The Euro Goes East

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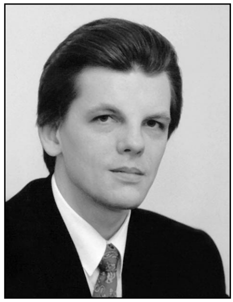

Ladies and Gentlemen,

After the Treaty of Nice and the Gothenburg Summit, it is clear that the enlargement of the European Union is only a matter of time. Given the current institutional framework, this also means that all new member countries will join the Economic and Monetary Union in due time. Therefore, it is only natural that the question should arise, both among policymakers and the public: what effect the emergence of the euro has had and is likely to have on these countries? Along with answering this question in respect of my country, I would also like to explain why Latvia, somewhat at odds with the general trend, has not changed its currency peg to the euro but still has the SDR basket as its foreign exchange anchor.

Due to the size of the Eurozone market and its importance for the rest of Europe, every country on the continent is affected by the creation of the single currency – through both trade and financial channels. For accession countries, including Latvia, the introduction of the euro has some additional and very important implications.

The most important feature of Latvian foreign trade has been its reorientation towards the European Union. The share of the EU in Latvia's total foreign trade turnover has increased from 30% in 1993 to almost 60% in 2000. Given this remarkable shift in the trade pattern, one would certainly expect a parallel increase in the use of the euro in foreign trade transactions. However, Latvia's trade with the Eurozone countries accounts only for 36% of its total trade turnover. This difference is due to the fact that the United Kingdom, Denmark and Sweden are all among Latvia's largest trade partners. The currency composition of foreign trade indicates that the share of the euro in our currency structure, amounting to 36%, mirrors the share of the Eurozone countries in our foreign trade turnover. It is obvious that the euro is currently used only for trade transactions with the Eurozone, whereas trade with our other partners, including those EU members that have opted-out of the single currency, is conducted in their national currencies, or in dollars.

The Bank of Latvia does not intend to either encourage or discourage the use of any particular currency. Instead, we believe that developments in this area are a reliable indicator of the market sentiment with respect to specific currencies, and we monitor them closely.

As regards the financial effects, in Latvia these are in line with the global trends. The government has been active in using the euro as international finance currency. Over the past year, the government twice issued euro-denominated bonds of a five-year maturity, and both issues were a success. As a result, the composition of the government's external debt has shifted in favour of the euro – from less than 30% of total external debt in euro-currencies in 1998, to over 60% in 2001.

The private sector in Latvia has been less active in using the euro in self-financing. Thus, for instance, the share of the euro in the banking sector's external debt has risen from the 20% average before 1999 to slightly over 30% in 2000. Here the dollar still plays a prominent role, accounting for 60% of total debt. A similar picture can be observed in the enterprise sector, where the share of the euro in the external debt has remained broadly unchanged at 25%.

The structure of foreign currency deposits in Latvia likewise does not reveal a significant shift towards the euro in the past couple of years. In fact, the euro, including the individual euro currencies, accounts for only 10% of all foreign currency deposits, while the remaining 90% are denominated almost exclusively in dollars. This has remained unchanged since the mid-nineties, and the introduction of the euro has not had any significant effect. We can only assume that the structure of foreign cash holdings of residents is broadly similar. If the Latvian public decide to hold foreign currency as a store of value, they choose the dollar in nine cases out of ten. It remains to be seen whether there is any significant change in this pattern once the euro starts circulating as cash.

In our opinion, the immediate or short-term effects of the introduction of the Euro are and will be rather limited in Latvia. The long-term impact of Latvia's overall efforts to join the EU, which will bring about the need to comply with the criteria for joining the Monetary Union, is much more obvious. Although it is often stressed that Maastricht criteria have been intended for EU economies only and do not apply to pre-accession countries, the principles behind the figures serve as useful guidelines for sound economic policies already at the present stage.

For that reason, we in Latvia have set fulfilling Maastricht convergence criteria as our medium-term target, and will be able to meet them when we have to. Our public debt is already much lower than the Maastricht ceiling, our budget deficit has always been below the 3% level (except in 1999, when the deficit increased temporarily to cushion the external shock that hit the economy in 1998). Inflation, for the last two years running, has been below 3%, and the peg to the SDR is evidence for our commitment to currency stability. Thus, both the introduction of the euro and the emergence of the policy framework associated with it have had a positive effect on the formulation and implementation of Latvia's economic policies.

To summarize, the introduction of the euro has been exerting certain impact on our economy, and we expect that the magnitude of this impact is likely to grow in the coming years. It does not mean, however, that we have to change our current exchange rate regime immediately. We are confident that the SDR basket is, at the moment, the most appropriate exchange rate anchor for Latvia. The situation may and certainly will change over time, as the euro strengthens its status as an international currency. Let me outline some of these future changes.

First, we can reasonably assume that the euro will be in higher demand throughout the countries of Central and Eastern Europe, including Latvia, after it turns into a tangible currency in January 2002. Moreover, the use of the euro may gradually increase in foreign trade settlements with Latvia's trading partners in the East. And finally, given Latvia's current trade pattern, the use of the euro in its foreign trade transactions is likely to be greatly enhanced if and when the three “non-euro countries” of the EU decide to join the Eurozone.

Yet it is very difficult to predict the exact course of development these trends will follow. In line with the very nature of central banking, we have to be conservative and act on the cautious assumption that the use of the euro in Latvia will expand gradually, rather than rapidly. Accordingly, the Bank of Latvia has repeatedly stated that the current peg to the SDR basket will be preserved until Latvia joins the EU. In due time after its EU accession and fulfilment of the Maastricht criteria, Latvia will adopt the euro as its national currency.

The current topic of debate in this area has been the extent to which real and nominal convergence should be pursued simultaneously. Achieving high economic growth to narrow the income gap between Latvia and the EU is not a statutory objective of the Bank of Latvia. However, we may consider whether policies pursued by the central bank have had any impact on real convergence: for instance, has the exchange rate regime facilitated the appreciation of the real exchange rate necessary for catching up?

As a country open to foreign trade and thus dependent on it, Latvia has by and large achieved price convergence in the group of internationally traded goods. The fixed nominal exchange rate keeps the prices of tradables stable and thus helps Latvian exporters to compete in the international market. Meanwhile, the already very moderate real exchange rate appreciation stems from the rising prices of nontradables. The alternative would be to aim for even lower overall inflation at the expense of nominal appreciation. However, due to the possible adverse effects on the external sector this option is not viable. Therefore we consider our fixed exchange rate strategy optimal for Latvia and will not change the peg until our accession to the EU.

Economic data support our policies. Since the mid-nineties, growth rate in Latvia has been well above the EU average. This year, Latvia will probably be the most rapidly developing accession country, with GDP growth over 7%. Remarkably, the very high GDP growth for a second year in a row has been achieved in a low inflation environment.

It is evident that Latvia has benefited from its fixed exchange rate regime. The Bank of Latvia has been able to sustain the current peg for more than seven years and, in due time, will be equally committed to the new exchange rate peg under the ERM-2.

Thank you for your attention.