Baltic ambition

Latvia looks likely to become the euro zone's 18th member next January

VALDIS DOMBROVSKIS is undeterred. In spite of Cyprus, Slovenia and the continuing euro crisis, the prime minister of Latvia wants his country to join the single currency on January 1st 2014. This week he flew to Paris to persuade the French who, along with the Spanish, are among the most sceptical about Latvia's designs.

On the face of it Latvia should be a shoo-in. The tiny Baltic state effortlessly fulfils the Maastricht criteria. So far the euro zone has never rejected a country that complied with all of them. Moreover, Latvia's economy is growing robustly, its currency has been pegged to the euro for nearly ten years and as much as 90% of its private and corporate debt is already in euros. Its northern neighbour, Estonia, joined in 2011 and Lithuania, the third Baltic state, is hoping to follow in 2015.

Yet Latvia has only recently become a Baltic success story. A deep slump saw GDP shrink by some 20% in 2009. In December 2008 the European Union and the IMF agreed to a €7.5 billion ($10.1 billion) bail-out for Latvia. A period of stringent austerity that drastically reduced public spending and wages followed. Unemployment and poverty increased. Today Latvia is the EU's third-poorest member.

Latvia's banks are another concern. Non-resident deposits represent about half of all deposits in Latvian banks. As much as 90% of these come from Russia, Belarus, Uzbekistan and other countries of the former Soviet Union. They go to Latvia because it is safer than at home, and the staff speak Russian and understand their business mentality.

Yet Mr Dombrovskis rejects any comparisons with Cyprus. He insists that Latvia's banking sector is comparatively smaller, its banks are better capitalised and the government has tightened up its money-laundering rules in recent years.

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The prime minister's biggest problem may be public opinion in Latvia. According to recent polls, only around a third of Latvia's 2.2m people favour joining the single currency. The Harmony Centre alliance, mainly supported by ethnic Russians, is calling for a referendum on whether to join. "People are very afraid of inflation," says Morten Hansen at the Stockholm School of Economics in Riga. After Latvia switched from the rouble to the lat in the wake of the collapse of the Soviet Union, inflation rocketed, wiping out many people's savings. Switching from the lat to the euro will hardly be inflationary, maintains Mr Hansen, but this is hard to explain to older folk.

Mr Dombrovskis hopes that, once Latvians see increasing investment from the euro zone and a boost to exports, many will change their minds about the benefits of the single currency. Life will also be easier for the large majority of Latvian borrowers who earn wages in lats but borrow in euros. Everything depends on the report about Latvia's euro prospects now being drafted by the European Central Bank and the European Commission, which is due in May. The omens are good, even if most Latvians remain to be convinced.

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