

Box I

THE INTRODUCTION OF THE EURO IN LATVIA ON 1 JANUARY 2014

Following a request submitted by Latvia on 5 March 2013, the ECB and the European Commission prepared their respective Convergence Reports in line with Article 140 of the Treaty on the Functioning of the European Union, which requires them to report to the EU Council on an EU Member State's progress in fulfilling its obligations regarding the achievement of Economic and Monetary Union. The two reports were published on 5 June 2013. On the basis of the results of the underlying examination, the European Commission concluded that Latvia had fulfilled the necessary conditions for the adoption of the single currency. On 9 July 2013 the EU Council adopted a decision allowing Latvia to adopt the euro as its currency on 1 January 2014. As of that date, the euro area will comprise 18 countries.

The EU Council also adopted a regulation fixing the irrevocable conversion rate between the Latvian lats and the euro. The conversion rate is set at 0.702804 lats to one euro, which corresponds to the central rate of the lats in the exchange rate mechanism (ERM II), agreed when the Latvian currency entered the mechanism. Since its participation in ERM II as of May 2005, the Latvian currency's central rate against the euro has not been changed, and the exchange rate has been maintained by Latvijas Banka within a fluctuation band of $\pm 1\%$ around the central rate as a unilateral commitment, thus placing no additional obligations on the ECB. The ECB supported the choice of the current central rate as the conversion rate for the lats. Following the determination of this rate, the ECB and Latvijas Banka will monitor developments in the market exchange rate of the lats against the euro in the context of the ERM II Agreement until the end of 2013.

Adopting the euro has been a long-standing objective for Latvia. The introduction of the single currency will provide the country with an anchor for sustained macroeconomic stability and further economic convergence.

At the same time, joining a currency union entails taking the irrevocable decision to forego national monetary and exchange rate instruments and therefore implies an increased importance of domestic policies to maintain the economy on a balanced and sustainable growth path. In order to fully reap the benefits of the euro it will be important for Latvia to continue comprehensive fiscal consolidation in line with the requirements of the Stability and Growth Pact and overall EU fiscal governance. It will also be important to lock in the competitiveness gains achieved in recent years by avoiding a renewed increase in unit labour cost growth. In addition, while Latvia has shown strong economic adjustment capacity, it will need to make further progress in improving the quality of its institutions and governance.

In the financial sector, the reliance by a significant part of the banking sector on non-resident deposits as a source of funding, while not a recent phenomenon, represents an important risk to financial stability. In addition to appropriate micro-prudential policies, it is crucial that a comprehensive policy toolkit is available to safeguard financial stability. This should include: (i) macro-prudential measures, national balance sheet analysis and stress tests; (ii) proper funding mechanisms for the deposit insurance scheme; (iii) effective resolution and recovery tools; (iv) strengthened monitoring of any build-up of macroeconomic imbalances that could threaten financial stability, with readiness to adopt additional measures if warranted; and (v) the highest standards possible in the implementation of international anti-money laundering rules.

Latvia has already made important progress in this direction. Finally, financial stability should also benefit from Latvia's participation in the single supervisory mechanism, which is expected to enter into force during the second half of 2014.

All in all, it is important that Latvia avoids complacency after adopting the euro so that it can take advantage of the opportunities the single currency offers. The Latvian authorities have announced important policy commitments to ensure the sustainability of the convergence of the Latvian economy once it is a part of the euro area. These policies should be vigorously pursued in order to facilitate Latvia's smooth participation in Monetary Union over the long term.