Bachelor Thesis

Westfälische Wilhelms-Universität Münster

Institut für Politikwissenschaft

1st Supervisor: Prof. em. Dr. rer. pol. Nobert Konegen

University of Twente

School of Management and Governance

2nd Supervisor: Prof. Tsjalle van der Burg

Latvian accession to the EMU during the European debt crisis – an attempt to evaluate the convergence attained according to the Convergence Criteria

Lisanne Kathrin Blümel
Münzstraße 41
48143 Münster, Germany

Email: l_blue02@uni-muenster.de
sNumber: s1381490
Matrikelnummer: 373259

Bachelor in Public Administration (BA)
Bachelor in Public Administration (Spec. Emphasis: European Studies) (BSc)
Münster, 29 October 2013

UNIVERSITY OF TWENTE

Abstract

The emergence and success of the Economic and Monetary Union (EMU) of the European Union (EU) was considered critically, especially by economists. In particular, the different degree of integration in the areas of economic and monetary union, in addition to the lacking compliance with the theory of optimum currency area, caused concerns. Since 2010, these objections against the EMU seem to be confirmed. The European single currency is facing one of its greatest challenges, in which its political actors have to respond immediately to potentially perilous market decisions. Despite the current situation, Latvia is going to adopt the euro in January 2014. While the global financial and economic crisis had severe impacts on its domestic situation, the country is currently seen as the poster child of austerity in the EU. In particular, it has to be emphasised that, in spite of the crisis, the Latvian elite never abandoned its EMU commitment. Consequently, the required Convergence Criteria were met within the reference period up to May this year. However, it is questionable how sustainable the convergence attained according to these criteria will be. For that reason, the thesis at hand, by using primary and secondary literature, examines the fulfilment of the criteria, as well as national and European variables which are significant for the preservation of Latvian convergence. Finally, it concludes that the euro members have to further pursue integration, especially in the economic union, in order to guarantee the common basis attained according to the Convergence Criteria and the associated smooth functioning of the EMU.

Die Entstehung und der Erfolg der Wirtschafts- und Währungsunion (WWU) der Europäischen Union (EU) wurde von vielen, besonders Ökonomen, äußerst kritisch betrachtet. Insbesondere der unterschiedliche Grad der Integration in den monetären und wirtschaftlichen Bereichen der Union verursachte, neben der fehlenden Übereinstimmung mit der Theorie des optimalen Währungsraums, Bedenken. Die Einsprüche gegen die WWU scheinen sich seit dem Jahr 2010 zu bestätigen. Die gemeinsame europäische Währung steht einer ihrer größten Herausforderungen gegenüber, in denen die politischen Akteure immer wieder umgehend auf potentiell bedrohliche Marktentscheidungen reagieren müssen. Trotz der aktuellen Situation wird Lettland den Euro im Januar 2014 einführen. Das Land, welches besonders durch die Folgen der globalen Finanz- und Wirtschaftskrise getroffen wurde, steht nach erfolgreichen Sparmaßnahmen als Musterbeispiel innerhalb der EU dar. Dabei ist besonders zu betonen, dass die lettische Elite sich trotz der Krise nie von ihrem WWU Engagement abwandte und die erforderlichen Konvergenz Kriterien in der Referenzperiode bis Mai dieses Jahres erfüllt wurden. Es ist jedoch fraglich, wie nachhaltig die Konvergenz, die durch diese Kriterien erreicht wurde, sein wird. Aus diesem Grund beleuchtet die

vorliegende Arbeit, mithilfe von primärer und sekundärer Literatur, die Kriterienerfüllung, sowie nationale und europäische Variablen, die für die Erhaltung der Konvergenz von Bedeutung sind. Letztlich kommt sie zu dem Schluss, dass die Euro Mitglieder die Integration besonders im Bereich der Wirtschaftsunion weiter fortführen müssen, damit zukünftig die durch die Konvergenz Kriterien erreichte gemeinschaftliche Basis und die damit verbundene reibungslose Arbeitsweise der EMU erhalten bleibt.

Table of Contents

List of Abbreviations

ABS	Asset-Backed Security
CEEC	Central and Eastern European Countries
EC	European Commission
ECs	European Communities
ECB	European Central Bank
EcoFin	(Council of) Economic and Finance Ministers
ECU	European Currency Unit
EDP	Excessive Debt Procedure
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
ESM	European Stability Mechanism
FDL	Fiscal Discipline Law
FED	Federal Reserve System
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LVL	Latvian Lat
MIP	Macroeconomic Imbalance Procedure
MS	Member States
NCB	National Central Banks
OCA	Optimum Currency Area
PHARE	Pologne et Hungarie Assistance pour la Reconstruction Economique
SEA	Single European Act
SGP	Stability and Growth Pact
TACIS	Technical Assistance to the Commonwealth of Independent Countries
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance
VAT	Value Added Tax

1. Introduction

> "The adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen – for economic as well as psychological and political reasons – as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community and avoid the transaction costs of converting currencies." (Committee for the study of Economic and Monetary Union 1989 in Chalmers, Davies, and Monti 2011, p.715)

The "irreversibility" of the Economic and Monetary Union (EMU) was first emphasised during the European debt crisis which began in early 2010 and is still lasting. In particular, national economic situations were aggravated through the absence of national monetary sovereignty caused by the common currency. The euro-zone member states (MS) had to accept economic adjustments by means of high unemployment, declining wages and increasing public budget deficits in place of currency devaluation. However, the euro crises do not only consist of the European debt crisis but also a "vicious circle" (GCEE 2012, p.2) of debt crisis, bank crisis and macroeconomic crisis causing a crisis of confidence. By attempting to rebuild trust into the euro-zone, the MS realised that the main reason for the occurrence of the crisis was embedded in the institutional structure of the EMU. The different pace of integration regarding the economic union and the monetary union caused macroeconomic imbalances[1] between the participating states. Contractually, the development of these imbalances should have been avoided by mechanisms like the Convergence Criteria and the included Stability and Growth Pact (SGP), but apparently their leverage within the EMU was limited.

Nevertheless, every member state of the European Union (EU) is obliged to join the EMU if it meets the Convergence Criteria. In Latvia's case, the national financial ministers in the Council of the European Union announced in July 2013 - on the basis of reports from the European Commission (EC) and the European Central Bank (ECB) - that Latvia is able to adopt the euro on 1st January 2014. Relying on the theoretical framework of Europeanization, the thesis at hand will evaluate the sustainability of Latvian convergence attained according to the Convergence Criteria. Thus, the main research question is: <u>Do the Convergence Criteria, as the main condition for joining the euro-zone, lead to sustainable convergence in the case of Latvia?</u>

[1] The EC identifies macroeconomic imbalances as the "large and persistent external deficits and surpluses, sustained losses in competitiveness, and the build-up of indebtedness […]"within the MS (European Commission 2012a, p.1).

The preliminary analysis therefore emphasises the significance of convergence between euro members, including the history and institutional design of the EMU additional to developments of the global and European crises and Latvian incidents. Moreover, the preliminary analysis will point out the actual reasons for Latvia's request to adopt the euro. In line with the theoretical considerations and comprehension of the EMU, the analysis will focus on the European level as well as on the domestic level. In order to receive a holistic picture, the theories of intergovernmentalism and supranationalism are left behind. Thus, the Latvian fulfilment of the Convergence Criteria, the domestic political system and the recently implemented European political instruments will be evaluated. Finally, the thesis is going to conclude on the research question.

2. Theoretical Framework

Previously, European studies have focused on the bottom-up effect of governance in form of European integration, i.e. the influences MS have on the "European institution-building process" (Börzel 2005, p.46). However, progress like the success of the single market, the development of the EMU, the increasing international competition and the process of enlargement influenced European studies to consider top-down effects as well, i.e. the effects of European polity, policy and politics on the domestic level of MS (Bulmer and Radaelli 2005). The theoretical term including this "increasing two-way interaction between states and the EU" is Europeanization (Bache, George, and Bulmer 2011, p.59).

Robert Ladrech first established the term Europeanization in his case study about France in 1994, in which he defined Europeanization as "an incremental process reorienting the direction and shape of politics to the degree that EC political and economic dynamics become part of the organisational logic of national politics and policy-making" (Ladrech 1994, p.69). Gradually, Europeanization became a more complex model, manifold in its occurrence, because neither the units of analysis, the EU and the MS, nor their relationship are static. It could be rather described as "a matter of reciprocity between moving features" (Bulmer and Radaelli 2005, p.340). Thus, Bomberg & Peterson (2000) and Börzel (2002) regard Europeanization mostly as a process in which MS seek to "anticipate and ameliorate the effects of top-down Europeanization pressures by 'uploading' their preferences to the EU level" (Bache, George, and Bulmer 2011, p.60).

The theoretical framework of Europeanization will be applied to analyse the sustainability of convergence attained according to the Convergence Criteria, as the accession process as well as EMU membership are affected by the co-operation between Latvian and European levels and units of analysis. In this context, Kenneth Dyson (2000) illustrates that "[…] 'top-down' Europeanization is, however, complemented by a 'bottom-up' process in which domestic elites construct EMU by reference to distinctive domestic institutional arrangements and project these constructions on the EU level." (p.2). It is noticeable that the European and domestic level of analysis within Europeanization are similar to the ones defined by Putnam:

> "At the national level, domestic groups pursue their interests by pressuring the government to adopt favorable policies, and politicians seek power by constructing coalitions among those groups. At the international level, national governments seek to maximize their own ability to satisfy domestic pressures, while minimizing the adverse consequences of foreign developments." (Putnam 1988, p.434)

Decisions made on an international level depend on their domestic ratification. Thus, Putnam (1988) determines that this two-level game is essential for the participants of the political system, as long as the national state is sovereign (p.434). Nevertheless, Putnam's two-level game does not consider the different division of power that may occur in accession processes. In case of negotiations between the EMU and its MS, the power among them is mostly equally distributed. In contrast, an asymmetry of power "rooted in conditionality for accession" is inherent during negotiations between the EMU and an applicant (Bulmer and Radaelli 2005, p.353). Vachudova (2005) examined this inequality in enlargement processes and distinguishes two manners in which the EU is exerting its superiority: passive and active leverage. Although Vachudova's theoretical considerations refer to the EU, within the thesis at hand, they will be applied to the EMU as a part of the EU concerned with deeper integration. Moreover, Latvia's weak negotiation position as a candidate for the EMU is similar to that of a potential EU member, and both applicants have to fulfil certain, predetermined requirements in order to join.

2.1 Passive Leverage

The 'passive leverage' the EMU holds is defined by the potential benefits applicants would gain in case of accession (Vachudova 2005, p.65). Economic benefits such as the increase of trade by entering the euro-zone market as well as the political gains through participation in institutions like the ECB, are weighted against the costs of non-participation. Passive leverage does not include any kind of European policy influencing the states and their decisions intentionally (ibid.).

2.2 Active Leverage

Vachudova (2005) identifies three characteristics of an 'active leverage' which are strengthening the impact of a passive leverage: asymmetric interdependence, enforcement and meritocracy (p.108). In case a state begins to strive for the adoption of the euro, the EMU can achieve convergence through its active leverage up to the enlargement. The asymmetric interdependence develops as accession to the EMU is appealing for the applying state, while the advantages of a membership are lesser for the EMU. The domestic enforcement of the non-negotiable requirements for the accession, the Convergence Criteria, is voluntary and thus illustrates a strong commitment. Finally, the process of implementation is monitored and controlled by institutions like the EC and the ECB, which are perceived as being fair and neutral by the applicants.

2.3 No Leverage

After the enlargement, the applicant is a full member of the EMU. Thus the domestic alignment, that was a result of the conditionality of the asymmetric interdependence, comes to an end. Instead, the member state and the EMU develop a relationship in which the power among them is distributed equally. It becomes difficult for the EMU to enforce reforms. Giving evidence to this assumption Vachudova (2005) mentions the case of Greek EU accession in 1981 (p.113). Although Greece was not fulfilling the requirements of EU membership, the governments decided to include it in order to protect its new democracy. Afterwards, it took Greece several years to implement basic conditions like the 'acquis communautaire' properly.

3. Preliminary Analysis

3.1 The EMU

The concept of an economic and monetary union in Europe seems to be relatively new considering its first adoption on 1st January 1999. However, the idea of a single currency was first introduced in 1969 within the European Communities (ECs). The great time span between the first idea for a common currency and the final introduction illustrates the significance and the difficulties such a project meant for Europe. It is characterised by great achievements, such as the fact that "[t]he euro is the second most actively traded currency in foreign exchange markets" (European Commission 2013b), as well as problematic situations like the crises the Union is currently facing consisting of a "vicious circle formed by the sovereign debt crisis, the banking crisis and the macroeconomic crisis in the euro area"

(GCEE 2012, p.2). In order to understand the failure of fiscal discipline and macroeconomic surveillance, which caused enormous debt burdens in several MS requiring the ECB to conduct unconventional and disputable measures, this chapter is going to explore the history of the EMU, as well as its organisational and institutional features.

3.1.1 Origin of the EMU

In 1969 at The Hague, national heads of states and governments of the ECs authorized a working group under the chairmanship of Pierre Werner, who was at that time the Prime Minister of Luxembourg, to explore the potential of monetary co-operation (Bache, George, and Bulmer 2011, p.137). The request for a monetary integration resulted mainly from the USA's actions financing the Vietnam War through expansive monetary policy and public debts (Pfister and Fertig 2004). Within the on-going Bretton Woods system some participating states were not willing to accept this kind of US inflationary policy. The European response was a blueprint for a monetary and economic union which could have been achieved in three steps by 1980 (Bache, George, and Bulmer 2011, p.137). However, the report included proposals - like a political union as the last consequence - that were too ambitious for the ECs which were determined by intergovernmental co-operation. Only the first step of the blueprint, a narrowing of exchange rates, was aspired. Facing the failure of the Bretton Woods system in 1971 the MS agreed on the so called 'snake in the tunnel'. This metaphor illustrated a "mechanism for managing fluctuations of their currencies (the snake) inside narrow limits against the dollar (the tunnel)" (European Commission 2010b). After the collapse of this exchange rate agreement, which occurred due to events like the oil-crisis and the dollar weakness as well as the persistence of MS to preserve their Keynesian national economic policies, the next overall attempt to adjust exchange rates resulted in the European Monetary System (EMS) in 1979 (Bache, George, and Bulmer 2011, p.143). Within the EMS the national exchange rates could fluctuate around the European Currency Unit (ECU) consisting of weighted participating currencies (ibid.). The Exchange Rate Mechanism (ERM) observed if the currency fluctuations were "kept within ±2.25% of the central rates" (European Commission 2010b). Until 1983, the central rate had to adopt seven times with 21 appreciations and depreciations emphasising the missing consensus of monetary discipline between the participants (Abelshauser 2010, p.42).

Beside the spread of monetarism, deeper integration caused by the implementation of the Single European Act (SEA) in 1986 influenced national monetary policies to orientate more towards the German Central Bank (ibid.). In particular, the SEA introduced a common market[2] “in which only countries with well-behaved exchange rates would be permitted to participate” (Eichengreen and Frieden 2001, p.3). Due to the gained stability of the EMS and the success of the SEA, the European Council agreed on a further exploration of a potential single currency on the Hannover Summit in 1988 (Bache, George, and Bulmer 2011, p.404). This time, the committee was chaired by Jacques Delors, President of the EC. The so called ‘Delors-Report’[3] entailed the blueprint for the current Economic and Monetary Union and was mostly adopted into the Treaty of Maastricht[4] and the Treaty on the Functioning of the European Union (TFEU). Within the report, the committee recommended an adoption of a common currency in three stages (European Commission 2010b). By 1994, the first stage was achieved with the completion of the single market, particularly the removal of all capital controls (ibid.). The events predominantly considered in the second stage were the establishment of the European Monetary Institute (EMI) in Frankfurt as the predecessor of the ECB, and the agreement on the SGP in 1997. In May 1998, eleven MS[5] fulfilled the criteria for the adoption of the euro. Denmark and Great Britain agreed with the EU on protocols, which were allowing them not to join the euro-zone (Bache, George, and Bulmer 2011, p.407). Aside from that, Sweden and Greece did not fulfil the criteria, although in the case of Sweden, the national government was delaying decisions, particularly the accession to the ERM (ibid., p.408). Finally, the launch of the euro as the third stage of the establishment of the EMU began on 1st January 1999. It was marked by the transition from national currencies to the euro within three years. On 1st January 2002, the EMU was officially set up and, henceforth, the euro became the single currency of twelve MS, after Greece fulfilled the criteria in 2001 (ibid.).

To sum up, the nation-states considered the advantages of common exchange rates and a common currency. However, monetary and economic alignment and co-operation were only achieved after several years and difficulties. Besides, the composition of the EMU was determined by the hesitant national compliance to greater co-operation and supranationalism.

3.1.2 Features of the EMU

The EMU is based on two pillars: the economic and the monetary union. While the monetary union complies with the maximum definition “the adoption of a single currency”, the

[2] A common market includes no internal tariffs, common external tariffs and full mobility of people, services and capital within the union.
[3] Report on Economic and Monetary Union in the European Community, 1989
[4] Treaty on European Union (TEU)
[5] Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal & Finland

economic union is characterised by the minimum definition of states which "cease to follow completely independent economic policies and instead follow closely co-ordinated policies" (Bache, George, and Bulmer 2011, p.402). The features resulting from these diverse paces of integration are examined in the following.

3.1.2.1 The Monetary Union

Contractually, the European System of Central Banks (ESCB) has "[…] the responsibility for defining and implementing the monetary policy of the single currency" (Chalmers, Davies, and Monti 2011, p.727). The ESCB consists of the ECB and the national central banks (NCB) of the 28 MS. Article 129 TFEU defines that the ESCB is guided by the Governing Board and the Executive Board of the ECB. Here, the ECB is mainly responsible for a smooth functioning of the common monetary policy, namely by securing the supply of money and the setting of short-term interest rates for the euro. In order to guarantee the effective operation of the ECB, the German government in particular persisted on a functional, institutional, personal and financial independence of the ECB (Art.130 TFEU). This arrangement further ensures that the main goal of price stability (Art.127 (1) TFEU) will be obtained. The definition of price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%" (European Central Bank 2013b) was first announced by the ECB in 1998, but still proves to be of value[6] (Puetter 2009, p.103).

The common currency in a monetary union generates certain specifics that differ from currencies not bound together. Consequently, the ECB can only realign its interest rates policy on the average economic situation of the euro-zone MS, while varying economies have to deal with the destabilising impact of lower or higher interest rates (Enderlein 2004, p.13). That emphasises the necessity of a similar economic basis within the EMU. Moreover, the common currency detains the MS from utilising their central banks and instruments like currency devaluation to resolve economic challenges. Instead, governments have to alter their fiscal and wage policies for economic improvement, which is usually more politically demanding.

3.1.2.2 The Economic Union

In Article 121 TFEU the MS agreed on co-ordination and surveillance of their economic policies. This loose arrangement arose from the inability of nation states to accept a solution

[6] HICP „measures the average change over time in the prices paid by households for a specific, regularly updated basket of consumer goods and services" (European Central Bank 2013c).

leading to a more supranational political regulation of economic policies. However, the significance of a common economic union was already emphasised by the Delors Report stating that

> "an economic and monetary union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries" while "uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sector of the Community" (Committee for the study of Economic and Monetary Union 1989 in Chalmers, Davies, and Monti 2011, p.715).

An attempt to enforce the common economic policy represents the SGP of 1997. It provides concrete measures in the case of an excessive deficit and thereby strengthens Article 126 (1) TFEU. Another instrument that was supposed to encourage balanced fiscal policies was the no-bail-out clause (Art.125 TFEU). It determines that the MS do not guarantee for other national obligations except for their own ones. Furthermore, the ECB is not allowed to directly purchase bonds of euro-zone states (Art.123 TFEU) in order to avoid a monetisation of public debts and thereby maintain the separation of the monetary union and the economic co-operation (Brunetti 2011, pp.115, 116).

3.1.2.3 The Convergence Criteria

> "In effect, the existing system is only a monetary union, not an economic and monetary union." (Bache, George, and Bulmer 2011, p.419)

Facing this structural weakness, the EMU attempted to achieve at least a common economic basis for the adoption of the euro through the Convergence Criteria, which were implemented in Maastricht. Especially Germany pleaded for a basic economic convergence as an accession condition while the French central bank was sharing the perception that a monetary union would gradually lead due to spill-over effects to an economic adjustment (Bache, George, and Bulmer 2011, p.414). Following the German claims, the criteria laid down in Article 140 TFEU and specified in Protocol No. 13 combine monetary and fiscal requirements. Beside those four criteria, Article 140 TFEU requires an evaluation if the national legislation of the applying state and the status of its central bank is consistent with that of the EU and the ESCB/ECB (Art.130, 131 TFEU). Moreover, the Convergence Reports created by the ECB and the EC include macroeconomic observations like "[…] the results of the 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." (Art.140 (1) TFEU).

3.1.2.4 The OCA Theory

Most of the analyses regarding the EMU are based on the theory of optimum currency areas[7] (OCA). Robert Mundell, who first published this theory in 1961, evaluated an OCA through a cost-benefit ratio. His argumentation contained that

> "the benefits of monetary unification, which take the form of the reduction in transactions costs consequently on replacing distinct national currencies with a single (common) currency, are balanced against the costs of sacrificing monetary and fiscal autonomy" (Eichengreen and Frieden 2001, pp.6, 7).

However, authors like Eichengreen and Frieden (2001) emphasise that the currency conversion costs are relatively small, i.e. around one per cent of EU national income in late 1980s (p.7). The deepening of the single market in light of the EMU was considered as the real benefit due to the increase of market transparency, implying an increase in market competition. Moreover, speculations against single currencies are prevented and the risks of financial transfers due to unstable currencies, e.g. in the common agriculture policy, are reduced. Along with several authors Waltraud Schelke (2010) identifies six major conditions for an OCA: high mobility of labour, very flexible real wage rates, open economies, small economies, a similar economic structure and a fiscal transfer mechanism (p.257). All these conditions are not fulfilled by the EMU (ibid., p.259). First of all, only few citizens are moving to other regions to work, particularly because of linguistic and cultural barriers, and mostly wage inflexibilities occur due to labour unions and social insurance systems (Eichengreen and Frieden 2001, p.8). Thus, these effects cannot replace the valuable depreciation of a national currency during economic deterioration. Furthermore, the economies of the EMU are rather open, but not as open and small that they would align their national price level to world market standards, e.g. through employment adjustments. Moreover, the economic structure and thus the economic situation and development of the MS vary. In addition to symmetric shocks, which can be relieved from tensions through a common monetary policy, asymmetric shocks can occur due to this economic variation in MS. While mechanisms of labour mobility and wage flexibility are insufficient to diminish asymmetric shocks, prior to the European debt crisis, also no financial mechanism existed that allowed MS to receive financial support through the union (cf. Art.125 TFEU).

All in all, although the EMU does not fulfil the criteria of an OCA, the theory points out that certain mechanisms are needed to compensate for the sacrifice of monetary and fiscal

[7] An OCA is defined "as the optimal geographic domain of a single currency, or of several currencies, whose exchange rates are irrevocably pegged and might be unified" (Mongelli 2002, p.7).

independence. Some European states already realised the difference in their economic situations and perceptions during the 1970s. However, the on-going euro crisis illustrates that the MS were not able to agree on binding instruments adjusting the euro-zone economies and preventing asymmetric shocks. Nevertheless, it has to be clarified that the OCA is not able to explain the occurrence of the EMU regarding the involvement of big economies like Germany and France adopting a common currency that seems less beneficial for them (Willett 2000, p.380). Regarding this aspect, the significance of the EU and national governments as political actors is important. The decision for the establishment and the structure of the EMU was not initiated by a benevolent dictator acting fully rationally and efficiently, but by politicians and political procedures (ibid., pp.379-381). For instance, it is estimated that one reason for France and Germany to commit to the common currency was to preserve the European peace facing a German unification.

3.2 Passive Leverage of the EMU

The examination of the EMU revealed its passive leverage as several political and economic benefits. The political benefits primarily consist of the Latvian possibility to participate in the ECB and its decision-making process by euro adoption. Furthermore, Latvia will be part of the informal Eurogroup in which the national finance ministers are debating and co-ordinating issues related to the euro. The economic benefits of the EMU Latvia may perceive are the great intra-euro-trade, the absent exchange rate risks, no transaction costs and price transparency, causing greater competition. However, these benefits are weakened by the difficulties experienced prior to the establishment of the euro and the absent consistent composition of the EMU. In particular, these disadvantages were easier to accept while the euro-zone was characterised through positive future outlooks, without uncertainty. Thus, the economic appeal of the EMU might further decrease with a lasting of the European debt crisis.

3.3 The Euro Crisis

3.3.1 From the US to a Global Crisis

Brunetti (2011) illustrates that within the years of global economic moderation, from the 1980s to 2007, the financial markets developed several characteristics which exposed partly as causes for the global financial crisis (pp. 13, 26). On the one hand, the willingness of banks to assume risks rose to the same extent as their equity decreased, while they got more and more involved in commercial papers. On the other hand, the globalisation of the financial markets caused greater linkages between all financial actors. The too-big-to-fail problematic occurred, in which the insolvency of one bank is able to endanger the whole financial system. This development enabled banks to accept even greater risks because they assumed that in case of their insolvency national governments would support them with financial means.

These financial system characteristics caused, together with US specific developments, the US housing crisis followed by a banking crisis arousing a global economic crisis (ibid., p.35). At first, the American investment rates were quite high due to the expansive monetary policy of the Federal Reserve System (FED). The facts that these investments were mostly utilised for consumptive investments and that increasing foreign debts indicated enormous trade imbalances for the USA, perceived little attention. Additionally, the financial market created new, disputable products for investments: commercial papers termed as asset-backed security (ABS) (ibid., p.40). In the case of the US housing market, mortgages were securitized into commercial papers and allocated into different risk types. Rating agencies were evaluating these commercial papers with best grades despite the missing experience with them (ibid., p.43). Due to the high demand of those forms of investment, the US banks provided more and more mortgages to greater risks[8]. This kind of business was working until the prices for houses dropped in 2006 (ibid., p.52). Due to an increase in interest rates by the FED, many debtors were not able anymore to finance their credits and gave their houses back to the banks. Therefore, the value of the ABS decreased and the bank's problems began. From 2007 onwards banks had difficulties to receive short-term credits on the financial market, particularly from other banks (ibid., p.61). The central banks tried to avoid the crisis through the supply of money but with the collapse of the investment bank Lehman Brothers in September 2008 the banking crisis magnified. It was expected that the US government would support Lehman Brothers because the bank was actually too-big-to-fail. However, this did not happen. Numerous banks lost their investments while not having enough equity to pay their debts. Moreover, the banks distrusted to provide short-term credits on the financial market after realizing the risks connected with several financial businesses (ibid, pp.67, 68). However, the freezing of the financial market caused an enormous problem for companies and enterprises needing short-term credits, i.e. commercial papers, for their daily business (ibid., p.60). Thus, the banking crisis led to a global economic crisis, the worst after the Great Depression in the 1930s.

[8] The credits were called NINJA-credits: **n**o **i**ncome, **j**ob or **a**ssets due to the missing securities (Brunetti 2011, p.45).

3.3.2 Developments in the Euro-Zone

With the beginning of the economic recession in 2008, governments all over the world were using Keynesian policy - co-ordinated fiscal and monetary stimuli - to support their national economies (Dyson 2010, p.21). Moreover, national support for financial systems, particularly for several banks, was necessary in many countries and thereby increased the domestic budget deficits. However, while states like the USA, Japan and Great Britain were able to preserve their refinancing with low interest rates, members of the euro-zone were confronted with rising ones, resulting from the missing monetary sovereignty (GCEE 2011, p.77). The impending insolvency of Greece in spring 2010 was the moment leading to the emergence of the European crisis. Overall, the potential insolvency though can only be regarded as the consequence of the actual euro-zone crises consisting of three different parts which determine each other: the macroeconomic crisis, the debt crisis and the banking crisis (GCEE 2012, p.2) (Figure 1).

The macroeconomic crisis was caused by macroeconomic differences within the European countries that already existed prior to EMU accession and that were aggravated by the adoption of the common currency. Before the establishment of the EMU, the national governments had to deal with increasing interest rates if their economic situation was e.g. stressed by inflation. However, due to the euro adoption, the exchange rate adjustment between the currencies became inexistent and the investors evaluated the interest rates for all euro-zone MS almost at the same level[9] (Brunetti 2011, p.79). Especially the interest rates of Greece, Spain and Portugal reduced considerably leading to a cyclical boom in these countries. In particular, the domestic demand increased quickly due to the low interest rates that stimulated investments and consumption. However, while the production capacities needed some time to develop and thus were more or less fixed, the increased demand led to higher prices and wages without the correspondent increase in production capacities (ibid., p.82). The resulting loss in competitiveness was illustrated by the fact that it was cheaper to produce outside of e.g. Greece[10] and therefore these countries began to increase their imports, especially from other euro-zone members, and diminish their exports. The resulting trade deficits were predominantly financed by other EMU countries, respectively their banks (ibid., p.84). Prior to the monetary union, the affected countries could have devaluated their currency in order to overcome inflation causing less competitiveness, but within the monetary union

[9] The interest rates particularly tended to the German level (Brunetti 2011, pp.79, 80).
[10] In 2008/2009 the wages in Greece were on average 40 percent higher compared to the German level (Enderlein 2010, p.9).

unpopular political reforms in the fiscal and wage policies would have been necessary. Unfortunately, no mechanisms within the EMU existed to detect these macroeconomic imbalances and suggest reforms. Nevertheless, these imbalances are difficult to discover as they are manifold and might at first glance be considered as beneficial for some states. On the other hand, the cyclical boom was accompanied by growing public budget revenues which were used for increasing public expenditures. While these expenditures were mostly used in a consumptive manner, they additionally expanded the national structural deficit (ibid.).

Since the beginning of the global recession in 2008, the budget positions of all MS have further been stressed through decreasing public revenues and increasing public expenditures, but within the countries with severe macroeconomic imbalances or imperilled banks the budget deficits exploded (ibid., p.85). The global financial markets, which evaluated investment risks after the crisis from a more suspicious point of view, realised the difficulties of Greece and other euro-zone MS in 2010. State bonds, which were primarily seen as safe spots, became risky in the light of immense budget deficits, macroeconomic imbalances and the characteristics of a common currency[11]. Thus, the interest rates for several MS, especially for the so called GIPS-countries[12], rose. The first country facing impeding insolvency was Greece. The extreme worsening of its financial situation was mainly caused by the government concealing the real public budget position until 2009, when a new Socialist government took office (Bache, George, and Bulmer 2011, p.411). The first rescue package for Greece was a bilateral credit provided by the EU and the International Monetary Fund (IMF). In order to eliminate speculations against other euro countries, a euro-rescue fund, consisting of the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), was established (European Commission 2013c). The EFSM was based on the EU budget while the EFSF and its funds were guaranteed by the euro-zone MS and the IMF. However, Ireland (in November 2010) and Portugal (in May 2011) had to request financial help provided by the newly implemented mechanism. Moreover, the situation in Italy and Spain aggravated as well due to higher interest rates (GCEE 2012, p.65). As a result of the ECB's measures, only Spain (in June 2012) had to ask the EFSF for financial means to support its banks. Recently, in March 2013 the ESFS guaranteed Cyprus financial assistance. Particularly, the case of Cyprus emphasised the vicious circle of the euro crisis. The Cyprian financial system is characterised as a tax haven

[11] An example: "the United Kingdom, despite running a budget deficit of 8.2% of nominal gross domestic product (GDP), was able to borrow in late October 2012 at a long-term interest rate of 1.8%, Italy – with a budget deficit of just 2.7% - had to pay a yield of 4.9%" (GCEE 2012, p.66).

[12] The term GIPS-countries terms Greece, Ireland, Portugal and Spain.

in which banks mainly refinance themselves through foreign and domestic assets, partly disposed of assets amounting 700% of the GDP (Frankfurter Allgemeine Zeitung 2013). Due to the fact that Cyprian banks held many Greek state bonds, a haircut in Greece made a governmental support necessary and thereby led to another national debt crisis (ibid.). Therefore, the euro-zone MS contractually agreed to expand these short-term measures to more sustainable ones through an international financial institution under Luxembourgian law named European Stability Mechanism (ESM) (Bundesministerium der Finanzen 2013).

Since October 2012, the ESM is inaugurated next to the EFSF which is limited up to 2013. Both instruments, the EFSM and the EFSF are replaced by the ESM, which has a total capital stock of 700 billion euro[13]. The ESM already adopted the EFSF credits for Spain and Cyprus. Nevertheless, it will only guarantee financial support to countries which signed the Fiscal Pact (TSCG). Besides, the ESM will be able to support banks through loans and purchase government bonds on the primary market (Gregosz et al. 2012, p.63). Subsequently, the ECB is able to terminate its short-term, "unconventional measures" through which it tried "to provide liquidity to the financial system" (Begg 2013, p.58). Considering the purchase of state bonds on the secondary market since 2010 and the provision of credits for credit institutions in exchange for risky government bonds, many authors judged the independency of the ECB as jeopardized (Gregosz et al. 2012, p.48). The monetary duty of the ECB became less important in the light of fiscal policy measures, preventing further speculations against the euro. The scepticism against those measures is further emphasised by the fact that the insolvency of a country could lead to markdowns within the ECB and that the purchase of state bonds increases the potential of inflation while the supported countries do not have to fulfil any reforming conditions (ibid., pp.50, 51).

Summarising, the major cause for the European crisis can be identified in the architecture of the EMU, leaving the responsibility for the fiscal and economic policies by the national governments while the macroeconomic differences between the MS were not efficiently monitored and prevented and no crisis mechanisms were incorporated. In particular, the dissolving of the fiscal co-ordination is illustrated by the failure to preserve the three fiscal rules of the SGP, the no-bail-out clause and the total independency of the ECB (Brunetti 2011, p.116). Currently, the EMU has to rebuild the trust in the euro through reforms and

[13] The common stock of 700 billion euro is divided into an asset of 80 billion euro which is already available and 620 billion euro which will be retrievable (Bundesministerium der Finanzen 2013).

signs of confidence. Thus, the Latvian adoption of the euro may be equally essential for Latvia and the EMU.

3.3.3 Developments in States with Derogation

Within the EU not only the euro-zone members were affected by the global financial and economic crisis, but also other participants, i.e. states with derogation[14]. One of the countries hit most intensely in 2008 was Latvia. The former soviet country, which fulfilled major political changes and reforms since the year of its independency, 1991, experienced a period of economic decline (1989-1995) as well as economic advancement (1996-2008) up to the current crisis. Major advancements achieved during this time are the triplication of the income per capita over the last 15 years, the increase of exports "with a peak in growth of 20% in 2005" and the reductions of citizens living on less than $4 a day "[…] from 25.8% in 1998 to 3.4% in 2008" (The World Bank 2013, p.32).

Although Latvia implemented so many reforms after its independency[15], these were not able to prevent an economic overheating with inflationary tendencies since 2005. As Schrader and Laaser (2012) emphasise the investments floating into Latvia were not used for the expansion of long-term production facilities, but for a more and more speculative demand for real estates and the consumption of non-tradable services – the consequences being a housing bubble and a wage-price spiral (p.315). Especially the credit granting increased to yearly rates of 75% since the new millennium (Hishow 2012, p.372). Besides, the increase in wages, mainly in the service sector, caused a reduction of competitiveness and an increase in prices, termed inflation. Finally, in 2008 the housing bubble burst and the global financial and economic crisis led to a sharp reduction of capital inflow and a decrease of domestic demand. The Latvian GDP dropped about 18% in 2009 (ibid.). The labour market was not able to absorb the consequences of the crisis, especially due to the missing monetary sovereignty[16]. On the one hand, the government had to deal with an increase in unemployment from 6% in 2007 to 20.6% in 2010 (ibid., pp.375, 376). On the other hand, the housing crisis transformed into a banking crisis of the Latvian bank Parex[17], which needed governmental support. The budget

[14] EU Member States with derogation are countries which are evaluated not to meet the Convergence Criteria. In 2012 those were Sweden, Latvia, Lithuania, Poland, Czech Republic, Hungary, Romania, Bulgaria and Croatia.
[15] An example for successful reforms is the construction permitting area. "In 2001 it took Latvian businesses 2 years to obtain all the licenses and inspections required to build a warehouse. By 2004, the government had reduced the time required to obtain a building permit by 2 months […]" (The World Bank 2013, p.33).
[16] The LVL is pegged to the euro with a ±1% fluctuation margin.
[17] In comparison to the banks in the other Baltic States, the Latvian bank Parex had a relatively small foreign share of 40% and thus it was not enough supported by foreign banks in times of the crisis (Hishow 2012, p.372).

deficit and the interest ratings for Latvia increased. In order to avoid currency devaluation Latvia had to ask for financial support of €7.5 billion from the IMF and the European Union with the obligation to reduce its budget expenditures by 7% of GDP. Overall, Latvia only borrowed €4.5 billion from the financial assistance programme with the last disbursement in the end of 2010 and returned to the international bond market in June 2011 (European Commission 2012b, p.77).

After severe austerity measures and several reforms, the Latvian economy currently seems to recover with an estimated GDP growth of over 4% for 2014 (Eurostat 2013). However, Hishow (2012) concludes that the economic difficulties illustrate that the successful Baltic model of strengthened division of labour within the EU and the global economy, including the liberalisation of goods and capital and the competitive advantages of sectoral specialisation is extremely fragile in times of a crisis (p.375).

3.4 Passive Leverage of the EMU

The political benefits of a participation in the EMU are still similar to the ones mentioned before. Nevertheless, the significance of actions taken by the ECB influencing Latvia due to its fixed exchange rate to the euro, while it does not have a vote, might have strengthened the political benefit. To put it in a nutshell, Latvia already transferred parts of its sovereignty to the EMU without preserving the benefits of membership. Furthermore, beside the consolidation of the Latvian independency on the European level, the domestic consolidation of its independency may be intensified through further integration into the EMU.

Although the economic developments in the EMU are less attractive for Latvia, the country still wants to join the euro-zone. On the one hand, the adoption of the euro may accelerate Latvia's economic recovery from its severe economic crisis due to increasing investments and trade. On the other hand, by means of the conditionality of the Convergence Criteria, it might have been simpler for the Latvian government to introduce serious domestic reforms after the economic downfall. Finally, Estonia's accession to the EMU in 2011 increased Latvia's costs for staying outside the euro-zone, particularly because of Estonia's importance as a trading partner (Figure 2).

4. Methodological Framework

4.1 Case Selection

On 9th July 2013 the EU financial ministers decided within the Council of the European Union that Latvia fulfils the Convergence Criteria and thus is going to be the eighteenth state which adopts the euro as its currency. The accession to the EMU seems to illustrate the final step of integration Latvia always pursued. In the case of the Central and Eastern European Countries (CEECs), especially in the Baltic States, the transformation[18] process they had to deal with was immense. Being a former part of the Soviet Union, the Baltic States had to implement several reforms: the political change from a socialist dictatorship to a pluralistic and liberal democracy, an economic change from a centrally planned economy to a free market economy, a societal change from demobilised, patronised citizens to active members of a society with civil structures and democratic values and a process of statehood building with the establishment of institutions and processes (Kneuer 2012a, p.75). Therefore, the integration into Western institutions, like the EU and the NATO, served as the basis for the Baltic consolidation of statehood and independency. At first glance, aspiring membership into organisations in which the MS have to hand parts of their sovereignty to supranational structures seems to be irrational. However, the Baltic States perceived the avoidance and the annulment of the Soviet political, economic and societal system by the incorporation of the European democratic and successful economic model as the best method to guard their independency against the Soviet Union[19].

The Baltic process of European integration was determined by the economic integration of markets which took place in three stages (Kneuer 2012b, p.126). In the first stage, shortly after their declaration of independency in 1991, the Baltic States agreed with the ECs on trade and co-operation agreements next to financial support[20]. In the second stage of integration, a free trade agreement was established in 1994, preparing for the single European market. In 1995 Estonia, Latvia and Lithuania were already applying for the EU membership (ibid., p.127). In order to become a member of the European Union, the applicants have to fulfil certain requirements like the Copenhagen Criteria[21] and the adoption of legal characteristics

[18] Transformation is defined as the generic term for the transition from one type of system to another (Kneuer 2012a, p.76).
[19] After the collapse of the Soviet Union in 1991 the Baltic mistrust oriented towards Russia.
[20] The Baltic States were supported through the assistance programme TACIS (before 1992) and PHARE (Kneuer 2012b, p.121).
[21] The Copenhagen Criteria, established in June 1993, require:
"(1) that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;

of the 'acquis communautaire'. Thus, the Baltic States implemented several reforms, which improved their market situations as well, as an increase in trade and foreign direct investments indicated. Beside their focus on the main trading partners in the EU, the Baltic States strove towards the global market, e.g. by accessing the WTO in 1999. The third stage began in the course of the actual accession negotiations in which the candidates were monitored and controlled by the EU. An evaluation of the EC in 1997 emphasised for the first time the different pace of development between the Baltic States and their capabilities for EU accession. While the progress in Estonia was satisfying, Lithuania and Latvia received several suggestions for improvement (ibid., pp.122, 123). However, in 2004 the Baltic States, within a group of eight CEECs[22], joined the EU collectively.

Ever since attaining EU membership, the Baltic States aimed at completing integration through the adoption of the euro. Lithuania and Estonia already requested EMU accession in 2006, but the EC and the ECB evaluated that both countries were not meeting the Convergence Criteria (Hishow 2012, p.369). Nevertheless, due to economic improvements Estonia adopted the euro in 2011. On 1st January 2014 Latvia is going to follow, although its economy was highly affected by the global financial and economic crisis and although the Convergence Criteria did not prevent the occurrence of macroeconomic imbalances in the current EMU MS. Nevertheless, the passive leverage already illustrated the EMU benefits that are still attractive for Latvia. Henceforward, the active leverage of EMU as well as the diminishment of its effects after accession will be considered in the analysis.

4.2 Hypotheses

In the preamble of the Treaty on European Union (TEU) the governments of the MS

> "resolved to achieve the strengthening and the convergence of their economies and to establish an economic and monetary union including, in accordance with the provisions of this Treaty and of the Treaty on the Functioning of the European Union, a single and stable currency".

The aspired economic convergence was not achieved. Instead, macroeconomic imbalances arose, which are one of the main causes of the European debt crisis. The role of the Convergence Criteria is therefore significant, because they are the main condition for the accession to the euro-zone which should ensure a basic level of fiscal and economic

(2) the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forced within the Union;
(3) the ability to take on the obligations of membership (the acquis), including adherence to the aims of political, economic, and monetary union." (Vachudova 2005, p.121).

[22] Estonia, Latvia, Lithuania, Poland, Hungary, Czech Republic, Slovakia & Slovenia

convergence between members. Thus, the participation in the euro-zone can be considered as a club-good, i.e. there is almost no rivalry in the consumption, but the MS may be excluded according to the Convergence Criteria (Sell 2001, p.2). Despite the missing sustainability, the Convergence Criteria proved with reference to the actual situation in the euro-zone, those criteria were never changed since the establishment of the EMU and are still applicable. Regarding the theoretical framework of Europeanization, the first hypothesis of the thesis at hand is: <u>The Latvian fulfilment of the Convergence Criteria was influenced on the domestic and European level by the conditionality of accession. (1. Hypothesis)</u>

Therefore, Mario Draghi (2013) emphasised:

> "Sustainable convergence means more than meeting a set of nominal targets at a certain point in time. It requires real economic, legal and institutional convergence prior to adopting the euro. And crucially, it requires continued efforts once inside monetary union."

So once Latvia will be part of the EMU, the active leverage that the Convergence Criteria had on the Latvian policy will be diminished. Consequently, a stable domestic political environment is required to continue the austerity and reform policy of the last years and thereby the attained convergence. However, the second hypothesis assumes that: <u>The political system in Latvia is too instable to maintain the current economic and fiscal adjustment policy. (2. Hypothesis)</u>

In order to replace the leverage effects of the Convergence Criteria and the weak fiscal rules like the SGP, the euro-zone members agreed on several reforms. In this thesis, the Six-Pack, the Two-Pack and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) will be analysed in consideration of the following hypothesis: <u>The new instruments within the EMU are not able to co-ordinate the national economic and fiscal policies efficiently in order to obtain the convergence attained according to Convergence Criteria. (3. Hypothesis)</u>

4.3 Research Design

The research conducted is characterised by gathering and analysing primary sources, including the Treaties of the European Union, as well as secondary documents. The structure of the thesis is affected by the theoretical framework provided by Vachudova (2005). In the preliminary analysis the passive leverage of the EMU and the significance of fiscal and economic convergence are illustrated by the examination of European historic and present developments in which authors like Bache et al. (2011), Puetter (2009), the GCEE (2012) and

Brunetti (2011) provide significant overviews and evaluations. Further references provided during the analysis are taken from reports of European institutions, particularly the EC and the ECB, Latvian authors and political scientists like Auers and economic experts as the CEP. Moreover, throughout the thesis websites and online newspapers are used due to the topicality of EMU enlargement and the economic data. Besides, these media channels provide statistical data and public opinions, e.g. Eurostat and Eurobarometer. Overall, these sources have been summarised and reviewed in order to answer to the research question in a structured manner.

4.4 Operationalisation

The sustainability of convergence attained according to the Convergence Criteria does not only depend on the Criteria, but also on the domestic political situation and the instruments implemented on the EU and EMU level. Thus, the analysis focuses on these three aspects. Regarding the Convergence Criteria, the Latvian fulfilment of every criterion will be examined, considering the domestic level's as well as the European level's influence. The stability of the Latvian political situation mainly depends on its party system. Therefore, the analysis will focus on an examination of this component. Finally, the new instruments implemented will be evaluated regarding their impact and efficiency. The results gained will be summarised in a discussion followed by a conclusion relating to the research question.

5. Analysis

The imperative "Return to Europe" characterises the political focus of many CEESs after their independency. While this target was mainly achieved by EU membership, the accession to EMU still illustrates a final step of integration. Within the analysis, the active leverage of the EMU as well as the mechanisms occurring after euro accession will be pointed out in order to evaluate if the convergence attained according to the Convergence Criteria is sustainable.

The characteristics of the active leverage, which have been described in the theory part, can be identified in the negotiations between the EMU and Latvia as well. First of all, the accession to the EMU is more economic and politically beneficial for Latvia, than for the EMU. Thus, the asymmetric interdependence between both parties leads to a more powerful basis for the EMU within negotiations. Considering this fact, the EMU is able to determine the access conditions in form of Convergence Criteria, which are voluntarily enforced in Latvia while contractually no timeframe is statutory. However, since Latvia seemed to be able to access the euro its situation was monitored and controlled, predominantly by the EC and ECB, in order to ensure economic and fiscal convergence to all euro members.

5.1 Fulfilment of the Convergence Criteria in Latvia

Since the establishment of the EMU, the Convergence Criteria are the requirements for euro adoption. On 5th March 2013 the Latvian government evaluated the national economy as able to fulfil the requirements of the monetary criteria of price stability, exchange rate stability, and sustainable long-term interest rates, in addition to the fiscal criterion of the avoidance of public deficits. Thus, an assessment conducted by the ECB and the EC was requested (European Commission 2013a, p.2).

5.1.1 Price Stability

The first criterion is in line with the major EMU goal of price stability. In order to prove that the national price development is sustainable, it is not allowed to exceed the price stability of the three best performing MS by more than 1.5 percentage points in a time period of one year. Here, inflation is measured by HICP inflation. Bünning (1997) emphasises that this criterion illustrates the economic perception that competitiveness of one country depends on the development of its prices (p.63). In case that national inflation of one state remains higher than that of its trading partners its competitiveness will decrease. Within a monetary union, the caused trade deficit cannot be balanced through exchange rate adjustments. Thus, countries joining the euro should have similar inflation rates.

The HICP inflation reference value determined by the EC for April 2013 was 2.7% with Sweden, Latvia and Ireland as the three best-performing Member States plus 1.5 percentage points (European Commission 2013a, p.3). With an average inflation rate of 1.3% Latvia was well below this value, despite the crisis that hit Latvia in 2008 and increased its HICP inflation temporarily to 15.3% (ibid,. p.6). However, the Latvian response to this demanding time in form of “significant nominal wage adjustments and a correction in import prices […]” reduced inflation and increased competitiveness (ibid.). Moreover, the constant economic amelioration was accompanied by a great export recovery (Figure 3).

However, the average HICP inflation from April 2012 to April 2013 was influenced as well by temporary means, i.e. “[…] a continuing wage restraint in the Latvian economy, a decreasing contribution from food and energy prices and the cut of the standard VAT rate by 1 percentage point as of July 2012” to 21% (ibid., p.26). In fact, the European Commission (2013a) estimates that only the VAT reduction caused a decrease of inflation about 0.5 percentage points (p.30).

Regarding the price stability criterion from the European level, it becomes evident that it does not only refer to euro-zone participants but also to EU members in terms of the reference value emerging from the three best performing countries. Therefore, Sweden, having nominal exchange rate flexibility, is influencing the accession conditions. However, it is also possible to exclude countries from the calculations. In the Latvian Convergence Report the EC (2013a) decided to exclude Greece[23] from the three best-performing countries in order to preserve the "[…] fairness of the criterion", due to the fact that "[…] its inflation rate and profile deviate by a wide margin from the euro average, mainly reflecting the severe adjustment needs and exceptional situation of Greek economy […]" (p.4).

Summing up, the Latvian government is able to temporarily affect the price stability to some extent. For instance, while the announced liberalisation of the retail electricity market in early 2014 may cause higher inflation, the reduction of VAT lowered it. With reference to medium-term inflationary developments, Latvia has to pay attention to the fact that it is a small and open economy that is notably influenced by the developments of global commodity prices. The experiences during the cyclical boom illustrated that it may be a difficult political task "[…] to control domestic price pressures and avoid renewed economic exuberance" (European Central Bank 2013a, p.35). Moreover, the gap between Latvia and the euro-zone regarding GDP per capita and price levels is still present. Particularly, the Balassa-Samuelson-model, explained through Enderlein (2004, pp.32, 33), indicates that a rise in inflation is likely to occur in the case of a fast growing economy like Latvia entering EMU. Due to its focus on tradable goods in the export sector, wages within this area are increasing as reason of greater growth in productivity. In contrast, non-tradable goods, especially services in the domestic sector, do not experience such a raise in productivity. Nevertheless, if the gap between both sectors becomes too large, a natural wage increase in the domestic sector develops in order to prevent a loss of workforces to the export sector. Due to the fact that the increase in wages is not in line with an increase in productivity, the prices for goods in the domestic sector will increase – inflation will occur. Overall, the ECB (2013a) emphasises that "[…] in the context of the process of economic convergence, it cannot be ruled out that significant demand pressures may emerge again" (p.35), especially considering the missing exchange rate flexibility.

[23] The average HICP for the last twelfth months in Greece was 0.4% compared to an average HICP for the euro-zone of 2.2% (European Commission 2013a, p.4).

5.1.2 Exchange Rate Stability

The exchange rate criterion requires the applicants to the EMU to participate in the ERMII in which their exchange rates can fluctuate in a margin of ±15%. In order to fulfil the criterion, the national exchange rates further have to attend the ERMII without serve tensions, in particular without devaluating the "currency's bilateral central rate against the euro on its own initiative" (Protocol No. 13 Art.3) for a period of two years. For the Baltic States an exchange rate commitment was significant after gaining independence in order to set the appropriate prices after their transformation to a market economy and due to their great economic openness[24] (Hishow 2012, pp.363, 364).

Since 2nd May 2005 the Latvian Lat (LVL) is participating in the ERMII. In contrast to other countries, the Latvian authorities committed the LVL to a fluctuation restriction with a margin of ±1% in order to place "[…] no additional obligations on the ECB." (European Central Bank 2013a, p.36). Since ERMII accession, Latvia remained within the fluctuation band while never actively devaluating the LVL (Figure 5), although it needed interactions of *Latvijas Banka*[25] on the foreign exchange market. Thus, it fulfilled this Convergence Criterion.

The severe financial and economic crisis from 2008 to 2010 challenged Latvian politicians not to ameliorate the domestic economic position through an abandonment of the exchange rate mechanism in order to devaluate the LVL against the euro and thus prevent the immense cuts in public spending. However, the Latvian government used the commitment to the currency peg for necessary structural reforms, e.g. regarding the balance of payments and investments, emphasising its ability to participate in the EMU.

Nevertheless, the Latvian central bank possessed too slender financial means[26] to defend the currency peg and thus the value of the LVL without requesting financial support from IMF and the EU. Due to the conditionality of the financial assistance programme and the efficient reform implementation, Latvia quickly regained competitiveness. However, the ECB (2013a) adds that "[…] further measures to increase productivity and support the supply of skilled labour will be needed to ensure that the gains […] are sustained." (p.48).

[24] "[…]the ratio of foreign trade in goods and services to GDP increased markedly from 41.9% of GDP in 2003 to 60.5% in 2012 for exports, and from 54.6% of GDP in 2003 to 63.5% in 2012 for imports."(European Central Bank 2013a, pp.47, 48).

[25] Latvijas Banka is the Latvian central bank.

[26] The Latvian central bank had to use already around 20% of its reserves in December 2008 after capital outflows in the banking system occurred (Lewis 2010, p.17).

5.1.3 Long-Term Interest Rates

For an entry to the euro-zone the applying states further need to have a sustainable long-term interest rate. Therefore, the domestic long-term interest rate is not allowed to exceed the average of the three best performing MS, in terms of price stability, by more than two percentage points during the year before the examination (Protocol No.13 Art.4). Securities like long-term state bonds serve as the basis for the calculation of the long-term interest rate. From May 2012 to April 2013 the harmonised long-term interest rates of Sweden (1.6%), Latvia (3.8%) and Ireland (5.1%) led to an average rate of 3.5% plus 2 percentage points resulting into a reference value of 5.5% (European Commission 2013a, p.22). Apparently, Latvia's interest rates for government bonds close "but below 10 years" (ibid., p.34) didn't exceed this value and fulfilled the criterion.

The development of Latvian long-term interest rates reflects national economic improvements and deteriorations (Figure 6). While from 2003 to mid-2006 the long-term interest rates declined from 5% to below 4% due to the economic amelioration, from mid-2006 onwards the rates were increasing due to the economic overheating resulting into a banking, debt and macroeconomic crisis (European Central Bank 2013a, p.48). Although, or rather because of the financial assistance programme, the financial markets additionally downgraded Latvia's government bonds. Its long-term interest rates reached the peak in the beginning of 2010 with around 14% (ibid., p.49). However, afterwards the "[…] macroeconomic conditions stabilised and the Latvian government intensified its efforts to comply with the policy conditionality of the financial assistance programme" (ibid., p.49), which caused a reduction of long-term interest rates.

Overall, the described criterion should emphasise the long-term monetary convergence of the participants in the euro-zone. However, the long-term interest rates mainly depend on current economic developments. Thus, an improvement in the government budget position and other macroeconomic conditions in the second half of 2012 led to amelioration of Latvia's global financial market conditions (ibid., p.36). Moreover, the reference value of the criterion is not based on the EU members with AAA long-term government bonds but on those with the lowest inflation rate in order to promote the correlation between the monetary criteria of inflation rate, exchange rate and long-term interest rate. Particularly, the Irish long-term interest was excluded in the EC's Convergence Report 2012 due to the Irish average rate of 9.1% which was caused by the participation in a financial assistance programme (European Commission 2013a, p.22). Currently, Ireland is included again. As a last point, the economist

Bünning (1997) emphasises that although the criterion is mainly an adequate indicator for sustainable inflation development and exchange rate stability, it may be influenced by the market expectation that the euro applicant is going to transfer its monetary policy to the ECB (pp.143, 144).. Accordingly, the national long-term interest rate would not only indicate the economic expectations for the applying state, but for the euro-zone as well, the more imminent the accession to the euro is (ibid.).

5.1.4 Public Deficits

The grant of stability in a monetary union notably depends on the budgetary position of the MS. Article 140(1) TFEU defines that a nation, which is not running an excessive deficit but has a sustainable budget position (Art.126 TFEU) fulfils the Convergence Criterion. However, within Article 126 TFEU no explicit reference values for a sustainable budget were determined. Therefore, the MS agreed to a proposal made by German minister of finance Theo Waigel, who emphasised the necessity of a specification of fiscal discipline in an institutional arrangement. Included in the negotiations about the Treaty of Amsterdam in 1997 the SGP was adopted in Protocol No. 12 (Puetter 2009, p.81). It is based on the decision of the Council of the European Union and the Council of Economic and Finance Ministers (EcoFin) and thus can be altered (ibid., p.119). However, the reference values for a sustainable budget were not changed since the SGP came into force: the planned or actual deficit of an applicant is not allowed to exceed 3% of the gross national product at market prices while the government debt has to be below 60% of the gross domestic product at market prices (Protocol No.12 Art.1). Within the reference year 2012, Latvia’s actual deficit was 1.2% of GDP, while its gross debt-to-GDP ratio was 40.7% (European Central Bank 2013a, p.43). Consequently, Latvia fulfilled the criterion.

Latvia is a relatively young independent country which held a small amount of government debts up to the crisis in 2008. However, the Latvian budget deficit increased about cumulatively 27.1 percentage points from 2003 to 2012 (ibid., p.44), mainly due to immense cyclical effects on Latvian budget position. This development indicates that prior to the crisis public revenues and expenses were not utilised in a sustainable manner. The political campaign of Latvia’s First Party – Latvia’s Way party alliance in 2006 with the slogan “Let’s put the [economic] pedal to the metal” (Auers 2012a, p.17) seems to approve this assumption. However, non-cyclical effects “[…] which are often taken to reflect structural or permanent adjustments to fiscal policies” (European Central Bank 2013a, p.13) contributed to the debt increase as well (Figure 8).

In July 2009, the Council agreed that an excessive deficit occurred in Latvia due to a deficit-to-GDP rose from 4.2% in 2008 to 9.8% in 2009 (European Commission 2013a, p.31). Latvia received recommendations for advancement under the excessive debt procedure (EDP)[27] which included a deadline in 2012. In line with the obligations of the financial assistance programme, Latvia implemented several reforms affecting tax rates, public wages and social benefits (ibid.). Due to the attained fiscal improvements and positive forecasts the Commission emphasised that Latvia is not under an EDP anymore and, therefore, can be examined for euro adoption corresponding to Protocol No. 13 Art.2.

Nevertheless, the EC (2013a) suspects that in the following years the Latvian budget situation could be stressed through further tax reductions, concessions in the pension system and "[…] publicly owned companies, of which some are in on-going restructuring processes" (p.32)[28]. On the other hand, efficiency gains regarding the tax system or reforms in the pension system might diminish those risks.

5.2 Domestic Environment

> "In particular, as experience has shown, the sustainability and robustness of the convergence process after euro adoption is to a significant extent endogenous, i.e. it depends on a Member State's domestic policy orientations after it has joined the euro area." (European Commission 2013a, p.43)

Examining the statement of the EC from a theoretical point of view, the conditionality emerging from the asymmetric relationship between the EMU and the applicant is not existent anymore after accession. The power rather allocates equally. From now on, Latvia, in particular its government and parliament, is obliged to further grant the convergence process confirmed by the fulfilment of Convergence Criteria. The Latvian Parliament, named Saeima, represents the legislative power as a unicameral system which is elected every four years with the proportional representation of hundred members. Despite its legislative duty, the executive informally dominates the process (Delna 2011, p.33). The executive consists of the Cabinet of Ministers with its administrative support through the State Chancellery.

It seems to be the heritage of the Soviet Union that most Latvians mistrust the actors of the Latvian political system[29]. Especially, Latvian parties, as the basis of the democratic system,

---

[27] The Protocol No. 12 (the SGP) refers to Article 126 TFEU which incorporates all countries, which signed the treaty.

[28] Several companies in the field of energy, rail transportation, telecommunications and the national airline are still owned by the Latvian state (European Central Bank 2013a, p.44).

[29] 88% of Latvians distrust the government, 92% of Latvians distrust the Saeima and 95% of Latvians distrust political parties (TNS Political & Social 2009, p.5).

are perceived with suspicion. Similar public attitudes in other CEESs caused that most of their party systems "[…] have usually been marked by weak institutionalization, a lack of party autonomy, a relatively high degree of fragmentation and persistent electoral instability – all problems which have inhibited the emergence of party identity" (Lewis, 2000:150-5 in Pridham 2007, p.567).

The Soviet rule in Latvia harshly reduced the number of civil actors which could serve nowadays as a basis and infrastructure for parties (ibid., p.568). The weak institutionalisation is underlined by only 9% of Latvians participating in the realm of civil society in 2009 (UNDP 2009, S.19,29 in Lindén 2012, p.249). In addition, the lack of interest in Latvian political parties is strengthened by the perception of a relatively high degree of corruption within these institutions. Overall, Latvia ranked place 59 out of 178 countries in the Corruption Perception Index 2010 (Delna 2011, p.23). Political parties were evaluated from 68% of Latvian respondents as corrupt, while 56% felt similar regarding the parliament/legislature (Transparency International 2013). Moreover, the mistrust into the political system is aggravated through the close ties between politics and economy established by oligarchs[30]. In fact, the contrasts of corruption against non-corruption and oligarch against non-oligarch are the weak cleavages in Latvian society. The most fundamental cleavage occurs between ethnic Latvians and the Russian-speaking population (Delna 2011, p.21) (Figure 10). In consideration of these societal topics, the political parties have few ideological characteristics. Thus, political figures are of importance. An example is the 'Zatlers' reform party' which was founded in July 2011 and got 20.8% of votes in the elections in September 2011. The success of Valdis Zatlers, the former president of Latvia, emphasises the weak party autonomy as well as the unstable voter support for certain parties. The fragmentation of parties is illustrated through their steady foundation, resolution and combination. Overall, officially 60 parties or their unions existed in Latvia in August 2011 (Delna 2011, p.142).

The actual economic advancement of Latvia is connected with its Prime Minister Valdis Dombrovskis. Facing the financial and economic crisis, the former Prime Minister Ivars Godmanis resigned in 2010 and President Zatlers assigned Dombrovskis to build up a new government. Through the elections in 2010 and 2011[31] Latvians confirmed Dombrovskis as a

[30] Oligarchs are in Latvia "an integral part of the political system in that they combined holding political office with their business interests." (Auers 2012b, p.2). The most known ones are Aivars Lembergs, Andris Skele and Ainars Slesers (ibid.).

[31] The Saeima, which was elected in 2010, had to dissolve due to the request of the President and a positive referendum "[…] after the legislature had voted against removing the parliamentary immunity of a powerful deputy, Ainars Šlesers, under investigation by Latvia's anti-corruption police for money laundering and

Prime Minister and therewith his austerity policy. In fact, he is one of the most popular Latvian politicians, "[…] seen as an honest, hard-working and dedicated politician – something that cannot be said about many of his party members." (Hõbemägi 2013). Hõbemägi (2013) even indicates that Dombrovskis is of great significance for the continuation of the actual policy. In case that the actual Prime Minister would leave Latvian politics, e.g. for a position in the EU, the result of the next Saeima elections in October 2014 will be rather uncertain, especially because the Unity party is not as popular as its leading candidate Dombrovskis.

The Latvian experience with the euro adoption will have further impacts on the next parliament election. Although 66.97% of Latvians voted for the entry to the EU, and thus for an adoption of the euro, in a referendum 2003, nowadays 67% of the citizens believe that Latvia can choose if it wants to adopt the euro or not (The Central Election Commission of Latvia 2013, TNS Political & Social 2013, p.17). Therefore, the actual government will have to take responsibility if the euro adoption will not proceed smoothly. Overall, the euro-zone accession is rather unpopular amongst citizens: 75% of Latvian respondents are certain that due to the euro adoption Latvia will lose parts of its identity (ibid., p.10).

5.3 New Instruments

Since the outset of the European debt crisis, the EU and its MS tried to resolve the causes and consequences with several political measures. The inefficient construction of the EMU and its instruments should have been corrected by focusing on macroeconomic balance and sustainable fiscal budgets, enforced in all MS, as well as prospective ones. However, the major reforms implemented, namely the Six-Pack, the Euro-Plus Pact, the Fiscal Pact and the Two-Pack do not change the EU's primary law but rather secondary legislation and international law. The Euro-Plus Pact thereby is the only agreement which is based on intergovernmental co-operation and thus holding no binding commitments. Characterised as a "gentlemen's agreement", the Euro-Plus-Pact will not be part of further analysis (Obwexer 2012, p.229).

5.3.1 The Six-Pack

The reforms identified as the most significant were the ones concerning the SGP with its formerly loose fiscal co-ordination and surveillance. The Six-Pack reform, pertaining to the

---

bribery."(Auers 2012a, p.19). In 2011 five parties got seats in the Saeima: Harmony Centre, Zatlers' Reform Party, Unity, "All For Latvia!" - "For Fatherland and Freedom/LNNK and Union of Greens and Farmers.

SGP, consists of six different regulations and directives strengthening the preventive and corrective arm of the SPG as well as the macroeconomic surveillance of MS, co-ordinated within the European Semester. It was implemented in November 2011.

The preventive arm[32] "[…] aims to ensure sound budgetary policies over the medium term by setting parameters for Member States' fiscal planning and policies during normal economic times." (European Commission 2013d). The European institutions thereby take the overall value of 3% deficit-to-GDP as a reference value. Besides, the 60% gross debt-to-GDP ratio was for the first time included as a reference into the preventive arm. In order to supervise the compliance of the national budgets with their medium-term budgetary objectives, euro participants have to provide Stability Reports, while other EU states transmit Convergence Reports to the EC. The preventive arm was further strengthened by the fact that sanctions, mainly in forms of interest-bearing deposits, can be applied now. Moreover, the deficit criteria are complemented by discretionary revenue measures which determine that states with an excessive deficit utilise unexpected greater national revenues to fulfil their fiscal requirements (Kullas 2011, p.1). Nevertheless, the impact of the reforms is contested due to a lack of sanctions applied automatically. Already on the second stage of the deficit process the Council has to resolve a modification of the Stability or Convergence Reports with qualified majority. Moreover, EC recommendations for sanctions can be declined by a simple majority of the Council members (ibid., p.12).

The corrective arm[33], designed as an instrument for the exceptional case that MS exceed the fiscal reference values, opens the EDP which can be complemented by sanctions. However, while 95 breaches of the reference values were counted in the last years, sanctions have never been applied (ibid. p.14). In fact, the actual reforms that emphasise the significance of national debt levels and the possibility to apply sanctions already in earlier stages of the EDP do not alter the principle that sinners judge over sinners (GCEE 2012, p.122). Effectively, the next stages in the EDP can just be reached through a qualified majority in the Council. An automating of sanctions in case of excessive deficits could only be attained by a change of EU primary law.

Additionally, the reforms introduced a macroeconomic surveillance[34] consisting of a preventive and corrective arm, as well. Firstly, the supervision and identification of

[32] Reform of Regulation (EG) Nr. 1466/97 through Regulations (EU) Nr. 1175/2011 and (EU) Nr. 1173/2011.
[33] Reform of Regulation (EG) Nr.1467/97 through Regulations (EU) Nr.1177/2011 and (EU) Nr. 1173/2011.
[34] Regulations (EU) Nr. 1176/2011 and (EU) Nr.1174/2011.

macroeconomic imbalances occurs within the Alert Mechanism Report of the EC in which a scoreboard of macroeconomic indicators is utilised. Secondly, the detection of a macroeconomic imbalance can cause a macroeconomic imbalance procedure (MIP) with possible EC recommendations and sanctions. Overall, the macroeconomic surveillance is contested, because it is difficult to detect macroeconomic imbalances on the basis of current data (Kullas 2011, p.29). Moreover, regarding EC recommendations during the MIP, it is disputable if the political will to implement these is sufficient in case they refer to high-politic areas, e.g. national taxes (ibid.). Finally, an automating of sanctions is still not applied, therefore, the Council is able to prevent them in the first stage of MIP due to the necessity of qualified majority.

The last renewal of the Six-Pack involves the European Semester which further aims to strengthen the economic and fiscal co-ordination on a yearly basis while referring to the Europe2020 strategy goals[35]. It determines that the EC's Annual Growth Survey is published in the beginning of the year so that the recommendations can be inserted in the following Stability and Convergence Reports of EU members. This holistic approach is expanded by the two-pack reforms.

5.3.2 The Two-Pack

The Two-Pack, implemented in May 2013, includes two regulations which complement the Six-Pack. The EU regulation Nr. 473/2013 strengthens the holistic approach of the European Semester by determining the publication of national euro budgets up to the 15th October of the preceding year. Subsequently, the EC will provide its opinion and comment on the overall budgetary situation in the euro-zone and its prospects. On the basis of this regulation, the EC can identify more easily if the euro-zone members include the values of the SGP into their policies. Furthermore, the regulation determines that euro states have to adopt middle-term budgetary objectives into their national law (Kullas and Hohmann 2012, p.2). However, this goes beyond the EU competences of Article 136 TFEU.

[35] The Europe 2020 strategy defined five headline targets for the year 2020:
"-75% of the population aged 20-64 should be employed.
-3% of the EU's GDP should be invested in R&D.
-The "20/20/20" climate/energy targets should be met (including an increase to 30% of emissions reduction if the conditions are right).
-The share of early school leavers should be under 10% and at least 40% of the younger generation should have a tertiary degree.
-20 million less people should be at risk of poverty." (European Commission 2010a, p.5)

The second regulation of the Two-Pack, EU regulation Nr. 473/2013, monitors the euro-participants in an EDP more closely. In fact, the regulation requires the euro states under an EDP to submit information about their economic development frequently. The supervision through the EC is extended through EC recommendations in case the aspired deficit reduction is at risk. However, this stricter surveillance only makes sense if sanctions in the EDP will finally be applied.

5.3.3 The Treaty on Stability, Coordination and Governance

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which came into force on 1st January 2013, consists of three parts: Title III TSCG about the fiscal policies (Fiscal Pact), Title IV TSCG about the politico-economic co-ordination and Title V TSCG about the politico-economic regulation of the euro-zone. The international treaty refers to EU members except for the Czech Republic and the United Kingdom. Thus, it is only applicable as long as it is in line with the EU treaties. Corresponding to Article 16 TSCG its content should be converted into EU law within five years. However, for this alternation, the agreement of all EU members is necessary.

Within the Fiscal Pact the contracting partners determined the following: to accept the recommendations of the EC regarding sanctions in the EDP[36], to implement a limit regarding the structural deficit into national law and to correct the exceedance of this structural limit automatically, thus implementing a debt bark. Article 3(1) TSCG provides the reference values for the MS. The yearly structural deficit should be limited to 0.5% of GDP, but this limitation is released to 1% of GDP a year if the gross debt-to-GDP ratio is "significantly below 60%" (Art.3 (1) TSCG). The states which signed the treaty are obliged to implement the debt bark within one year.

In Latvia, the Saeima agreed on the Fiscal Discipline Law (FDL) in January 2013, which includes a reference value of 0.5% of GDP for the structural deficit and an independent Fiscal Council, which is going to monitor the debt bark from 1st January 2014 (European Commission 2013a, p.84). Although Latvia is currently not part of the euro-zone, it was advantageous to sign the TSCG in order to be allowed to approach the ESM during severe economic and fiscal times (GCEE 2012, p.129), and to underline its commitment to the EMU. So while the reform apparently caused an alternation in Latvia, Kullas, Sauer and Hohmann (2012) criticise that an effective implementation and enforcement still depends on the national

[36] Except for the case the Council votes against the recommendation with a qualified majority.

political will (p.3). Assuming that the participating states do not adopt the agreement, a complaint in front of the Court of Justice of the European Union is contractually intended. However, Article 126(10) TFEU basically excludes a complaint in front of the Court due to a breach of contract (ibid., p.4). Furthermore, the contracting parties are not allowed to monitor and intervene, if the national states do not respect their implemented debt barks. In that case, fines on the European level are not legal. Another part of the Fiscal Pact, which is not in line with EU primary law, is the agreement that the MS within the Council just accept the EC's recommendations for sanctions in an EDP. Particularly, the EU primary law of Article 126(13) TFEU in conjunction with Article 16(3) TEU provides another modus operandi (ibid.).

Moreover, the states want to strengthen their politico-economic co-ordination regarding the goals of "[…] fostering competitiveness, promoting employment, contributing further to the sustainability of public finances and reinforcing financial stability." (Art.9 TSCG). Therefore, the participants agreed to discuss all major national economic reforms to be able to co-ordinate them more efficiently. Moreover, the states are obliged to discuss their "debt issuance plans" with the Council and the EC (Art.6 TSCG). The intensified co-ordination is mostly evaluated as advantageous, though Kullas, Sauer and Hohmann (2012) calculate that some MS could try to diminish reforms in other countries to their benefits. Besides, the authors regard the publications of debt issuance plans as not necessary and a further step towards Eurobonds (pp.3, 4). Finally, the politico-economic regulation within the euro-zone should be improved by Article 12 TSCG which determines that the heads of states and governments meet at least twice a year to examine the governance of the euro-area.

6. Discussion

6.1 Reflection: Fulfilment of the Convergence Criteria

As Bünning (1997) describes from an economic point of view convergence can be classified into nominal, real and politico-economic convergence (p.34). Due to their composition, the Convergence Criteria are emphasising the nominal convergence a member state should fulfil. The real convergence, in form of, e.g. similar national GDPs per capita and unemployment rates, is tried to be attained with the help of instruments emphasising macroeconomic surveillance and common objectives like the ones in the Europe 2020 strategy. Finally, the politico-economic convergence is demonstrated through similar expectations and preferences about meaning and organisation of economic institutions, which led in the case of the EU to EMU establishment (ibid.). However, the controversy about the necessity of a political union influenced the structure of the EMU as well as the current reforms implemented during the crisis. Overall, the only convergence which is contractually compulsory is the nominal convergence and it becomes significant regarding the deficient real and politico-economic convergence.

Nevertheless it has to be regarded that the conditionality of the accession process is noticeable in the point of time Latvia chose for the evaluation of convergence attained according to the Convergence Criteria. During the crisis, Latvia implemented severe austerity measures in line with the obligations of the IMF and the EU rescue programme. The Latvian population accepted public budget reductions and measures like the increase in taxes, which enabled the country to retrieve economic growth already in 2010 and refund the rescue means of the IMF ahead of schedule. Currently, Latvia holds the reputation as "[…] the poster child of austerity" (Auers 2013a, p.3). Particularly regarding Greece, it is considered as a role model[37]. Latvian politicians perceived 2013 as the appropriate political momentum for euro adoption, because the Latvian development strengthened its commitment to the EMU.

Focusing on the Convergence Criteria, the analysis illustrates that Latvia partly influenced the fulfilment of the criteria through temporary measures. Nevertheless, the European level contributed to the Latvian applicability to some extent as well. The inflation in Latvia, which exceeded the reference value in 2012, was mainly reduced through strict public austerity and specific temporary measures like the reduction of VAT rate about 1%. Considering the Convergence Reports, the EC and the ECB excluded the Greek average inflation rate of 0.4% from their calculation of the reference value, thus reducing it around 0.1 percentage points. Nevertheless, Latvia would still have met the criterion. Examining the exchange rate criterion, it has to be emphasised that Latvia did not abandon the strict exchange rate mechanism in favour of devaluation, because of its commitment to join the euro-zone. The EU supported this strategy with the allocation of financial means. Through the conditions combined with the rescue fund, the EU even received a greater leverage on the Latvian development. The financial assistance programme further enabled Latvia to finance its budget up to the point where its competitiveness was consolidated and long-term interest rates were decreasing again. The Latvian and European commitment to introduce the euro may have strengthened the trust of the financial market into Latvian long-term interest rates as well. Finally, the low

[37] http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/im-gespraech-valdis-dombrovskis-austritt-waere-fuer-griechen-keine-loesung-11558671.html

public debt mainly illustrates the young age of independent Latvia, although its abrupt increase during the crisis indicates a previous inappropriate usage of public spending.

Overall, the first hypothesis can be approved regarding the temporary domestic and European impact on the compliance with economic and fiscal convergence. Besides, the accession conditionality mainly affects the point in time an applicant is choosing for euro adoption. While prior to the crisis, Latvia was challenged through the fulfilment of the real exchange rate and inflation criteria and afterwards the fiscal and interest rate criteria caused difficulties (Lewis 2010, p.2), the Latvian case underlines the significance of reforms and their potential success.

6.2 Reflection: Domestic Environment

The majority of Latvians (55%) is against the introduction of the euro (TNS Political & Social 2013, p.65). Although this development is regarded carefully, the euro adoption is not endangered. The EU and the euro project are regulated by political elites within a top-down relationship between politicians and citizens. Due to Latvian's low trust into parties, the legislature and the executive, the popularity of certain politicians is significant. Currently, Prime Minister Dombrovskis is respected, although he represents the severe austerity measures implemented. However, within the next Saeima elections in October 2014, political scientists like Auers (2013a) expect Dombrovskis to leave Latvian politics for an appointment in the EU (p.3). In that case, the recent policy direction may by challenged by "[…] old fractured, frail and quarrelsome parties, politicians and oligarchs" which are still existent (ibid.). It should be noted that the party system in Latvia is characterised as a "structural disequilibrium" (Krupavičius 2012, p.229), in which an election is shaped by the intense competition between parties and an alternating party offer. The structural consolidation will come to an end if a stable number of parties and a stable party offer have developed, but it is disputable if this will occur within the next year regarding the little public trust in these institutions (ibid.).

Furthermore, the low public trust in politics could have been further increased by the severe economic and financial Latvian crisis and the continuing austerity measures. Although Delna[38] does not possess concrete information about an increase of corruption, it seems to be comprehensible. Particularly, due to facts like a Gini coefficient of 3.7 as the highest in the EU and the 18.4% drop of GDP in 2009, "[…] the relative gain from corruption has increased

[38] Delna represents Transparency International in Latvia.

both for public officials with their reduced salaries and individuals for whom the regulatory burden imposed by the state has become harder to bear." (Delna 2011, pp.22, 25).

All in all, the second hypothesis that the political system in Latvia is too instable to maintain the actual economic and fiscal adjustment is partly confirmed. Nevertheless, is has to be considered that "Latvia has no major Eurosceptic parties" (Auers 2012b, p.8) and a major part of the political development depends on respected politicians like Dombrovskis. Currently, Latvia's political system is stable, but the upcoming incidents in 2014 will definitely be able to alter this.

6.3 Reflection: New Instruments

The Six-Pack, the Two-Pack, as well as the TSCG do not alter the primary EU law[39]. For an amendment all EU members, including their parliaments or their citizens in form of a referendum, would have to confirm the legitimacy of alteration. This process, pointing to a political union, is an interminable process that was not achieved in the three years of euro crisis, which is characterised by quick developments and financial market expectations of an immediate response.

Contractually, the most significant instruments agreed on during these years, which include measures to strengthen national implementation and compliance, partly contradict the EU primary law. Especially, the aspired strengthening of the SGP through the Six-Pack and the Fiscal Pact is not possible as long as the primary law is not changed. Thus, the implementation of a national debt bark, included in the Fiscal Pact, can be evaluated as the most considerable agreement. The GCEE (2012) confirms that, in general, debt barks have positive effects on national fiscal budget (p.134). However, previously, debt barks were implemented voluntarily, including a national political will to not exceed the set limits (ibid.). It is disputable if debt barks, implemented due to the Fiscal Pact, will have the same efficiency. Overall, the reforms referring to sound fiscal positions contain expandable approaches, but they try to rather diminish the symptoms than the causes of the crisis (Kullas, Sauer, and Hohmann 2012, p.3). In contrast, the instruments referring to greater macroeconomic surveillance and economic co-ordination are more compatible with the primary law and thus easier to realise. Especially, the European Semester is evaluated as efficient and transparent. Nevertheless, these instruments are mostly not associated with

[39] However, these reforms refer to the EU primary law, especially Art.121 TFEU, Art.126 TFEU and Art.136 TFEU.

sanctions and have to be partly assessed on the national level. Hence, the political will of the MS is still most significant.

All in all, the instruments implemented are pointing towards a political union, but without an amendment in the primary law they are, overall, not able to replace the leverage effect existent during the accession process. The EU is still perceived as an image of "procrastination, indecision and a failure to grasp the extent of the problems to be resolved." (Begg 2013, p.50). Furthermore, the reforms mostly reduce the transparency of the European processes and increase the administrative tasks of the MS. Thus, the hypothesis that the new instruments within the EMU are further not able to generate and obtain economic and fiscal convergence can be confirmed.

6.4 Reflection: Europeanization

Europeanization identified as an exchange between two levels and units of analysis, in particularly between the EMU and Latvia, is inherent in the different stages of application up to the euro adoption. However, the accession period is dominated by the passive leverage of the EMU, strengthened by its active leverage. Thus, the fulfilment of the Convergence Criteria is caused by the conditionality of euro accession. While this effect diminishes after entering the EMU, the domestic political system has the main responsibility to sustain the economic and financial convergence. However, the Latvian compliance should have been guaranteed and monitored through instruments on the European level, as well. Regarding the current crisis, the EU members tried to enhance the minor leverage of the European instruments, like the SGP, through several reforms. All in all, the Europeanization process defined by MS like Latvia which "anticipate and ameliorate the effects of top-down Europeanization pressures by 'uploading' their preferences to the EU [EMU] level" occurs only after the accession to the euro-zone and after the establishment of an equal relationship between the units of analysis (Bomber and Peterson 2000, Börzel (2000) in Bache, George, and Bulmer 2011, p.60). To sum up, the theoretical framework of Europeanization serves as an appropriate basis for the examination of the research question. Nevertheless, it may be the case that not all parts of the leverage, especially of the passive leverage, were identified during the (pre)analysis. Moreover, the possibilities allowing the EMU and EU to have leverage on the MS were reduced to an analysis of the newly implemented reforms, due to their significance for the current EMU and their illustration of co-operation between the members.

7. Conclusion

Referring to sustainable development, sustainability is defined as a "development that meets the needs of the present without compromising the ability of future generations to meet their own needs" (Europe Direct 2013). The nominal convergence attained according to the Convergence Criteria entails a similar intention. On the one hand, the convergence gained is perceived as the requirement for a functioning EMU, while on the other hand, this convergence should persist. However, the euro-zone MS agreed on specific time horizons for the Convergence Criteria, because economic conditions are altering steadily. In fact, the criterion of price stability is evaluated on a yearly basis, and can thus be temporarily influenced. Furthermore, economic characteristics, like the Balassa-Samuelson effect, indicate an increase of inflation in Latvia due to euro adoption. The exchange rate criterion, which will be absent after the accession, illustrates Latvia's commitment to the EMU by aligning the national monetary policy to the one of the ECB for at least two years. The long-term interest rates and public deficits criteria are monitored over a one year period. While the interest rates reflect the positive financial market expectations due to the amelioration of the Latvian economic situation, the reduction of the public deficit and debt indicate the severe economic and fiscal adjustment Latvia had to endure after its inefficient exposure to its economic boom. So, while the Convergence Criteria have to some extent a backward-looking perspective, but most notably a present focus and a weak sustainability, "[s]trong governance and sound institutions are also essential to supporting sustainable output growth over the medium to long term." (European Central Bank 2013a, p.8). However, the analysis emphasises that the stability of the Latvian political system, which determines the economic and fiscal adjustment policy, is uncertain regarding the Saeima election in 2014 and the potential turnaround of the population favouring increasing public revenues after the severe austerity measures and the successful economic consolidation. Auers (2013) indicates on "[r]ecent international criticism of disequilibrium in government welfare and tax policies hint[ing] that political backsliding has already begun." (p.3). Moreover, the thesis at hand evaluated the recently implemented political reforms on the European level as insufficient to obtain the economic and fiscal convergence attained according to the Convergence Criteria. Overall, the main research question, if the Convergence Criteria, as the main condition for joining the euro-zone, lead to a sustainable convergence in the case of Latvia, can be refuted.

As the analysis criticises that a grater sustainability of convergence could only be gained through more efficient European political instruments, requiring a greater transfer of sovereignty to the supranational level, it has to be regarded that not economists but national politicians are determining the institutional frame of EMU. Although greater integration in the EMU economic pillar may be seen as “good economics” it is simultaneously “bad politics” (Schelkle 2013, p.47). Politicians have to be aware of citizens and national taxpayers who may not notice the necessity of greater integration and thus greater obligations (ibid.). So while the nominal convergence attained according to the Convergence Criteria can’t be guaranteed in a sustainable manner, neither by the Criteria themselves, nor by European instruments which should replace the leverage effect of accession conditionality, future developments are affected by uncertainty. Mainly the political will of the euro members to comply with the EMU demands longer than ‘medium-term’ and to alter the current conditions is significant (European Commission 2013a, p.46). Despite these obstacles, welcome Latvia as the 18th Member of the EMU after its consistent accession efforts.

References

Abelshauser, W. (2010). Die Erblast des Euro - eine kurze Geschichte der europäischen Währungsunion. *APuZ, Aus Politik Und Zeitgeschichte,* (43), 39-45.

Auers, D. (2012a). Country focus. Latvia. *Political Insight,* (3(3)), 16-19.

Auers, D. (2012b). Europe and the early Latvian election of September 17 2011. EPERN election briefing no.66. *European Parties, Elections and Referendums Network Briefing Paper 01/2012.*

Auers, D. (2013a). And then we were eighteen...will Latvia join the euro zone in 2014?. *Free Policy Brief Series*. Riga: University of Latvia.

Auers, D. (2013b). Latvia. In E. Elgar (Ed.), *The Handbook of Political Change in Eastern Europe* (3rd Volume ed., pp. 85-123).

Bache, I., George, S., & Bulmer, S. (2011). *Politics in the European Union* (3rd ed.). Oxford u.a.: Oxford Univ. Press.

Begg, I. (2013). Are better defined rules enough? An assessment of the post- crisis reforms of the governance of EMU. *Transfer: European Review of Labour and Research; Quarterly of the ETUI-REHS Research Department*, 49-62.

Börzel, T. A. (2005). How the European Union interacts with its Member States. In S. Bulmer (Ed.), *The Member States of the European Union* (pp. 45-62). Oxford u.a.: Oxford Univ. Press.

Brunetti, A. (2011). *Wirtschaftskrise ohne Ende?*. Bern: Hep, der Bildungsverl..

Bulmer, S., & Radaelli, C. M. (2005). The Europeanization of National Policy. In S. Bulmer (Ed.), *The Member States of the European Union* (pp.338-359). Oxford u.a.: Oxford Univ. Press.

Bundesministerium der Finanzen. (2013). Europäische Finanzhilfen: ESM. Retrieved 09/20, 2013, from http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Europa/Stabilisierung_des_Euro/Zahlen_und_Fakten/europaeische-finanzhilfen-esm.html

Bünning, L. (1997). In Hasse R., Schäfer W., Straubhaar T. and Zimmermann K. W. (Eds.), *Die Konvergenzkriterien des Maastricht-Vertrages unter besonderer Berücksichtigung ihrer Konsistenz* (Schriften zur Wirtschaftstheorie und Wirtschaftspolitik; Band 1 ed.). Hamburg u.a.: Peter Lang.

Chalmers, D., Davies, G. T., & Monti, G. (2011). *European Union Law*. Cambridge u.a.: Cambridge Univ. Press.

Delna. (2011). *National Integrity System Assessment Latvia.* Riga: Transparency International.

Draghi, M. (2013). Euro Conference - Latvia. Retrieved 09/30, 2013, from http://www.ecb.europa.eu/press/key/date/2013/html/sp130912_1.en.html

Dyson, K. (2000). EMU as Europeanization: Convergence, Diversity and Contingency. *Journal of Common Market Studies,* 38(4), 645-666. http://www.blackwellpublishing.com/journal.asp?ref=0021-9886

Dyson, K. (2010). Krise? Welche Krise? Wessen Krise? *Aus Politik Und Zeitgeschichte* (43), 19-25.

Eichengreen, B. J., & Frieden, J. A. (2001). *The Political Economy of European Monetary Unification* (2nd ed.). Boulder u.a.: Westview Press.

EKI. (2012). *Baltic facts 2012*. Tallinn: Estonian Institute of Economic Research.

Enderlein, H. (2004). *Nationale Wirtschaftspolitik in der Europäischen Währungsunion*. Frankfurt u.a.: Campus-Verl..

Enderlein, H. (2010). Die Krise im Euro-Raum: Auslöser, Antworten, Ausblick. *Aus Politik Und Zeitgeschichte,* (43), 7-12.

Europe Direct. (2013). Sustainable Development. Retrieved 10/15, 2013, from http://europa.eu/legislation_summaries/environment/sustainable_development/

European Central Bank. (2013a). *Convergence Report. June 2013*. Frankfurt am Main.

European Central Bank. (2013b). The definition of price stability. Retrieved 09/13, 2013, from http://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html

European Central Bank. (2013c). Measuring inflation - the harmonised index of consumer prices (HICP). Retrieved 09/13, 2013, from http://www.ecb.europa.eu/stats/prices/hicp/html/index.en.html

European Commission. (2010a). *Communication from the Commission. Europe 2020. A strategy for smart, sustainable and inclusive growth.* Brussels.

European Commission. (2010b). The road to EMU. Retrieved 09/11, 2013, from http://ec.europa.eu/economy_finance/euro/emu/road/ems_en.htm

European Commission. (2012a). *Report from the Commission. Alert Mechanism Report - 2013*. Brussels.

European Commission. (2012b). *Report from the Commission. Convergence Report 2012*. Brussels.

European Commission. (2013a). *Convergence Report 2013 on Latvia*. Brussels.

European Commission. (2013b). The euro in the world. Retrieved 09/30, 2013, from http://ec.europa.eu/economy_finance/euro/world/index_en.htm

European Commission (2013c). Financial assistance in EU Member States. Retrieved 09/30, 2013, from http://ec.europa.eu/economy_finance/assistance_eu_ms/index_en.htm

European Commission. (2013d). The preventive arm. Retrieved 10/06, 20123, from http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm

Eurostat. (2013). Real GDP growth rate - volume. Retrieved 09/30, 2013, from http://epp.eurostat.ec.europa.eu/tgm/graph.do?tab=graph&plugin=&pcode=tec00115&language=en&toolbox=data

Frankfurter Allgemeine Zeitung. (2013). Euro Krise. Was ist, wenn Zypern kentert? Retrieved 09/20, 2013, from http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/zypern/euro-krise-was-ist-wenn-zypern-kentert-12125890.html

GCEE. (2011). *Assume responsibility for Europe.* [Verantwortung für Europa wahrnehmen]. Wiesbaden: German Council of Economic Experts.

GCEE. (2012). *Stable architecture for Europe - need for action in Germany* [Stabile Architektur für Europa - Handlungsbedarf im Inland]. Wiesbaden: German Council of Economic Experts.

Gregosz, D., Müller, S., Rindfleisch, E., & Schäfer, M. (2012). *Fragen und Antworten zur Eurokrise.* Berlin: Konrad Adenauer Stiftung.

Hishow, O. (2012). Wirtschaftsmodell und Integrationsprozess der Baltischen Staaten. Die Finanzkrise und ihre Konsequenzen. In M. Knodt, & S. Urdze (Eds.), *Die politischen Systeme der Baltischen Staaten* (pp. 363-378). Wiesbaden: Springer VS.

Hõbemägi, T. (2013). Latvia: Trends, Events and People to watch in 2014. Retrieved 10/04, 2013, from http://www.balticbusinessnews.com/?PublicationId=d1a9eee3-08ab-45cd-8b90-416a8c5629fb&ref=rss

Kneuer, M. (2012). Die Baltischen Staaten als Transformationsstaaten. In M. Knodt, & S. Urdze (Eds.), *Die politischen Systeme der Baltischen Staaten* (pp. 75-96). Wiesbaden: Springer VS.

Kneuer, M. (2012). Die Baltischen Staaten und ihr Weg in die EU. In M. Knodt, & S. Urdze (Eds.), *Die politischen Systeme der Baltischen Staaten* (pp. 117-138). Wiesbaden: Springer VS.

Krupavičius, A. (2012). Fluide Parteiensysteme in den Baltischen Staaten. In M. Knodt, & S. Urdze (Eds.), *Die politischen Systeme der Baltischen Staaten* (pp. 241-258). Wiesbaden: Springer VS.

Kullas, M. (2011). *cepStudie. Kann der reformierte Stabilitäts- und Wachstumspakt den Euro retten? Absichten, Einsichten, Übersichten.* Freiburg: Centrum für europäische Politik (CEP).

Kullas, M., & Hohmann, I. (2012). *Überwachung der Haushaltspolitik und Ausbau des Defizitverfahrens.* (No. 14 ed.). Freiburg: Centrum für Europäische Politik (CEP).

Kullas, M., Sauer, O., & Hohmann, I. (2012). *Völkerrechtlicher Vertrag. Fiskalpakt.* (Nr.13 ed.). Freiburg: Centrum für Europäische Politik (CEP).

Ladrech, R. (1994). Europeanization of domestic politics and institutions: The case of France. *JCMS: Journal of Common Market Studies,* 69-88.

Lewis, J. (2010). How has the financial crisis affected the eurozone accession outlook in Central and Eastern Europe? *DNB Working Papers,* (No.253).

Lindén, T. (2012). Interessenverbände und Zivilgesellschaft in den Baltischen Staaten. In M. Knodt, & S. Urdze (Eds.), *Die politischen Systeme der Baltischen Staaten* (pp. 241-258). Wiesbaden: Springer VS.

Mongelli, F. P. (2002). *"New" views on the optimum currency area theory: What is EMU telling us!* (Working Paper No.138 ed.). Frankfurt am Main: European Central Bank.

Obwexer, W. (2012). Das System der "Europäischen Wirtschaftsregierung" und die Rechtsnatur ihrer Teile: Sixpack - Euro-Plus-Pakt - Europäisches Semester - Rettungsschirm. *Zeitschrift Für Öffentliches Recht,* (67), 209-252.

Pfister, U., & Fertig, G. (2004). Einführungen in die Wirtschafts- und Sozialgeschichte des 19. und 20. Jahrhunderts. Retrieved 09/11, 2013, from http://www.uni-muenster.de/Geschichte/SWG-Online/wirtschaftswachstum/glossar_brettonwoods.htm

Pridham, G. (2007). Legitimating European Union accession? Public elites and public opinion in Latvia. *Party Politics, Vol. 13*(No. 5), 563-586.

Puetter, U. (2009). *Die Wirtschafts- und Sozialpolitik der EU.* In J. Pollak (Ed.). Europa Kompakt. Wien: Facultas.wuv.

Putnam, R. D. (1988). Diplomacy and domestic politics: The logic of two- level games. *International Organization,* (42(3)), 427-460.

Schelkle, W. (2010). Monetary union. In M. P. Egan, N. Nugent & W. E. Paterson (Eds.), *Research agendas in EU Studies* (pp. 256-271). Basingstoke u.a.: Palgrave Macmillan.

Schelkle, W. (2013). Monetary integration in crisis: How well do existing theories explain the predicament of EMU? *Transfer: European Review of Labour and Research, 19: 37*, 18-48.

Schrader, K., & Laaser, C. (2012). Aufbau und Bewährung der Marktwirtschaften im Baltikum. In M. Knodt, & S. Urdze (Eds.), *Die politischen Systeme der baltischen Staaten* (pp. 299-322). Wiesbaden: Springer VS.

Sell, F. S. (2001). *Braucht es monetäre und reale Konvergenz für eine (in einer) Währungsunion? Anmerkungen zu einer aktuellen Debatte.* München: Universität der Bundeswehr München.

The Central Election Commission of Latvia. (2013). *2003 National Referendum on Latvia's Membership in the EU.* Retrieved 10/04, 2013, from http://www.cvk.lv/cgi-bin/wdbcgiw/base/sae8dev.aktiv03era.vis

The World Bank. (2013). *Doing business 2013. Smarter regulations for small and medium-size enterprises* (10th ed.). Washington.

TNS Political & Social. (2009). *Eurobarometer 72. National Report. Executive Summary. Latvia* (72nd ed.) European Commission.

TNS Political & Social. (2013). *Flash Eurobarometer 377. Introduction of the euro in the more recently acceded member states*. European Commission.

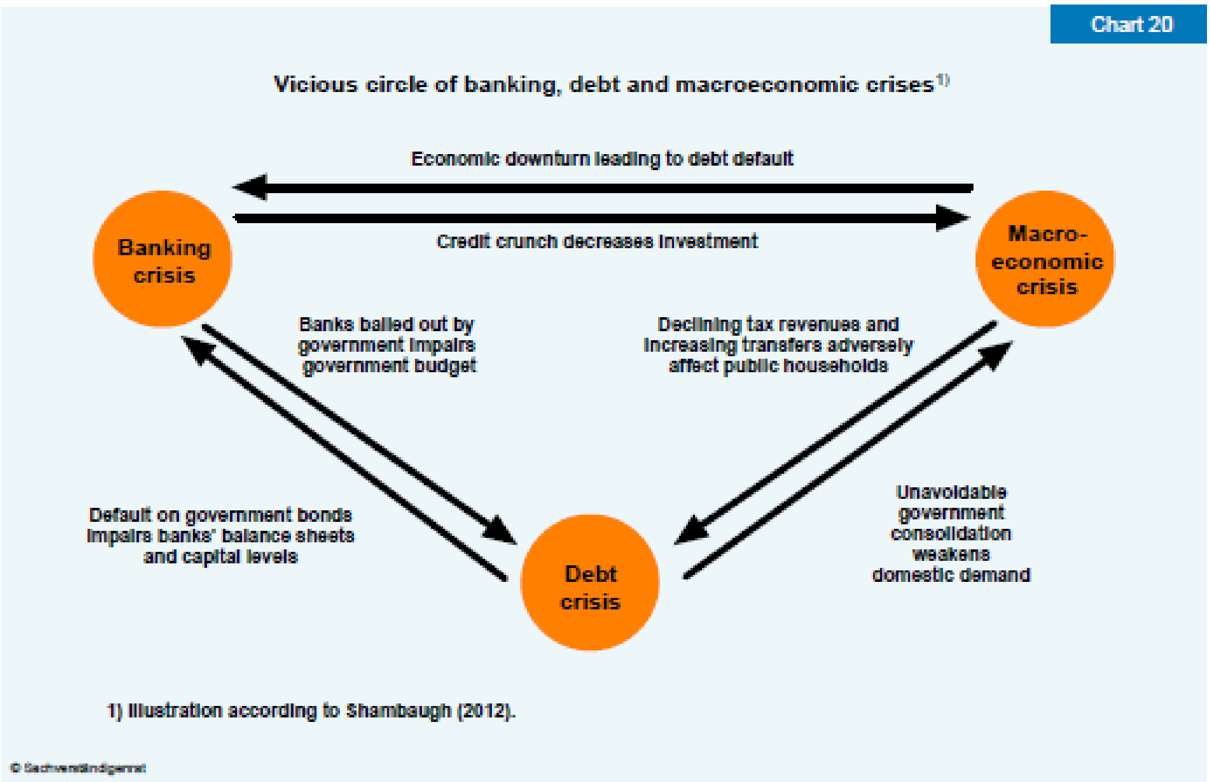
Transparency International. (2013). Global corruption barometer. Latvia. Retrieved 10/04, 2013, from http://www.transparency.org/gcb2013/country/?country=latvia

Vachudova, M. A. (2005). *Europe undivided*. Oxford u.a.: Oxford Univ. Press.

Willett, T. D. (2000). Some political economy aspects of EMU. *Journal of Policy Modeling*, (Vol.22(3)), 379-389.

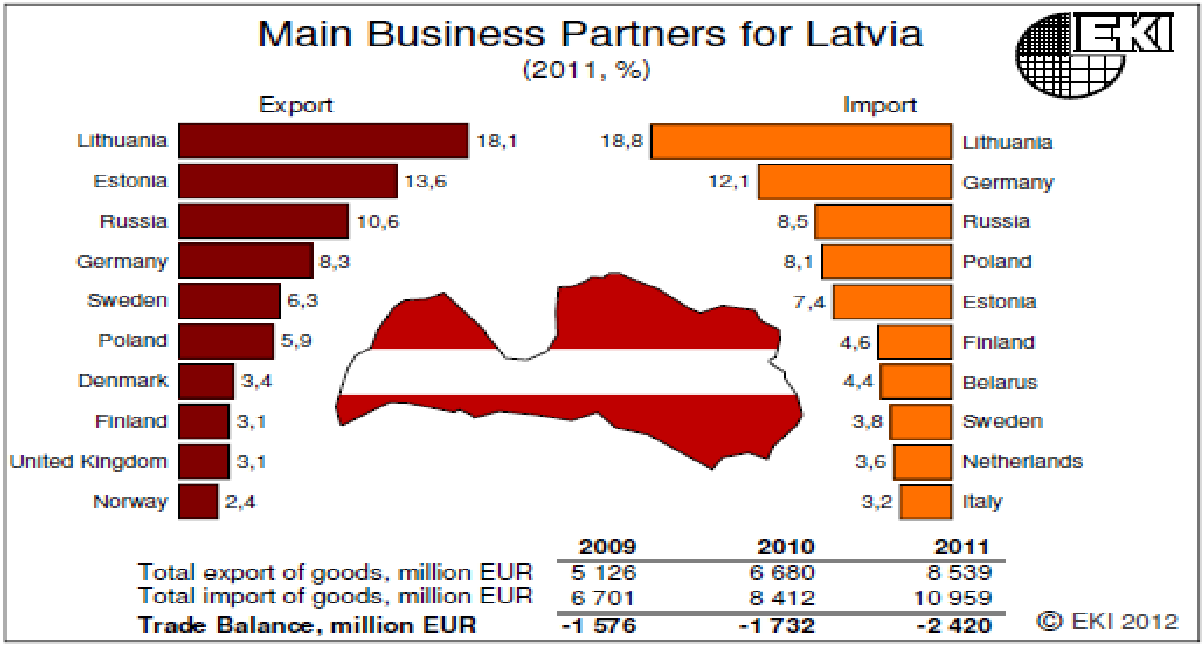
List of Figures

Figure 1: Vicious circle of banking, debt and macroeconomic crises



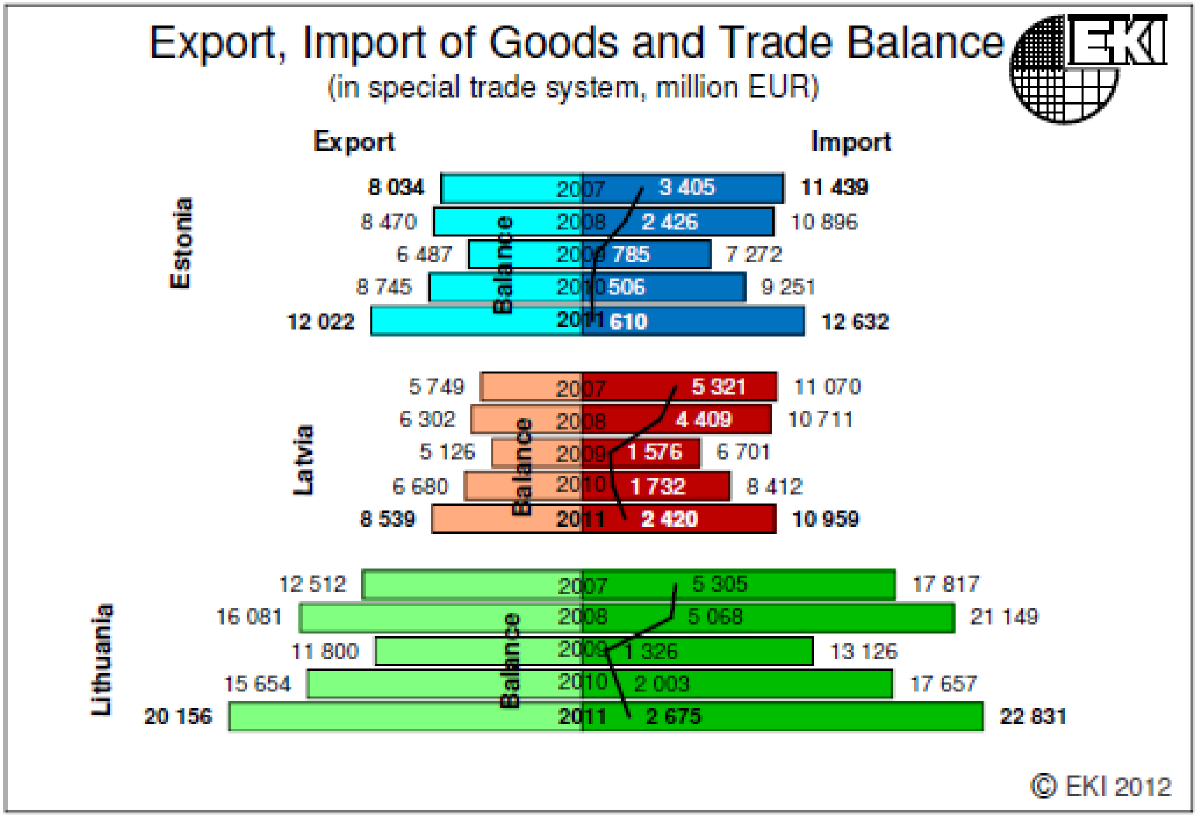
(GCEE 2012, p.65)

Figure 2: Main Business Partners for Latvia



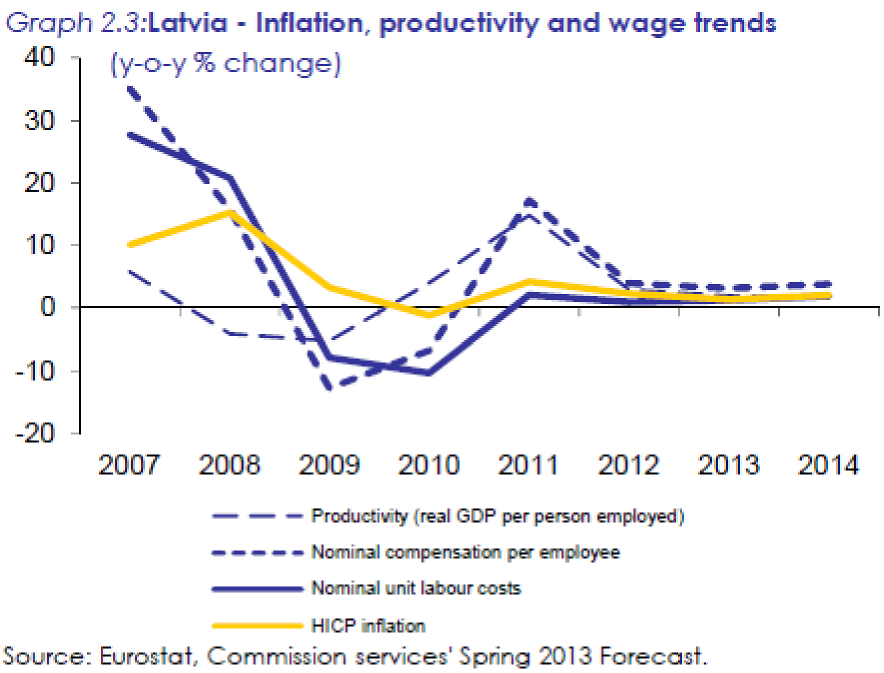
(EKI 2012, p.92)

Figure 3: Export, Import of Goods and Trade Balance



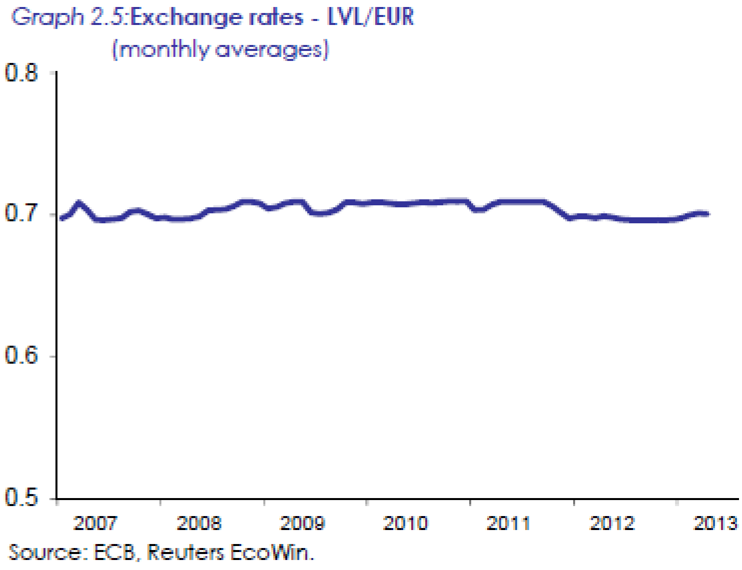
(EKI 2012, p.89)

Figure 4: Latvia – Inflation, productivity and wage trends



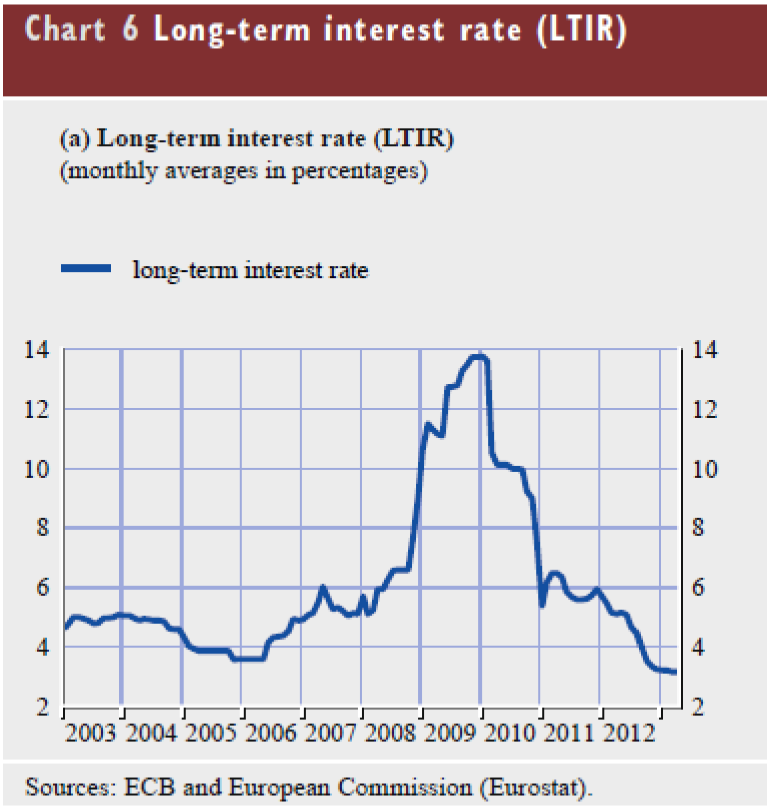
(European Commission 2013a, p.29)

Figure 5: Exchange rates – LVL/EUR



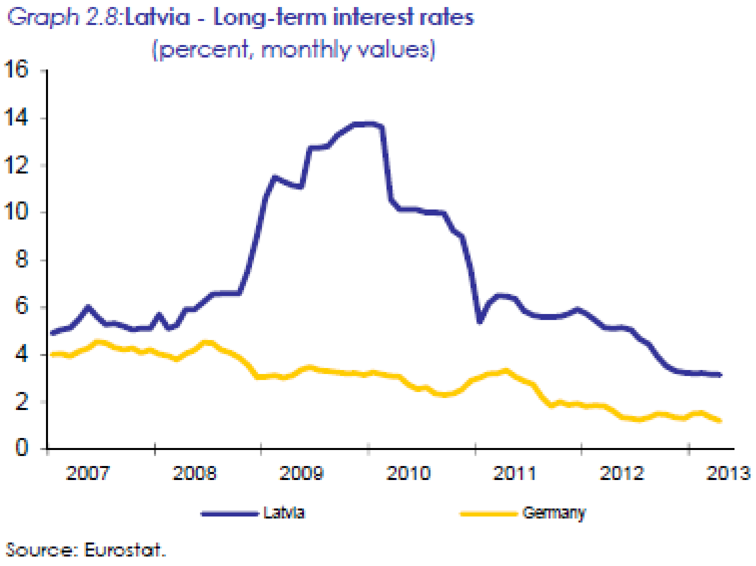
(European Commission 2013a, p.33)

Figure 6: Long-term interest rate (LTIR)



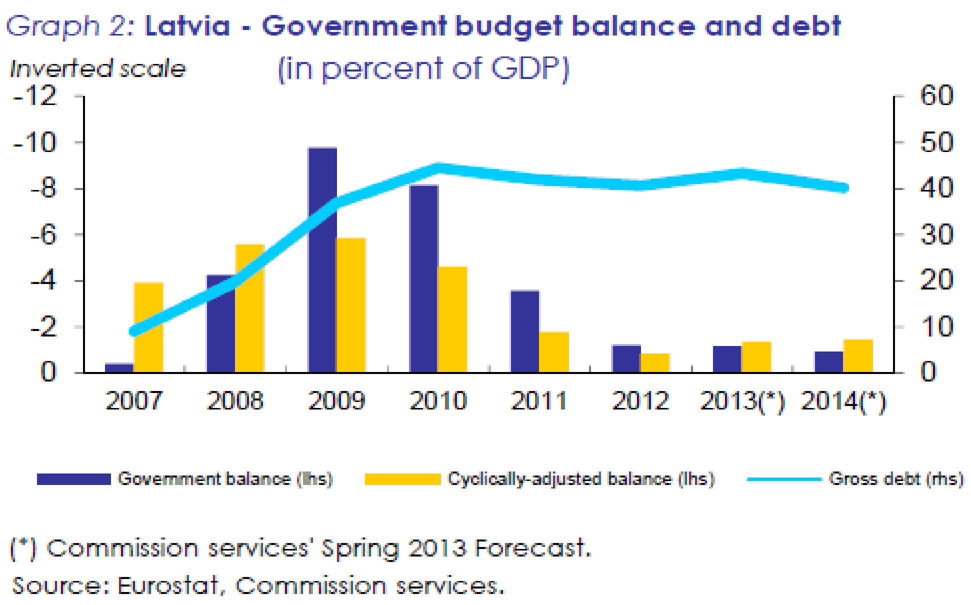
(European Central Bank 2013a, p.60)

Figure 7: Latvia – long-term interest rates



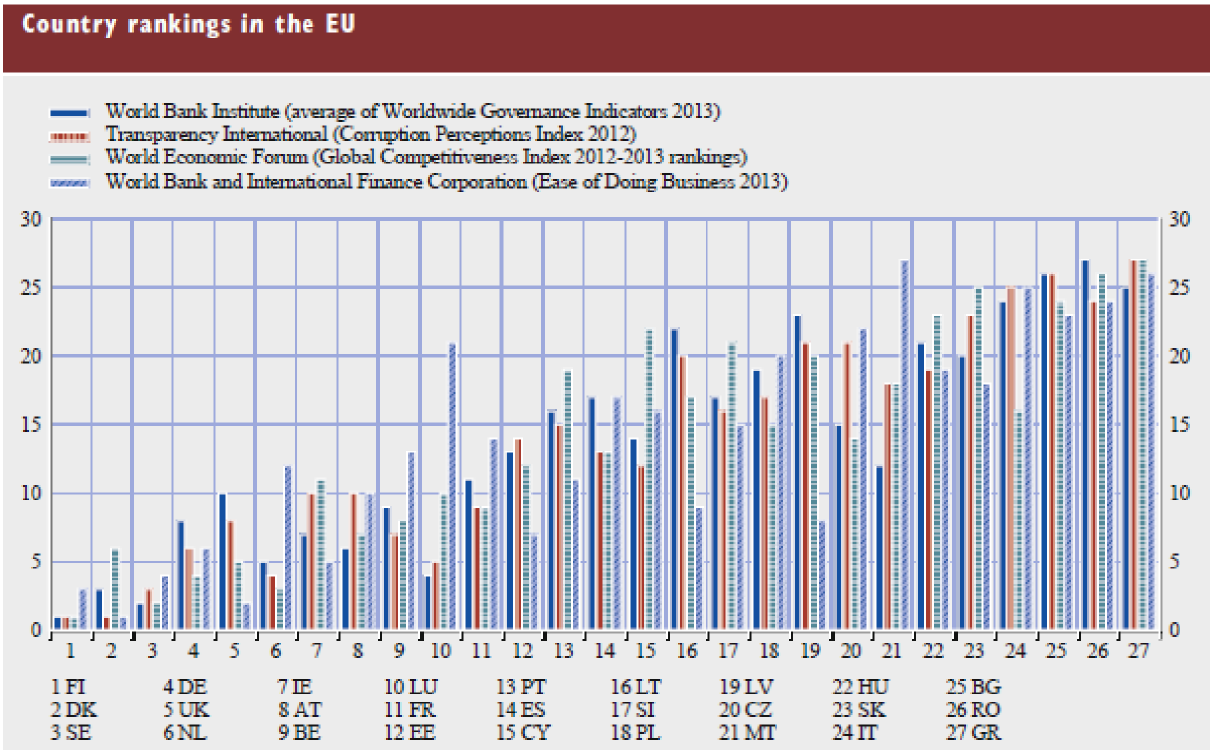
(European Commission 2013a, p.35)

Figure 8: Latvia – Government budget balance and debt



(European Central Bank 2013a, p.8)

Figure 9: Country rankings in the EU

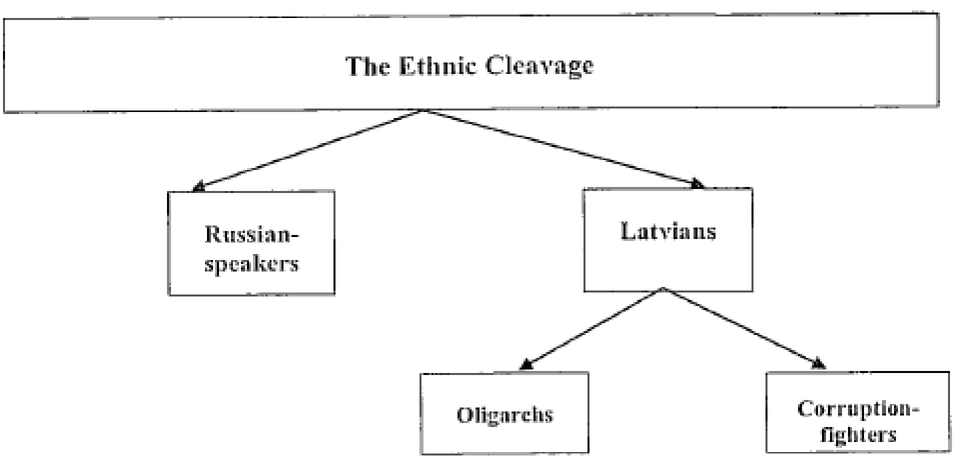


Source: The World Bank Institute (Worldwide Governance Indicators 2013), World Economic Forum (The Global Competitiveness Index 2012-2013 rankings), Transparency International (Corruption Perceptions Index 2012) and the World Bank and the International Finance Corporation (Ease of Doing Business 2013).
Note: Countries are ranked from one (best performer in the EU) to 27 (worst performer in the EU) and ordered according to their average position in the rankings.

(European Central Bank 2013a, p.42)

Figure 10: Salient cleavages in Latvia

Figure 5.2: Salient cleavages in Latvia



(Auers 2013b, p.94)

Declaration of Academic Honesty

I declare that the attached Bachelor Thesis is wholly my own work, and that no part of it has been copied from any work produced by other person, provided by other students, taken from other persons programme or copied from any other source.

I declare that all referenced work from other people have been properly cited and documented on the reference list.

Münster, 29.10.13

(Lisanne Kathrin Blümel)