Mr Repse gives a short speech on monetary policy in Latvia and exchange rate strategies

Speech given by Mr Einars Repse, Governor of the Bank of Latvia, at the ECB Seminar on the Accession Process, held in Helsinki on 11 November 1999.

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Ladies and Gentlemen,

Accession to the European Union (EU) is a strategic aim of Latvia, and we see joining the European Monetary Union (EMU) as an integral part of this process. We strongly hope that the European Council will accept the Commission's recommendations and a decision will be made to commence accession negotiations with Latvia in year 2000. The Bank of Latvia will be well prepared for these negotiations, as we have already established our status and policies with a perspective of future membership in the EU.

The Bank of Latvia enjoys a high degree of independence, fully compatible with the requirements of the EMU. Price stability is clearly defined as the main objective of the Bank of Latvia, and its monetary policy instruments and procedures largely correspond to the monetary policy framework used within the European System of Central Banks. And we are implementing a very conservative monetary policy, which, as we believe, is in line with the policy principles of the European Central Bank (ECB).

Since 1993, Latvia has been using the exchange rate based stabilisation programme. In February 1994, the Bank of Latvia pegged the national currency to the SDR basket. We based our decision on the belief that a fixed exchange rate regime, if it is durable and credible, reduces uncertainty, eliminates currency risk and provides businesses with a sound basis for planning and pricing. It fosters investment and international trade, which are of a particular importance for the restructuring of a small, open economy like Latvia.

The Bank of Latvia has indeed ensured that the exchange rate arrangement is credible and durable, and the Latvian economy has benefited from the stability. Inflation has declined to a level consistently below 3%, there has been considerable growth in exports, especially to the EU countries, and it has contributed to the strong GDP growth over the last years. The achieved macroeconomic stability allows us to set the target of fulfilling the nominal convergence criteria at the time of Latvia's accession to the EU.

Pegging the national currency to the SDR rather than to a single currency, the Bank of Latvia has made the lats fluctuate less against any individual currency than it would otherwise. Furthermore, the structure of Latvian foreign trade by settlement currencies largely corresponds to the composition of the SDR basket, thus providing extra rationale for the current peg.

To sustain the current exchange rate regime, the Bank of Latvia intervenes in the foreign exchange market by selling or buying the national currency at a predetermined exchange rate, thus acting in a close analogy with the currency board arrangement. We are also in line with another important feature of the currency board: Latvia's monetary base is permanently covered by Bank of Latvia's net foreign reserves at more than 100%. At the same time, the Bank of Latvia is not bound by the legal and institutional restrictions of the currency board arrangements. As a full-fledged central bank we flexibly manage liquidity in the banking system by steering short-term interest rates. The current exchange rate arrangement has allowed us to develop the full set of market-based monetary instruments and operational practices.

In our opinion, the present exchange rate regime is the best option for Latvia on our way towards the membership in the EU and the EMU. Therefore we intend to maintain the existing peg to the SDR until the accession to the EU.

We are aware of the currency stability requirement as set out in the Maastricht Treaty and the Protocol on the convergence criteria. It is our understanding that the current interpretation of said criterion prescribes mandatory participation of the new Member States, including those with a fixed exchange rate regime, in the ERM II before the eventual adoption of the euro. This requirement does not represent any difficulty for Latvia. Due to its peg to the SDR, exchange rate fluctuations of the lats against the ECU (and later against the euro) have not exceeded 10% in either direction for the last six years. In effect, we are already observing the required fluctuation margins without a formal participation in the Exchange Rate Mechanism. The Bank of Latvia is strongly committed to ensure stability of the national currency also in the future, so formal participation in the ERM II will hardly affect our daily operations.

Let me conclude by saying that we highly appreciate the opportunity provided by the ECB to exchange opinions on the challenges the candidate countries will be facing in the coming years. We look forward to increased cooperation with the Eurosystem and individual central banks of the EU countries.