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Accession of Baltic countries to the euro area.

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Introduction. The economic situation of Central and Eastern Europe countries.

Despite a decrease in the economic growth of Central and Eastern Europe (CEE) countries, the second half of the last year presented prospects for the reversal of the region's downward trend in 2014, mainly through the improvement of consumption following a decrease of interest rates. Moreover, in the second half of 2013 and the year 2014 the region's economy is expected to pick up due to the improved situation in the euro area. The main cause of the economic slowdown in CEE was the deepening crisis of the euro area in 2012, the continued consolidation of public finances and the debt adjustment of the private sector. What is important, reports indicate a small improvement of export dynamics in the Baltic countries which compensated for the weakening euro area export with increased export to former USRR countries.[1]

In its World Economic Outlook (WEO) survey of July 2013, the International Monetary Fund presented prospects for economic growth in the CEE region, projecting a pick-up of 2.2% in 2013 and 2.8% in 2014. Central and Eastern Europe is the only group without a projected decrease in this or the following year.[2] The projected global GDP decreased by 0.2% to 3.1% and 3.8% respectively.

"This is less than forecast in the April 2013 World Economic Outlook (WEO), driven to a large extent by appreciably weaker domestic demand and slower growth in several key emerging market economies, as well as a more protracted recession in the euro area"

– states the report.

"Downside risks to global growth prospects still dominate: while old risks remain, new risks have emerged, including the possibility of a longer growth slowdown in emerging market economies, especially given risks of lower potential growth, slowing credit, and possibly tighter financial conditions if the anticipated unwinding of monetary policy stimulus in the United States leads to sustained capital flow reversals"

– adds the report.[3] In the April World Economic Outlook, the International Monetary Fund forecasts that economic growth in Poland will rise from 1.3% in 2013 to 2.2% in 2014.

[1] International Monetary Fund, World Economic Outlook 2013

[2] International Monetary Fund, World Economic Outlook 2013

[3] International Monetary Fund, World Economic Outlook 2013

Despite global market changes and economic slowdown, investors continue to view Central and Eastern Europe as an area with high economic growth potential. Consequently, direct foreign investments in new Europe countries will continue to rise, especially in the long-term perspective. The region's attractiveness is also connected to the fact that European Union provides funds for its development. Such conditions support the development of companies in the region and the increase of their value. Investment funds have for years invested in Central Eastern Europe, concentrating their assets in the shares of top companies with high growth potential.

A number of institutions have revised the recent economic data, evaluations and projections of CEE economic growth in 2013 and 2014, bringing the values down, similar as with almost all world economies. Despite the protracted economic stagnation observed in 2013, the year 2014 is expected to mark a return to relatively fast economic growth.[4]

Economic situation of Baltic countries.

Estonia

In the Economic Outlook, the Organization of Economic Co-operation and Development (OECD) published projections regarding Estonia's economic development, according to which Estonian economy will grow by 1.5% in 2013 and 3.6% in 2014.

The results differ from the previous projections, especially for the current year – 3.7% and 3.4%. Projections regarding Estonia's economic growth in 2013 and 2014 are above the OECD average for the euro area. Economic growth is driven by strong national demand combined with lower unemployment and higher wages. OECD expects a gradual improvement of external conditions in the second half-annum, as well as further development of the labour market. However, labour market results may be lower due to unmatched qualifications, increased wage pressure and lower population. Price increases will continue to slow down, but are expected to remain above the euro area average, reaching 3.4% in 2013 and 2.9% in 2014. OECD expects the continuation of the current fiscal policy, through the implementation of a multi-annum expenditure ceiling and an independent budget committee.

The rating agency[5] has confirmed Estonia's A+ rating, thus judging the country to be stable. A key factor in assigning such a rating was the country's excellent public finances result, even though a small deficit was reported in 2012 (0.3% GDP). Moreover, the Estonian government is confident that it will maintain structural surplus in the medium term. The agency praised Estonia for exiting the crisis, noting that the 3.2% GDP increase of 2012 was the highest in the whole euro area. However, the agency cautioned that, as a small and open economy belonging to the euro area and the European Union, Estonia is vulnerable to external economic and financial fluctuations.[6] The inflation level decreased in July 2013, largely due to lower power costs – informs the Statistical Office of Estonia.

[4] Narodowy Bank Polski, Analiza sytuacji gospodarczej w krajach Europy Środkowej i Wschodniej 2013

[5] Fitch Agency

[6] Based on information released by the Polish Embassy in Tallinn and Estonian economic press

Lithuania

The European Commission has raised Lithuania's GDP growth projection. According to the latest projection, the GDP will rise by 3.4% in 2013 and by 3.6% in 2014. EC analysts expect the inflation level to reach 1.4% in 2013 and 1.9% in 2014. Government deficit is expected to reach 3% of the GDP in the current year and 2.6% of the GDP in 2014.[7] According to Eurostat data, Lithuania's annual GDP growth in the III quarter (2.2%) was the third highest result among the 28 EU member states, bested only by Romania (4.1%) and Latvia (3.9%). Estonia's economy grew by 0.6%. The GDP growth in all of EU was 0.1%. Cyprus reported the most severe annual fall in the III quarter (5.7%). It should be noted, however, that 8 countries have yet to submit their data to Eurostat.[8] According to the Department of Statistics, the unemployment level stood at 10.9% in the III quarter, 0.8 pp less than in the II quarter. There were 159.6 thousand unemployed in the III quarter, i.e. 12.1 thousand less than in the II quarter.[9]

Latvia

After economic fluctuations which occurred a few years ago, mainly due to the crisis, Latvia's economic situation has stabilized, foreign trade turnover has increased and unemployment continues to gradually decrease. In 2011 Latvia resumed its dynamic development and now reports one of the highest GDP growth values in the EU. According to forecasts, in the coming years Latvia will maintain its position as one of the most rapidly developing EU member states with a GDP growth rate of approx. 3.8% in 2013 and 4.1% in 2014.

The European Commission projected that in 2013 the rate of economic growth in Latvia would reach 3.8%. In the current year 2014 this value is expected to reach 4.1%. The median of growth rate projections for the first quarter was 3.7%. According to the World Bank economists, the economic activity of EU 11 countries will gradually stabilize in 2013 and increase in 2014. The Bank's projections indicate that Latvia's economy will undergo the fastest growth in the region, with the GDP increasing by 3.6%.

The National Bank of Latvia expects Latvia's gross domestic product to grow by 3.6% in 2013. According to Ilmars Rimsevics, Governor of the National Bank of Latvia, the growthwill be smaller than in the previous year due to unfavourable processes in the global economy. Large European economies continue to enter into recession and suffer negative economic growth. This, of course, has a detrimental effect on Latvia's export, reducing the country's GDP growth. Rimsevics notes that, even though Latvia's GDP will be weaker this year, the country will maintain its status as one of the most rapidly developing EU countries. Latvia's GDP increased by 5.0% in 2012 – estimates the bank.

It should be noted that, following a strict savings programme compliant with EC criteria, on 1 January 2014 Latvia joined the euro area as its 18th member.

Due to the economic crisis in the years 2008-2009, Latvia's national income decreased by as much as 20%. To remedy this issue, the government took a EU loan of 7.5 billion euros. After a relatively short period, inflation was brought down to a low level and the country's debt was reduced without the devaluation of the national currency. The loan was paid back in full. Latvia has not yet fully recovered its level of economic development, which is still 12% lower than before the crisis. Despite high emigration, the unemployment level is relatively high – 12.4%.

In its assessment of economic and legal convergence (05.06.2013), the European Central Bank indicated that between May 2012 and April 2013 the 12-month inflation rate in Latvia stood at 1.3%, way below the reference value constituting the criteria for price stability, i.e. 2.7%. The reference value was calculated by adding 1.5 pp to the unweighed arithmetic mean of HICP inflation rates for these 12 months in Sweden (0.8%), Latvia (1.3%) and Ireland (1.6%).

[7] Lietuvos rytas, Verslo žinios, 06.11.2013

[8] Lietuvos žinios, 15.11.2013

[9] Lietuvos rytas, 16.11.2013

However, it should be noted that in the last ten years the consumer price inflation has been very dynamic: its annual average rate oscillated between -1.2% and 15.3%. This is connected with the presence of business cycles of extremely high amplitude and highly variable macroeconomic indicators. In the last period inflation in Latvia, which reached its peak level in the first half of 2011, fell to a low level, mainly due to the impact of lower raw material prices around the world and lower VAT since July 2012.
Nevertheless, latest forecasts predict a rise in inflation, while the balance of risk factors connected with inflation projections is veering toward an increase.

In the long-term perspective, the maintenance of low medium-term inflation in Latvia will be difficult. The inflation rates gap between Latvia and the euro area will likely further deepen in the medium term as a result of attempts at reducing the development gap with other countries.

In conclusion, Latvia does not exceed the reference values of convergence criteria. However, there are doubts as to the possibility of maintaining economic convergence in the long term. Accession to monetary union entails foregoing national monetary and currency policy, thus increasing the significance of internal flexibility and resistance. Due to the above, Latvia must continue the broadly understood fiscal consolidation in compliance with the requirements of the Stability and Growth Pact. Latvia should also secure its current competitiveness, which has improved over the years, by preventing further rises in unit labour costs. Moreover, despite the high adaptability of Latvian economy, its institutions and management are in need of improvement.

Latvia also requires a comprehensive set of policy tools which will help the country fight threats to financial stability arising from, among others, the dependence of a large part of the bank sector on non-resident deposits as a source of funding.

One should also note that, following an analysis of country rankings, the World Bank classified Latvia and Lithuania (besides Russia, Chile and Uruguay) among countries with high GPD per capita.
Previously, its GPD per capita was at an average level. The first place on the ranking of wealthiest countries is occupied by Monaco, followed by Liechtenstein, Bermuda, Norway and Switzerland.

The Gross Domestic Product Per Capita reached 15.8 thousand USD in Estonia, 14.2 thousand USD in Latvia, and 13.9 thousand USD in Lithuania.[10]

[10] Lietuvos rytas, 05.07.2013

Table / Graph 1

Baltic countries – Real GDP (annual changes in %)[11]

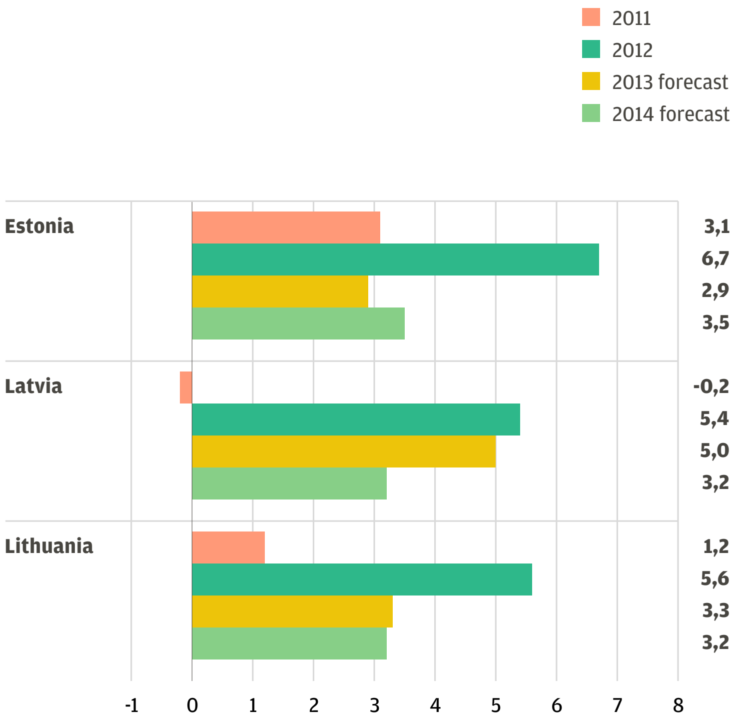
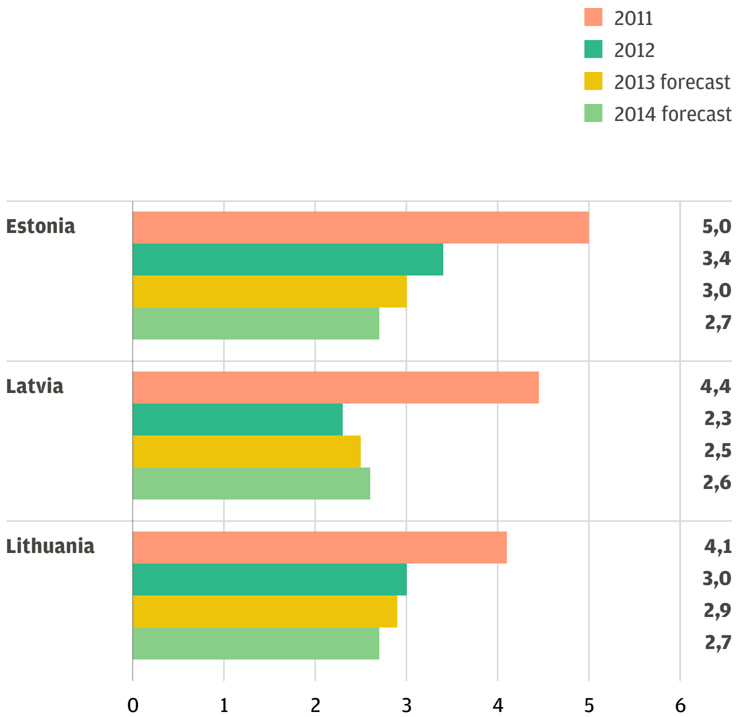


Table / Graph 2

Baltic countries - Inflation (annual changes in %)[12]



[11] Based on Economics Consensus, EBRD, EBC, IMF, OECD, FocusEconomics, WorldBank, UniCredit Bank Austria AG, UniCredit Research

[12] Based on Economics Consensus, EBRD, EBC, IMF, OECD, FocusEconomics, WorldBank, UniCredit Bank Austria AG, UniCredit Research

Baltic countries and the euro area

Numerous economists believe that the accession of Baltic countries to the euro area, and the consequential economic reforms, has always been and continues to remain the best method of fighting the consequences of instability on financial markets, as well as supporting the development of those economies.

According to Professor Leszek Balcerowicz, the former Chairman of the National Bank of Poland, "Baltic countries are good models for some Western European countries struggling with economic problems" and that a crisis can only be solved through "reforms which contribute to the improvement of the competitiveness of economies".[13] Accession of Baltic countries to the euro area can improve its condition, without any negative consequences for the new members.

Valdis Dombrovskis, Prime Minister of Latvia, lists reduced transaction costs for companies and the transparency of prices as some of the practical reasons for adopting the common currency. He also notes that Latvia's key trade partners include countries from both the euro area and outside it. "Most trade transactions take place within the region: with other Baltic countries such as Sweden, Finland, Poland, Germany and Russia" and many of the country's exporters conduct transactions in Euro. "We have also taken a close look at Estonia which adopted the Euro during a debt crisis, which served as a positive indicator of financial and economic stability".

Latvia, similar as the other two Baltic countries, chose this method to strengthen the credibility of its currency, as opposed to Poland which decided to completely float the exchange rate of polish zloty. "For a small, open economy, exposed to international financial flows, permanent association with the euro currency was a guarantee of stability and credibility" – says Rimcevics. However, what provided stability in times of prosperity, proved deadly during times of crisis. Latvia was exposed to attacks of speculators who knew that the government would protect the lats currency. After years of the most rapid economic growth in the EU, Latvia experienced deep recession.

13 http://www.bankier.pl/wiadomosc/Balcerowicz-kraje-baltyckie-powinny-przyjac-euro-2662790.html

This was caused not so much by the currency rate, as the overload of the economy and a bubble effect on the real estate market. However, the currency regime certainly did not help the matter, and Riga regretted not meeting the conditions and accessing the euro area in 2008.

Baltic countries consider accession to the euro area as a step on the way towards greater independence. When last year Commissioner Siim Kallas of Estonia was asked about his view on his country supporting Greece, he replied: "History has taught us one thing: never alone again".

Unlike Poland, the Baltic countries do not intend to wait for the stabilization of the euro area and are even prepared to face the financial consequences of instability in this group of countries. It should be noted that Lithuania is also in queue for accession – in 2013 its government approved a program for the introduction of euro in 2015. The program includes promoting common currency throughout the Lithuanian society, of which currently only a third supports the adoption of the common currency.

Latvia in the euro area.

As of 1 January 2014, Latvia is officially a member of the euro area. Latvia is the 18th country to access the euro area after Estonia, which adopted the EU currency in January 2011.

> "This is good news not only for Latvia, but also for the euro area which only a few years ago was rumoured to be on the verge of collapse"
>
> – notes the Valdis Dombrovskis, Prime Minister of Latvia.

"We believe that this is good news not only for Latvia, but also for Europe and the euro area. This constitutes proof that the euro area enjoys trust, despite any issues or rumours about its impending collapse from a few years ago" – underlines the Prime Minister of Latvia.[14]

Equally positive opinions appeared on websites of European institutions: "Latvia's fiscal policy should serve as a model for other countries" – comments Mario Draghi, President of the ECB.

Olli Rehn, European Commissioner for Economic and Monetary Affairs and the Euro, notes that Latvia's admission to the euro area was possible thanks to the country's "sustainable convergence with the euro area". Latvia and Estonia are already in the euro area, while Lithuania plans to adopt the euro in 2015. This means that all Baltic countries are members, or will soon become members, of the euro area.

Latvia hopes that the adoption of the euro will positively impact its economy, boosting foreign investments, which happened in Estonia after it adopted euro in 2011. The Prime Minister also assured that Latvia will take on the responsibilities connected with the crisis. As a member of the euro area, Latvia will be required to pay contributions to the euro area's EMS rescue fund (European Stability Mechanism).

"Latvia's annual contribution to EMS will be 40 million euros for the first five years, and later (...) an additional 120 million euros. The total contribution will amount to over 300 million euros. This is not a lot of money, but it is important that we participate in this mechanism in case of any trouble" - said Andris Vilks, the Minister of Finance of Latvia.[15]

The negative attitude of the Latvian society constitutes a sort of counterweight to the above-mentioned euro-optimism. The people of the new member of the currency community are against their country's accession to the euro area, while the number of currency union supporters continues to decrease – in Spring 33% of Latvians were in favour of euro area accession, while recent surveys indicate that only 20% of the country's population is in favour of euro adoption, with 60% determined to maintain the lats currency.

Despite the negative opinions and dissatisfaction of the people, the government and politicians continued to implement their program, leading to Latvia's accession to the euro area on 1 January.
"Latvia is a country with a small, open economy, and the adoption of euro will have a positive impact on investments. One needs only to look at Estonia where investments in the financial sector have doubled since the adoption of euro" - said Valdis Dombrovskis, Prime Minister of Latvia, in July 2013.

The change of currency raises doubts concerning prices. Latvian retailers have been displaying two prices, in lats and euro, for the past few weeks. However, this provides little consolation to the people. Latvians expect the prices to rise considerably in January. However, the Latvian government seeks to assuage these fears. "When Estonia entered the euro area in 2011, the prices rose by only 0.2-0.3%." - responds Andris Vilks, the Minister of Finance of Latvia.

Latvia is the second Baltic republic, after Estonia, to access the euro area. Lithuania is also eager to adopt the euro – the country's government would like to enter the area in 2015.

14 metromsn.gazeta.pl , Agora SA

15 http://www.rp.pl/artykul/1027800.html

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