Box 2

LATVIA ADOPTS THE EURO

On 1 January 2014 Latvia adopted the euro and became the 18th member of the euro area. The conversion rate between the Latvian lats and the euro was irrevocably fixed at 0.702804 lats to the euro. This was the central rate of the Latvian lats throughout the country's membership of ERM II.

Latvia is a very small economy compared with the rest of the euro area. As such, the country's adoption of the euro will have no significant impact on the euro area's aggregate macroeconomic data (see the table).

Latvia's population is around 2 million and its GDP accounts for about 0.2% of euro area GDP. GDP per capita in purchasing power parity terms was slightly below 60% of the euro area average in 2012.

Key economic characteristics of Latvia and the euro area

	Reporting period	Unit	Euro area excluding Latvia	Euro area including Latvia	Latvia
Population and economic activity					
Total population	2012	millions	333.2	335.2	2.0
GDP	2012	EUR billions	9,483.5	9,505.8	22.3
GDP per capita	2012	EUR thousands	28.5	28.4	10.9
GDP per capita (PPP)	2012	EA17=100	100.0	99.7	57.6
GDP (share of world GDP) [1]	2012	percentage	13.5	13.5	0.04
Value added by economic activity [2]					
Agriculture, fishing, forestry	2012	percentage of total	1.7	1.7	5.0
Industry (including construction)	2012	percentage of total	25.0	25.0	25.7
Services (including non-market services)	2012	percentage of total	73.3	73.3	69.3
Monetary and financial indicators					
Credit to the private sector [3]	2012	percentage of GDP	139.4	139.2	67.6
Stock market capitalisation [4]	2012	percentage of GDP	47.5	47.3	3.8
External trade					
Exports of goods and services [5]	2012	percentage of GDP	45.8	45.9	61.6
Imports of goods and services [5]	2012	percentage of GDP	43.2	43.3	65.5
Current and capital account balance [6]	2012	percentage of GDP	1.4	1.4	0.5
Labour market [7]					
Labour force participation rate	Q2 2013	percentage	72.2	72.2	73.3
Unemployment rate	Q3 2013	percentage	12.1	12.1	12.0
Employment rate	Q2 2013	percentage	63.6	63.6	64.8
General government					
Surplus (+) or deficit (-)	2012	percentage of GDP	-3.7	-3.7	-1.3
Revenue	2012	percentage of GDP	46.3	46.2	35.1
Expenditure	2012	percentage of GDP	49.9	49.9	36.4
Gross debt outstanding	2012	percentage of GDP	92.7	92.6	40.6

Sources: Eurostat, IMF, European Commission, ECB and ECB calculations.
1) GDP shares are based on a purchasing power parity (PPP) valuation of countries' GDP.
2) Based on nominal gross value added at basic prices.
3) Comprises loans, holdings of securities other than shares and holdings of shares and other equities.
4) Defined as the total outstanding amount of quoted shares excluding investment funds and money market fund shares issued by euro area/Latvian residents at market value.
5) National accounts data for nominal trade in goods and services (includes intra-euro area trade).
6) Balance of payments data. Euro area data are compiled on the basis of transactions with residents of countries outside the euro area (i.e. excluding intra-euro area flows). Data for Latvia include transactions with residents from the rest of the world (i.e. including transactions with the euro area).
7) Refers to the working age population (aged between 15 and 64).

In the years up to 2007 Latvia was one the EU's fastest growing economies, but this growth was accompanied by a build-up of sizeable macroeconomic imbalances. Adjustment began in 2007 and intensified a year later, on account of the global financial crisis. International lenders provided support, and sizeable fiscal consolidation efforts followed in 2009 and 2010 under the supervision of the EU and the IMF. Despite a strong fall in output, the budget deficit was reduced from 9.8% in 2009 to 1.3% in 2012. A credible and frontloaded consolidation strategy, combined with structural reforms, helped Latvia to keep its fixed exchange rate. A recovery began in the last quarter of 2009, led by a strengthening in domestic demand and subsequently supported by a rebound in exports on account of regained competitiveness. Latvia concluded a financial assistance programme with the EU and the IMF in early 2012 and has already fully repaid the loan received from the IMF. The public debt-to-GDP ratio rose from a very low level during the economic crisis. Despite this increase, the public debt ratio stood at 41% in 2012, which was significantly below the euro area average of 93% in the same year.

More recently, activity has been dynamic and real GDP grew by 4.1% year on year in the third quarter of 2013. Developments in the labour market have also been positive, with the unemployment rate standing at 12.0% in the third quarter of 2013, compared with its peak of 20.9% in the first quarter of 2010. However, over the last five years Latvia's labour market has suffered from a significant decline in the labour force, resulting from a large number of people emigrating to search for work in other EU countries. In the third quarter of 2013 total employment in Latvia was still around 20% below the level it was before the crisis. At the same time, the labour force participation rate and the employment rate were slightly above the respective averages for the euro area.

Latvia's production structure is broadly similar to that of the euro area as a whole. In the Latvian economy, industry (including construction) contributes around 26% to total value added. The share of services is slightly lower, at around 70%, while the contribution of the agricultural sector, at 5%, is somewhat above that of the euro area as a whole. Furthermore, Latvia is a very open economy and the rest of the euro area is its key trading partner, accounting for around 30% of its total exports and 40% of its total imports. Other important trading partners include Lithuania and Russia.

The country's financial sector is heavily bank-based. Bank credit to the private sector amounted to 68% of GDP in 2012. The banking system is fairly concentrated compared with other euro area countries. Although it is dominated by Nordic banks, a number of mainly domestically owned banks actively engage in providing financial services to non-residents. Non-resident deposits comprised almost 50% of total deposits in the second half of 2013. Meanwhile, the country's non-banking financial sector is very small – its stock market capitalisation, at just below 4% of GDP in 2012, is the lowest among the euro area countries.

In order to fully reap the advantages of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, Latvia needs to continue its reform efforts. Economic policies should be geared towards ensuring the sustainability of the convergence process and sustainable growth in the long term. Ensuring a low inflation environment is crucial in that respect. In addition, the functioning of the labour market should be improved to allow it to reach its full potential.

The Latvian authorities have publicly stated their goal to avoid pro-cyclical policies and strengthen the quality of institutions, the business environment and governance to ensure the stability and competitiveness of the economy. In addition, the authorities have announced a commitment to fully comply with the Stability and Growth Pact and the fiscal compact on a permanent basis, as well as to implement further structural reforms. The available toolkit of micro and macro-prudential policies should be effectively used and enhanced, if necessary, in order to limit risks stemming from, in particular, financial services provided to non-residents. In the context of the stability-oriented monetary policy of the ECB, the fulfilment of and long-term adherence to these commitments is essential to ensure that the economic environment in Latvia is conducive to sustainable output and job creation in the medium and long term.