Strong Buy Latvia!

+ 6: That's how many countries have joined the European Monetary Union since 2007. At the rate we're going, the EMU could expand from 18 to 25 members within ten years, or even more—unless, of course, it sheds a few and actually shrinks. But who's to know, and how to know, where such a deeply dysfunctional currency bloc is heading?

We'd love to share the enthusiasm (however perfunctory) that customarily surrounds the addition of a new eurozone member. We'd rather not be criticizing what looks like a mad scramble to glue together a steadily rising number of countries that stand next to no chance of functioning properly under the same interest rate—the ECB's. Unfortunately, we can't help sensing that Latvia will eventually be going the same road as Greece, Ireland, and Spain. If it does, it won't be due to mismanagement, as some pundits may fear. It will happen because even with the best of intentions, the Latvians will be powerless to offset the impact of a monetary policy that is inherently unsuited to their situation

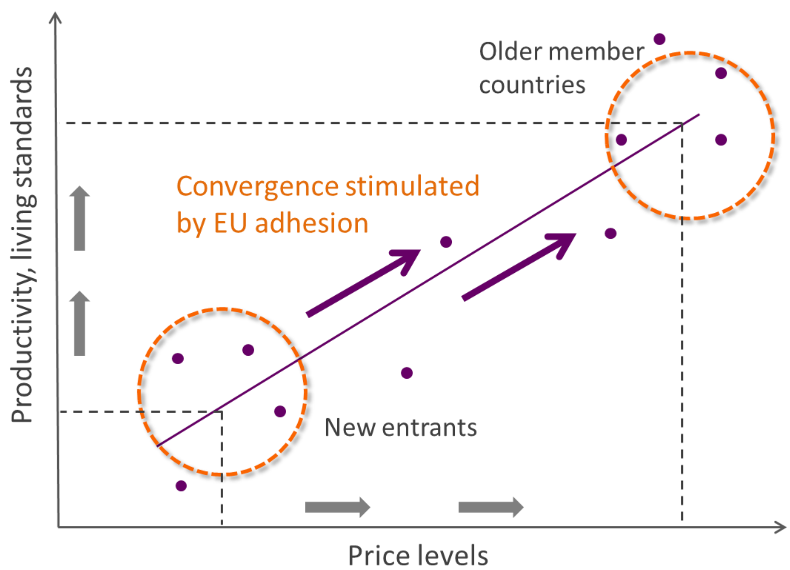
Latvia's EMU membership offers a good opportunity to step back and focus on a crucial underlying issue often overlooked by economists: fast-tracking insufficiently developed economies into the currency bloc is irresponsible policy (for a slightly different treatment, see our article of July 2012, "From High Hopes to Despair: The Missing Metric in the European Monetary Union").

Why such a harsh judgment? Because the record shows that economies can't converge after joining the EMU; they have to do it beforehand.

In joining the EU, new member countries, which usually have less developed economies than longer-standing members, enter a European convergence process driven by several factors:

– They gain access to a large export market with no internal borders.
– Free capital flows accelerate technology transfer to new entrants.
– New members benefit from EU support policy combining structural transfers and development policies.
– They enjoy the economic protection afforded by EU membership.

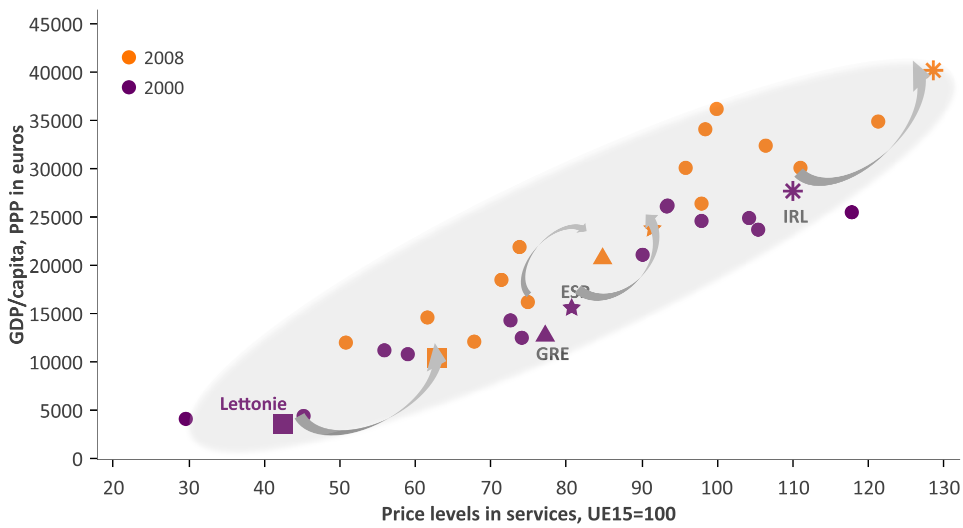
The European Catch-Up Process



Characteristic of the convergence phase are two major trends: higher productivity and an overall rise in domestic prices. The concurrence of the two is a standard feature of all economic catch-up processes, since productivity determines both living standards (growth potential) and price levels, at least in the "protected" sector of the economy—basically in services (see figure above and chart below).

Convergence Process in the EMU 2000-2008

Eurozone living standarts relative to price levels in services



Sources: RichesFlores Research, Macrobond

As a result, new member states almost automatically experience stronger economic growth than older ones and thus feel confident that their living standards will eventually rise, perhaps even to nearly the same level as in the EU's pioneering countries. This, in a nutshell, is what European integration is all about and why it appeals to non-member countries. Moreover, precisely because this convergence process is central to European construction, it is essential to ensure that new members have the means to accomplish it. The EMU must set appropriate economic policies, in particular efficient monetary policy, which in this instance can mean only one thing: a policy that doesn't bias capital allocation. Any other approach is likely to turn open borders into a cause of long-term instability instead of long-term growth.

But there is a key requirement for such a process to be successful: the cost of capital must be adjusted to actual profitability in a new member state. This means that interest rates have to be brought roughly in line with nominal GDP growth in that country—not nominal GDP growth in the rest of the bloc. This is the vital issue facing Latvia. Given that GDP per capita currently lags 62 percent behind the eurozone average, catching up with European living standards will be impossible unless the Latvian economy outperforms the rest of the EMU by 3.9 percent for twenty-five years straight. This in turn will make it necessary for interest rates in the country to exceed euro area rates by as much. If we now factor in the greater domestic price inflation resulting from the convergence process, **Latvia's interest rates will have to remain at least 6.0 percentage points higher for a quarter of a century to ensure real economic convergence without creating imbalance.**

Hypothetical differential between Latvian and EMU 17 nominal interest rates during the transition period

	Euro area	Latvia
GDP per capita, PPP in current euros		
- Level in 2012	28.500	11.000
- Growth differential required for convergence in 25 years		**3.9%**
Price levels in services, EMU 17=100		
- Level in 2012	100	59,1
- Inflation differential required for convergence in 25 years		**2.1%**
Hypothetical interest rate differential		**6.0%**

Source: RichesFlores Research

As matters now stand, the kind of assistance outlined above will be unavailable to Latvia as it rushes into the EMU, like so many other countries before it. The Latvian economy will undoubtedly get a hefty boost, most likely powered by speculative capital flows that initially raise high hopes but ultimately prove destructive. (This will sound grimly familiar to the Spaniards.) In fact, the currency bloc this new member is joining looks a lot less like Noah's Ark than like a raft drifting in a storm.

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