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ECFIN Country Focus

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

HIGHLIGHTS IN THIS ISSUE:

- *The euro changeover has entailed only a very small one-off rise in consumer price inflation while strengthening competition and long-term price stability*
- *Stronger bank intermediation, including a steep rise in bankcard payments, provide clear economic gains*
- *On the policy side, structural reforms need to be reinforced in order to maintain competitiveness*

Latvia: benefiting from the euro, facing new challenges

*By Gatis Eglitis, Radoslav Krastev, Christian Weise**

Summary

Latvia appears to be already reaping a number of benefits from its changeover to the euro in January of this year. Enhanced competition, bank intermediation and the low-interest rate environment are bringing immediate and long-term benefits to the economy. Moreover, despite concerns that traders might take advantage of the introduction of the new currency to raise prices, consumer price inflation has turned out lower than expected. On the other hand, house prices and wages increased at a faster rate, which may have been partly driven by euro-related expectations.

While the favourable impact of the euro is broadly in line with the Commission's expectations, a steep rise in non-cash transactions and efficiency gains for consumers and banks has come as a positive surprise. The initial positive momentum from improved economic sentiment has not, however, been fully reflected in investment growth, although this is most likely due to the external shock to the country from the tensions between Russia and Ukraine.

The successful changeover to the euro should not give ground for complacency as policy makers are still facing challenges, such as how to cope with accelerated labour-cost growth at a time when the external environment is worsening. Therefore, to ensure its competitiveness in the euro area, Latvia will need to reaffirm its commitment to the implementation of structural reforms.

This Country Focus analyses price dynamics, unit labour costs, business and investment sentiments, banking sector developments and structural reforms in Latvia shortly before and after the introduction of the euro on 1 January 2014. It compares actual outcomes with expectations or public perceptions and points out some positive effects and risks. It covers both direct and indirect impacts of the euro changeover while acknowledging that precise separation of correlation and causality is not always possible.

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Introduction

While Latvia's experience with euro adoption is largely positive, progress with structural reforms remains a concern

The Latvian experience with the euro changeover confirms, contrary to public perceptions, that the impact of rounding and administrative costs on consumer price inflation is small and very limited in time, while signs of growing competition and lower transaction costs point to rather positive long-term implications. However, a more significant upward price effect has been observed in the housing market, along with overall positive confidence effects in the business sector and to a lesser extent in the household sector. Economic data also show accelerated wage growth, posing some challenges to businesses and policy makers to keep labour costs in line with productivity in the context of a deteriorating external environment. While house prices and wages are not directly linked to the euro, it is estimated that their changes have been partly affected by euro-related expectations. In the case of wages, the wage bill in the public sector might also have been pushed up by some relaxation of government policies after achieving the euro adoption goal. In the banking sector, there are clear benefits for the country arising from lower cost of cross-border financial services, cheaper credit, and a much greater use of electronic payments, which allows both banks and consumers to benefit from efficiency gains and supports efforts to limit the shadow economy.

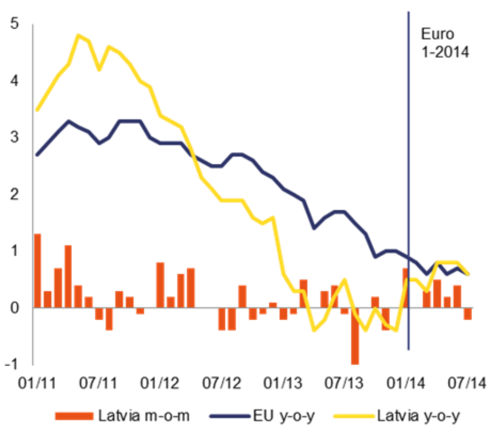
Despite ambitious structural reform commitments made at the time of euro-area accession decisions, the reform momentum has slowed down and Latvian authorities have failed to make significant progress in key sectors (e.g., higher education and science, access to healthcare and social inequality, state asset management and energy market liberalisation), possibly due to the general elections on 4 October 2014, strong vested-interest groups, and deficiencies in the decision-making process. Stepping up the pace of structural reforms is, however, of high importance if Latvia's competitiveness is to be sustained in the future. As the government budget deficit and debt ratios remain quite low, fiscal policy analysis in this Country Focus is limited to some challenges linked to wage developments in the public administration.

Price developments

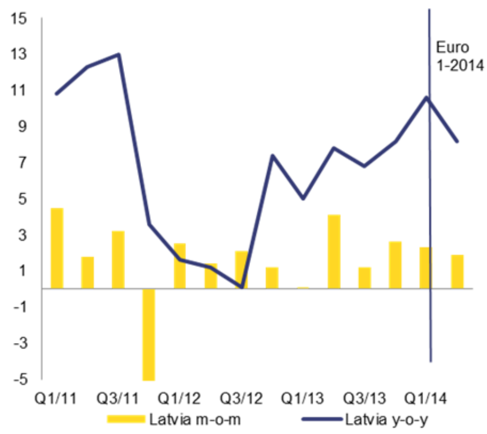
Contrary to public perceptions, consumer price inflation has remained low since euro adoption and well below official forecasts

As in other countries, opinion polls in Latvia revealed fears of inflation around the date of adoption of the euro.[1] Yet, previous euro changeovers in other Member States show that, while rounding and administrative costs can be passed to consumers, this is a one-off occurrence and has a rather modest impact, in the range of 0.2-0.3 pp. The euro changeover in Latvia at the beginning of 2014 is no exception, with estimates in the lower part of this range.

Graph 1: HICP inflation (%)



Graph 2: House prices (% change)



Source: Eurostat

The harmonised index of consumer prices (HICP) did not indicate any inflationary pressures immediately after the release of the positive European Commission

- *Rounding and administrative costs passed to consumers are estimated at around 0.2 pp, in line with experience in other countries*

convergence assessment[2] on 5 June 2013 and the Council decision of 5 July 2013 (graph 1). In fact, monthly changes in the index were mostly negative in the second half of 2013. In January 2014, HICP increased by 0.7% m-o-m and part of this rebound may indeed be assigned to rounding and administrative costs. Fluctuations in different price items show that slightly more than 50% of the monthly inflation came from seasonal factors. In fact, the monthly hike was lower than the historical average for this part of the year, with the notable exception of January 2013, when a substantial drop in prices of imported energy inputs and related heating prices dominated seasonal effects. Furthermore, higher taxation of tobacco products also contributed (about 0.1 pp[3]) to the inflation rate. As prices remained unchanged on a monthly basis in February, it can be concluded that all rounding and administrative effects took place in January. All these calculations, covering price developments before and after the euro adoption, show that the euro one-off impact on inflation was around 0.2 pp. A more detailed assessment carried out by Eurostat puts the likely one-off impact on Latvia's HICP in the range of 0.12-0.21 pp. in January 2014[4].

In annualised terms, inflation picked up in January, also reflecting the low base from a year earlier, but retreated afterwards and remained below the EU average in March 2014. In the second quarter, HICP inflation edged slightly above the EU and EA average values and this was in line with the catching-up forces described in the Commission's convergence report for Latvia. Nevertheless, Latvia's inflation in 2014 is performing below all official forecasts released before or shortly after the euro changeover.

- *Increased competition, helped by cheaper cross-border transactions and increasing online trade, augurs well for long-term price stability*

Some of the main arguments in favour of the single currency suggest that the medium- and long-term implications of the euro introduction are overall positive for price stability, as better price transparency, cheaper cross-border transactions and enhanced competition should result in tighter sales margins. The Latvian case also supports this view as the country's full-year inflation in 2014 is moving well below the initial Commission and consensus forecasts.[5] Part of the undershooting is due to lower-than-expected inflation in the EU, a delay in the deregulation of household electricity prices and some supply shocks stemming from the drop in export sales to Russia, but there is some evidence that increased competition has also contributed to moderating inflation. In particular, a substantial increase in electronic payments and internet shopping, clearly linked to the euro introduction, has provided more trade options and thus contributed to tighter competition on the retail market. Apart from the growth in bankcard payments (analysed further below), Citadele Bank reports that its customers increased online purchases by 40% y-o-y in the first half of 2014, including a surge by 50% in orders from foreign e-stores.

- *Euro-related expectations may have contributed to house price growth although other factors have been also in place*

As regards asset price inflation, changes in Latvia's house and stock price indices signal some upward movements that could be partly attributed to the euro introduction (graph 2). The process may have been partly driven by investor expectations as mortgage lending was broadly stable despite a drop in interest rates. Annualised house price inflation monitored by Latvia's statistical office (CSB) accelerated from 5% in the first quarter of 2013 to 8.2% in the last quarter of the year, 10.6% in the first quarter of 2014 and 8.2% in the second quarter of 2014. It should be noted, however, that the house price index remains about 35% below the peak level from 2008 and is not generating any immediate risk of imbalances. Moreover, the main part of the increase in 2013-14 is linked to other factors not directly related to the euro, such as income growth, increased issuance of residence permits due to anticipated legal amendments, and falling interest rates in the EU.

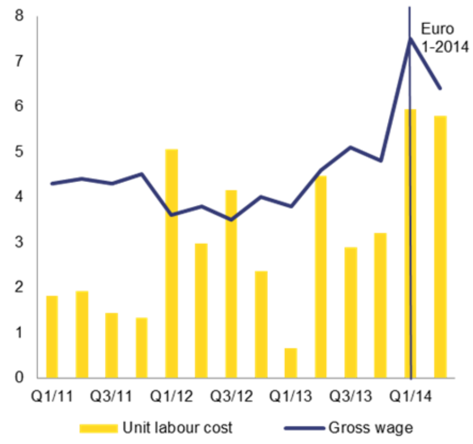
On the stock market, Latvia's headline index OMXR recorded peaks in July 2013, following the Council decision, and in January 2014, upon the introduction of the euro. In month-on-month terms, the index rose by 8.7% and 5.2% respectively but these were short-lived fluctuations followed by downward corrections. Over a longer time horizon, as expected, other market drivers seem to have a more decisive effect on the stock index, such as uncertainty about the Russian-Ukrainian conflict.

Unit labour costs

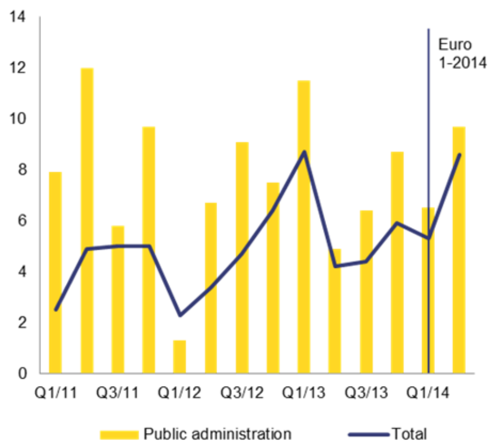
■ *Rising unit labour costs appear to be a major risk after the euro changeover as positive business expectations and some fiscal relaxation exert upward pressure on wages*

The European Commission's Convergence Report 2013 on Latvia points out that the country's long-term price stability and competitiveness both hinge on the sustainable development of unit labour costs, since the catching-up status of the economy creates difficulties in maintaining the right balance between wage and productivity growth. Gross wages rose by 7.5% y-o-y in the first quarter of 2014 and by 6.4% y-o-y in the second quarter (graph 3), accelerating from annual average growth rates of 4.6% in 2013 and 3.7% in 2012. Total labour costs (graph 4) increased at similar rates despite the slowdown in production activities. Unit labour costs are thus estimated to have risen by nearly 6% over the same period, posing some challenges to competitiveness amid rising risks to external demand.

Graph 3: Wages and labour cost (% change, y-o-y)



Graph 4: Labour costs (% change, y-o-y)



Source: Central Statistical Bureau of Latvia

While the euro introduction brought certain non-wage competitiveness gains to businesses, which could offset higher labour costs, the rising wage bill in the government sector is a particular concern. This may be an indication of some complacency after the euro adoption decision in mid-2013 and ahead of the general elections on 4 October 2014. Indeed, gross wages in central government grew much faster than in other sectors: by 8.4% y-o-y in the first quarter of 2014, following another strong increase of about 10% in the second half of 2013. Furthermore, part of the wage growth in both the private and public sectors has been driven by the government decision to raise the minimum wage by 12% from 2014 onwards. However, wage growth in central government slowed to 4.8% y-o-y in the second quarter of 2014 and the change in total labour costs was also contained, holding out some hope that the wage setting mechanism in the public sector may return to a more prudent approach.

■ *Policy challenges over labour costs are further stretched by an adverse geopolitical situation*

Part of the increase in unit labour costs may be attributed to slower-than-expected output growth as a result of rapid deterioration in external demand due to the Russian/Ukrainian conflict. With the worsening of the geopolitical tensions from March 2014 onwards and a further escalation to trade restrictions in the third quarter of the year, it could be expected that businesses and national authorities might adjust wage policies so that unit labour costs may move towards more sustainable levels.

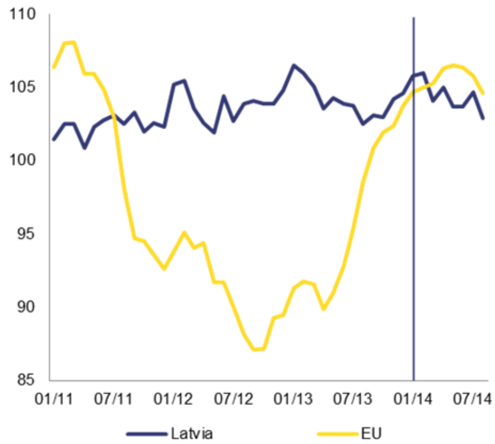
It should be noted that, to some extent, the recent increase in public wages corrects a wage gap between government employees and similar high-skilled counterparts in the private sector, which had emerged during a long period of fiscal constraints. It may also reflect increases already planned but delayed until the final Council decision on the euro adoption was known. In any case, events linked to the euro seem to be at least partly responsible for the accelerated wage growth and future policy decisions related to wages and labour market policies in general would need to take the underlying risks of such developments into account.

Economic sentiment, investment

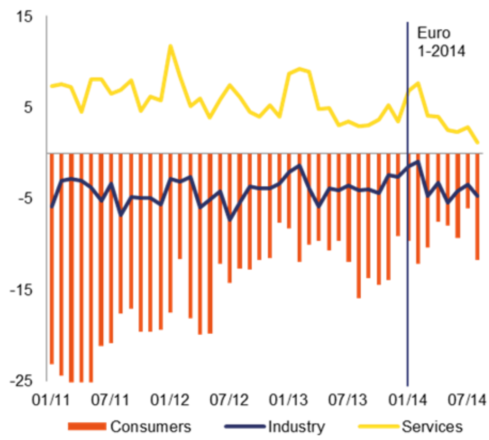
■ *Rating agencies and businesses surveys show some euro-related benefits to economic sentiment*

International rating agencies see Latvia's euro changeover as positive for the country's economic development. These views were expressed well ahead of the euro adoption along with a series of rating upgrades before and after the changeover. S&P and Fitch raised Latvia's long-term foreign currency rating by one notch to BBB+ in June and July 2013, respectively, and further to A- in May and June 2014. Moody's also made one-notch upgrades to Baa2 in March 2013 and to Baa1 in June 2014. All rating actions highlighted the benefits of the euro, in particular reduced exchange rate risks and access to ECB liquidity and institutional support. Latvia's businesses are also positive about the euro changeover, which is reflected in various business surveys but is not fully mirrored in the volume of actual investments due to various external shocks experienced before and after the switch to the euro.

Graph 5: Economic sentiment indicator



Graph 6: Economic sentiment by sector



Source: European Commission

■ *However, investments fail to fully match economic sentiment due to an adverse external environment*

The European Commission's economic sentiment indicator (ESI) shows no immediate positive reaction in Latvia to the Council decision of July 2013 allowing the country to adopt the euro. However, the indicator began a gradual improvement in September 2013 and recorded a more substantial increase when the euro changeover took place – from 104.6 in December 2013 to 105.8 in January 2014 (graph 5). The surge in January came from industrial, service and construction companies, while consumer confidence and retailers registered negative changes (graph 6). For the period from the Council decision to the euro changeover, the ESI improvement was broad-based with the exception of construction sentiments, which deteriorated slightly due to seasonal effects. The ESI improvement continued at a slow pace in February but experienced a downward correction afterwards over regional uncertainties stemming from the Russian/Ukrainian conflict.

Despite the overall positive euro effect on economic sentiment, investment has performed below expectations since mid-2013, with the exception of a one-off rebound in the first quarter of 2014, and full-year prospects for 2014 look rather bleak as tensions over Russia and Ukraine forced many companies to delay expansion plans. Along this line, a Swedbank survey on SMEs carried out in mid-2014 revealed that about two-thirds of nearly 100 sampled firms were planning investments but were nevertheless undertaking a cautious approach due to external risks.

Money supply and banking

Money supply aggregates experienced large fluctuations upon the euro changeover, mainly for technical reasons. The major change stems from currency in circulation, the actual value of which can no longer be measured directly after changing the lats for the euro. From January 2014 onwards, the central bank switched to reporting currency in circulation in accordance with the capital key[6] allocation of ECB and the corresponding value surged dramatically, indicating potential gains from future redistribution of ECB monetary income (seigniorage).

Higher seigniorage base, reflecting ECB rules for monetary income distribution, indicates potential gains for Latvia

In concrete terms, currency in circulation moved from EUR 1,633 m at the end of January 2013 to EUR 898 m at the end of 2013 and jumped to EUR 3,800 m (calculated using the ECB capital key) at the end of January 2014. More precisely, the base for approximating seigniorage gains from January 2014 onwards rose by 133% compared to a year earlier. This indicates that Latvia's potential gains from seigniorage could have more than doubled. The net benefit could reach 0.2% of GDP annually under the assumption of a 2% net return over the added seigniorage base.

It should be also noted that the newly reported value for currency in circulation, starting from 2014, cannot be used for estimating the actual value of currency circulating in the Latvian economy and any comparison to the lats period is only for the purpose of approximating potential seigniorage gains. There are however clear indications that the propensity to hold cash has declined, as households placed more money on bank deposits prior to the euro changeover. This was a convenient way of exchanging lats for euro and part of the money remained with the banks after the changeover. Accordingly, resident bank deposits increased substantially towards the end of 2013 and part of this increase was sustained in 2014 along with the reported increase in non-cash transactions.

A strong increase in electronic payments and bank intermediation in general brings clear efficiency gains to both banks and consumers

Data from the association of commercial banks in Latvia (ACBL) show that the euro changeover has substantially expanded the role of electronic payments. The number of bankcard payments for goods and services rose by 29% y-o-y in the first quarter of 2014 and the overall value of those payments grew even faster by 73%. A TNS Latvia survey carried out for Swedbank in late January 2014 also confirmed that the euro adoption helped Latvians change their financial habits by using payment cards and online banking services more actively and keeping more money in banks. The survey found that intentions to withdraw cash from ATMs only when necessary increased from 42% in June 2013 to 55% in January 2014. At the same time, the use of bankcards for shopping rose from 32% to 43% along with a rise in online banking services from 35% to 39%. The shift to non-cash transactions has thus expanded the overall usage of bank services and is also expected to contribute to the government efforts to fight the shadow economy.

Contrary to expectations, banks are managing to improve profits despite lower cost of international payments

Somewhat unexpectedly, the banking sector has also managed to improve its profit after the introduction of the euro, despite a substantial fall in fees for cross-border (SEPA) transfers and revenues from exchange rate transactions. In the first half of 2014, the bank sector posted a net profit of EUR 176.8 m, up by 60% from a year earlier. The aggregated bank statistics published by the Latvian financial and capital market commission (FCMC) show that the upturn comes from lower expenses for provisions on bad loans. This is related to the falling share of non-performing loans over the last few years and is not directly linked to the euro changeover, although the aforementioned positive impact on asset prices is also having a favourable effect on revaluations of bank collateral.

Both gross and net revenues from commissions and fees were stable as it seems that the drop in cross-border payment fees was offset by the above-mentioned increase in the volume of bank transactions. Revenues from exchange rate operations dropped by 7% but the negative effect on the income balance was largely offset by some contraction in administrative costs of banks. Since nearly 50% of the assets are managed by the so-called non-resident banks, whose operations are mainly in US dollars, the revenue loss on the account of exchange rate transactions was relatively small.

Interest rates fall but differentials between credits and deposits remain broadly stable

As regards interest rates, the banks' income statements show a decrease in both interest revenues and expenses, but it is hard to distinguish the impact of the euro changeover from the impact of falling interest rates in the EU and the euro area in particular. The share of net to gross interest income widened to 77% in the first half of 2014 from 72% a year earlier due to faster corrections to interest rates on deposits than credits. On one hand, this is an indication of some widening of the interest rate differentials but, on the other hand, the net interest income of banks dropped by 4% over the same period. Therefore, for the moment, it is difficult to estimate the impact of the euro changeover on bank interest rates. In principle, better access to ECB liquidity and institutional support, as notified by all mainstream rating agencies, should induce a lower-interest-rate environment.

The balance between resident and non-resident banking remains largely unaffected by euro changeover

Indeed, a lower interest rate is a benefit of adopting the euro in the view of the central bank and the government of Latvia, and this seems to be supported by the contraction in Latvia's sovereign debt spreads. Yet, other EU member states also experienced a reduction in sovereign debt spreads over the past year along with lower interest rates in the private sector.

Finally, the introduction of the euro seems to have few implications for the balance of resident and non-resident banking services in Latvia. The large size of Latvia's non-banking sector was analysed in the Commission's convergence report for Latvia as well as in a dedicated Country Focus.[7] The share of non-resident deposits, coming mainly from businesses of the Commonwealth of Independent States (CIS), contracted to 48.2% at the end of June 2014 from 49.4% a year earlier. The growth rate of non-resident deposits slowed down from annualised double-digit rates in late 2012 and early 2013 to about 7% as of the end of June 2014. Part of this slowdown could be attributed to the situation in Ukraine and Russia but it any case the euro changeover seems to have had no significant impact.

Structural reforms, commitments

Sustainable convergence will require reforms in many areas (higher education and science, state asset management, healthcare, energy)

In the years following the crisis of 2008-09, Latvia became an important example of an effective internal adjustment without recourse to currency devaluation.[8] Now, as part of the euro area, the need to "stay fit" and implement structural reforms to further enhance competitiveness and strengthen the functioning of product and labour markets remains unchanged. In this context, ahead of the key decisions on Latvia’s euro accession, a number of structural reform commitments were outlined by the Latvian authorities' in June 2013 in a letter to the Eurogroup and the ECB.[9] These include reducing risks from the growing non-resident banking sector, improving the anti-money laundering framework, reforming higher education and state-owned asset management, addressing poverty, opening up the gas and electricity markets, strengthening public administration, and establishing a Fiscal Council.

One year on, the authorities have made good progress as regards fiscal policy commitments: improving cyclically-adjusted budget balances, introducing the Fiscal Discipline Law and Medium-Term Budget Framework Law, and implementing comprehensive pension reforms. As regards the financial sector, commitments were implemented to a large extent, in particular as regards closer supervision of non-resident banking and improving the anti-money laundering framework. Still, setting-up the Single Development Institution is significantly delayed, while comprehensive insolvency regulation amendments are yet to be implemented and tested.

Reform momentum has been lost in some areas, reflecting signs of complacency after the euro adoption

On structural reforms, there are indications that big-item reforms have been put on hold or have slowed down, reflecting some complacency and loss of incentives after achieving the euro adoption goal. This applies to introducing a centralised management of state-owned enterprises and the appointment of professional board/council members. Likewise, there is little progress on reforms of higher education, broader means-testing of social assistance, credible gas market liberalisation, reforms to make public administration more professional and improving access to and financing of healthcare. The general elections on 4 October 2014, strong vested-interest groups in state-owned enterprises, health, education, energy and other sectors, as well as deficiencies in the decision-making process have also contributed to the reform slowdown. Indeed, important law amendments or new government initiatives were held up in the Parliament. These and other structural challenges will continue to be highlighted by the Commission under the European Semester surveillance framework.

Conclusion

Latvia's economic indicators portray an overall positive experience with the euro introduction. Enhanced competition, bank intermediation and low-interest rate environment are bringing immediate and long-term benefits to the economy. While consumer price inflation has been lower than projected, the euro changeover seems to have pushed up some assets prices, in particular housing and to a lesser extent stock market indices. At the same time, accelerated wage growth, partly affected by positive euro-related business expectations and some fiscal relaxation, is posing policy challenges amid worsening external demand. While the favourable impact of the euro is broadly in line with the Commission expectations, the Latvian experience also provides some positive surprise in the banking sector, where the steep rise in non-cash transactions and clear efficiency gains on the side of both banks and consumers look quite impressive. On the other hand, the positive momentum from improved economic sentiment has not been fully reflected in investment growth, most likely due to offsetting adverse external shocks from the conflict in Ukraine. To maintain its competitiveness in the euro area, Latvia needs to re-invigorate the process of structural reforms, which seems to have lost momentum.

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[1] According to a flash Eurobarometer survey carried out in January 2014, the majority of Latvians (57%) thought that the euro would increase inflation in their country (compared to 55% of Estonians, 19% of Slovaks, 66% of Cypriots, 37% of Maltese and 52% of Slovenes just after their respective changeovers), while only 19% believed that it would help Latvia to maintain price stability.

http://ec.europa.eu/economy_finance/euro/communication/polls/index_en.htm

[2] The convergence report for Latvia is available at:

http://ec.europa.eu/economy_finance/publications/european_economy/2013/ee3_en.htm

[3] The tax effect on consumer prices is also illustrated by the constant-tax HICP rate for January 2014, reported at 0.6% m-o-m or 0.1 pp less than the headline rate.

[4] The Eurostat price assessment is available at:

http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_pub/Euro-changeover-Latvia-2014.pdf

[5] Commission forecasts published in February and May put Latvia's HICP inflation at 1.9% and 1.2% respectively in 2014, while the corresponding consensus forecasts, as published by Consensus Economics (www.consensuseconomics.com), were 1.7% and 1.2% respectively. The latest data suggest that inflation is likely to stay below 1% in 2014.

[6] The capital keys of member states are based on the paid-up capital in ECB, reflecting with equal weights the respective country share in the total population and gross domestic product of the EU:

https://www.ecb.europa.eu/ecb/orga/capital/html/index.en.html. The capital keys are also used for redistribution of the ECB monetary income (seigniorage).

[7] See ECFIN country focus on Latvia's financial sector published in April 2014: http://ec.europa.eu/economy_finance/publications/country_focus/2014/cf-vol11_6_en.htm

[8] In this respect, it should be noted that households and the corporate sector entered the crisis with a significantly low level of debt: less than 80% of GDP compared to 140% for all euro-area members (EA18).

[9] Latvia's commitment letter is published on the website of the finance ministry: http://www.fm.gov.lv/files/eiro/2013-06-20_Apnemsanas-vestule-euro-grupai.PDF