Directorate-General for Internal Policies
Directorate A - Economic and Scientific Policy
Committee on Economic and Monetary Affairs

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Background Note

Criteria for euro adoption and indicative assessment of Latvian readiness

Exchange of Views on the prospects of euro adoption by Latvia

ECON Committee, 26 February 2013

Executive Summary

In the coming weeks, Latvia is set to request the Commission and the ECB to prepare a convergence report on the progress made by Latvia in fulfilling its obligations regarding euro adoption, with a view to adoption of the euro in Latvia as of 1 January 2014. Provided the process is launched by this request, the European Parliament will be involved in May/June 2013 by giving its opinion to the proposal by the Commission.

This note outlines the process of euro adoption, by summarizing both the legal framework of the procedure as well as the convergence criteria. Moreover, a second part presents the findings for Latvia included in the latest Convergence Reports (2012) of the Commission and the ECB and updates them in the light of the most recently available data. Without prejudice to developments in the near future or indeed the expected official assessment by the Commission and the ECB, the data of the convergence reports suggest a favourable assessment. This is cautiously confirmed by other international bodies such as the IMF. However, it should be noted that the assessment by the Commission and the ECB of the legal compatibility of the recently adopted relevant legislation in Latvia is yet to be carried out.

A final third section summarizes recent developments in the national debate and the public opinion on euro adoption in Latvia. This seems indeed challenging as a small majority of the population seems to be against euro adoption. The share of those undecided also seems high. As a latest development, however, the support for the euro seems to be on a gradual upward trajectory as the government launched information campaigns.

NOTE: Next to this note, a separate "Background Note on EU economic governance procedures and related information" will be published by the Economic Governance Support Unit ahead of the exchange of views.

1. The EU legal framework for euro adoption

The legal requirements for joining the euro are set out in the Treaty of the Functioning of the European Union (TFEU Article 140). Below is a summary of the procedure for joining the euro and the convergence criteria.

1.1 Procedure

- At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank 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. (The latest "**Convergence Reports**" having been prepared in the spring of 2012, in 2013 a specific request of a Member State with a derogation is necessary in order to produce these reports.)

- These reports 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. They also examine the achievement of a high degree of **sustainable convergence** by reference to the fulfilment by each Member State of the **convergence criteria** (see below).

- On the basis of the Convergence Reports the Commission makes a proposal to abrogate the derogation for the Member State(s) concerned (traditionally published in May; in 2013 this may be as late as beginning June after the publication of the draft country-specific recommendations). The **consultation of the European Parliament** takes place on this basis. The Member State(s) in question need to be given 6 months to effectively prepare for euro adoption and legal certainty is needed for this. The legal procedure therefore needs to be finished before the summer. This leaves Parliament very little time for adoption of its opinion; in the past, the opinion has therefore been voted in an urgent procedure with restrictions to the standard timetable and the language regime.[1]

- After the consultation of the European Parliament, the **Council on a proposal from the Commission decides** (by qualified majority of euro area Member States) **whether Member States with derogation fulfil the necessary conditions**. At the same time, (acting with unanimity), **Council irrevocably fixes the rate** at which the euro shall be substituted for the national currency.

1.2 Convergence Criteria

The convergence criteria that are assessed in detail are the following (Art. 140 TFEU):

1. the achievement of a high degree of **price stability**; this will be apparent from a rate of inflation which is close to that of the three "best performing"[2] Member States;

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[1] Parliament has on numerous occasions complained about the tight schedule of past consultations for euro adoption. The time given of about 2-3 weeks makes it very challenging to conduct a proper assessment. The latest four euro adoption procedures and Rapporteurs in Parliament are/were as follows:
2013: Latvian accession 1 Jan 2014, Rapporteur: Burkhard Balz (EPP).
2010: Estonian accession 1 Jan 2011, Rapporteur: Edward Scicluna (S&D),
2008: Slovakian accession 1 Jan 2009, Rapporteur: David Casa (EPP),
2007: Malta and Cyprus accession 1 Jan 2008, Rapporteur: Werner Langen (EPP).
2006: Slovenian accession 1 Jan 2007, Rapporteur: Werner Langen (EPP).

[2] There is no generally accepted definition of "best-performing" between the Commission and the ECB, although the ECB uses the guiding notion of "below but close to 2%" to determine this.

2. the sustainability of the **government financial position**; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6) TFEU;
3. the observance of the normal fluctuation margins provided for by the **exchange-rate mechanism** of the European Monetary System, for at least two years, without devaluing against the euro;
4. the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the **long-term interest-rate levels.**

The degree of integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices should also be taken into account.

2. Convergence Reports

2.1 The latest convergence reports of 2012

In 2012, the Commission and ECB published Convergence Reports respectively (Commission Convergence Report March 2012, ECB Convergence Report May 2012). The conclusions of both reports for Latvia were largely similar, and the reference values and figures used in the assessment were identical. For illustration, below is a summary of the Commission's report only. For more detailed analysis, please consult the reports under the links given above.

According to the latest **Convergence Report of the Commission from March 2012**, at the time Latvia did not fulfil all the convergence criteria for joining the euro, as summarized in Table 1 below.

Table 1: Summary of convergence criteria assessment for Latvia in 2012

Criterion	COM March 2012 assessment	Reference value	Value for Latvia	Further comments in the Report
Price stability (12 months average - March 2012)	did not fulfil	3.1%	4.1%	potential for further price convergence over the long term
Government financial position	did not fulfil	3.0% deficit 60% debt	deficit was 3.5% in 2011	government debt was 42.6% in 2011
Exchange-rate mechanism	fulfilled	±15% margin	within ±1%	additional indicators did not reveal significant pressures on the exchange rate
Convergence of long-term interest rates	fulfilled	5.8%	5.8%	

Legal Compatibility Analysis in the COM Convergence Report 2012

The Commission Convergence Report 2012 identified incompatibilities in Latvian legislation with regards to the independence of the central bank, prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption. Imperfections in the legislation were also identified in the report in the field of central bank independence and ESCB tasks.

Regarding **central bank independence**, the report argued that both the principles of financial and institutional independence were breached by the fact that the Latvian parliament could liquidate the bank by means of a resolution. The report also identified imperfections in the legislation with regards to personal independence of the Governor of the Bank, incl. rules and procedures regarding succession and termination of office. Further remarks regarded the institutional independence of the central bank, protecting it from being subject to decisions and regulations adopted by other bodies; and stressed the law should explicitly prohibit third partied from trying to give instructions to the Bank of Latvia or members of its decision making bodies. With regards to the transfers from the Bank to the state budget, the report argued the law should be amended to increase the financial independence of the Bank of Latvia.

In order to comply with the **prohibition of monetary financing** requirement of the central bank, according to the report, the scope of the public sector entities covered with regards to the prohibition of issuing credit and buying securities needed to be significantly extended. Regarding **the integration in the ESCB**, the report identified an imperfection in the objective of price stability being confined to the territory of the Member State, as well as incompatibilities and imperfections regarding the tasks of the bank; the former mainly concerned non-recognition of the role of the ECB.

Based on this analysis the Convergence Report concluded that Latvian law was at the time not compatible with the requirements. For more detailed analysis please consult the technical annex of the Convergence Report.

2.2 Current situation - 2013

Changes in the legal framework

Since the publication of the Convergence Reports in 2012 measures have been taken to prepare Latvia for joining the euro. In July 2012 Andris Vilks, The Latvian Minister for Finance, and the European Commission Vice-President Olli Rehn, signed a Partnership Agreement on euro changeover communication activities (see more information here). According to the Commission post-programme surveillance report published in January 2013 "The necessary practical preparations for possible euro adoption in 2014 are under way in Latvia: e.g. preparation of the legal framework, information website, working groups, euro coin design, etc."

On 10 January 2013, amendments to the Law on the Bank of Latvia were passed by the Saiema (Latvian Parliament) in order ensure full compliance with the TFEU, and the ESCB and ECB Statutes. This legislation also provides for the integration of the Bank of Latvia into the Eurosystem.

On 31 January 2013, the Saeima passed two other laws important for qualifying for euro membership; a fiscal discipline law, which transposes the Fiscal Compact principles into national legislation by establishing a number of fiscal rules; and a law detailing the switchover to the euro (Reuters).

Both above mentioned legal packages have been promulgated by the President of the Republic Andris Berzins and are already in force. However, the assessment of the legal reforms has not been officially concluded yet by the Commission and ECB.

Moreover, the Latvian authorities have started a campaign using television, radio and leaflets to inform about the advantages of the euro. An information website has also been launched by the government.

Recent indicative data regarding the convergence criteria

As regards the criteria on which Latvia failed in the latest assessment in 2012, the following development in the meantime should be taken into account:

- **Price stability:** Following the non-fulfilment of this criterion in March 2012, inflation has continued on a downward trend and the **latest inflation data available** (Eurostat HICP December 2012, 12-month average) gives a value of **2.3% for Latvia**. For the sake of argument, with this data set, the reference value would be 2.8%[3]. It can be concluded that if the assessment was based on these data, Latvia would fulfil the criteria. Moreover, as annual inflation has been declining in Latvia and stood at 0.6% in January 2013 according to the national CPI inflation measure, and it is expected that also the 12-month average HICP inflation will continue to decrease.
- **Government financial position**: Following the non-fulfilment of this criterion in March 2012, the Commission Winter Forecast (released 22 February 2013) estimates a Latvian government **deficit of 1.5% of GDP for 2012** (and 1.1% in 2013), combined with estimated gross government **debt of 41.9% of GDP in 2012** (and 44.4% in 2013). Again, if the assessment was based on these figures Latvia would be fulfilling this criterion. It is unlikely that the final figures for 2012 public debt and deficit will be revised radically enough to endanger this assessment; at least there are currently no signs in this direction. On the contrary, so as to confirm the assessment and without prejudice to the official data to be released in April, the IMF on 28 January 2013 provided a similar and favourable estimate for the general government debt and deficit of Latvia for 2012: 1.8% deficit (Maastricht definition) and 37.6% debt.

Of the criteria that Latvia fulfilled already in 2012, the following updates can be mentioned:

- **Exchange Rate:** The Latvian lats (LVL) joined the **Exchange Rate Mechanism** (ERM II) on 2 May 2005. The lats observes a central rate of 0.702804 to the euro and Latvia unilaterally maintains a 1% fluctuation band around the central rate (while the fluctuation margin permitted by the convergence criteria is ±15%).[4]
- **Convergence of long-term interest rates**: If the assessment was carried out on the basis of the relevant ECB data (December 2012)[5], the reference value would be around 5.9%, while Latvia with 4.6% would be within the range and thus fulfilling the criterion.

[3] Calculated from the arithmetic average of the December 2012 HICP 12-month average values of Sweden (0.9), Greece (1.2), and Ireland (1.9), adding the 1.5% margin. Note that depending on one's definition of "best-performing" in terms of low inflation, the outlier approach may be used to exclude some of the above. In this case, the Latvian figure would be even more comfortably within the range of the reference value.

[4] The exact daily exchange reference rates can be consulted on the website of the European Central Bank.

[5] Source: ECB - secondary market yields of government bonds with a remaining maturity close to ten years, harmonised data. The indicative reference value of 5.9 is calculated from the same values as for inflation in December 2012, using 12-month average data, for Sweden (1.61) and Ireland – (6.51), adding 2 percentage points. Greece with a value of about 22.5% can be reasonably excluded from the calculation of the reference value as an outlier. If Greece was in the calculation, Latvia would fulfil the criterion even more comfortably.

The **fulfilment of the convergence criteria by Latvia seems very likely at this point** (February 2013). As a general **disclaimer,** however, the Commission and the ECB do not regard the above criteria as mechanical but make an assessment also based on the **estimated sustainability of the convergence**.[6]

Recent assessment by other international bodies and observers

According to the IMF mission chief in Latvia Mr Shekhar Aiyar (January 2013), Latvia should be "comfortably within" the criteria for public deficit and debt, but some "technical uncertainties" regarding the inflation and interest rate target remain. Mr Aiyar further commented that "the European Commission has assured the [Latvian] government that Latvia will be given fair treatment when assessing the inflation and the interest rate criteria" but that they [the IMF] "believe that Latvia's adjustment during the [recent IMF] program already demonstrates a strong track record."

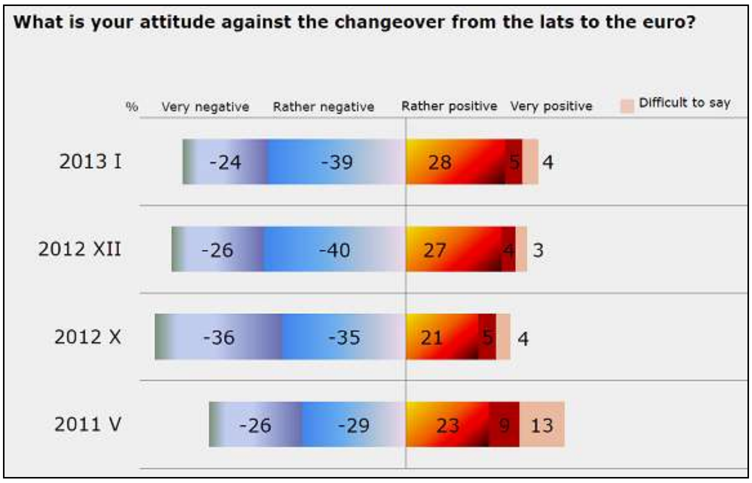
Among other commentators, Anders Åslund, Senior Fellow at the Peterson Institute of International Economics, recently stated that "Latvia clearly qualifies by a wide margin". SEB bank, a Swedish bank strongly active in Latvia, published analysis arguing that "Latvia will easily meet the requirements".

3. National debate in Latvia on joining the euro

Evidence on the Latvian public opinion on the euro

It appears from recent polling data that public support for euro adoption is relatively low, albeit increasing. Bloomberg (1 February) quoted a poll showing that 66% of Latvians had a somewhat negative or negative attitude towards the euro in December 2012, down from 71% in October; the poll identified fears of stoked inflation and curbed incomes as arguments against the euro.

Diagram 1: Latvian public opinion poll on joining the euro



[6] Given the relatively high degree of complexity of the methodology behind projections of sustainability, the outcome of this assessment cannot be predicted. It may also be worth recalling the rejection of Lithuania to the euro area in 2006 (with intended adoption in 2007). The Lithuanian inflation rate was at the time in violation of the reference value by 0.1 percentage points. The formal reason of rejection was therefore the violation of the reference value, while the sustainability assessment supported the negative decision.

Diagram 1 above shows recent results from the Latvian polling company TNS, adapted from an article published in Latvian media on 11 February. The survey indicates 63% of the interviewed are either very or rather negative towards the euro, compared to 33% who have a very or rather positive attitude towards it.

An article in Baltic Business Daily (11 February) quoted economist Uldis Osis saying that the support for the euro may grow to 50% this year as a result of government euro awareness campaigns, as many members of the Latvian public are still undecided but may choose to support the euro.

Recent discussions in the Latvian Parliament and attempts to hold a referendum

The government is determined to apply for euro adoption and Prime Minister Dombrovskis has underlined this arguing that the country fulfils the criteria "with a considerable reserve" (euobserver). On 31 January, the "Law on the Procedure for introducing the Euro" received the support of 52 MPs in the Saeima; 40 MPs voted against it and two abstained (the total number of MPs being 100). According to the press service of the Saeima the law outlines "the period while both lats and euros will be in circulation, the exchange of cash and transfer currency, price marking of goods and services in two currencies, as well as adaptation of accountancy registers and financial markets".

The opposition that voted against the law argues that neither the Latvian economy nor society are ready for the euro and that the current state of the Eurozone is not ideal; therefore, they would prefer to wait than to introduce the euro already in 2014 (BBC, 8 February). According to The Baltic Times (6 February), after the above mentioned vote in the Saeima, MP Iveta Grigule (Green/Farmers' Alliance (ZZS) of the opposition first attempted to collect the required 34 MP signatures to initiate a referendum on euro adoption, and then proposed collecting 30,000 signatures of citizens instead. The majority of the opposition, however, decided in February not to support the referendum since they mainly disagree with the timing of the switchover and not euro adoption as such.

Another attempt by the political organisation of social-democrats 'For Independent Latvia' ('Vislatvijas socialdemokratu kustiba 'Par Neatkarigu Latviju'') to organise a referendum on the date of euro adoption was rejected on 31 January by the Latvian Central Election Commission (Bloomberg). A political science lecturer at the University of Latvia, Daunis Auers, quoted by Bloomberg on 1 February argued that a "referendum in Latvia is highly unlikely", because the "political and economic elite is united in support of euro accession [...] even if the public is less enthusiastic". The Baltic Course on 6 February reported an open letter signed by a group of public figures criticises the government and Saeima for going forward with euro plans, calling for postponing the introduction of the euro and organising a referendum. At the same time, many representatives of Latvian intellectual elite have voiced their support for the euro and closer integration into the EU and this should also be seen as a part of the ongoing public debate.

Drafted by ECON Secretariat

Maria WILKMAN and Arttu MAKIPAA (document responsible, tel. 32620) with the participation of Mara KAMPARE and Solveiga KUMSARE