euro fails, then it is not only the money that fails. It is more that fails. It is Europe, it is the idea of European unification that fails"².

Germany's approach to overcoming the Eurozone crisis corresponds to its traditional economic concept of ordoliberalism, giving priority to price-stability, independence of the central bank and fiscal consolidation. The dominant German reading of the crisis is that enormous bubbles and imbalances emerged in some Eurozone states, because they were neither tough enough with their public finances nor had they carried out necessary reforms to improve competitiveness. In crisis management, Germany's main objective has been to convince its European partners to embark on strict budget consolidation, while at the same time improving competitiveness and innovation capacities. As the biggest net contributor to Eurozone aid schemes like EFSF or ESM (Germany accounts for 27% of the ESM), Germany has tried to shape reforms of the Eurozone and reforms in member states according to the German model. Germany's basic idea has been to enshrine efficient, (quasi-)automatic sanctions against countries with substantial budget deficits in

² Rede von Bundeskanzlerin Angela Merkel zur Verleihung des Internationalen Karlspreises an Premierminister Tusk, Aachen, 13.5.2010 [Laudation Speech of Chancellor Angela Merkel on the Occasion of the Charlemagne Prize 2010 to Polish Prime Minister Donal Tusk, Aachen, 13.5.2010] <http://www.bundesregierung.de/Content/DE/Rede/2010/05/2010-05-13-karlspreis.html>

exchange for support. This all has to happen by defining central rules and establishing functioning implementation mechanisms for these rules (which often in the past have not been observed).

This “conditioned solidarity” is the spirit behind most of the Eurozone and EU economic-governance reforms initiated or supported by Germany. It is visible in the reform of the Stability and Growth Pact (SGP) and the so called Six Pack, as well as in the stability treaty signed in January 2012 by 25 member states (the so called Fiscal Compact, aimed at the introduction of a sovereign debt ceiling or debt brake according to the German model). At the same time, Germany rejected an active role in the European Central Bank as a lender of the last resort, since “there is a price we are not willing to pay – the cost of price stability”³. The German government has also repeatedly criticized growth through cheap money as well as a relaxed or Keynesian pro-growth policy. It has instead been favoring a strategy of inducing growth through budget solidity as a precondition for sustainable economic development: “when it comes to restoring confidence, consolidation and growth are basically two sides of one and the same coin.”⁴ This posture results from Germany’s historic experience with hyperinflation and its dangerous social and political consequences, as well as from the economic doctrine of “social market economy”, which was the guiding principle of Germany’s Wirtschaftswunder, i.e. the successful economic recovery after World War II.

Despite considerable German contributions to aid schemes and rescue funds for ailing Eurozone states, from the point of view of France or Southern European countries, Germany appeared to hesitate. For them, Germany is the biggest beneficiary of European integration and the Eurozone, so Berlin should not be reluctant to assist and to generate additional aid for partners in need. Nevertheless, Germany has continuously pursued its current approach. In doing so, Berlin tried to launch the narrative of a new balance between solidarity and responsibility⁵. However, this did not really work, and Germany’s philosophy soon gained the character of “austerity”. What has been perceived as an adamant German position has much to do with domestic developments: today, every German government has to consider at least three factors, which in previous times did not exist as they do now. First is public opinion, which has never been enthusiastic about the introduction of the euro and which reacts in a sensitive way to any sign of possible currency weakness; second is the Federal Constitutional Court, which has recently (in a verdict on the Lisbon Treaty) shown where the red-lines in the German Constitution are for European integration; and third is the parliament, where even among the political groups of ruling parties more and more members of parliament are critical about the growing financial risks coming from Eurozone stabilization⁶.

³ According to Germany’s minister of the economy Rösler, see: Euro calm must not cost price stability: German economy minister, Reuters, 17.1.2013, www.reuters.com

⁴ Speech by Federal Chancellor Merkel at the World Economic Forum Annual Meeting 2013, Davos, 24.1.2013, <http://www.bundesregierung.de/Content/EN/Reden/2013/2013-01-24-merkel-davos.html>

⁵ At the beginning of 2012 chancellor Merkel said: “we do feel and show solidarity, but we must not forget that all countries must also act responsibly. You can’t have one without the other.”; “Deutschlands Kraft ist nicht unendlich”, Süddeutsche Zeitung, 26.1.2012 [“Germany’s capacities aren’t infinite”, Interview with chancellor Merkel in Süddeutsche Zeitung, 26.1.2012], www.sueddeutsche.de

⁶ For the center-right alliance of Mrs. Merkel, the emergence of a Euro-skeptical group is a particular challenge, because such a group would probably absorb some of the voters of the conservative Christian Democrats CDU/CSU or the market-liberal Free Democrats FDP, which make up the coalition. In April 2013, the so-called Alliance for Germany was formed, gathering among others many former CDU and middle-class activists.

Apart from Eurozone reform and rescue mechanisms proper, in the course of the crisis Berlin has pursued the following objectives:

- Berlin has been highlighting that it has a predilection for the unity of European integration. Although Germany has supported strengthening the political scaffolding of the Eurozone (Eurozone summits, the Eurogroup, etc.), a multi-speed Europe is seen only as the second best option. Germany accepted the way the Fiscal Compact was launched, i.e. as an accord that, due to British resistance, is an intergovernmental treaty between 25 member states; but Germany would have preferred for the agreement to be part of the EU-treaties⁷. That is why Germany has also called for the prospect of inserting it into the EU framework in the long-run. At the same time, Germany has always been relatively open to including non-Eurozone states (especially those without a formal opt-out, i.e. all except for Great Britain and Denmark) in a soft way into the Eurozone structures (of course without a vote). This is slightly different from the French approach, which has been sympathetic to “a Union within the Union”.
- The German government has consistently rejected the idea of Eurobonds, i.e. common sovereign bonds of Eurozone member states. On one occasion, Chancellor Merkel is reported to have said that there would be no comprehensive debt sharing “as long as I live”⁸. German Finance Minister Schäuble (a member of Merkel’s Christian-democratic party CDU), seemed to be a little more nuanced, arguing that a Eurozone pooling of bonds is imaginable, but only once a functioning fiscal union has been achieved – which for him is a medium-term process⁹. Even this modest statement (which in practice would postpone the possible introduction of joint bonds for many years and make it conditional on tough reforms), has sparked criticism from the liberal coalition partner of the CDU, which excludes Eurobonds for good¹⁰. For Berlin this means the mutualization of debt and the entry into a union of transfers. A similar cautiousness could be observed with regard to the plans for a European banking union. In spring 2013, the German finance minister called for treaty changes as a necessary precondition to have a full-fledged banking union¹¹. Politically, the idea of creating joint deposit guarantees (which are also a form of mutualization of risks) is unpopular in Germany. The social-democratic and green opposition parties are more open to such ideas.
- Germany has accepted and actively supported plans to give the EU more legitimacy. German politicians agree that especially if the Eurozone moves to more fiscal centralization, the growing democratic deficit has to be reduced: “stronger democratic legitimacy and oversight – this principle must be adhered to in all measures aimed at deepening economic and monetary

⁷ In the run-up to the December European Council 2011, the German chancellor said that a change to the European treaties would be necessary in order to overcome the crisis in the Eurozone. However, if this would not be possible, special treaties among Eurozone members would also be accepted; cf. Merkel: Eurozone crisis will take ‘years’ to solve, EUObserver, 2.12.2011, <http://euobserver.com>

⁸ The Coming EU Summit Clash: Merkel Vows ‘No Euro Bonds as Long as I Live’, Spiegel Online International, 27.6.2012, www.spiegel.de

⁹ Schaeuble Tells Handelsblatt Fiscal Union Comes Before Euro Bond, Bloomberg, 5.6.2012, www.bloomberg.com
10 Westerwelle gegen Schäuble – „Niemand Euro-Bonds“ [Westerwelle against Schäuble – „Eurobonds never“], Die Welt, 2.7.2012, www.welt.de

¹¹ Germany puts brakes on EU bank union with treaty call, Reuters, 13.4.2013, www.reuters.com

union. It forms the centrepiece of a renewed European Union!”¹² Around 2011 and early 2012 a consensus seemed to emerge according to which “more integration”, and accordingly building a “political union” including improved economic and fiscal governance, is the way to overcome Europe’s problems. However, the picture is less clear when it comes to the question of how far political reform should go. By the end of 2012, two camps seem to have appeared. The first camp argues for focusing first of all on economic governance reform and above all improving competitiveness in member states. In a speech to the German parliament in December 2013, the chancellor emphasized better regulation of financial markets, improved banking supervision, better fiscal cooperation and the “key-question” of competitiveness. Proposals by European Council President van Rompuy (in the so-called quadriga report “Towards a genuine Economic and Monetary Union”) were called a “background document” and obviously seen as a question for the far future¹³. This option would revitalize the Eurozone economies with a “pact for competitiveness”, based on bilateral agreements between (Eurozone) member states and the Commission. If treaty changes are required for this purpose, they should be narrow and focused on the improvement of economic coordination¹⁴. Obviously, the fear of opening a Pandora’s box is quite strong among proponents of this pragmatic way, as they are afraid that the EU has no amendment culture and risks becoming entangled in incalculable reform complexities. Then there is a second camp, for which a comprehensive reconstruction of EU institutions and mechanisms towards a genuine European democracy is necessary given the major reforms that are going on in the economic sphere and in the EMU. The paper produced by a group of EU foreign ministers and initiated by German Foreign Minister Westerwelle is certainly part of this second view. Although it consolidates many proposals attainable within the existing treaties, changes of primary law are not excluded¹⁵. Also, the German finance minister has called for a major overhaul of the political system of the EU: “we should have the confidence to allow a European Commission President to be directly elected, to abolish national rights to appoint commissioners, to evolve the Commission into a European government, and create a bicameral system comprising a Parliament elected by an equal, general vote and a Chamber of Member States in which seats are distributed according to degressive proportionality.”¹⁶

¹² Speech by Federal Chancellor Angela Merkel in the European Parliament in Brussels, 7.11.2012. www.bundesregierung.de/Content/EN/Reden/2012/2012-11-07-merkel-eu.html

¹³ Regierungserklärung von Bundeskanzlerin Merkel zum Europäischen Rat am 13. und 14. Dezember 2012 in Brüssel, 13.12.2012, Berlin [Government Declaration of Federal Chancellor Merkel on the European Council on December 13 and 14 in Brussels], www.bundesregierung.de/Content/DE/Regierungserklaerung/2012/2012-12-13-eu-rat.html

¹⁴ There are two ways for a “narrow” treaty change: either via the “simplified procedure”, which has been applied for primary law adaptation of the European Stability Mechanism (Art. 136 Treaty on the Functioning of the European Union). If additional competences are inserted into the treaties, only the “ordinary procedure”, which “usually” involves a convention and an intergovernmental conference, is a possible option. However, also in this case a convention can be skipped, if the European parliament approves.

¹⁵ The final report of the 17 September 2012. Final Report of the Future of Europe Group of the Foreign Ministers of Austria, Belgium, Denmark, France, Italy, Germany, Luxembourg, the Netherlands, Poland, Portugal and Spain, www.auswaertiges-amt.de/cae/servlet/contentblob/626338/publicationFile/171783/120918-Abschlussbericht-Zukunftsgruppe.pdf

¹⁶ Speech by Dr Wolfgang Schäuble at the award ceremony for the 2012 Charlemagne Prize, Aachen, 17.5.2012, www.bundesfinanzministerium.de/Content/EN/Reden/2012/2012-05-17-karlspreis.html

2. Who are Germany's partners?

Since the emergence of the crisis Germany has tried to build coalitions and partnerships with other member states in order to get support for its understanding of reforms and in order to avoid the emergence of new dividing lines in the EU.

- France has been the key partner in efforts to stabilize the Eurozone and to rearrange the economic governance of the EU. After a difficult beginning with French President Sarkozy, the German chancellor and the French head of state have actively built a key axis of crisis management. The sovereign debt crisis has brought about a renaissance of Franco-German relations, as both countries have become the source for various initiatives aimed at the reduction of economic and fiscal imbalances. “Merkozy” was, of course, an asymmetric partnership. Nicolas Sarkozy, in party-political terms a close friend Angela Merkel and her Christian Democracy, quite soon acquiesced to Berlin's call for budgetary discipline. To quite a considerable extent this resulted from France's economic weakness. Whereas at the beginning of the 2000s these were seen as two countries that both experienced a crisis of “Rhine capitalism” (with high social security standards, rigid labor markets and strong trade unions), after the reforms of social-democratic Chancellor Gerhard Schröder Germany laid the groundwork for a pathway to more dynamic economic growth. France did not implement comparable reforms, which obviously opened the economic gap between both countries¹⁷. This gap has translated into political weight. The constellation changed somehow after the presidential elections in France in 2012. New French President Francois Hollande questioned Germany's “austerity-first” approach and demanded a shift towards more elastic, stimulus-oriented fiscal policies. Although Hollande has acted in a more pragmatic way than his resolute rhetoric has sounded, in the first months of his tenure he was able to receive a certain trophy, whereby Germany agreed to a European “Compact for Growth and Jobs” – which was Hollande's condition to accepting the fiscal compact. Nevertheless, the growth pact is not a broad stimulus-package, it is a rather modest initiative without big extra money, re-shifting existing financial aid from structural funds, establishing guarantees for “project bonds” or increasing the capital of the European Investment Bank¹⁸. In spite of these differences, German and French leaders are aware of their common responsibility for the EU. During the 50th anniversary of the Franco-German Elysée treaty in January 2013, both sides declared their determination “to develop Franco-German cooperation further and put it at the service of deeper Economic and Monetary Union, so that Europe may overcome the difficulties and enable us to emerge stronger from the crisis”¹⁹. At the same occasion, the French president and the German chancellor announced common proposals for developing the Eurozone and deepening fiscal integration²⁰. However, the upcoming elections in the German parliament have made it difficult to produce such proposals before the June

¹⁷ E.g., one of the major differences is a growing gap in industrial manufacturing, where Germany has one of the highest shares in gross value added in the EU (22.6%), whereas France is at the end of the list (10.1%, having lost almost 5% in a decade); cf. Karl Brenke, *Industrial Development: France and Germany Drifting Apart*, in: DIW Economic Bulletin, 2/2013, pp. 3-13, www.diw.de/documents/publikationen/73/diw_01.c.415236.de/diw_econ_bull_2013-02-1.pdf

¹⁸ Conclusions of the European Council, Brussels, 29 June 2012, EUCO 76/12, www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf

¹⁹ France and Germany reaffirm EU partnership and cooperation, Berlin Declaration. 50th anniversary of the Elysée Treaty, <http://ambafrance-uk.org/France-and-Germany-reaffirm-EU>

²⁰ Germany, France to table new proposals for the eurozone, Euractiv, 23./24.1.2013, www.euractiv.com

2013 EU-summit. The French socialist party has fiercely attacked the German chancellor and only the intervention of party leadership softened a draft document in which Mrs. Merkel was called “selfish” and the “chancellor of austerity”²¹.

- The Southern EU countries have been critical of the “German course”, since they are afraid of the economic, social and political implications of bold fiscal consolidation. However, there has been no efficient Southern caucus that would have been able to push through a fundamental revision of the stability through consolidation formula. However, there were situations where these countries could provide effective counterbalancing of Germany, e. g., when Spain and Italy tried to establish a new trilateral format with France. This coordination led to softened conditions for access to money from the European Stability Mechanism for countries in need. With a relatively weak France, Southern European leaders have (despite their differences) continued to maintain direct relations with Germany; especially Italy and Spain have sought to stabilize cooperation with Berlin.
- A group close to Germany’s philosophy of consolidation are the AAA-ranked Eurozone states (without France). These countries, from Northern or Central Europe (Finland, Netherlands, Luxembourg, Austria), are natural allies for Germany. At the end of 2011 some German politicians thought about the idea of issuing “elite bonds”, i. e. common sovereign bonds of the AAA Eurozone countries. This concept was not accepted by the German government, but the discussion showed that within some sections of Germany’s political elite there is a feeling of proximity to the other AAA states. At the beginning of 2012, for the first time, the finance ministers of four AAA states had a meeting in Berlin.
- The new Central and Eastern European member states are mostly like-minded when it comes to Germany’s culture of stability. The radical social and economic transformation after 1989 made these countries less empathic with the countries in Southern Europe. Slovakia’s skepticism towards Eurozone assistance for Greece or the ESM was a typical example of this posture. Slovakia’s foreign minister, for example, justified the rejection of aid schemes for Greece in 2011 by arguing that there was no solidarity of the poor for the rich and of the responsible for the irresponsible. Also, the then-president of the European parliament, Jerzy Buzek from Poland, in a speech in Berlin stressed that there can be “no solidarity without responsibility”²².
- For Germany, Great Britain has been traditionally a less “awkward partner” than for France. In many respects, London is an important ally for Germany – despite British euroskepticism. The main reason for this is Britain’s function as a pro-market counterweight to French influence in issues regarding the single market or economic policy in general. However, the December 2011 European Council, when Great Britain via its veto-threat forced Germany, France and others to anchor the Fiscal Compact outside EU treaties, was an event that irritated many in Berlin. Since that time, after Prime Minister Cameron’s veto of a compromise for the mid-term EU budget framework in November 2012, and after Cameron’s announcement about holding a referendum on EU membership in his country by 2017, in Germany (as well as in other member states) there is a growing worry that the British government could complicate essential EU reform for domestic political reasons.

²¹ French Socialists soften tone on Merkel, Reuters, 27.4.2013, www.reuters.com

²² Buzek on Greece: There can be no solidarity without responsibility, Berlin, 22.3.2010, www.europarl.europa.eu

3. The Big Challenge: A “Normalized Germany” in Need of Partners

Germany faces huge challenges in the EU. It is supposed to lead, but is reluctant to do so. And when Germany begins to (co-)lead, many partners are bothered. Particularly because a considerable number of member states are afraid of a special German moment in European integration, which (according to them) would create favorable conditions for Berlin to export the German concept of ordoliberalism to the EU level. Consequently, there is an obvious lack of partners in leadership, especially within the Eurozone. Although Germany is not isolated in the EU, the political landscape of Europe is not conducive to Berlin and a something like a new German loneliness seems to emerge. But apart from this leadership dilemma, it is above all the confluence of four big themes that will determine Germany's and the Union's political prospects.

- The new British question: Will Great Britain continue to drift away from the EU (or at least from its political center)? The successful conclusion of negotiations on the multiannual EU budget framework in February 2013 (Great Britain had already once vetoed a European Council) had shown that Germany can play an important role in building bridges with London. However, if in the context of the British EU referendum and rising anti-European sentiments in the British public and mass media London should call for additional substantial opt-outs from the EU, this might complicate Eurozone and EU reform. This is especially true if Great Britain wants treaty changes, in which case a complicated process of negotiations would have to be initiated.
- The scope of future EU reform: the British question is particularly grave if the EU decides to embark on a path of deep and comprehensive political reform. Commission President Barroso has called for the creation of a “federation of national states” in Europe. The European Parliament would certainly press for a Convention if anything more than cosmetic changes to the treaties would happen. If a Convention process is launched, a rather complex endeavor is waiting: the whole exercise might be “uncontrollable” in terms of what direction it takes, and the reform process could be lengthy and risky due to the resulting negotiations among governments and the ratification procedures, which would probably include referendums in some member states. In any case, this would be linked with the British question and London might use its veto power on EU or Eurozone reform as a bargaining chip.
- The state of the French economy and public finances: if France has economic troubles, it might not meet the stability and fiscal criteria of the new (and old) mechanisms. Would Germany push for tough sanctions against its most important partner? If so, this would put strain on the Franco-German couple and would produce domestic resistance and problems for President Hollande and his government. If not, the new architecture of fiscal consolidation and the philosophy of a rule-based approach including sanctions, as was initiated basically by Germany, is watered down before it really begins to work.
- And finally, the developments in crisis-struck states in the Eurozone: even though the EFSF and ESM, ECB intervention (especially outright monetary transactions OMT), and the first steps towards a banking union have calmed down the turbulence in the Eurozone, the emergence of new hot-spots is still possible. But even if the outbreak of new worst case scenarios can be avoided, it is important that countries like Portugal, Ireland or Spain will have a real prospect for a positive economic pathway. Without an optimistic horizon and signs of economic recovery, the model launched by Germany and implemented in these countries will again be challenged.

All in all, opposition to Germany's recipes is on the rise. Commission President Barroso obviously felt compelled to visibly endorse Chancellor Merkel's line after he had cast doubt on the hard-line consolidation policy, which according to him had "reached its limits" and should be complemented with "stronger emphasis on growth"²³. With more and more resistance against the German way of economic and financial reform, Berlin has already started to soften its "consolidation only" rhetoric and accepted the need to strengthen the growth dimension of adaptations. It has also tacitly consented to the Commission's approach of giving more time to the consolidation paths of deficit countries such as France or Portugal. This could be the first step towards mitigating the growth vs. austerity confrontation by introducing "flexible discipline"²⁴. In an optimal scenario, dialogue between Germany and France (*as pars pro toto for North and South*) would achieve a grand bargain, which would include Berlin's "yes" for the French concept of solidarity in integration (*intégration solidaire*)²⁵ as well as German demands for better competitiveness and tough budget rules.

In the end, the shocks of the sovereign debt crisis will leave Germany (and its partners in the EU) with an overarching predicament: on the one hand, the crisis will make Germany a more "normal" member state – defending national interests, considering domestic political factors and trying to shape European integration with less self-restraint than in the past²⁶. On the other hand, Germany is faced with a new burden of responsibility for Europe and with the awareness that despite asymmetries in power it is more than ever reliant on its partners. In spite of being the most important political and economic player, Germany can lead and mould the EU only together with, and not without or against key partners. The balance and reconciliation of these two exigencies will be a permanent task for German European policies in the upcoming years.

4. Towards A German-Baltic Agenda in the EU

In this broader picture, what is the possible role of German-Baltic relations? What is the added value of German-Estonian, German-Latvian or German-Lithuanian cooperation? At first glance, Germany and the Baltic states share a very similar understanding of the crisis and exit strategies. In terms of budget consolidation, debt reduction and improving competitiveness, Germany, Estonia, Latvia and Lithuania are like-minded countries. From the German point of view, the pro-Euro-orientation and Eurozone accession in times of turmoil is a valuable contribution to regaining trust in the common currency: the Baltic states are not only examples for successful "growthsterity", they are also believers of the euro project in a period of incertitude. So Germany and the Baltic states – alongside the countries of Northern Europe and Poland – belong to the EU area of fiscal

²³ Barroso: EU austerity has 'reached its limits', EUobserver, 24.3.2013, www.euobserver.com

²⁴ „Flexible Disziplin“ in Portugal [“Flexible Discipline“ in Portugal], Frankfurter Allgemeine Zeitung, 3.5.2013.

²⁵ This idea has been repeatedly emphasized by French President Hollande. It entails the principle that each deepening of integration should be accompanied by additional efforts to strengthen the social dimension of Europe; cf. Conférence de presse conjointe du Président de la République et de M. Giorgio NAPOLITANO, Président de la République d'Italie, 21.11.2012 [Common press conference of French and Italian presidents F. Hollande and G. Napolitano, 21.11.2012], www.elysee.fr/conferences-de-presse/article/conference-de-presse-conjointe-du-president-de-la-republique-et-de-m-giorgio-napolitano-president-de-la-republique-d-italie/

²⁶ On Germany's normalization due to the crisis cf. Simon Bulmer, William E. Paterson, A Life More Ordinary? Ten theses on a normalization of Germany's role in the EU, http://euce.org/eusa/2011/papers/2g_bulmer.pdf

conservatism, market-orientation and innovation. However, there are also different interests, which both sides should not forget and which will continue to subsist after the crisis. Discrepancy might emerge around the governance mode of the EU – with the Baltic states having a predilection for the community method and Germany moving towards the “Union method”, i.e. a new balance between member states and communitarian institutions that gives more weight to capitals. Also, when it comes to economic policy variance might reemerge at some point. Despite considerable reforms, Germany still has an embedded tradition of social policy, social dialogue and welfare systems. Whereas the Baltic states are a useful “counterweight” to “Southern European” welfarism, Germany would rather not look for a workfare state without attributes, but instead for a model of competitiveness with a social dimension. Especially if the Social Democrats were part of the government, the Northern European approach of flexicurity would be more attractive than the tough Baltic way. Even though these differences will not be an immediate obstacle, they should be taken into account in the definition of a German-Baltic cooperation agenda. To reduce the risk of divergence and to improve the potential of mutual relations, four feasible steps could be made:

- Germany and the Baltic states should strengthen their dialogue surrounding EU reform, particularly regarding possible scenarios with and without treaty changes, the future mode of governance in the EU, and the practice of basic values in the Union (e.g., the scope and conditions of solidarity in financial affairs, as well as in energy or foreign and security policy). Below the level of foreign ministers, a German-Baltic “mini-reflection group” including European directors and experts could be set up.
- As competitiveness will continue to be a leitmotiv for overcoming the crisis and for the post-crisis agenda, Germany and the Baltic states should care about this issue. Representatives of the ministries in charge of the economy, social affairs, labor markets, science and technology (and the ministries of foreign and European affairs) could establish a German-Baltic working group on competitiveness. This group would not only reinforce exchange and best practices, it would also focus on the construction and content of envisaged bilateral contractual reform arrangements between Eurozone states (and maybe other member states) and the Commission.
- Under the auspices of (and with coordination of) government institutions (e.g., the ministries of economy) a quadrilateral pool of interested companies, representatives of national administrations, self-governments and research institutions could be set up. This pool would serve as a reservoir of participants for bilateral or multilateral “innovation and competitiveness partnerships”.
- The crisis has downgraded the relevance of foreign policy on the EU’s political agenda. However, foreign and security policy challenges remain or have increased. Foreign and defense ministries from Germany and the Baltic states could generate a common CFSP risk and opportunity analysis with special attention to the wider Baltic Sea region, Eastern Europe and Russia.

Latvia's Socio-Economic and Political-Institutional Challenges in the Context of the Eurozone Accession

by Aldis Austers and Kārlis Bukovskis

Introduction

The Republic of Latvia is aiming to join the Third Stage of Economic and Monetary Union (Eurozone) in 2014. Within the context of the economic and financial problems in some of the Eurozone member states, and taking into account the equivocal public support, rather heated political debates have been taking place in Latvia. The debates on Eurozone accession in Latvia were even used by some political forces to re-start the debate on Latvia's place and future in the European Union (EU). The situation is rather biased, because in accordance with Article 140 of the Treaty on the Functioning of the European Union, accession to the Eurozone for Latvia *de jure* means abrogating derogation from euro membership, while *de facto* it means deepening integration and the delegation of monetary policy decision making powers to a collective supranational body.

Taking this into account, the authors of this article aim to reassess the arguments and highlight some of the "forgotten" aspects of Latvia's accession to the Eurozone. As more and more indicators demonstrate the economic readiness of the second Baltic state to join the single currency system, social and economic challenges as well as political and institutional shifts are still ahead. Thus, we argue that Latvia's accession to the Eurozone is not simply an economic matter, but even more importantly it is a political, strategic choice.

1. The Socio-Economic Aspects of Latvia's Integration into the Eurozone

The goal of the Latvian government to introduce the European common currency in Latvia from January 1, 2014 remains rock firm. The preparations for the introduction of the euro are well under way: the government has drawn up the necessary plans for the change-over, put responsible officials and committees in place, and made financial provisions to cover the change-over expenditures. In March 2013 the government requested that the two relevant European authorities, the European Commission and the European Central Bank, examine Latvia's level of convergence¹ (the respective reports shall be published at the beginning of June 2013). The Latvian Parliament, Saeima, adopted the Law on the Procedure for the Introduction of Euro (*Euro ieviešanas kārtības likums*) on January 31, 2013. Latvian public officials recognize that euro introduction is not seen as a goal for its own sake. Rather, through the introduction of the euro the government seeks to create greater stability for the Latvian economy and better credit conditions to sustain growth in

¹ According to the Treaty on the Functioning of the European Union, Article 140, at least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between the national legislation of each of these Member States, including the statutes of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB.

the longer term. Moreover, the euro has been considered a “domestic” currency² in Latvia for a while already. Also, in response to the 2008 financial and balance-of-payments crisis, Latvia, with international financial support, implemented a harsh adjustment program centered on a massive fiscal consolidation and internal price and wage deflation. A particular feature of this program was Latvia’s commitment to keep the national currency peg to the euro unchallenged, so that once the nominal entry criteria are fulfilled Latvia could join the Eurozone at the earliest date possible. Membership in the Eurozone was seen as a measure to strengthen investors’ confidence in Latvia’s financial system after Latvia’s exit from the adjustment program.

Latvia’s economy is now showing strong signs of recovery from the recent recession of 2008-2010. GDP growth reached 5.6% (y-o-y)³ in 2012 – the highest level among European Union member states. Increasing productivity and export performance are the major drivers behind this economic growth. Yet, as is noted by the International Monetary Fund (IMF)⁴, Latvia continues to face major long-term challenges: high unemployment and poverty rates, a falling working-age population, and low income levels (by EU standards). Hence, in the opinion of the IMF, the overarching challenge for Latvian policymakers is to promote economic growth that can raise living standards sustainably, while avoiding a repeat of past imbalances.

According to the most recent Global Competitiveness Report⁵, published by the World Economic Forum, the Latvian economy is at a stage of transition from an efficiency-driven to an innovation-driven economy. Even though Latvia’s economy can still continue to grow by improving the functioning of its institutions, goods and financial markets, and by the more efficient use of existing technologies, the long-term economic achievement and convergence in living standards with the developed economies will not be possible without such drivers for growth as technological advancement, business sophistication and innovation.

Latvia’s National Development Plan for 2014-2020 (NDP-2020)⁶ sets an ambitious target to double the GDP per capita by 2020 (compared to the level of 2010). In order to achieve this goal, the government, among other things, wants to attract more foreign direct investment (FDI), reorient FDI flows toward the tradable sector, increase the competitiveness of the Latvian products and services, enhance investment in education and research, introduce an outstanding business environment, improve the demographic trend and foster the capacity of Latvia’s human resources, and also encourage growth in the regions. However, the achievement of these tasks will largely depend upon the availability of human and financial resources. Latvia is short in both. The

² In Latvia the legal tender so far has been its national currency – lats. However, a high level of transactions in euro in the private sector has been tolerated since 2005, even promoted, as the banks’ exposure to the euro exchange risk against the lat was considered irrelevant by the authorities. See Republic of Latvia: Selected Issues Paper, IMF Country Report No. 06/354, Washington: IMF Publishing Services, October 2006, 53.

³ Central Statistical Bureau of Latvia, “Gross Domestic Products in the fourth quarter of 2012 increased by 5.1% and in 2012 - by 5.6%”, March 11, 2013, <http://www.csb.gov.lv/notikumi/iekszemes-kopprodukts-2012gada-ceturrtaja-ceturksni-palielinajies-par-51-2012gada-par-56-363>

⁴ Republic of Latvia: Selected Issues Paper, IMF Country Report No. 13/29, Washington: IMF Publishing Services, January 2013, 15.

⁵ Global Competitiveness Report 2012-2013, World Economic Forum, 2012. http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf

⁶ The National Development Plan 2014-2020 was approved by the Parliament of Latvia on 20 December 2012. http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf

situation in the labor market is particularly tense – the IMF estimates that labor is not going to contribute to Latvia's potential growth in the coming years⁷.

This sub-chapter will address the economic vulnerabilities and the political, economic and social implications for Latvia in relation to the Eurozone accession. The traditional Strengths-Weaknesses-Opportunities-Threats (SWOT) method will be used to highlight some (in authors' opinion significant) internal and external factors which might have a positive or negative impact on the chances of success (or failure) for the euro adoption project in Latvia.

1.1. Is Latvia Ready for Participation in the Monetary Union?

Strength: Latvia fulfills the nominal convergence criteria.

The Treaty on the Functioning of the European Union requires that a non-participating EU country, before joining the Eurozone, achieves a high degree of sustainable convergence⁸. The level of convergence is measured by means of the so-called convergence criteria. These criteria include price stability, government budgetary position, exchange rate stability, and long-term interest rates. In economic literature these formal criteria are described as nominal convergence, in contrast to real convergence, which is measured in terms of per capita national income.

The data on Latvia's current situation (see Table 1) suggests that Latvia has achieved the nominal convergence: all criteria are fulfilled with a wide margin of reserve compared to earlier Eurozone entrants. If this is the conclusion of the examination reports that is awaited by European authorities, then this will provide a significant boost to the credibility of Latvia's government.

The nominal convergence of entrant countries											
	Price stability (%)		Budgetary position				Macroeconomic position				
	Result	Reference	Budgetary balance (% of GDP)		Public debt (% of GDP)		Long term interest rate		Exchange rate stability		
			Result	Reference	Result	Reference	Result	Reference	Result	Reference	
Latvia ¹	1,6	2,9	-1,2	-3,0	40,7	60,0	4,0	5,7	84 month	24 month	
Estonia	-0,7	1,0	-1,7		7,2		--- ²	6,0	72 month		
Slovakia	2,2	3,2	-2,2		29,4		4,5	6,5	30 month ³		
Malta	2,2	3,0	-2,6		66,5		4,3	6,4	24 month		
Cyprus	2,0	3,0	-1,5		65,3		4,5	6,4	24 month		
Slovenia	2,3	2,6	-1,8		29,1		3,8	5,9	22 month ⁴		

Sources: Bank of Latvia, ECB Convergence Reports

Notes:

- The data from the Bank of Latvia, <http://www.bank.lv/es-un-eiro/mastrihtas-kriteriju-izpilde>.
- In Estonia the harmonized long-term interest rates were absent, and for the assessment of the durability of convergence various other financial market indicators were used.
- Slovakia participated in ERM II mechanism since November 28, 2005; however, on March 19, 2007 she reevaluated the central parity of koruna against euro by 7.8%.
- Slovenia joined the ERM II mechanism on June 28, 2004, but the convergence assessment was based on result of April 28, 2006, two month short of requested 24 month period.

⁷ Republic of Latvia: Selected Issues Paper... January 2013, 10.

⁸ Under the Treaty on the Functioning of the European Union all EU member states not fully participating in the Economic and Monetary Union, except United Kingdom and Denmark, shall treat the achievement of convergence with the economic and monetary union as an obligation.

However, the achievement of nominal convergence raises three essential questions: (1) how the compliance was achieved (through policy manipulations?); (2) how long will the compliance last (will there be divergence afterward?); (3) do the nominal convergence criteria matter at all.

Even though the ECB has repeatedly emphasized that convergence must be achieved on a long lasting basis and not just at a given point in time, the creation of the Eurozone and its subsequent enlargements had to do more with politics than with economic logic. As the convergence criteria were established as a result of a political bargaining, and were fixed in the Treaty of the European Union, there is very little room for a flexible interpretation⁹. This has rendered the process of Eurozone enlargement very stiff: countries are allowed to succeed or fail at euro introduction exclusively based on their nominal convergence.

The strictness of the application of the convergence criteria has encouraged the governments of aspiring countries to pursue targeted policies to achieve compliance artificially. Data on the economic development of Estonia, Slovakia, Malta, Cyprus and Slovenia after their Euro adoptions seems to confirm this assumption (see Table 2). Inflation and the level of public debt have jumped up in all cases, while the growth of the economy, except in Estonia, has been rather sluggish. Apparently, immediately after euro adoption the governments relaxed their overly tight pre-adoption policies and this has led to hikes in prices and public debt. There is little reason to think that the Latvian government will follow a different path¹⁰.

The nominal impact of the euro introduction			
Country (year of introduction)	Cumulative GDP growth (%)	Cumulative inflation (HICP)	Public debt (% of GDP)
Estonia (2011)	11,7	9,5	10,1
Slovakia (2009)	4,5	9,7	52,1
Malta (2008)	6,9	15	72,1
Cyprus (2008)	0,01	14,5	85,8
Slovenia (2007)	1,4	18,4	54,1

Source: Eurostat

As to the third caveat – whether the nominal convergence criteria matter at all – there has been a long-lasting debate among the European policy makers and academic researchers about the relevance of these nominal convergence criteria. It is argued that those criteria were designed for the selection of countries at the launch of the euro, but have lost importance since then as they measure convergence against the EU-27, not the Eurozone. Moreover, some critics have pointed

⁹ Previous examinations of the convergence criteria indicate that not all criteria are being afforded with the same significance. Namely, compliance with the criteria of price stability, budgetary balance and long-term interest rate was assessed much more strictly than the other criteria (e.g., public debt, and exchange rate stability). Thus, Lithuania was disqualified from the euro adoption in 2006 because it missed the price stability target by mere 0.1%. At the same time, Cyprus and Malta received positive assessment despite excessive public debt, and Slovakia despite a revaluation of the currency shortly before euro adoption.

¹⁰ In the case of Latvia, it has been recommended by the European Council in 2012 to shift taxation away from labour to consumption and housing, thus helping to reduce unemployment, scale down the informal economy and increase budgetary revenues. However, the government preferred to abstain from such manipulations as this would have increased the level of inflation. Even on the contrary, the government reduced the value added tax from 22% to 21% in 2012.

out that the enlargement of the European Union led to a substantial increase in the number of sample countries against which the convergence is measured, thus making compliance even more challenging¹¹. Another strand of arguments is directed at the peculiar situation of the EU member states from Central and Eastern Europe. As fast-growing economies with a rather low initial level of real convergence, these countries naturally experience a higher level of inflation. Another problem is the large capital inflows that are associated with the approaching Eurozone membership: the closer the country gets to Eurozone membership, the more capital flows in, the more difficult it is to fulfill the nominal convergence criteria, and, consequently, the greater the risk of sudden reversals of capital flows and a currency crisis if the euro target date is missed¹². European policy makers, however, have so far swept aside arguments raised against the nominal convergence criteria, and have insisted on a thorough application of the Maastricht Treaty, as any changes to those rules would endanger equal treatment among member states, put at risk the smooth functioning of the euro, and create moral hazards.

Strength: Latvia has a proven record of massive internal adjustment under a fixed exchange rate.

Latvia, like Estonia, prides itself on having extensive experience in economic development under a fixed exchange rate. Indeed, Latvia's quasi currency board¹³ was already introduced back in 1994, when this board was seen as essential part of the macroeconomic stabilization program for Latvia's economy shortly after the restoration of independence in 1991. Since then, the monetary policy has been focused overwhelmingly on maintaining the exchange rate peg (until 2005 against the Special Drawing Rights, since 2005 – against the euro). Until now, the Bank of Latvia has successfully defended that parity within the margin of +/- 1%, without recourse to currency devaluation or revaluation.

Since 1994, Latvia has had a few bursts of economic growth and recession (due to the banking crises in 1995, 1998 and 2008). However, the moment of truth came in late 2008, when, after five years of booming, Latvia's economy abruptly collapsed and the peg was put under severe pressure. In the summer of 2009 the Bank of Latvia lost a quarter of its reserves by defending the lat's peg. But the mechanics of the currency board system worked well – the amount of lats in circulation dropped sharply, thus pushing up the lats' interbank rates – up to even 80%, which gradually led to the lat's market stabilization toward the end of 2009.

There exist a couple of explanations as to why a fixed exchange rate is considered the best option for small and open developing economies. Firstly, it is used to reinforce the authorities' commitment to stabilization and boost investors' confidence. It worked well both in the early 90s and also during recent years. The macroeconomic stabilization program and international

¹¹ This argument is particularly important when measuring the compliance of price stability and the long-term interest rate. The performance of an aspiring country is measured against the average performance of those three EU member states with the lowest indicators. As the EU has become more diverse, the reference rate has a tendency to drift downwards.

¹² In fact, Slovenia, Slovakia, Malta and Cyprus managed to join the Eurozone exactly at the intended target date. For Latvia, Estonia and Lithuania, the road to the euro turned out to be bumpy.

¹³ Under the currency board regime the central bank exchanges the local currency against the foreign currency, theoretically, in unlimited amount at a fixed parity. Thus, the amount of incoming foreign currencies determines the amount of the national currency supplied. In Latvia's case the regime is called quasi, because the Bank of Latvia (Latvia's central bank) allows limited fluctuations around the parity, within the margins of +/- 1%.

liquidity assistance which Latvia received through 2008-2011¹⁴ was centered on the commitment to keep the exchange rate peg. According to program, the adjustment was to be achieved through an “internal devaluation”. This involved a huge fiscal effort – to the magnitude of 15% of GDP over three years¹⁵ – and a series of structural reforms, e.g., the introduction of a medium term budgetary planning framework, downsizing the public sector, restructuring the health and social assistance sectors, improving the administration of public revenue, etc.

Secondly, the currency markets cannot be relied upon to deliver the “right” exchange rate to stabilize a small and open economy, as solitary trade (export/import) or investment transactions can lead to significant fluctuations in the exchange rate. Therefore, the markets are supposed to adjust to the fixed parity of the exchange rate, which they actually do through price and wage adjustments.

Thirdly, the phenomenon of the “fear to float” has been observed in small open economies experiencing large capital inflows. Since countries like Latvia cannot borrow internationally in their own currency, large capital inflows lead to a mounting stock of foreign debt denominated in foreign currencies. Exchange rate variations then expose the government and the private sector to fluctuations in their balance sheets, or currency risk. However, the comfort offered by the exchange rate peg can be quite betraying. As the risk of exchange rate variability seems to be low, private borrowers and the government are more inclined to borrow in foreign currencies than they would do otherwise¹⁶. Latvia is a good example of this – at the peak of the boom in 2007, the current account deficit, a measure of investment inflows, reached a record high 23% of GDP.

Latvia’s macroeconomic stabilization program from 2009 to 2011 has delivered the expected results: the currency peg has stayed untouched, competitiveness has been restored through wage and price devaluation, and economic growth has returned. This success has rendered Latvia some world fame, and proves that Latvia might do well within the Eurozone if another crisis would strike.

Weakness: Latvia has a relatively low level of real convergence with the Eurozone, and further real convergence is not assured.

The real convergence denotes the correspondence between the per capita levels of GDP of two countries. The process of real convergence is usually accompanied by structural changes in the weaker economy: in industry, in labor, and in the composition of trade flows. These structural changes are both preconditions and consequences of real convergence¹⁷. Latvia’s GDP per capita (in purchasing power standard) is still very low: it is only half of the average ratio of the Eurozone. The Latvian level is also the lowest of the new EU member states that have already joined the Eurozone (see Table 3).

¹⁴ Out of earmarked 7.5 billion, Latvia used only 4.4 billion euro. See Anders Aslund and Valdis Dombrovskis, *How Latvia Came Through Financial Crisis*, Peterson Institute for International Economics, Washington, DC, May 2011, 46.

¹⁵ Bas B. Bakker and Christoph Kligen, ed. *How Emerging Europe Came Through the 2008/09 Crisis*, IMF, 2012, 115-212.

¹⁶ Jurgen Von Hagen and Iulia Traistaru-Siedschlag, *Macroeconomic Adjustment in the New EU Member States*, SUERF Studies No. 4/2006, July 2006.

¹⁷ Aleš Čapek, “Real and nominal convergence: implications for macroeconomic policies,” in *Economic Convergence and Divergence in Europe*, ed. Gertrude Tumpel-Gugerell and Peter Mooslechner, Cheltenham: Edward Elgar Publishing Ltd, 2003, 236.

Economy before the euro introduction			
Country (year of examination)	GDP (mill. EUR)	GDP per capita in PPS (euro area =100)	Global Competitiveness Index
Latvia (2012)	20,211	53.7	4.24
Estonia (2010)	14,322	58.3	4.61
Slovakia (2008)	64,413	67.0	4.40
Malta (2007)	5,575	69.7	4.21
Cyprus (2007)	15,901	86.2	4.23
Slovenia (2006)	31,050	79.8	4.64

Sources: Eurostat, ECB, WEF, own calculations
Note: Data for Latvia from 2011; for other countries from the year of the convergence examination.

The low level of real convergence suggests that Latvia still has a long journey ahead until it catches up with the developed European economies. According to IMF estimates, it could take from 30–40 years for Latvia to approach the EU ratios of capital-to-labor¹⁸. Firstly, it is difficult to imagine such a long period of growth without major disruptions, secondly, endogenous growth theories suggest that economic convergence with more developed regions is not assured, as under certain conditions a permanent divergence in wages, incomes and labor productivity may occur.

Indeed, it seems that under the current rules of the EU, the cross-border movement of labor is more pronounced than that of productive capital. Cheap labor is not anymore an argument for moving a factory from, say, Germany to Latvia. Moreover, the bleak demographic picture suggests that Latvia is losing its labor market flexibility – brainy and not so brainy labor has become quite scarce in Latvia as a result of the recession. The Ministry of Economy estimates that Latvia will have around 130,000 vacant working places by 2030, but that the working age population will shrink to 946,000 by then¹⁹. Consequently, good government policies (such as low taxes, ease of doing business, good public infrastructure) will be of the utmost importance to attract productive investment and reduce labor outflows. Latvia can hope that stronger trade and financial integration, induced by membership in the Eurozone, will boost large inflows of productive investment. However, it has to be remembered that there was a similar expectation with regards to Latvia's participation in the EU back in 2004. To Latvia's (and other new EU entrants') misfortune, most of the incoming investment was short-term and went into the services sector, inflating the credit bubble, wages and consumption, with a devastating effect on the industrial sector. Unfortunately, the EMU has few instruments at its disposal to help to avoid such negative boom-bust developments induced by short term and speculative capital flows.

Weakness: Differences in economic structure and business cycles between Latvia and the Eurozone's core countries will expose Latvia to asymmetric shocks.

If large differences in economic structures and business cycles persist between a country and the other EMU members, the common monetary policy of the ECB will amplify macroeconomic fluctuations caused by country-specific or asymmetric shocks, leading to excessive disequilibrium

¹⁸ Republic of Latvia: Selected Issues Paper, IMF Country Report No. 06/354, Washington: IMF Publishing Services, October 2006, 28-47.

¹⁹ Report on Latvian Economic Development by the Ministry of Economics of the Republic of Latvia, December 2012, 82.

in that country. A shock is considered asymmetric if a change in economic conditions affects different parts of a country or different groups of countries within a monetary union in different ways. The country's ability to cope with asymmetric shocks depends on the elasticity of fiscal policies and the flexibility of factors that affect production, particularly labor, in moving from one sector to another or across borders.

Even though the structure of Latvia's economy has converged with that of the developed EU countries in terms of trade and GDP composition²⁰, there are still considerable differences. First of all, due to the miniature size of the economy and shallowness of the financial sector, the business cycle fluctuations in Latvia are more pronounced than in Germany and other large EMU members. Secondly, as shown in the Global Competitiveness Report, Latvia's global competitiveness index (GCI) and subsequent ranking is very low compared to other EMU member countries. Latvia's backwardness is apparent not only in technologies, business sophistication and innovation, but also in areas such as public institutions, infrastructure, and the state of overall macroeconomics²¹. Thirdly, as was explained earlier in this article, Latvia's labor market flexibility has decreased substantially. With a persisting huge income inequality between Latvia and developed EU regions, the labor market in Latvia will remain tight. Besides this, Latvia has very high structural unemployment (workers whose skills are not needed for jobs) – reaching 12% according to IMF estimates²².

However, there is some good news too. The theory suggests that the business cycle fluctuations of Latvia and the Eurozone should converge as trade integration with the Eurozone countries proceeds. Looking at Latvia's trade and financial flows (see Table 4), one can see that Latvia has already achieved a high degree of trade integration with members of the Eurozone – with trade volumes of 120.8% of GDP, Latvia by far outpaces earlier Eurozone entrants. To a large extent this can be attributed to the expansion of the Eurozone, particularly Estonia's accession; however, this fact only reinforces the argument that there will be large increases in efficiency resulting from Latvia's participation in the Eurozone.

The degree of economic integration				
Country (year of examination)	External trade in goods with the Eurozone (% of GDP)	External assets and liabilities (% of GDP)	Net international investment position (% of GDP)	Share of foreign currency loans (% of total)
Latvia (2012)	120.8	283	-72.5	86
Estonia (2010)	72.6	299	-81.8	83
Slovakia (2008)	90.6	142	-80.0	22
Malta (2007)	52.6	1144	37.5	8
Cyprus (2007)	78.4	773	10.3	18
Slovenia (2006)	77.8	291	-19.3	40

Sources: Eurostat, EC Convergence Reports, own calculations
 Note: Data for Latvia from 2011; for other countries from the year of the convergence examination.

²⁰ See Aleksejs Meljhovs, Ivars Kasjanovs, Processes of Convergence in Europe and Latvia, Bank of Latvia, 1/2011.

²¹ Global Competitiveness Report 2012-2013, World Economic Forum, Geneva, Switzerland, 2012, http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf

²² Republic of Latvia: Selected Issues Paper... January 2013.

The data on financial flows also suggest that Latvia has reached a much higher level of integration with international markets than earlier entrants. The indicator of Latvia's net international position shows that Latvia is highly dependent on foreign capital, and, like all other emerging market economies, Latvia has accumulated a large stock of debt denominated in foreign currencies. Moreover, the share of foreign banks in Latvia's banking sector assets reached 94.1% at the beginning of 2013. Altogether, this leads to the conclusion that Latvia's financial market is largely dominated by foreign currencies; therefore, abdication from the national currency and adoption of the euro would add to the domestic market's stability and reduce friction caused by currency mismatches.

Weakness: Latvia needs substantial further reforms at a micro-level; however, there is a risk of free-riding after euro introduction with dire consequences.

According to the recent Global Competitiveness Report 2012-2013²³, Latvia belongs to the group of countries in transition from efficiency-driven to innovation-driven economies. Latvia's current rank among 144 countries is 55th (up from 64th in 2011-2012). This is well behind Estonia (34th). There is a widespread consensus that disciplined macroeconomic policies are a necessary condition for sustained economic growth in small and open economies like in Latvia; however, it is also believed that structural reforms are easier to carry out in a less restrictive macroeconomic environment than is suggested by membership in the EMU. Anecdotally, the GCIs for some earlier Eurozone entrants have deteriorated since euro adoption, namely for Slovakia and Slovenia (see Table 5).

The euro and competitiveness		
Country (year of assessment)	Global Competitiveness index ⁶	
	Before euro	In 2011
Estonia (2010)	4.61	4.64
Slovakia (2008)	4.40	4.14
Malta (2007)	4.21	4.41
Cyprus (2007)	4.23	4.32
Slovenia (2006)	4.64	4.34

Source: WEF

In order to succeed in the Eurozone and on the global stage, Latvia will need to implement a series of further reforms. The areas where action is needed include judicial efficiency, the taxation system, the quality of roads, technological transfer and innovation, higher and vocational education, a reversal of the "brain drain", energy efficiency, competition in the energy sector, the social assistance system, and active labor market policies²⁴.

²³ Global Competitiveness Report 2012-2013, World Economic Forum, Geneva, Switzerland, 2012, http://www.nap.lv/images/NAP2020%20dokumenti/NDP2020_English_Final.pdf

²⁴ See Global Competitiveness Report 2012-2013, Republic of Latvia: Selected Issues Paper... January 2013, and Council of the European Union (2012).

Weakness: the introduction of the euro will reinforce the persistent high income inequality and widespread poverty in Latvia.

A particular structural feature of Latvia's economy relates to the size of the gray or informal economy (up to 40% of GDP)²⁵, large regional disparities, remarkable inequality between different groups of population, and massive poverty. In all these indicators, Latvia is the "leader" not only among the Eurozone countries, but also within the whole European Union. These figures might be significantly distorted by unregistered emigration; however, the challenge remains, as euro introduction most likely will not lead to a more fair distribution of the national income between different groups of society and geographical regions in Latvia. On the contrary, it seems that the persistent disparities will continue to widen, and will inflict more pain on socially disadvantaged people.

Firstly, evidence from the previous Eurozone enlargements indicates that, in general, inequalities have widened after euro introduction (see Table 6). Admittedly, one can argue that the rise in inequality, and also in poverty, is a problem for the whole European Union because of ongoing economic turbulence, and, for this reason, it is difficult to establish a cause-effect relationship between the worsening social situation and participation in the Eurozone. Undeniably, this argument cannot be completely dismissed; however, taking into account the lack of solidarity instruments within the EMU, one has to conclude that the common currency mainly benefits economically active people and more prosperous regions.

The social impact of the euro introduction				
Country	At risk of poverty (% of population)		Gini coefficient	
	Before	In 2011	Before	In 2011
Latvia	40.4		35.4	
Estonia (2010)	21.7	23.1	31.3	31.9
Slovakia (2008)	20.6	20.6	23.7	25.7
Malta (2007)	19.4	21.4	26.3	27.4
Cyprus (2007)	25.2	23.7	29.8	29.1
Slovenia (2006)	17.1	19.3	23.7	23.8

Source: Eurostat

Secondly, poor people are very likely to suffer from the introduction of the euro. In Latvia, every third person can be considered as living in poverty (the official figures, however, might be disrupted by unregistered emigration). The indices from earlier Eurozone entrants indicate that prices will go up, and there is little reason to believe that Latvia will not follow the same track. The records also testify that the price increases will first appear in the service sector and marketplaces. As poverty is closely related to structural unemployment, the promised economic growth after euro introduction will not help these people, at least not in the near future. Instead, the price increases on groceries and basic services will reduce their already miniscule purchasing power.

²⁵ Latvian Competitiveness Report 2011. January 2012, http://www.mk.gov.lv/files/latvian_competitiveness_report.pdf

Weakness: strong public concerns about euro introduction will reinforce euroscepticism, and deepen public mistrust in the political and economic elite.

One of the basic reasons that nation states prefer to have their own national currency is its symbolic value – it serves as a sign of nationhood. Latvia is a good example. Because of historical hardships, Latvians have few proper symbols of nationhood: the constitution (Satversme), the Latvian language and culture, and the national currency – the lats. Opinion polls testify to people’s close attachment to lats, and an estrangement from the euro at the same time (see Table 7). In Latvia, the share of people who feel well informed (comfortable) about the euro is considerably lower than it was in Estonia (39% and 49%, respectively), and much lower than in Slovenia shortly before euro introduction (80%). Popular familiarization with the euro in Latvia will be further hampered by the contradiction between the official spelling of the name “euro” and the Latvian version “eiro”. Following pressure from the European authorities, the Latvian government gave up the Latvian spelling version, and agreed to use “euro” in official documents, while in popular communication to keep the traditional “eiro”.

Table 7						
The public reception shortly before the euro introduction (% of replies)						
	Latvia (2012)	Estonia (2010)	Slovakia (2008)	Malta (2007)	Cyprus (2007)	Slovenia (2006)
<i>Opinion survey in the year of convergence examination</i>						
Feel well informed about the euro	39	49	64	74	67	80
Support euro introduction	47	37	52	56	44	64
Support euro introduction as soon as possible	9	23	25	39	30	38
Concerns that euro introduction will increase prices	67	77	76	65	74	65
<i>Opinion survey of October 2012</i>						
The euro is a good thing	67	77	76	65	74	65
Sources: Eurobarometer						

A convincingly large portion of Latvians find the euro a good thing (67%); however, less than half support euro introduction, and only a tiny 9% think that this should happen as soon as possible. This public aversion appears anecdotal, if one looks at what happened during the summer of 2009²⁶. Back then, most people fell prey to rumors about the lats’ imminent devaluation, and in a panic exchanged their lats savings into euros or other currencies. Even today, in a more solid situation, the role of the lats in the Latvian economy is quite marginal: out of total residents’ deposits in Latvian banks, 52% are in foreign currencies, and the share of loans in foreign currencies has reached 86%²⁷. Indeed, it seems that Latvians tend to be paid and shop in lats, but they tend to

²⁶ Ludmila Nola, Fighting the Devaluation Ghost (Cinoties ar devalvācijas rēgu). Bank of Latvia, January 29, 2013, <http://www.bank.lv/es-un-eiro/publikacijas/eiro-ieviesana/cinoties-ar-devalvacijas-regu>

²⁷ Macroeconomic Process analysis (Makroekonomisko norišu pārskats). Bank of Latvia, April 2013.

save, borrow, and take out mortgages in euros.

Public opinion polls also indicate that in Latvia the major concern about euro introduction is related to possible price increases. Government officials, however, insist that these concerns are ungrounded, as tough measures will be taken to avoid abuses of the currency change-over with the purpose of increasing prices during the conversion. However, as was demonstrated earlier in this article, the public concerns do have some ground. Firstly, elevated inflation is unavoidable due to economic growth and other factors like long-delayed changes in taxation and regulated prices. Secondly, as the value of one lat is superior to that on one euro, after conversion to the euro prices will appear higher, thus reinforcing people's perception of price increase.

Thus, as soon as the inflation becomes apparent, people will blame the euro, as for the general public it will be too difficult to distinguish the price impact stemming from euro introduction from other factors. For Latvia, the tricky question is how apparent the inflation will become before the general elections in October 2014 (i.e., 10 months after the euro-day). The risk is that instead of being glorified the current governing political forces may be faced with public discontent and accusations of a conspiracy against the people.

1.2. How will membership in the Eurozone affect Latvia?

Opportunity: membership in the Eurozone will improve financial stability in Latvia and boost investors' confidence, as the risk of a currency crisis will be removed and participants in the financial market will gain access to the ECB's emergency assistance instruments.

The volatility of the exchange rate is seen as one of the greatest risks to the economic development of countries like Latvia. Therefore, the stability stemming from Latvia's membership in the Eurozone can be considered the most significant argument behind Latvia's Eurozone aspirations. The stabilizing effect can already be felt before the introduction of the euro. Firstly, the commitment to introduce the euro was one of the founding principles behind Latvia's macroeconomic stabilization program, as euro introduction was seen as the ultimate goal and anchor for all reform and austerity measures implemented under the program. Secondly, credit rating agencies have also reacted positively, by explicitly linking the increase in Latvia's sovereign rating with the country's progressively improving prospects for membership in the Eurozone²⁸.

Another important argument much exploited in the debate about accession to the Eurozone is the right of entry to the emergency liquidity instruments of the ECB, whose lending capacity is something Latvia can only dream of at the moment. If Latvia was already member of the Eurozone in 2008 when the crisis started, the slump in the Latvian economy probably would have been averted, or at least would have been less pronounced.

With the economy already partially euroized, the stability argument gains even more weight in Latvia. The current tormenting headaches about a probable devaluation and currency mismatches between the assets (earnings) and liabilities (debts) will fade away, as the exchange rate of the national currency against the euro will be fixed irrevocably, and responsibility for the conduct of the exchange rate policy will move to European authorities²⁹.

²⁸ See information on the website of the Ministry of Finance of Latvia.
http://www.fm.gov.lv/lv/aktualitates/jaunumi/standart_poor_s/

²⁹ According to the Treaty on the Functioning of the European Union, monetary policy is an exclusive competence of the ECB, but the exchange rate policy of the euro is a shared competence between the ECB and the Council of Ministers of the European Union.

Opportunity: Latvia's participation in the Eurozone will boost Latvia's foreign trade with both the Eurozone and the rest of the world.

Researchers and policymakers widely agree that the foremost benefit of membership in a monetary union is the growth of trade. Moreover, the effect of a common currency appears to be an order of magnitude larger than that of eliminating exchange rate volatility but retaining separate currencies³⁰. Clearly an increase in trade stemming from the euro is one of the few undisputed gains from the EMU. The magnitude of trade growth within the currency union is estimated in the range from 5% to 23%.

The impact of the euro on Latvia's foreign trade growth might be somewhat smaller, as Latvia has already achieved a high degree of trade integration with the Eurozone. But nevertheless there are good reasons to believe that the boost will come. First of all, replacing the lats with the euro will make cross-border price comparisons easier. Greater price transparency will increase competition between shops and suppliers, keeping downward pressure on prices.

Secondly, euro introduction will bring huge savings from currency exchange and commissions paid for credit transfers to other European countries. This will make cross-border travel much easier and business conduct more efficient. The Bank of Latvia has calculated that savings from the currency conversion after euro introduction could be estimated at around 70 million euros in Latvia. On the other hand, Latvian gains from cheaper cross-border payments within the Eurosystem will be of a lesser magnitude, as these have already materialized through Latvia's participation in both European cross-border payment systems, TARGET II and SEPA³¹.

Thirdly, euro introduction will also benefit Latvia's trade transactions with foreign countries outside the European Union. The Eurozone is one of the largest global trading blocs, and the euro is one of the world's most significant reserve currencies. Making transactions in euros will be an attractive proposition for Latvian business partners outside the Union, to the advantage of Latvians who will benefit from paying and being paid in euros without concern for global currency fluctuations.

In general, the Latvian public and businesses stand to be the main beneficiaries of euro introduction (without considering the impact of growing poverty and inequality), and the commercial banks will be the main losers. However, commercial banks will benefit too. Firstly, Latvia's participations in the Eurozone will allow the banks to borrow more cheaply and with longer maturity. Secondly, the expected inflow of investments and economic growth will increase revenues in the banking sector too.

Opportunity: Latvia's stable exchange rate environment within the Eurozone and growth prospects will advance the inflow of foreign capital and investment.

Inflow (or return) of foreign investment in Latvia is seen as the second major argument behind Latvia's move towards the Eurozone. Indeed, there is ample evidence that the creation of

³⁰ See Andrew Rose, "One Money, One Market: Estimating the Effect of Common Currencies on Trade", paper from 17 February 2000. <http://faculty.haas.berkeley.edu/arose/Grav.pdf>

³¹ TARGET stands for the Trans-European Automated Real-time Gross settlement Express Transfer system. It is a real-time gross settlement (RTGS) system owned and operated by the Eurosystem. TARGET2 is the second generation of TARGET. The central banks of non-euro countries can participate on a voluntary basis. SEPA stands for the Single Euro Payments Area, which is a payment-integration initiative of the EU for the simplification of bank transfers. As of March 2012, SEPA consisted of the 27 EU member states, the four members of the EFTA (Iceland, Liechtenstein, Norway and Switzerland) and Monaco.

the EMU and its subsequent enlargement has increased the stock of the foreign investment in the member states. Moreover, it seems that within the EMU the investment flows tend to concentrate in productive sectors. This implies a qualitative difference between membership in the European Union and in the Eurozone. It should be mentioned here that Latvia and other new EU member states were drowning in investment from 2004-2007; however, most of this investment went into the services sector, without significant impact on production. When the crisis struck in 2008, these investment flows reversed.

Latvia, after the slump, has restored investors' confidence, largely thanks to the success of the macroeconomic stabilization program. The investors' improving sentiment is confirmed by the improving Latvian sovereign credit ratings and relatively low interest on Latvian government 10-year bonds (see Table 8).

The euro and investment climate			
Country	Interest on 10 year government bonds	Interest on business loans up to 1 mill. with 1 to 5 year maturity	Moody's Investors Services credit rating
Latvia	3.17	5.13 ²	Baa2
Estonia	-	4.96	A1
Slovakia	3.95	4.86	A2
Malta	3.56	-	A1
Cyprus	7.00	(6.82)	Caa3
Slovenia	5.09	6.46	Baa2
Germany	1.35	3.58	Aaa
Finland	1.61	3.71	Aaa
Sweden	1.92	3.27 ²	Aaa
Lithuania	4,15	(3,92) ²	Baa1

Sources: ECB
Notes: Loans in national currency (1)

Interestingly, on the one hand, the rate on Latvian bonds is considerably lower than not only the Lithuanian rate, which does not participate in the Eurozone, but also of Slovakia and some other members of the Eurozone. On the other hand, the Latvian rate is still much higher than the German, Finnish and Swedish rates. Statistics on the dynamics of bond rates implies a few things for Latvia. Firstly, the current low rates might be associated with the so called "convergence play" – namely, the anticipation of the euro change-over event pushes the rates down – but this might reverse soon after the actual euro introduction. Secondly, participation in the Eurozone does not guarantee lower bond rates, as the data from Cyprus, Slovenia and other recent entrants testify. Even though Latvia's public debt is relatively low – even compared to other EU members from Central and Eastern Europe – the risk of volatility for investors remains, as the investors' appetite for risk in emerging economies is much lower than in the developed economies³². Thirdly, Latvia, with the help of good policies, has the chance to achieve even lower bond rates, to see its rates converge with the Finnish and German rates; however, one also has to admit that membership

³² Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different. Eight Centuries of Financial Folly*, Princeton and Oxford: Princeton University Press, 2011, 21-33.

in the Eurozone will not insulate Latvia from the risks associated with bad internal and external (Eurozone) policies.

Threat: The EMU has few instruments at its disposal to level out the macroeconomic imbalances among Eurozone member economies. Without these instruments, Latvia will be subject to extremely volatile cycles of development, as the government's capacity to intervene and correct growing imbalances will be very limited.

The logic behind the EMU is not about making all the countries' performance converge, but about creating a common price stability framework whereby countries can unleash their growth potentials, where good policies are rewarded (and bad policies punished), and where catching-up can take place. At the inception of the EMU, the real convergence among potential member states was considered sufficiently close to avoid large imbalances under the umbrella of a monetary union. This stabilizing umbrella had two pillars: an independent ECB, which would impose monetary discipline, and the Stability and Growth Pact, obliging members of the union to adhere to fiscal moderation.

Despite the initial expectations of stable non-inflationary growth and further real convergence, a divergence and huge macroeconomic imbalances was the effective result of the EMU. These imbalances manifested themselves in real estate booms (Ireland, Spain), public and private overconsumption (Greece, Portugal), reckless credit lending (Cyprus), and delayed structural reforms (Italy, Spain). Once these imbalances started to unwind due to global financial turbulence in 2007, a lack of a coordinated policy response on the part of the governments of Eurozone countries led to a rapid deterioration of the situation in the banking sector, subsequent bail-out efforts at national level and soaring sovereign debt in several member states, ultimately crippling the growth of the real economy.

The problem is that once inside the Eurozone Latvia will be even more exposed to growth volatility than Greece, Spain or Portugal, mainly because of Latvia's low level of real convergence with the average of the Eurozone. The responsibility for smoothing the path of growth will be entirely in the hands of Latvia's government, demanding an extremely vigilant and discretionary attitude. However, as experience shows, there are clear limits to what the government can really achieve. Firstly, there is the problem of free-riding once the pressure for immediate action is elevated. Secondly, the markets will always be the first to detect a bubble, the central banks and governments are left only to cope with the consequences of the burst. In good times it is very difficult for the government to mobilize political support for preemptive action, as it risks sending the economy in recession. On the other hand, in bad times, even if there is political support for a change, governments are constrained financially from implementing reforms. Thirdly, although it is recognized nowadays that better fiscal policies (which focus on counter-cyclicality and balance in the medium term) or the creation of a "fiscal space" to help support monetary policies are required, delays in the formulation and implementation of fiscal measures due to political meddling reduces the efficiency of fiscal instruments.

Latvia's economy is growing with astonishing speed and is already close to reaching its full potential. In order to sustain growth without overheating, Latvia will need more investment in productive sectors, as well more investment in human capital. As both productivity-boosting measures will take time, Latvia runs the risk of overheating in the short term. The one-size-fits-all monetary policy of the EMU will exacerbate the forthcoming Latvian imbalances. According to

the rules of the Fiscal Compact, the Latvian government would have to run considerable budget surpluses in order to cool down the economy. Even if the government follows these prescriptions, and commits to building reserves, the capacity of the government to extract all the excess liquidity from the system will be something difficult to achieve, taking into account free movement of capital.

2. Latvia's Strategic Motivations and Political-Institutional Shifts after Eurozone Accession

Not only will Latvia face the previously mentioned economic challenges after its planned Eurozone accession, but there are several strategic choices and political-institutional shifts on the way as well. For conceptual purposes, this subchapter addresses only the strategic motivations, general institutional environment, motivations and challenges for Latvia's membership in the Eurogroup and the Eurosystem with the purpose of answering the question of whether Latvia is becoming a new global financial player.

As previously argued, Latvia has to face several direct and indirect challenges in economic and social spheres in relation to Eurozone accession. Many of these economic and social challenges will have repercussions within the domestic political arena and could be tied to the introduction of the single currency as such. At the same time, there are several significant political and strategic benefits Latvia sees in Eurozone membership. In spite of institutional and resource challenges, Eurozone accession can result in a major political gain for the small Baltic state.

2.1. A Strategic Choice?

Since its 1995 application for EU membership, Latvia has seen its existence within the EU as a foreign policy and national security goal. In terms of the security strategies of small states³³, binding foreign policy to benevolent neighbors or multilateral organizations and alliances is among the most frequently used strategies in the modern international system. Therefore, Latvia's willingness to go further and tie its monetary policy to the Eurozone countries is not surprising from strategic and security points of view. Being a small and vulnerable state, Latvia seeks stable and reliable ties with the European Union. It has been Latvia's prerogative to be a trustworthy and constructive partner. Latvia's ratification of the Treaty establishing a Constitution for Europe on June 2, 2005, right after it was rejected in a referendum in France on May 29 and in a consultative referendum in the Netherlands the day before, demonstrated country's political will to go on with European integration. Not only did the Lisbon Treaty ratification process in the Latvian parliament (Saeima) on May 8 last just 12 minutes, but also the current willingness of the country to join the Eurozone is evidence of its belief in the future of the euro-project. Currently, when many analysts discuss the sustainability and even the continued existence of the Economic and Monetary Union

³³ Håkan Wiberg defines the following foreign policy strategies for small states: 1) a bilateral alliance with a major power; 2) an alliance of two or several small states; 3) membership in a multilateral alliance around one or more major powers; 4) nonalignment, whether aiming at neutrality in any war or without such a generalized commitment; Please see, Håkan Wiberg, "Security Problems of Small Nations" in *Small States and the Security Challenge in the New Europe*, ed. by W. Bauwens, A. Cleese, O. F. Knudsen, London-Washington: Brassey's, 1996, 36.

and the European Union itself, Latvia's foreign policy goals of deeper integration into the core of the European Union remain unchanged.

Latvia set the goal of full integration into the Economic and Monetary Union in a 2003 referendum on membership in the EU without derogations or opt-outs. It tried to follow the Eurozone accession path right after it joined the union, and in 2005 it already pegged the lat to euro, thus joining the Exchange Rate Mechanism II. Because of a lack of political will to tackle the inflation rate, Latvia did not come to the point of fulfilling the Maastricht criteria before the financial crisis started at the end of 2008. In March 2009, with the first Valdis Dombrovskis led government, Eurozone membership began to be advocated as the "prize" for overcoming financial and economic problems through austerity³⁴. Thus, with the planned membership in the Eurozone, yet another foreign policy goal of Latvia's will be achieved.

The strategy of deepening integration within the European Union is not only tied to security arguments, but include Latvia's interest in having a presence at the decision making core of the European Union as well. The Sovereign Debt Crisis induced institutional and legal innovations within the Eurozone over the last several years – namely, the European Stability Mechanism, the Treaty on Stability, the Coordination and Governance in the Economic and Monetary Union, the European Banking Authority (and the emergence of the European Banking Union), plans on a financial transaction tax and the ideas about a Federal Europe. All these plans tend to build up and intensify cooperation between state authorities of the Eurozone member states. The increasing number of regulations and solutions that apply only to the Eurozone de facto creates different integration speeds in the European Union. Instruments like banking supervision rights of the European Central Bank (ECB) or the European Stability Mechanism have been argued to provide significant support for the pluralistic, volatile and foreign capital-controlled financial sector of Latvia in the prevention of future financial troubles³⁵.

The argument to avoid different integration intensities (multi-speedism)³⁶ in the European Union is a phenomenon that has been highlighted not only by analysts, but also by Latvian politicians promoting the Euro-project: "The reality is that currently we see the emergence of a two-speed Europe and the first speed is the core of Europe, which more or less will consist of the Eurozone member states. It is a geopolitical choice, whether we would like to be at the core or periphery. We need to be at the core."³⁷ Moreover similar reasoning can also be identified in the positions of the leading Lithuanian politicians³⁸, who express plans to become part of the

³⁴ For a detailed explanation, please see, Kārlis Bukovskis, "Latvia's Austerity Model in the Context of European Austerity versus Growth Debate" in The Riga Conference Papers 2012. Riga, Latvian Institute of International Affairs, Latvian Transatlantic Organization, 2012, 10-15, http://liia.lv/site/docs/The_Riga_Conference_Papers_20121.pdf

³⁵ See, for instance, Roberts Zile, European Banking Union – A chance to Reevaluate the Experience with the Saving of "Parex"; in Delfi, September 15, 2012, <http://www.delfi.lv/news/eiropa/versijas/roberts-zile-eiropas-banku-savieniba-iespeja-no-jauna-izvertet-pieredzi-ar-parex-glabsanu.d?id=42671104>

³⁶ European Union, Central And Eastern Europe And Ukraine: Transformation, Prognosis And Perspectives Scenarios for Central-Eastern Europe and Ukraine in a Case of Multi-Speed Europe Creation. http://liia.lv/site/docs/EU_Central_Eastern_Europe_Ukraine_TPP_book_dissemination_January_2013.pdf

³⁷ Dombrovskis: if Referendum Takes Place, Euro Will Not Be Introduced in 2014 (Dombrovskis: Ja bus referendum, 2014.gada eiro neieviesisim). In LETA/BNS, December 7, 2012, http://financenet.tvnet.lv/zinas/446020-dombrovskis_ja_bus_referendums_2014gada_eiro_neieviesisim

³⁸ Butkevičius: Lithuania Will Introduce Euro in 2015. In LETA, January 25, 2013, <http://www.delfi.lv/news/eiropa/zinas/butkevics-lietuva-eiro-ieviesis-2015gada.d?id=43003500>

Eurozone in 2015, and even the Polish³⁹.

Latvia initially had rather feared the emergence of a political or economic multi-speed Europe. Being a small country both politically and economically, Latvia lacked the resources to be immediately associated with the countries of the first speed. “Enhanced cooperation” along with the “open method of coordination” and the multiple opt-outs gradually psychologically prepared the EU states to go further with regulations that were not applicable in all of the member states. Because of economic problems, the Eurozone countries decided upon more intensive financial and economic regulation in the Eurozone, including the allocation of additional responsibilities and powers to the European Commission.

Thus, Latvia’s interest in joining the Eurozone is strategic from the political and small state security point of view. Eurozone membership demonstrates coherence in Latvia’s EU integration and the state’s reintegration into the Western world in general, just as Estonian politicians figured before 2011 and Lithuanians are contemplating now. Evidently, not only economic arguments play an important role in Latvia’s choices – firstly, there are political arguments. And there is not only a general anchoring of Latvia in the region and in the world, but also a strategic positioning of the country among the central decision makers in the Council of the European Union, i.e. the Eurogroup, and within the Eurosystem. The main pragmatic practicalities and challenges for Latvia in its institutional accession to the Eurozone will be thus addressed.

2.2. Latvia’s “Eurogroup-ing”

The Eurogroup is an informal decision making format constituted of the ministers of finance of the EU member states that have adopted the euro. Protocol 14 of the Lisbon Treaty states that “the Ministers of the Member States whose currency is the euro shall meet informally”. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency.”⁴⁰ Traditionally, these meetings take place before the Economic and Financial Affairs Council (ECOFIN) meetings. As a meeting format it is permanently chaired by a non-voting president of the Eurogroup. Latvia’s accession into the Eurozone will open the possibility for the small country to discuss matters in one of the most influential economic decision-making authorities in the European Union and the world. Taking into account the projected influence of the Eurozone on global financial structuring, the Eurogroup becomes a key format.

Latvia’s interest regarding the Eurogroup, firstly, includes the right to be part of the meetings. Before countries become full members of the Eurozone, according to officials⁴¹ interviewed by the authors, access to the discussions is strictly limited. Especially in case of smaller EU member states with fewer diplomatic resources, the possibility to familiarize themselves with the matters that were discussed and even decided is rather limited. Moreover, as 17 out of the current 27 member

³⁹ Karolina Slowikowska, “Analysis - Poland leans towards euro entry despite crisis.” In Reuters, October 24, 2012, <http://uk.reuters.com/article/2012/10/24/uk-poland-euro-idUKBRE89N12W20121024>

⁴⁰ Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, in power since December 1, 2009, Protocol 14.

⁴¹ Authors’ anonymous interviews with officials responsible for the Eurozone accession from the Bank of Latvia and the Ministry of Finance of the Republic of Latvia in Riga in April 2013.

states – including the traditional EU economic policy heavyweights Germany, France, Italy, Spain and the Netherlands – are part of the grouping, and many decisions later discussed within the ECOFIN, the pre-agreed issues could potentially overrule the votes of member states that do not belong to the Eurogroup.

The special case of Eurogroup is even further codified in the Lisbon Treaty, as only the countries within the Eurogroup are allowed to vote on matters related to the Euro area. Thus, Latvia's influence on economic and financial matters in the group where most of the EU member states participate is a logical interest. Staying out of the single currency that unites most of the leading economies of the European Union (which are currently pressured into intensifying mutual cooperation) is, frankly speaking, illogical from the perspective of maintaining a political presence in the decision making process.

By joining the Eurogroup, not only will Latvia have the opportunity to acquire first-hand information and knowledge of the situation in the Eurozone, but it will also be granted voting rights. Voting rights in an additional decision making forum increases the number of bargaining chips Latvia possesses within the European Union. Casting Latvia's vote in one particular way can become significant if different economic approaches or ideologies clash or any of the matters that balance between "accepted" and "rejected" are in question.

In this regard, two examples for the current divisions within the Eurogroup could be named. The first division is in relation to the Stability & Growth debate. One group of countries supports the sovereign spending cuts during times of crisis in order to achieve economic stability and economic improvements; the other group seeks additional public investments in the economy in order to secure economic growth, which leads to overcoming national financial problems. Latvia and the other "Northern" European Union countries tend to support the first approach, while the "Southern" or more socialist oriented countries oppose this heavily. The second division line that is emerging surrounds the attitudes towards further EU integration or the "depth of the EU". The debate between the supporters of a "Federal Europe" and "Intergovernmentalists" is not as clear cut as the first division, but will raise more questions and debates in the near future.

Thus, the bottom line is that Latvia's participation within the Eurogroup is firstly most essential for the small Baltic state itself. As the interviewees informed, not currently being part of the Eurogroup forces Latvia to react to decisions made within the group. For Latvia to be able to actively participate and shape the decisions that could have an effect not only on the Eurozone, but the whole European Union, it must be a member of the club. This aspect becomes especially fundamental when the Latvian presidency of the Council of the European Union in the first half of the 2015 is in progress. Latvia's chances to lead a successful presidency will naturally increase if the country is part of the Eurogroup and Eurozone in general.

Finally, Latvia's institutional readiness to be an active member of the Eurogroup has been questioned for this research. No significant disturbances besides the widely discussed capacities and incapacities of the Latvian administrative sector could be identified. In spite of the pragmatically limited administrative resources of the Ministry of Finance of the small EU country, Latvian decision makers are convinced of a successful transition into the Eurogroup. The Ministry of Finance of Latvia is not currently planning on increasing the number of staff working specifically with Eurogroup matters. However, reasonable doubt remains as to whether the current staff has had the possibility of training in the slightly different environment, scale and

issues that Eurogroup membership will offer, especially regarding participation in the European Stability Mechanism.

2.3. The Bank of Latvia as a systemic part of the Eurosystem

The Eurosystem is currently the main cooperation format between the central banks of the Eurozone member states. The format came into existence because of a legal conundrum with the European System of Central Banks that requires all of the EU member states to adopt the single currency before acquiring decision making authority. Thus, currently the Eurosystem is constituted by the European Central Bank (ECB) and the governors of central banks of the 17 Eurozone member states. The operational basis of the ECB/Eurosystem is the Treaty establishing the European Community and the Statute of the European System of Central Banks and of the European Central Bank.

The main decision making bodies within the Eurosystem are the central decision making structures of the European Central Bank: the Executive Board (the President and Vice-President of the ECB and four European Council-appointed professionals) and the Governing Council (the Executive Board along with the national central banks of the Eurozone member states). The third body is the General Council, which performs advisory functions for the ECB, statistical reporting, analysis and several other tasks. It is comprised of the ECB Presidents and Vice-President and all the EU member states.

The significance of the Eurosystem lies not only in the coordination of the work of the central banks and the execution of a common monetary policy, but in benefiting from economies of scale. Thus, smaller Eurozone countries both acquire greater influence over the monetary system of an economy and area many times larger than their own, and have to learn to make decisions on national matters collectively. This apparently is one of the appealing aspects for the national central bank governors and leadership in general. The right to become a part of the Eurozone – or even the worldwide – decision making process for the small states and their leadership is a once in a lifetime opportunity. Thus, in a situation where most of the decision making tasks for the national central banks are not lost, but their presence and engagement on an international level is gained, small states tend to make a rational, strategic decision of alignment. From the point of view of Latvian monetary policy, the Bank of Latvia will not lose any functions as the central bank in Latvia. The number of functions and policies that the Bank is responsible for will remain the same, with some new ones added. The Bank of Latvia will still have its say over the national financial system and economic development, but decisions affecting Latvia will be made collectively. At the same time, the economy of the Euro area will become part of Latvia's economy as well. Thus, Latvia will not exercise monetary policy autonomously anymore, but it will have to look for allies in the decision making process. The psychological and political readiness of Latvia's politicians and officials to do this, of course, is another issue that may be addressed separately elsewhere.

The Bank of Latvia will preserve many of its current functions, including the management of Latvian gold and foreign currency reserves, except for the 261 million euros (approx. 4.9% of the total amount of the reserves)⁴² that will be delegated to the ECB. The Bank of Latvia will also

⁴² Rimševičs: Bank of Latvia after the Introduction of Euro will Deposit with ECB 261 million EUR Worth of Foreign Currency and Gold. In BNS, November 20, 2012, http://www.delfi.lv/bizness/bankas_un_finanses/rimsevics-lb-pec-eiro-ieievesanas-nodos-ecb-valutu-un-zeltu-261-miljona-eiro-apmera.d?id=42841778

preserve the responsibility of monitoring the circulation of bank notes and coins, as well as its analytical and statistical responsibilities. Some new functions will be added. The most important of these, of course, is the meetings of the Governing Council twice a month. This is the central decision making format discussing not only monetary issues, but also other aspects concerning the stability and growth of the Eurozone. Based on the decision to postpone the introduction of the rotation principle in voting rights⁴³, the President of the Bank of Latvia will have one vote alongside the other members of the Governing Council.

From the point of view of Latvia's influence and the increase in the country's institutional power and responsibility, the first aspect to be mentioned is the fact the President of the Bank of Latvia will no longer be only the President of the Bank of Latvia. The person in charge of the Bank of Latvia from January 1, 2014 (on the condition of Latvia's acceptance) will represent a decision making organ of a much larger economic area and currency, the Governing Council of the ECB. This is yet another example how the small state of Latvia will have additional bargaining powers and new channel of representation on the global stage. As the euro is a global currency, Latvia's projected influence within debates both in the European Union and with third countries will grow.

At the same time, for various reasons Latvia will not become a core country in the Governing Council of the ECB. Among these reasons one can clearly name the lack of experience of Latvia in the format, its limited administrative capacity compared to larger countries, its significantly smaller structural economic role and the availability of financial influence. Yet again, not only does Latvia have an experience like this. Estonia, Luxembourg or all the other small states within the Eurosystem are politically positioned differently than bigger and financially more influential countries like Germany or France. But, of course, in many cases the role or influence of a representative within a collective decision making body depends on the intellectual and personal capacities of the participant.

When the preparedness of Latvian state institutions, namely the Bank of Latvia, in relation to joining the Eurozone is examined a significant trend stands out. The Bank of Latvia has been a legally independent decision making authority in the Latvian state and, because of its functions, has had rather limited experience in collective decision making in the matters of its responsibility; however, the bank has rather extensive international cooperation experience. Most importantly, this includes participation in the decision making process within ECOFIN and related working groups, as well as cooperation with the International Monetary Fund or the World Bank and other international financial institutions. Moreover, within the three years (2009-2011) of the Program for International Financial Assistance (*Starptautiskā aizdevuma programma*) the role and functioning of the Bank of Latvia was bound by international actors. In spite of these experiences, the traditional unilateralism of the Bank of Latvia becomes one of its core challenges in the collective character of the decision making process. The operational framework will be new for the Bank of Latvia and, as noted by a source from the Bank of Latvia, "we have to get comfortable with the fact that the decisions will not be made by us alone anymore."⁴⁴ Because of its accumulated institutional memory, the Bank of Latvia is planning on entering the Eurosystem

⁴³ ECB Governing Council decides to continue its current voting regime. European Central Bank, December 18, 2008, <http://www.ecb.europa.eu/press/pr/date/2008/html/pr081218.en.html>

⁴⁴ Authors' anonymous interviews with officials responsible for the Eurozone accession from the Bank of Latvia and the Ministry of Finance of the Republic of Latvia in Riga in April 2013.

rather prepared. Yet again, the decision making powers of the small central bank will be tested when Eurozone, EU or even global level issues will have to be addressed.

Conclusions for the Way Forward

After several trial and error periods, Latvia at last complies with the nominal convergence criteria of the Eurozone. This window of opportunity will not stay open for much longer; therefore, the government will do everything possible to achieve membership in the Eurozone. However, though the ghost of currency devaluation will be gone, stability in the currency sector will intensify volatility in others segments of the economy, such as prices and wages. It is often argued that in the Eurozone the situation for the current account balance of a particular member state has little relevance; nonetheless, in the longer term the imbalance in trade flows will lead to a surge in private and public debt, with all its associated risks, as was witnessed by the Southern Eurozone member states. Hence, membership in the Eurozone will not remove from the agenda other essential issues like the sustainability of growth, the stability of the macroeconomic framework, implementing further reforms to increase Latvia's competitiveness, or the renewal of labor resources.

For Latvia participation in the Eurozone makes sense, as the exchange rate manipulation is not a very effective tool for the management of such a small and open economy. As noted by the magazine "Economist", even Milton Friedman, the most passionate advocate of flexible currencies, believed that a currency union with a big steady neighbour was the best policy for small developing economies⁴⁵. Latvia's success within the Eurozone will depend largely on the prudence and vigilance of Latvia's government. A repetition of the drama of 2008-2011 cannot be ruled out, as Latvia will continue to suffer from strong cyclical growth volatility even within the Eurozone – though the scale of the difficulties will be close to impossible to repeat. Additionally, the very logic of the EMU, where price and wage flexibility plays an important stabilizing role in combination with the mobility of various factors across borders, suggests that a significant side-effect of Latvia's participation in the Eurozone will be growing inequality and poverty among some groups of Latvian society.

During the drafting of the Lisbon Treaty, the issue of changes to the nominal convergence criteria was not raised, even despite the earlier experience of Lithuania, which missed euro membership because of approximately a 0.1% departure from the reference value of the price stability criterion. Evidently, the issue was not considered relevant enough to be opened for discussions. Hence the lesson for the aspirants, including Latvia is not to mess with the nominal convergence – once the window of opportunity is open, use it immediately, otherwise it will soon close and nominal convergence will stay out of reach until the next recession. Simply too many "ifs" would appear on the stage should the decision to postpone Eurozone accession be made. Too much administrative and entrepreneurial energy would be wasted if the current opportunity to join the Eurozone is not seized. Even if the Maastricht criteria are disputable, they are not easily achievable for any country, let alone for small and rapidly growing economies like Latvia's.

Thus, in the end the decision to make the leap towards Eurozone membership is not only an economic opportunity or necessity. It is a strategic economic and political decision that will

⁴⁵ "Lessons of the Lat", The Economist, October 17, 2009, 18.

have both social and institutional consequences. In spite of the fact that the decision is made at the expense of immediate public support, from the point of view of a small state's foreign policy choices, and from the perspective of the continuity of Latvian integrationist relations with the European Union, from the position of being at the core of the emerging "political multi-speed Europe". Moreover, Latvia is not the only one for whom membership in the Eurozone is of political and economic significance. The Eurozone and its current member states have a political decision to make to accept or not accept a country which currently fulfills all of the Maastricht criteria and which symbolizes trust and hope in the sustainability of the Economic and Monetary Union.

Latvia has made the decision to adjust its economy to fulfill the criteria necessary to be accepted into the elite economic and political club which is capable of projecting its influence on the global scale. It's each country's decision to give up its autonomous monetary policy for the projected political and economic gains. The Eurozone can currently be quite strict with membership, but it is the positioning and inclusion that it offers to European Union member states, especially the smaller, economically and politically more vulnerable ones. Thus, Latvia's decision has at least two immediate effects: it demonstrates that the Eurozone is still viewed as worth fighting for and that Latvia is on the brink of an assessment of its further goals and positioning in the European Union and global politics if the membership in the Third Stage of Economic and Monetary Union is achieved on January 1, 2014.

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