The Moscow Times
30 YEARS
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Latvia's Rocky Path to the Euro

February 20, 2013

Latvia's president signed a decree on Feb. 15 announcing that as of next year the national currency would cease to exist and that the country would join the euro zone.

As a rule, countries join a monetary union because the currency to which they gain access is more reliable than their own. On the other hand, when a country enters a monetary union or ties the exchange rate of its own currency to that of a foreign currency, it also gives up some of its sovereignty because it can no longer conduct an independent monetary policy. Why? Because if the exchange rate is fixed, the country's central bank cannot print as much money as it wants, but only the quantity required to maintain the exchange rate of the national currency at a fixed level.

Latvia's choice to join the euro zone has come at a very high price. During the global financial crisis, its unemployment rate jumped from 6.2 percent in 2008 to 20.4 percent in 2009. The country's currency, the lats, was already tied to the euro at that point, but had Latvian monetary authorities been free to devalue it, the effects of the crisis would not have been so disastrous.

With an expensive lats, companies were forced to lay off large numbers of employees. Had the government devalued the lats, employee salaries would have been lower and many jobs would have been saved — but the commitment to join the euro zone prohibited such a move. (This course was supported by Scandinavian banks, among others, because they would have been forced to announce significant losses otherwise.)

The government took the heroic step of implementing "internal devaluation" by deliberately lowering the salaries of state employees, thereby enabling it to lay off fewer workers. Voters even supported that policy during elections. However, those measures provided only minimal assistance to the economy because salaries in the private sector remained at their former levels and overall unemployment remained high. More rapid emigration was another consequence of the crisis, with tens of thousands of people choosing to leave the country.

Given the firm position of the government and the heroic resolve of the Latvian people, it was unpleasant to see euro supporters unwilling to admit what a high price it was costing the country to join the euro zone. Even the International Monetary Fund, the main source of high-quality macroeconomic analysts for countries such as Latvia, carefully tried to suggest in its reports that the jump in unemployment was not a result of the "course toward the euro." But talks given by leading macroeconomists Paul Krugman and Olivier Blanchard, along with a thorough analysis of the data, forced even the IMF to acknowledge in its January 2013 report that the euro had played a role in Latvia's economic struggles.

At the peak of the crisis, the Latvian government resorted to the draconian measure of arresting an economist for claiming publicly that the lats would soon be devalued. However, judging by the fact that such a shameful incident was not repeated, the lesson has been learned: Crises, sharp increases in unemployment and rapid devaluations cannot be the result of the actions — much less the words — of economists. They can only result when leaders pay too little attention to what economists are telling them.

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