MAIN PROBLEMS OF LATVIA'S MONETARY POLICY

The key objective of the central bank's monetary policy is to facilitate the favourable macroeconomic environment for growth of the national economy in the long term. The course of global economic development assumes that monetary policy, employment and financial stability can foster the economic growth most of all by ensuring the low inflation rate. The central bank creates a stable and predictable business environment by maintaining the price stability. Regarding the developed countries the general monetary policy objectives deals not only with maintenance of stability of the exchange rate and general price level, but also with stimulation of economic development, growth of employment and incomes of the citizens. In other words, the purposes of monetary policy and monetary regulation should correspond to the purposes of social and economic policy of the state and requirements of the society.

Commencing the implementation of an independent monetary policy in the early 1990s, the Bank of Latvia had to decide on an exchange rate regime. Since 1993, Latvia has been using the fixed exchange rate based stabilisation programme. In February 1994, the Bank of Latvia pegged the lats to the Special Drawing Rights (SDR) basket consisting of the four major currencies: the US dollar, the euro, the British pound sterling and the Japanese yen. Such a durable and credible peg has served to reduce uncertainty, eliminate currency risk and provide businesses with a sound basis for planning and pricing. It fostered international investment and international trade, which are of a particular importance for the ability to compete of the small, open economy that Latvia is.

It is essential to note that the Bank of Latvia ensures the external stability of the lats under free capital movement and unlimited convertibility of the national currency: Latvia has established one of the most liberal foreign exchange and capital movement regimes in the world. Both foreign currency and the lats can freely enter and leave the country; accounts can be opened in lats and foreign currencies without any restrictions, and lats can be purchased and sold freely in exchange for foreign currencies. Foreign investors can repatriate their profits in any currency without restriction.

By the time Latvia becomes a participant in the Economic and Monetary Union, the Bank of Latvia continues the implementation of its monetary policy, provided that it is in agreement with the EU common interests, without prejudice to the development of other EU Member States and facilitate economic stability.

Accession to the EU implies preparation for the participation in the Economic and Monetary Union and introduction of the euro, for the new Member States of the EU may not choose to stay outside the euro area. Hence, after joining the EU, Latvia will have to demonstrate its capability to meet the criteria for joining the Economic and Monetary Union.

Economic convergence is a serious pre-requisite for successful operation of a monetary union; therefore, prior to joining the euro area the EU Member States have to ensure compliance with the Maastricht convergence criteria: achieve price stability, sustainability of the Government's financial position, exchange rate stability against the euro and long-term interest rate convergence.

Maastricht convergence criteria:

- price stability is measured as the average consumer price increase of the last 12 months in three EU Member States with the lowest inflation plus 1.5 percentage points;

- sustainability of the Government's financial position means that the Government deficit and the Government debt do not exceed 3% and 60% of GDP, respectively;

- long-term interest rates convergence criterion is interpreted as the average yield rate of 10-year Government bonds within a 12 months period in three countries with the lowest inflation plus 2 percentage points;

- exchange rate stability criterion provides for participation in the Exchange Rate Mechanism II (ERM II) without severe tensions, which, in turn, primarily means without currency devaluation against the euro. If required, other adequate indicators may be used to assess stability.

One of the criteria implies participation in the Exchange Rate Mechanism II for two years. Latvia joined Exchange Rate Mechanism II on May 2, 2005. Exchange Rate Mechanism II means that, for at least two years prior to the introduction of the euro, the lats will have to be pegged to the euro, with the fluctuation margins of the lats exchange rate against the euro not exceeding +/-15% against the lats/euro peg rate. The Bank of Latvia plans to ensure narrower fluctuation margins against the euro than the prescribed maximum, thus maintaining higher stability of the lats against the euro.

In order to achieve the key objective as well as join the Economic and Monetary Union successfully, the Bank of Latvia has chosen its exchange rate strategy for the implementation of monetary policy. Under this strategy, the Bank of Latvia's intermediate target is the external stability of the national currency, i.e. the peg of the lats to the euro (at the rate 1 EUR = 0.702804 LVL). The normal fluctuation margins around the fixed peg rate are +/-1%. The Bank of Latvia performs interventions when the exchange rate of the lats exceeds the normal fluctuation margins of +/-1%. The Bank of Latvia has been implementing the lats pegging policy since February 1994 when the lats was pegged to the SDR currency basket. As of

January 1, 2005 the lats has been pegged to the euro. Now Latvia almost complies with the majority of the Maastricht convergence criteria necessary for joining the Economic and Monetary Union (except for a parameter of inflation).

Table 1. Compliance with the Maastricht Criteria[1]

	Criterion in 2003	Latvia's performance in 2003	Criterion in 2005	Latvia's performance in 2005	Criterion as at June 2007	Latvia's performance in June 2007
Budget balance (% of GDP)	3.0	1.2	3.0	1.0	3.0	0.3
Government debt (% of GDP)	60	14.6	60.0	14.7	60.0	9.4
Average annual inflation rate of last 12 months (%)	2.7	2.9	2.5	6.7	2.7	9.5
Long-term interest rates on government securities (%)	6.09	4.9	5.4	3.96	6.4	5.3
Exchange rate regime	Fixed exchange rate against the euro and participation in ERM II for at least two years	Fixed exchange rate against the SDR since 1994	Fixed exchange rate against the euro and participation in ERM II for at least two years	Fixed exchange rate against the euro since 2005 and participation in ERM II since May 2005	Fixed exchange rate against the euro and participation in ERM II for at least two years	Fixed exchange rate against the euro since 2005 and participation in ERM II since May 2005

[1] Sources: Data of the Treasury, central Statistical Bureau of Latvia and Eurostat.

Statistical data available for the last years indicate that the initial plan of Latvia to adopt the euro in 2008 cannot be implemented due to the high inflation rate. The schedule has not been revised as yet but according to the information released by the Ministry of Finance, in 2007 the Government would discuss a new target for the changeover to the euro, tentatively in 2011-2013. The introduction of the euro in Latvia will be an issue of the EU multilateral relations affecting common interests of all EU countries. Therefore, the projected timeframe for the introduction of the euro is merely tentative and will gain an official status only after the completion of all negotiations and other formal procedures.

The major quantity indicator of monetary circulation is the money supply representing a total purchasing volume and legal tenders, which serve for economic circulation of financial recourses of private persons, enterprises and state. The analysis of structure and dynamics of money supply has a great significance for development of reference points of the monetary policy of central bank.

The monetary aggregates are applied to money supply definition. The cash assets are the basis of all monetary aggregates. The share of cash in money offer can vary depending on the circumstances. So, the more economy of the state is developed, the more banking system is stable and wide and the fewer shares of cash. The Bank of Latvia applies the following main monetary aggregates to the characteristic of monetary system and banking:

(M0) monetary base - monetary base is calculated on the basis of the Bank of Latvia's methodology and comprises the lats banknotes and coins issued by the Bank of Latvia and demand deposits of resident MFIs and financial institutions (overnight deposits) with the Bank of Latvia. The Central bank directly creates this part of the monetary offer. By increasing the assets the Central bank creates the money of high efficiency, by reducing it destroys them. The opportunities of Central bank towards the creation of money of high efficiency are extremely great, as its liabilities (passives) are the money itself.

M2X (wide money) - broad money aggregates are calculated on the basis of the Bank of Latvia's methodology and comprise the lats banknotes and coins issued by the Bank of Latvia (less vault cash of MFIs) and overnight deposits and time deposits in lats and foreign currencies (including deposits redeemable at notice and repurchase agreements) held with MFIs by resident non-financial corporations, financial institutions, households and non-profit institutions serving the households. M2X incorporates the deposits placed by local governments as a net position on the demand side. This parameter characterizes the total money in national economy. As foreign currency is of great significance for Latvian economics, this parameter includes both the deposits of the enterprises and private persons in foreign currency. Let's review the monetary parameters presented in table 2.

Table 2. The basic indicators of monetary policy in Latvia from 1998 till 2007.

(mill. lats)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP	3971,2	4265,0	4750,8	5219,9	5758,3	6392,8	7434,5	9059,1	11171,6	13957,3
Growth	109,3	107,3	111,4	109,9	110,3	111,0	116,3	121,0	123,3	124,9

GDP (%)										
M0	471,5	526,2	566,7	617,1[1]	755,1	806,8	957,2	1350,7	2248,8	2471,2
M2X	923,0	997,2	1275,9	1541,4	1864,9	2220,3	2816,5	3905,8	5479,9	6171,3
Growth M2X (%)	105,9	108,0	127,9	120,8	121,0	119,0	127,0	138,7	140,3	112,6
M2X / M0 (%)	195,8	189,5	225,1	249,8	247,0	275,2	294,2	289,2	243,6	249,7
GDP/ M2X	4,3	4,3	3,7	3,4	3,1	2,9	2,7	2,3	2,0	2,3

[1] As of January 2001, the time deposits with the Bank of Latvia are not included in the monetary base.

Since 1998, the GDP growth in Latvia has exceeded the average GDP growth rate of the EU countries, thus the income per capita differences has gradually narrowed. In 2007, the Central bank's money supply or monetary base M0 increased only by 9,9% , less than in 2006, and totalled to 2471,2 mill. lats at the end of the period, whereas the cash component of the monetary base decreased to 42,5% in comparison with 47,8% at the end of 2006. Such changes are caused by tendencies of the money market development. Thus, the deposits of credit institutions and other financial institutions held with the Bank of Latvia grew to 246,8 million lats or by 21,0% in 2007 contrary to 2,5 times increase in 2006. For the first time, the demand for cash decreased and currency in circulation shrank by 24,4 million lats or 2,3% (a 22,4% increase in 2006).

In 2007, the overall pace of global economic growth was rather solid, though in the last quarter of the year some deceleration occurred in many regions as a reaction of the impact of financial sector development. The worsening of the conditions of financial sector was primarily caused by the US sub-prime mortgage market problems.

The monetary situation in Latvia is characterized also by other parameters: monetary multiplicator (M2X/M0) and velocity of money (nominal GDP/M2X). The great importance has monetary multiplicator – a parameter describing the opportunities of economy as a whole and banking system in particular to increase a money stock in a turnover. Its size pays off as the attitude of M2X to monetary base (M0). The monetary multiplicator is necessary to control over the monetary volume dynamics and the rate of inflation in Latvia. In 2007, the monetary multiplicator has not changed essentially, and by the end of the year it consisted 249,7 % (in 1998 – 195,8%).

The velocity of money testifies the communication between monetary circulation and processes of economic development. In 1998, the velocity of money made 4,3 times per year.

The stable economic situation and increase of accumulation stimulated the decrease of rate of the money turnover from 4,3 in 1998 up twice to level in 2008. In relation to this parameter Latvia approaches to the developed countries where the speed of money turnover does not exceed 1,5 times. The decrease of rate of turnover of monetary volume (in 2 times) for the last 7 years cannot lower the negative influence of prompt monetary growth which increases more than by 30 % per year. During 2006 the monetary aggregate M2X has increased by 40,3 % and has reached 5477,8 mill. lats on the end of the year (tab. 2). Since 1998, it is possible to observe the tendency of decrease in relative density M0 in the structure of M2X. A bank crisis of 1998 indicated such tendency and the subsequent decrease of monetary offer in the native currency.

The basic problem of Latvia for the last ten years was a balance of payments deficit of current transactions.

Table 3. Parameters of foreign trade of Latvia from 1998 till 2007.

(mill. lats)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Import*	1881,3	1723,9	1933,9	2201,6	2497,4	2989,2	3768,2	4866,9	6378,5	7746,3
Export*	1068,9	1008,3	1131,3	1256,4	1408,8	1650,6	2130,7	2888,2	3293,2	4038,7
Balance	-812,4	-715,6	-802,6	-945,2	-1088,6	-1338,6	-1637,5	-1978,7	-3085,3	-3707,6

* export in FOB prices; import in CIF prices.

Balance of payments deficit arises as a result of excess of import over export. Within last ten years the volume of foreign trade of Latvia has considerably increased – export almost in 3,8 times, but import in 4,1 times. The volume of foreign trade has been increasing year from a year, except 1999 when the consequences of the Russian crisis have occurred (tab. 3).

In 2007, the export has grown by 745,5 mill. lats in comparison with 2006. In 2007, the import has grown by 1367,8 mill. lats in comparison with the last year. In 2007, the increase of difference between export and import has proceeded. So, in 2003 it totalled to1338,6 mill. lats and has reached 3707,6 mill. lats in 2007. The role of the EU in Latvia's foreign trade is strengthening: 78,6% of total export from Latvia went to the EU countries in 2007.

Let's consider the main financial instruments and principles of monetary policy in Latvia. The choice of monetary instruments is wide enough. The basic tools of monetary regulation are: the standing facilities of lending and deposit of funds (refinancing); the reserve requirements; the market operations. The choice and combination of instruments of monetary regulation depends, first of all, on issues, which are settled by central bank at the stage of economic development.

The regulation of discount rate relates to market instruments of monetary regulation. The mechanism of regulation is simple enough; therefore it is widely used in developed and developing countries. The official discount rate is a reference point for other market rates. The above level of official discount rate is the above cost of central bank refinancing. It means that the policy of change of discount rate represents a variant of regulation of qualitative parameter of money market – the cost of bank credits.

The refinancing of commercial banks is carried out by holding of credit auctions, granting of Lombard loans, etc. The Bank of Latvia has started using of refinancing as monetary policy instrument in 1993 only by granting the short-term credits to commercial banks for liquidity maintenance. Originally the credits were granted to each bank within the limits depending on the bank's performance in accordance with regulatory requirements established by the Bank of Latvia.

Such an order was necessary because the credits were granted without collateral. Since November 1993, when the demand for credits exceeded the supply of credit resources, the Bank of Latvia has started carrying out of the credit auctions. As earlier, the credits were granted without collateral, therefore the quantity of the participants of auction was defined depending on the size of the equity capital of the bank, liquidity, and the bank performance in accordance with regulations of the Bank of Latvia.

The Bank of Latvia has started granting the Lombard loans in September 1995. It is the form of refinancing when the Central bank grants the credit under pledge. The Bank of Latvia grants two types of Lombard loans: the automatic Lombard loans and Lombard loans on demand. The commercial banks can exceed the balance of the correspondent account within the limit of the Lombard loan during a payday for maintenance of efficiency of the interbank payment system. The Bank of Latvia grants the credits to commercial bank for one day in amount of the debit balance of corresponding account, in case the commercial bank could not involve the money resources till the end of a payday to liquidate the lack of resources on a corresponding account. The Bank of Latvia grants the Lombard loans to commercial banks automatically in the end of a payday without special requirement.

The basis for the Lombard loan issuance is the special agreement between the Bank of Latvia and commercial bank. Usually the Lombard loan interest rate is higher than credits repo interest rate. It is a kind of "penalty" for the usage of resources of the Central bank. The interest rate of Lombard loans can vary depending on the terms of drawdown. As the Lombard loans interest rate is higher than the interbank market interest rates and the interest rate of refinancing of the Bank of Latvia, the demand for these credits is usually small. The commercial banks use the Lombard loans only in case of emergency.

The Bank of Latvia supports the money volume in the set parameters and adjusts the level of liquidity of commercial banks by changing the minimal reserve requirements. It is assumed that credit institutions have to hold a certain share (currently 6 %) of the attracted non-bank deposits with the Bank of Latvia. In event the reserve requirements are increased, these credit institutions will have to hold more funds with the Central bank. It means that the amount of funds attracted by credit institutions, which is at their disposal and could be freely placed in the economics, thus increasing the level of credit and broad money, will decrease. The reserve requirements as a monetary policy instrument ensure the higher stability in the monetary base demand and facilitate the effectiveness of market operations, preventing the excessive interbank interest rate daily fluctuations.

There is a dogmatic "rule" of the monetary policy: the actual rate of refinancing should be positive (though it was negative in many developed countries in specific years, and in 2007 the refinancing rate was below the rates of inflation in the majority of these countries). In Latvia, the monetary market rate is below the inflation rates. It is obvious there is an imported inflation in the conditions of prices rise which is underestimated by the Central Bank. Accordingly, it overestimates the measurements of the base inflation depending only on the monetary factors. Therefore, the refinancing rate should be minimal, i.e. at a level of correctly estimated base inflation.

In the first half of 2007, the Bank of Latvia continued to pursue the tough monetary policy and in two occasions raised the refinancing rate by a total of 100 basis points (to 6.00%), thereby dampening the excessive domestic demand. Later, when the signs of economic overheating abated, the Bank of Latvia left its interest rates unchanged, but in the first half of 2008 due to the slowdown in the growth of lending and the associated deterioration in the banks' role in fuelling the domestic demand, it lowered the minimum reserve requirement for bank liabilities with agreed maturity of over 2 years by 2.0 percentage points (to 6.00%).

The Bank of Latvia regularly performed the following market operations:

- the security repurchase arrangements with maturity of 7 and 28 days, where the Bank of Latvia grants the funds in lats to credit institutions against securities collateral;

- the currency swaps with maturity of 7, 28 and 91 days, where the Bank of Latvia sells lats by US dollars and Euros to credit institutions with subsequent repurchase at the end of the maturity term.

Other market operations - the security reverse repo arrangements, security auctions on the secondary market - were held irregularly or have not been performed at all by the Bank of Latvia. The Bank of Latvia has started using the repo operations in October 1995 instead of auctions of short-term credit recourses. The Bank of Latvia has started using the repo reverse later, in May 1996.

Since March 24, 2007, the name of the Bank of Latvia's main refinancing operations has been changed: the main refinancing operations with 7-day maturity are conducted instead of the previous repos with maturity of 7- and 28-days. As with the case of the marginal lending facility the shortening of the term ensured the higher flexibility both to the Central bank as a supplier of reserves and the banks borrowing the reserves. The Bank of Latvia introduced the long-term refinancing operations with 3-month maturity, whereas in 2007 these operations were not conducted due to an adequate amount of the structural liquidity of banks. The foreign exchange swaps with 28- and 91-day maturities were suspended, maintaining only the transactions with 7-day maturity. Actually, since the above date, the Bank of Latvia uses only the Euro in foreign exchange swaps.

The reasons of failures of monetary policy include the methods of monetary regulation used by the Bank of Latvia. They are reduced by application of several "rules" which are considered to be suitable for any condition in any country. The first "rule": in order to decrease the rates of inflation it is necessary to limit the monetary offer or to apply the quantitative credit restrictions or to overestimate the refinancing rate.

One more dogmatic "rule" – I order to decrease the inflation it is necessary to strengthen the rate of national currency; on other hand, it reduces the price competitiveness of national commodity producers. It could be raised by depreciation of the credits, but it is forbidden by the first "rule". The application of such "rules" of monetary policy by no means is rather offensive: the economics can get to a condition called by the "trap". In such conditions the measures of state regulation do not bring positive results. These traps are known: "the debt", "the liquidities" and "the negative effect rendered by strengthening of actual exchange rate of national currency on economic development".

The debt trap occurs at excessive debts of the state and private sector at small duration of debt. By involving the short-term and intermediate term loans under low interests the borrowers count them as refinance by new loans. In case of steep increase of interest rates in the financial markets its long service sharply rises. If the borrower is not in position to extinguish it, the avalanche growth of debts begins, and it is impossible to extinguish it even after decrease of the interest rates. Now, there is a growth of interest rates which were on rather low level for the long period. The Latvian enterprises borrowed the financial resources abroad and can shortly face the refinancing problem and service of debts.

The liquidity trap occurs at too low nominal interest rates when the Central Bank decreases refinancing rate, but it do not lead to expansion of the credits and stimulation of economic growth.

The third trap is caused by the increase in balance of the international payments. It leads to the strengthening of national currency and shifting of employment to sphere of services. The Bank of Latvia can use the maintenance of the exchange rate by buying up the foreign currency, and it conducts to the growth of monetary offer and inflation strengthening. At high inflation the strengthening or stability of the nominal exchange rate leads to strengthening of the actual exchange rate. In other words, the efforts of the Central Bank do not achieve the object on maintenance of price competitiveness. Thus, there is a necessity of sterilisation of superfluous liquidity. The escalating of the gold and exchange currency reserves by Latvia basically is crediting of the USA and the European Union countries.

The inflation is mostly supported by excessive inflows of a variety of financing: the credit resources from foreign parent banks, the foreign direct investment, the EU funding, the workers' remittances from abroad. To avoid the imported inflation the high validity of monetary policy is required. For example, the most effective remedy of the negative effect rendered by strengthening of actual exchange rate is crediting of the enterprises by the government and the Central Bank by replacing the foreign loans. Certainly, such replacement of credits is better than the accumulation of superfluous currency provisions. However, from the macroeconomic point of view the replacement of foreign loans of the Latvian enterprises by local credits is similar to repayment of external debt. Now, the Latvian commercial banks involve the foreign loans, and the Central Bank is compelled to buy up the foreign currency, generating the superfluous monetary offer which needs to be sterilised immediately.

The growth in the monetary base was mainly supported by increase of net foreign assets of the Bank of Latvia by 361,6 million lats or 15,0%, the purchasing foreign currency in net amount of 158,6 million lats and conducting of foreign exchange swaps. Large amounts of foreign currency were sold to the Bank of Latvia due to the continued rapid growth of Euro loans subsequently converted into lats and by the expansion of the minimum reserves, which created an additional demand for the lats liquidity. Also large amount of foreign currency was sold to the Bank of Latvia because of inflows of foreign investment and foreign financial assistance funding in the economy. The foreign assets of the central bank expanded also on account of the government's foreign currency deposits. At the end of 2007 the Bank of

Latvia's reserve assets covered the goods imports of 4,4 months (4,6 months at the end of 2006), whereas the backing of the national currency with the Bank's net foreign assets was 112,3% (107,4% at the end of 2006).

With the view of restriction of money growth the Bank of Latvia does not refinance sufficiently the credit organisations by establishing the refinancing rate at high level. It leads to the overestimate of credit resources cost for banks and enterprises. Therefore, the Latvian enterprises increase the foreign loans. The vicious circle turns out - the Bank of Latvia is compelled to get the additional volumes of the foreign currency arriving in the form of foreign credits to private sector of economy, increasing thereby the monetary base. The government is compelled to "freeze" huge budgetary funds on accounts of the Bank of Latvia in order not to admit an excessive monetary issue and inflation strengthening.

The failure includes the preservation of high rates of inflation which exceed 16 % in 2008. The ways of their decrease in conformity with anti-inflationary program developed by the government are not enough clear. At low technological efficiency of the majority of Latvian economic branches and growing world prices for energy sources it is impossible to stop inflation, including the attempts to limit the growth of monetary weight. However, the high inflation at stable or raising exchange rate of lat leads to the strengthening of the actual rate of exchange, and consequently - to corresponding decrease of competitiveness of the Latvian enterprises. Though the indicator of parity of purchasing capacity is considerably underestimated regarding the currencies of the developed countries, the actual exchange rate strengthening brakes the economic growth and promotes the advancing growth of import. At high inflation the investors of banks receive negative real percent on deposits, and the enterprises pay the overestimated income and added cost taxes.

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