LATVIA'S ACCESSION TO THE EUROZONE DURING ITS SOVEREIGN DEBT CRISIS

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Abstract. The sovereign debt crisis has not stabilised, and it continues worsening in several euro area states. Latvia prepares to join the euro area in 2014, replacing the national currency lat with the single European currency euro. Therefore, the aim of the research is to analyse the main gains and losses from Latvia's accession to the euro area during its sovereign debt crisis. Several gains to Latvia's national economy are expected after the accession to the euro area, the main and most realistic of which is an improved financial system and, along with it, a higher credit rating for the country, which means lower borrowing rates for the country at international financial markets. It is important, given the fact that Latvia's government debt is quite high, approximately 40% of GDP, and its interest cost is essential. However, several additional expenses are expected with the introduction of the euro. The key expense relates to contributions to the European Stability Mechanism, part of which will have to be possibly written off or lost in case of crisis, incurring part of the debt of the economically weakest euro area countries having excessive government debt. For this purpose, scenarios for the eurozone debt crisis are developed and potential losses from Latvia's membership in the euro area are estimated in the present research. Under negative debt crisis scenarios, Latvia's losses from the membership in the euro area exceed its gains. Therefore, it is advised to join the euro area after the eurozone sovereign debt crisis is over.
Key words: eurozone crisis, accession to the eurozone.
JEL code: G01, F14

Introduction

The years 2012 and 2013 are important to Latvia, as during this period its national institutions have to make various decisions and pass various legal acts on joining the euro area. Therefore, this period will determine much in relation to Latvia's national economy, foreign trade, government debt, and other issues. There is certain unclearness and concern among economists and the entire society regarding Latvia's need of joining the euro area already in 2014, given the unsolved problems in the single currency area.

An economic recession has began in the euro area, as for two consecutive quarters – in quarters 2 and 3 of 2012 – the euro area GDP declined, although a slight increase in GDP was observed in the entire European Union (EU), to which the comparatively fast economic growth of the Baltic states contributed as well. The worst situation is observed in southern Member States of the euro area, where the longest and fastest recession is observed. Among these states, the worst situation exists in Greece, where the last annual economic growth was registered in 2007; as regards its quarterly economic growth, no data are available in the Eurostat database for the recent six quarters, and only provisional data exist about many earlier quarters, which indicate that there are problems to make GDP change calculations. A comparatively better situation is observed in the other southern Member States of the euro area: in Italy, its GDP declined for five consecutive recent quarters, in Spain – for four quarters, and in Portugal – for eight consecutive quarters (Eurostat, n.d.).

Given the present situation, all East European countries of the EU, including Lithuania, do not plan to join the euro area within the nearest years, presumably understanding the serious problems of the euro area. Latvia's government is the only one among seven East European countries, which firmly pursues the objective of joining the euro area and introducing the euro on 1 January 2014. Unlike the government of Latvia, according to a survey conducted by the company Latvijas Fakti in August of 2012, only a small proportion of the Latvian society (13.1%) strongly supports the introduction of euro as early as possible; 21.9% want the introduction of the euro, but not within the nearest years (Freimanis, 2012). According to the European Commission report, only 9% of the respondents in Latvia want the euro, and 37% are rather in favour of euro adoption (European Commission, 2012a). In Estonia, where the euro has been in circulation since 1 January 2011, in its turn, the society's support for the euro is high – 71% of the respondents are in favour of the European Economic and Monetary Union with one single currency, the euro (European Commission, 2012b). Yet, a certain part of Estonia's public expresses its dissatisfaction with the fact that the country has to make contributions to the European Stability Mechanism (ESM), which is intended for rescuing indebted governments of the eurozone countries that are wealthier than Estonia. Although no ESM funds have been used for writing off government debts, it is not excluded in the future, as it is not possible to precisely forecast further developments of the eurozone debt crisis.

The research aim is to analyse the main gains and losses from Latvia's accession to the euro area during its sovereign debt crisis.

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Research tasks:

1) to describe the fulfilment of the Maastricht criteria by Latvia and its contributions to the European Stability Mechanism;
2) to analyse the causes of the eurozone debt crisis and to develop scenarios for the future development of this crisis;
3) to analyse Latvia's gains from its membership in the euro area and to estimate its potential losses in the case of negative scenarios developing in the euro area.

The following research methods were employed in the present paper: analysis, synthesis, the abstract and logical methods, and the scenario method. Data and reports of the European Central Bank (ECB), the European Commission, the Bank of Latvia, the Ministry of Finance of the Republic of Latvia, Eurostat, and the World Bank as well as other information sources were used in the present paper.

Research results and discussion

1. Meeting the Maastricht criteria by Latvia and the cost of joining the ESM

Latvia joined the European Union in 2004. Its membership in the EU, which is the largest free trade bloc, determines the need for the single currency that fosters international trade within this bloc, which, in its turn, may promote economic growth and along with it an increase in welfare.

The Treaty concerning the accession of Latvia to the EU, like that for the other new EU Member States, stipulates the adoption of the euro as soon as all economic conditions (Maastricht criteria) are met. The highest level of economic integration of the Member States is implemented in the European Union in such a way (Ministry of Finance, n.d.).

Initially, it was planned that Latvia would join the euro area in 2008, yet, since the country was not able to meet all the Maastricht criteria, it was postponed to the year 2014. The inflation criterion was not met until 2008, and inflation was a double digit figure for several years (Ministry of Finance, n.d.), mainly due to fast economic growth as well as other factors (Ancans S., 2012). Over the next years – from 2008 to 2011 – Latvia was not able to meet the criterion on government budget deficit, i.e. not more than 3% of GDP (Eurostat, n.d.). As regards inflation, the inflation rate for September of 2012 corresponded to the inflation rate needed to meet this convergence criterion (Ministry of Finance, n.d.). Meeting the inflation criterion was facilitated by a value added tax reduction from 22% to 21% on 1 July 2012. The forecast and execution of the government budget for 2012 also met the relevant Maastricht criterion. Therefore, one may conclude that all the Maastricht criteria will be met both in 2012 and in 2013, which will pave the way for joining the euro area in 2014. Yet, a reasoned question arises: whether it is necessary to join the euro area if the government and also private debt crisis in several Member States continue and possibly expand as well. In all the previous times when Latvia tried to join the euro area, no problems with sovereign debts, unlike the present situation, existed.

If Latvia joins the euro area, funds have to be necessarily contributed to the ESM. Latvia's ECB capital key is equal to 0.2837 (European Central Bank, 2011), while its ESM capital key, if the country joins the euro area, will be slightly greater or approximately 0.3 (for comparison, Estonia's ECB capital key is 0.179, while its ESM capital key is 0.186). The ESM size in 2012, when it started operating, was EUR 700 billion. At such an ESM size, Latvia will have to contribute EUR 199 mln to its paid-in capital during the period of first five years, and, after the transitional period of 12 years is over, this contribution will have to reach EUR 324 mln (Rutkaste U., 2012) and provide a callable capital of approximately EUR 1.5 bln. After the transitional period, Latvia's ESM capital key will be approximately 0.4, therefore, the country's contribution to the ESM paid-in capital will reach EUR 324 mln, and at such a value of ESM capital key, the amount of callable capital will be approximately EUR 2.5 bln.

If the ESM size is increased, Latvia's contributions to the ESM's paid-in and callable capital will proportionally increase. The government debts of the southern Member States of the euro area – Greece, Portugal, Spain, and Italy – totalled more than EUR 3 trn in 2011 (Eurostat, n.d.). As of 2012, approximately EUR 400 bln were or will be lent to all these countries, except Italy, which so far needed no financial assistance; Greece's debt of almost EUR 150 bln was written off. It has to be noted, that the debts of these countries continue increasing.

In case, if these countries do not restore or lose investor confidence in financial markets and are not able to refinance their debt as well as if other euro area member countries need to be bailed out, the ESM size will probably need to be increased, and Latvia's contributions to the ESM's paid-in and callable capital will also increase. The international financial community discusses an ESM size of EUR 2 trn, and a part of it will be financed from private sources. Thus, Latvia's contributions to the ESM might reach EUR 4 bln or even more, which becomes comparable with the Latvian government's present debt.

2. Causes of the eurozone sovereign debt crisis and its further development scenarios

In 2007, a financial crisis or the so called sub-prime credit crunch began in the USA in its real estate market, which arose owing to a too large proportion of mortgage loans made to households with bad credit history. The fourth largest US bank Lehman Brothers invested too much in the US sub-prime mortgage-backed securities, therefore, this bank became insolvent in September of 2008. The bankruptcy of this large US bank soon caused a financial crisis in the largest part of the entire world, including Latvia, followed by an economic crisis a little later – both exports and economic output started declining.

To overcome the crisis, the central banks of developed countries took the following two key measures: 1) reduced their key interest rates up to a very low level, thus financial capital became very cheap, i.e. at low interest rates; 2) increased the money supply by injecting large quantities of money into their commercial banks through quantitative easing measures. As regards the central governments, they continued spending, under the circumstances of crisis,

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Table 1

Macroeconomic indicators of the countries causing the eurozone crisis

	2008	2009	2010	2011	2012*
Greece:					
GDP change, %	-0.2	-3.1	-4.9	-7.1	-4.7
Government deficit, % of GDP	-9.9	-15.6	-10.8	-9.5	-6.7
Public debt, % of GDP	112.9	129.7	148.3	170.6	-
Exports, % of GDP	24	19	22	25	-
Current account, % of GDP	-14.9	-11.2	-10.1	-9.9	-
Ireland					
GDP change, %	-2.1	-5.5	-0.8	1.4	0.5
Government deficit, % of GDP	-7.4	-13.9	-30.9	-13.3	-8.6
Public debt, % of GDP	44.5	64.9	92.2	106.4	-
Exports, % of GDP	83	91	101	107	-
Current account, % of GDP	-5.7	-2.3	1.1	1.1	-
Portugal					
GDP change, %	0.0	-2.9	1.4	-1.7	-3.3
Government deficit, % of GDP	-3.7	-10.2	-9.8	-4.4	-5.0
Public debt, % of GDP	71.7	83.2	93.5	108.1	-
Exports, % of GDP	32	28	31	35	-
Current account, % of GDP	-12.6	-10.9	-10.0	-6.5	-
Spain					
GDP change, %	0.9	-3.7	-0.3	0.4	-1.8
Government deficit, % of GDP	-4.5	-11.2	-9.7	-9.4	-5.3
Public debt, % of GDP	40.2	53.9	61.5	69.3	-
Exports, % of GDP	26	24	27	30	-
Current account, % of GDP	-9.6	-4.8	-4.5	-3.5	-
Italy					
GDP change, %	-1.2	-5.5	1.8	0.4	-1.4
Government deficit, % of GDP	-2.7	-5.4	-4.3	-3.8	-1.7
Public debt, % of GDP	106.1	116.4	119.2	120.7	-
Exports, % of GDP	28	24	27	29	-
Current account, % of GDP	-2.9	-2.0	-3.5	-3.1	-

* forecast

Source: author's construction based on Eurostat, the World Bank

at a comparatively high level, although tax revenues significantly decreased.

Owing to implementing these measures of central banks and governments, the financial and economic crisis lasted in developed countries for about one and half years in the years 2008 and 2009, and already in 2010 the countries returned to economic growth. However, all these measures did not fully solve the problems that emerged in the national economies of these countries. In several relatively weak South European countries – Greece, Portugal, Spain, Italy, Cyprus as well as in Ireland, government debts rose at a fast rate, reaching debt amounts that started worrying private investors. This led to the situation that these countries were not able to refinance their debt in international financial markets or the borrowing rate reached a too high level, creating a need to apply for assistance to the International Monetary Fund and the European Commission. Thus, the measure implemented by governments – comparatively greater spending under the crisis to restore economic growth in the economy – may become a cause for a new crisis or the so called second wave of crisis.

Since Cyprus is a small country (0.9 mln inhabitants), it is not analysed in this research, as it may not significantly affect the crisis.

Unlike Ireland, all the other analysed countries, i.e. the South European countries have relatively weak economies – their value added in their tradable sector is comparatively low, as their manufacturing industry, in which high value added is created like in other developed countries, is not highly developed. Therefore, such an

indicator as the ratio of exports to GDP is comparatively low (Table 1). In Ireland, this indicator reaches 100% of its GDP, whereas it ranges around 30% in the mentioned South European countries. The lowest indicator is in Greece, ranging within 20-24% of GDP. It is a very low indicator, as a certain empirical correlation exists – the smaller is a country in terms of population and, therefore, smaller is its national economy, the higher ratio has to be. It may be explained by the fact that small countries have to import a lot, as they are not able to produce the whole assortment of goods and services that is consumed by the modern society. If a lot of goods and services have to be imported, exports have to be large as well. The other indicators of the South European countries – the current account balance, GDP growth, annual deficit/surplus of government budgets, and total public debt – are weak as well. In order that these countries can refinance their public debt, i.e. investor confidence returns as well as tackle other economic problems, they need GDP growth, a normal (balanced) current account (preferably with a surplus), and a government budget with a surplus.

The further development of the crisis in the eurozone will be determined by both the economic growth of the EU Member States and the overall situation with general government (central and local) budget deficit/surplus and debt. The main factor will be economic growth that enables a government to collect more tax revenues, thus reducing a deficit in the government budget (or even maybe having a surplus) and decreasing the public debt or at least not increasing it. If there is no growth in addition to the inability of these countries to implement austerity measures (due to public protests) and make structural reforms in the national economy, the situation will continue worsening – these countries will need more bailout funding and, possibly, a controlled bankruptcy, thus writing off a part of their debt like it was in Greece in 2011 and 2012.

To estimate the amounts of public debts that might be written off, three potential negative scenarios are developed:

Scenario 1. A relatively long crisis exists in the southern Member States of the euro area, yet, no crisis is observed in the remaining part of the euro area and other regions in the world, including the USA and China. In this case, the public debts of the South European states, which are above 100% of their GDP, are written off.

Scenario 2. A relatively long crisis is observed in almost entire euro area and the EU, yet, there is no crisis in other regions in the world, including the USA and China. The crisis is deeper compared with the previous one, and decreases in foreign trade and GDP are greater. The public debts of the problematic South European states, which are above 80% of their GDP, are written off.

Scenario 3. A relatively long crisis persists in both the euro area and the EU and other regions in the world, including the USA (owing to large public debt (more than 100% of GDP), changes in the tax policy and other factors) and China (after two decades of continuous economic growth, "bubbles" might emerge in the markets of stocks and real estate). The crisis in the world is the deepest and longest one. The public debts of these South European states, which are above 60% of their GDP, are written off.

3. Latvia's gains from its euro area membership and the potential losses in the case of negative scenarios

According to the assumptions made by the Bank of Latvia, the credit rating of Latvia after its accession to the euro area will rise by 1-2 levels, which will provide lower borrowing rates for the government by approximately 1.5%-points. It enables the country to save approximately EUR 900 mln in a ten-year period (Kauzens E., 2012). Besides, there are two other major gains: a gain of approximately EUR 8 bln from an increase in exports and a decrease in the interest rate for the private sector (from 2014 to 2020) and a gain of approximately EUR 700 mln from the partial disappearance of foreign exchange costs (within 10 years after the adoption of the euro) (Rutkaste U., 2012).

All these three main gains from the adoption of the euro are either relative, or might be possible only in case the euro area develops relatively positively, i.e. the situation existing in the middle of 2012 will not worsen. As regards the mentioned gain, estimated by the Bank of Latvia, from foreign exchange cost reduction, it is relative or it actually does not exist, as in this case, what is saved by exporters and importers, because they do not have to exchange their euros for lats and vice verse, is lost by Latvia's commercial banks, and in general nothing changes in the national economy as a system (Table 2). Since commercial banks lose this income, they will try to partially or fully regain it in different ways (by increasing the spread between deposit and loan rates, possibly, by increasing the spread between foreign exchange purchase and sale rates for businessmen making international transactions with countries outside the euro area etc).

The other two main gains estimated by the Bank of Latvia will be true, if there is no long and serious crisis in the euro area caused by the excessive public debts of several Member States. If such a long crisis exists, Latvia as a member of the euro area will have to borrow additional financial capital, the amount of which will be at least two billion euros or approximately 10% of GDP (in addition to the existing Latvian government debt of more than LVL 5 bln or EUR 7 bln (Treasury, 2012)), a part of which might be used to write off part of debts of other euro area countries. In 2012, the public debt of Latvia was equal to approximately 40% of GDP (Treasury, 2012). During a crisis, there will likely be a deficit in the government budget, therefore, the public debt will continue increasing, and contributions to the ESM's callable capital will additionally increase it. In a medium-term, Latvia's public debt will approach the level set by the Maastricht criteria, i.e. 60% of GDP, which is the size of debt that any national government can service sustainably. In this case, one could expect that the risk premium for Latvia might increase in international financial markets, as Latvia, which is not a developed country, assumes an additional burden of public debt for tackling problems of other countries (including for writing off their debts) instead of tackling its own problems. With an increase in risk, the borrowing rate rises, thus partially or fully losing the gain from the expected rate reduction after joining the euro area, which, according to the estimate of the Bank of Latvia, might be approximately

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Table 2

Gains and losses to the national economy, if Latvia is or is not a member of the euro area

Indicator	Euro area member		Not a euro area member	
	crisis	no crisis	crisis	no crisis
Foreign exchange	≈ 0	≈ 0	≈ 0	≈ 0
Public debt, its refinancing	-	+	+	-
Decrease in interest rates for the private sector	+	+	-	-
Increases in exports and real investments	+/-	+	+/-	-
Foreign direct investments	-	+	+	-

Note: gain (+); loss (-)

Source: author's construction

Table 3

Amounts of general government debts of the problematic Member States and the potential amount of debt to be written off at various scenarios, bln EUR

	Greece	Portugal	Spain	Italy	Total
Public debt in 2011	355.7*	184.7	736.4	1906.7	
Debt to be written off according to:					
Scenario 1	40	12	0	316	368
Scenario 2	80	46	0	632	759
Scenario 3	120	81	86	949	1236
Latvia's loss according to:					
Scenario 1	0.025-0.050	0.007-0.015	0	0.197-0.393	0.229-0.458
Scenario 2	0.05-0.099	0.029-0.058	0	0.393-0.786	0.472-0.944
Scenario 3	0.075-0.149	0.05-0.101	0.054-0.108	0.059-1.180	0.768-1.537

* before debt restructuring and writing off a debt of EUR 107 bln

Source: author's construction based on Eurostat

1.5%-points; moreover, this increase in the borrowing rate, owing to the risk, might exceed the expected rate reduction estimated by the Bank of Latvia. In this case, the government saving gained from lower borrowing costs (owing to an increase in the public debt and an increase in refinancing rates) after joining the euro area will be negative compared with a situation that Latvia is not a member of the euro area.

The third main gain estimated by the Bank of Latvia arises from lower interest rates for the private sector and increases in real investments and exports (lower interest rates increase real investments and exports). In this case, increases in real investments and exports have to be analysed separately from the decrease in interest rates for the private sector. Only lower interest rates for the private sector, if Latvia is in the euro area, according to the author, is an undisputable gain for the entire national economy in any case (according to the estimate of the Bank of Latvia, a decrease in long-term interest rates reaches approximately 0.5%-points). Any borrower (both households and enterprises) will have lower expenses, whereas owners of financial capital or depositors will have lower incomes. Since about half of the money deposited in Latvia's commercial banks comes from abroad (FCMC, n.d.), foreign capital owners will not gain approximately half of the funds saved by domestic borrowers. Besides, in case some problems with any bank arise, like it was with the bank Parex in 2008, Latvia's commercial banks will have a possibility to borrow cheaper money at the ECB. The amount of loans lent to Latvia residents exceeds LVL 10 bln or EUR 14 bln, and a decrease in borrower expenses is estimated at LVL 50 mln or EUR 70 mln, of which about half (LVL 25 mln) will not outflow from Latvia as financial investment income of non-residents.

As regards real investments and exports, under a crisis, the amount of real investment will shrink, and a decrease in exports is also expected like it was during the first wave of crisis, yet, probably these decreases will be observed at smaller amounts compared with a situation if the euro is not adopted, although it is difficult to predict what a situation might emerge. When the first wave of crisis began in 2008, a phenomenon was observed that business partners of Latvia's exporters (foreign importers) did not want to purchase goods and services made in Latvia, as they knew that Latvia had a serious crisis and believed that it might negatively affect the quality and delivery of goods and services from Latvia.

Although the debt and problems of government are not directly related to the private sector, foreign

investors may believe that it is better not to invest capital in Latvia under conditions that its government has its own significant debt and additionally debts of other richer countries of the euro area have to be financed. Therefore, it is possible that in this case, too, Latvia's gain from an increase in foreign investment, being a member of the euro area, will not be positive, but negative compared with a situation, if Latvia is not a member of the euro area.

It is difficult to exactly predict a situation in the fields of finances, exports, and investment as well as in the entire national economy. Yet, one can conclude that Latvia will definitely benefit from being a member of the euro area in case no new serious financial and economic crisis or the second wave of crisis occurs. On the other hand, Latvia is disadvantaged if staying outside the euro area and no serious crisis in the euro area is expected within a foreseeable period (Table 2). Therefore, the need to join the euro area in Latvia depends on whether or not a serious crisis in the world or at least in the euro area occurs.

Further in the paper, potential losses of the government of Latvia are estimated, if political extraordinary decisions, forced by circumstances, are made to restructure and write off part of public debts of the economically weakest South European Member States, like it was with Greece in 2011 and 2012, owing to a long and serious crisis, however, this time losses will be suffered not by private holders of government bonds and not by the European Central Bank, but by euro area governments, i.e. by writing off funds of the European Stability Mechanism. In the future, such decisions would be eliminated by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Table 3 presents the potential losses of Latvia at various negative scenarios, assuming that the euro area governments write off a quarter to half of debts, while the rest is written off by private investors.

Given the fact that Latvia's ESM capital key is approximately 0.25 and assuming that 25-50% of debts are to be written off by governments of the euro area Member States, the Latvia government loss at Scenario 1, according to which debts above 100% of GDP are written off, is around EUR 0.3-0.5 bln. This might be the most probable scenario. According to Scenario 2, Latvia's loss is almost EUR 0.5-0.9 bln (by writing off a debt of above 80% of GDP). Although it is unlikely that it will be needed to write off all the debts above 60% of GDP (Maastricht criterion for euro area Member States), yet, in this case Latvia's loss would be more than EUR 0.7-1.5 bln. It is not possible to predict the future of economic life for several years ahead, therefore, it is impossible to forecast the development of a crisis in the euro area and, possibly, outside it – in the USA and/or in China. Yet, such negative developments may not be ignored. According to the estimates, the losses are significant, besides, it has to be taken into consideration that in case economic processes develop negatively in the euro area, the cost of refinancing the debt of Latvia government will not decline by an extent estimated by the Bank of Latvia, or it will even increase; besides, the gains in other areas will be smaller or even negative.

Conclusions

1. For the first time in a decade after joining the EU, Latvia is able to meet all the Maastricht criteria and join the euro area, yet, it requires to make financial contributions and provide callable capital estimated at around EUR 1.7 bln during the transitional period and around EUR 2.8 bln in 12 years after joining the euro area at the present ESM size of EUR 700 bln; its size, possibly, will be increased, thus Latvia's contributions to the ESM will increase as well.
2. The financial and economic crisis, which started in Europe in the second half of 2008 (the first wave of crisis), significantly increased the public debts in many Member States, which may be a cause for the second wave of crisis. It actually began in the economically weakest South European Member States, and it may spread further in the euro area. A crisis is possible also in the USA due to its excessive public debt and in China after fast economic growth for more than 20 years.
3. Out of the gains estimated by the Bank of Latvia, in case a serious crisis begins, only a gain from lower interest rates for the private sector is undisputable. In any case, there is almost no gain for the national economy as a systemfrom the partial disappearance of foreign exchange costs, whereas the cost of refinancing the government's debt will be greater, and the increases in real and foreign investments and in exports, under a crisis, will be smaller, besides, they might be lower compared with a situation, if Latvia stays outside the euro area.
4. In the case of the negative scenarios in the euro area and if the ESM funds are used to partially write off the debts of the economically weakest South European Member States of the euro area, Latvia's losses may reach a few or even many hundreds of millions of euros.
5. If economic and financial developments are negative in the euro area during the present sovereign debt crisis, Latvia's gains from its membership in the euro area significantly decrease, or even the losses exceed the gains during this period, therefore, in this case it is advised not to join the euro area and wait together with the remaining six East European EU Member States until the sovereign debt crisis in the euro area ends. The accession to the euro area may be advised only in the case of positive development of the euro area.

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