

## OPPORTUNITIES OF MONETARY TOOLS APPLICATION IN ACHIEVEMENT OF SUSTAINABLE DEVELOPMENT OF ECONOMY OF LATVIA

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### Abstract

The expansion of the borders of the European Union has forwarded a problem of convergence of new countries with the developed countries of an "old Europe". An improvement of the level of economic development and life standard is both a condition and a result of convergence. A problem can be solved only in case of the achievement of a sustainable growth of economy. The given problem is being made actual in terms of Latvia's surmounting the world financial crisis, on the one hand, and solution of problems connected with the entry in the euro region, on the other hand. It also reflects a logic of the integration processes in the EU. In the structure of GDP of Latvia a prevailing specific weight over 75% of a general added value belongs to services, while a specific weight of agriculture compiles about 3%, at that, only a real sector of economy can support a long-time stability. A high inflation in 2008 did not allow Latvia to use the first opportunity to introduce the euro. As a result the government has chosen a strategy of the economic growth correction by the inner devaluation. At this stage, all attempts are directed to a consolidation of the state budget of the country within the frames of the Maastricht criteria. On 1 January 2008 the government of Latvia established 1 January 2014 as a date of the entry to the euro region. Whereupon Latvia will become a full member of the monetary and economic union that will give a number of advantages to the economy of Latvia: stabilization of a balance of payments, an equilibration of interest rates and a decrease of the investment risk, as a consequence, an attraction of the investment capital and additional work creation.

**Key words:** Convergence, financial crisis, the stabilization, stable growth of economy, long-term stability.

### Introduction

The expansion of the borders of the European Union has forwarded a problem of convergence of new countries with the developed countries of an "old Europe". An increase of the economic development is a necessary condition of convergence reflecting a logic of the integration processes in the EU. The problem can be solved only by the achievement of a stable growth of economy of new countries including Latvia. A high speed of the economic growth of Latvia in the pre-crisis period did not justify hopes for a quick realization of the optimistic scenario of leveling of the considerable differences between the EU countries. At present a state of the economy (in I and II quarter of 2010) gives grounds to say that the national economy is slowly entering a reviving phase. However, it should be noted that a reviving of a joint demand as one sign of surmounting the crisis and a stabilization of economy of Latvia happens mainly due to an increase of the outer demand that improves a state of a balance of payments. But, an evaluation of this phenomenon is ambiguous because with a fall of GDP the import opportunities decrease.

And, such factors as a high unemployment, an insufficient accessibility of credit resources,

as well as a restricting taxation policy of the fiscal measures point out a weakness of the inner demand. Thus, a situation in the national economy of Latvia can be characterized as a completion of the recession stage and the beginning of the stagnation stage in terms of an insufficiency of the inner and instability of the outer demands.

### 1. Role of state regulation

#### 1.1. Structure of national economy of Latvia

In the structure of GDP of Latvia a prevailing specific weight is formed by services over 75%, of a general added value, while a specific weight of agriculture complies about 3%, at that only a real sector of economy can support a long-term stability. An accession to the European Union has cardinally changed the economic environment of Latvia. Together with the direct investments, the European funds, an accessibility of the credit resources has increased impetuously. However, a development of the credit market has mainly stimulated an inner consumption, and a change-over from export to import has led to an increase of the outer debt. A great role in the existing situation also belongs to the fiscal expansion policy pursued by the government. A floating of the private investments from a real sector to the financial sector due to high

interest rates with the growing joint demand has caused a pressure on the general level of prices towards its increase, an expansion of new loans has led to a result that a large share of the state budget expenditures has been directed to payment of interests of the public bonds, as a result the social payment have been threaten, alarms have been caused that the state cannot cope with the servicing of the inner debt that may lead to the decrease of cost of the lat. In the graph a dynamics of the money aggregates of the Bank of Latvia from the middle of 2003 till the end of 2010 is shown. So, the M3 aggregate had its least value in July 2003, and maximum – in July 2008, and a growth compiled about 320% during 5 years.

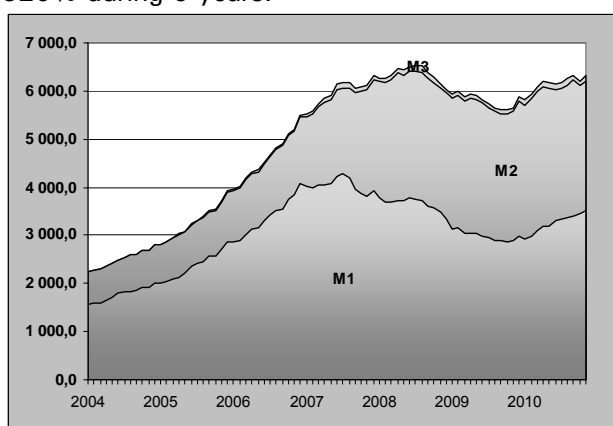


Fig. 1. Monetary aggregates

### 1.2. Inner demand and inflation

A high inflation in 2008 did not allow Latvia to use the first opportunity to introduce the euro. As a result the government has chosen a strategy of the economic growth correction by the inner devaluation. From one hand a growth of prices inside the country with relatively stable prices of import has shift a part of demand from the inner goods to the import goods, by that having decreased export, that is an inner revolution has taken place with maintenance of a nominal exchange, on the other hand – a growth of the level of prices has forced the economic subjects to borrow money by that increasing a demand for money and increasing their profitability. As a result it caused a weakening of the inner joint demand and its reorientation to consumption. A necessity of an immediate government intervention with the aim of an adaptation of economy to new conditions and elimination of disproportions excluding the achievement of the inner and outer balance in economy is brewing. The occurred disproportion between the product

and monetary markets as a result of the exceeding of a joint demand over a joint supply required a decrease of the monetary supply and that was what the Latvian government was trying to do in 2007 when developing the anti-inflation plan. Unfortunately, in the core of the composition of a plan a calibrated or gradual policy lied that had no great success because it was perceived as a lack of the government's confidence, and correspondingly it just strengthened the inflation expectations. More noticeable effect concerning the prevention of inflation has been achieved by the government of Latvia as a result of regulating supply or of the so-called "Price and Income" policy when in the directive order a growth of wages has been constrained for elimination of the inflation inertia and the agreements with trade unions demanding an increase of wages have been concluded. Up to 2007 inflation could be classified as the inflation of supply connected with the exceeding of expenditures over income of the state budget and an impetuous development of the credit market, and from 2008 the signs of inflation of costs as a result of a negative shock of supply supported by the expectations of the economic subjects have been strengthening. As a consequence of the budget costs cutting and rather moderate structural reforms and the governmental policy of "Prices and Income" the result has been achieved. In October of this year the inflation for the recent 12 months in comparison with the previous year was negative and was preserved at the level of -1,6%, for comparison a value of the Maastricht criterion in the EU is about +1,9%. The influence of the outer factors on the inflation processes of Latvia will continue in connection with the worldwide growth of prices for foodstuff and energy resources. But, taking into account a weakness of the inner demand a risk of prices increase, at this stage, is considerably constrained. To our opinion, a considerable influence on the inflation processes an increase of the tax burden will cause, in particular, the value-added tax that will considerably increase the inflation risk and strengthen a negative influence on the inner demand. According to the calculations of the Bank of Latvia an increase of VAT up to 22% will cause an increase of inflation to 0,7%.

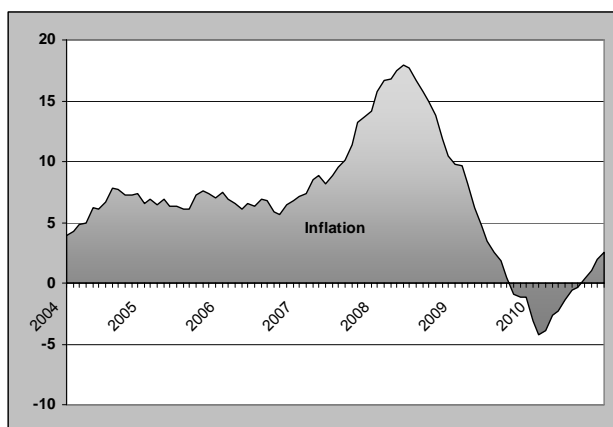


Fig. 2. Inflation

## 2. Macroeconomic correction tools

### 2.1. Maastricht criteria

The government of Latvia has established 1 January 2014 as a date of the entry to the euro region. Whereupon Latvia will become a full member of the monetary and economic union that will give a number of advantages to the economy of Latvia: stabilization of a balance of payments, an equilibration of interest rates and a decrease of the investment risk, as a consequence, an attraction of the investment capital and additional work creation. At present, all attempts of the government are directed to a consolidation of the state budget within the frames of the Maastricht criteria fulfilment. The given task is analyzed in terms of Latvia surmounting the world financial crisis, on the one hand, and solution of problems connected with the entry to the euro region, on the other hand. To change-over to the euro, Latvia must fulfil several conditions of common currency introduction or the so-called Maastricht criteria.

According to the information of the Bank of Latvia in August 2010 only three of five criteria meet the EU indices: general national debt, average annual inflation for the recent 12 months and exchange rate regime. The most painful problem is a deficit of the state budget, which index is considerably behind the norm and compiles -10,5% of GDP, while the EU index is -3%. The same can be said about the long-term interest rates of the public bonds: the EU index compiles 7,03%, and in practice in Latvia it is 11,88%.

### 2.2. Interaction of monetary and fiscal policies.

The existing situation demands a development of the strategic plan of the macroeconomic correction on the basis of a use of the available

tools of the economic policy. Usually, the government has two groups of tools within the frames of the open economy: tools of demand control and tools of supply control. It is accepted to consider that the demand control is the most efficient and it includes the policy of changing and reswitching of costs.

The cost changing policy foresees a maneuvering by tools of the monetary and budget policy with the aim of the achievement of the macroeconomic equilibrium. A fixed currency rate and a high mobility of capital typical for the economy of Latvia assumes that the budget policy is the most efficient tool, while the monetary policy plays a support role and may be used for strengthening of the budget policy. For stimulation of the inner joint demand and prevention of the long period of stagnation it is possible to recommend a discretionary stimulating taxation and budget policy that assumes a growth of the state expenditures and/or a decrease of the taxation rate, but there, there is a restriction regarding a fulfillment of the Maastricht criteria. So, by increasing the state expenditures and/or by decreasing the taxation rates that meet the reality of the economy of Latvia, an increase of the state budget expenditures will happen automatically and it is in conflict with the fulfillment of the Maastricht criteria. Therefore, in reality, at the given stage, the government of Latvia has no opportunity to use the budget policy for stimulating a joint demand.

The use of the monetary policy also has its restriction in connection with the fixed currency rate, because changing of the money supply is neutralized by the necessity of the national currency rate support within the certain borders. In accordance to the Law about Bank of Latvia the purpose of its monetary policy is a support of sustainability of prices in the state. And, the selected strategy is a stability of the national currency rate that is permanent since 1994. The usual traditional tools of the monetary policy are: trend of discount rate or refinance rate, alteration of norms of the required reserves as well as transactions in the open market. The first and second tools of the monetary policy indirectly influence the money supply. Using the third tool, the central bank directly influences the money supply. Therefore transactions in the open market are the most operative means of the money supply control. The reserve ratio and the discount rate in Latvia are the indicators of content and directions of the monetary policy for the in-

ter-bank credit market rather than they have a practical importance.

After the accession of Latvia to the EU in 2005 the lat was pegged to the euro, and since that time it is supported by the passive currency interventions within the frames of corridor  $\pm 1\%$  or 0,6958 to 0,7098 to the euro. In accordance to the Mundell-Fleming model in economy the fixed currency rate, a full capital mobility and independent monetary policy cannot exist simultaneously. To overcome the problem of the "Impossible Trinity" the Bank of Latvia has been forced to refuse from the independent monetary policy. On the one hand, it was undoubtedly that a fixation of the exchange rate had a serious advantage: an uncertainty during the decision-making by the economic agents decreased, and on the other hand, the Central Bank obtained an obligation to behave itself with moderation in the area of the monetary policy, because all its functional activities for the stimulation of the business activity after some time come down to zero by the self-adjustment that decreases the money supply obeying the fixed currency rate. It is also important that after the pegging of the lat to the euro, the credit market has changed over to the euro currency, therefore the traditional measures of the CB are incapable to achieve a necessary effect.

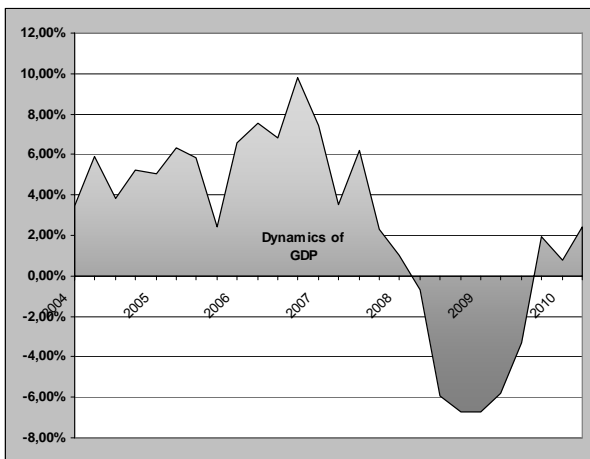


Fig.3. Dynamic of GDP to the previous quarter

### Conclusions and suggestions

Having considered a real situation of the economy in Latvia it is possible to note that a use of the budget policy is impossible due to a restriction according to the Maastricht criteria, and a use of the traditional monetary policy is possible, but is ineffective owing to the fixed currency rate. In accordance to the rule of Tinbergen: for the achievement of the certain quan-

tity of the economic goals it is necessary to use the same or greater number of tools of the macroeconomic policy. A use of the smaller number of tools does not ensure an achievement of a goal at all.

Therefore, in the crisis period one of the tasks is a development and use of the administrative tools of the monetary policy that goes from an objective character of the economic laws effect typical for the market economy. It is known that the administrative methods are irreplaceable in the extremal situations, and also in the situations when there are no efficient economic methods. Therefore, recommendations have a short-term character. The results of a use of one or another tool for the achievement of tasks of the goal-oriented macroeconomic correction in critical degree depend on the state policy in respect of the international capital flow. More considerable factor determining an efficiency of the monetary policy is not the strategy of the fixed currency rate, but almost a complete mobility of capital existing in the Latvian economy. Going back to the problem of the "Impossible Trinity", a use of the monetary policy as a stabilizing policy of the state, with the regime of the fixed currency rate in the small open economy is possible in case of the introduction of the capital flow control.

In terms of the economy of Latvia a control of the capital flow must be performed in two directions both of the capital influx and its outflow. A control of the capital outflow in search of the higher income by the financial system must be directed to a stimulation of the priority branches of the economy. In its turn, a control of the capital influx will ensure a knockout of the speculative investments that will first leave the country in the process of a new wave of crisis that will allow to achieve a macroeconomic sustainability, will give an opportunity to regulate not only an amount but also a structure of the foreign investments, and as a consequence it will strengthen real sectors of the economy. If such strategy is not appropriate for the Bank of Latvia and the government of Latvia, then an alternative is a long stage of stagnation in the economy in terms of a weakness of the inner and instability of the outer demands. Having studied a real situation in the economy of Latvia it is possible to note that a use of the budget policy is impossible due to a restriction according to the Maastricht criteria, and a use of the traditional monetary policy is possible but is inefficient because

of the fixed currency rate, since all its purposeful activities directed to the stimulation of the business activity after some time are compensated or come to zero because of the self-correction decreasing the money supply that obeys the fixed currency rate. According to the Maastricht criteria the CB still had an efficient tool of the macro-economic correction: an expansion of the corridor of fluctuation of the lat to the euro from the present  $\pm 1$  to  $\pm 15\%$  that, unfortunately, was not used. With its help it was an opportunity at the initial stage to restrain a joint demand directed to consumption, but the right time for its use has been lost. As a result of the one-sided strategy chosen by the Bank of Latvia – a stability of the national currency – such indicator of the economic overheating as the money supply was not under control. Various empirical re-

searches of the interconnection of a rapid growth of the money supply and an increase of a general level of prices show that a considerable growth of the money supply has been a major driving force of inflation. A well-known expression of the American economist P. Samuelson might be used relating to Latvia and it may sound like this: “Well now, the Good Lord gave us two eyes to watch the money supply by one eye and the currency rate by other eye”.

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