

RACE TO THE EUROZONE: WHY LATVIA JOINED BEFORE LITHUANIA¹

Anastazija Markevičiūtė,
Vytautas Kuokštis

ABSTRACT

Why did Latvia join the Eurozone in 2014, while Lithuania only acceded a year later? The two countries' diverging experiences are surprising. Latvia suffered a more pronounced economic crisis from 2008 to 2010, which created greater euro adoption challenges in terms of meeting fiscal criteria. This article argues that, while the willingness to adopt the euro increased in both countries during and after the crisis, the will to seek euro adoption was stronger, clearer and more consistent in Latvia than in Lithuania. In examining this divergence, we argue that relying on aggregate economic costs and benefits, identity considerations, geopolitical considerations, societal support, and interest group preferences does not produce a satisfactory explanation of fluctuations in these countries' willingness to adopt the euro. Instead, we propose that changes in this willingness can be traced to domestic political processes, such as the timing and results of elections and the magnitude of the economic crisis's impact.

Keywords: Eurozone, accession, Latvia, Lithuania

INTRODUCTION

Latvia and Lithuania both joined the European Union (EU) in 2004, which entailed a commitment to eventually adopt the euro. Despite numerous pertinent similarities between Latvia and Lithuania, such as country size, economic structure, level of development, and even monetary regime (a currency board system in Lithuania and *de facto* currency board arrangement in Latvia), their paths towards the adoption of the euro were not identical. In 2004, World Bank representative Lajos Bokros predicted that Lithuania, together with Estonia and Slovenia, would be among the first countries to adopt the euro (International Monetary Fund, 2004). Lithuania

ANASTAZIJA MARKEVIČIŪTĖ, MA in Public Policy from the Institute of International Relations and Political Science, Vilnius University, anastazija.markeviciute@gmail.com.

VYTAUTAS KUOKŠTIS, corresponding author, Associate professor at the Institute of International Relations and Political Science, Vilnius University, kuokstis@gmail.com.

¹ Acknowledgments. This work was supported by the Research Council of Lithuania under Grant No. MIP-010/2013. The article was written as part of the *Lithuania in the EU: transformation or imitation?* project implemented by Vilnius University's Institute of International Relations and Political Science. Earlier versions of this article were presented at the 22nd International Conference of Europeanists in Paris, held in July 2015 and at the 8th Pan-European Conference on the European Union in Trento, Italy held in June 2016. The authors thank Ramūnas Vilpišauskas, Magnuh Feldmann, and Niamh Hardiman for their valuable suggestions.

joined the Exchange Rate Mechanism (ERM II) in 2004—a year earlier than Latvia. Furthermore, Lithuania was planning, and had a realistic opportunity, to adopt the euro as early as the start of 2007. This had been Lithuania's plan since 2003, as stated in its Pre-Accession Economic Programme (PEP). To the north, Latvia's PEP mentioned 1 January 2008 as the earliest possible date for euro adoption (Dean, 2004, p. 761). The years that followed the development of the two countries' PEPs brought increasing inflationary pressures and a subsequent economic crisis that precluded euro adoption in both countries.

In response to the Great Recession, all three Baltic countries sought to preserve fixed exchange rates, and therefore implemented internal devaluation by adopting rapid fiscal consolidation. All three countries also emphasized their willingness to adopt the euro, though their degrees of willingness varied. Estonia adopted the euro as early as 2011, largely as a result of its prudent pre-crisis fiscal policy, but also due to Estonia's better tax collection results during the crisis. Latvia and Lithuania struggled, much more than Estonia did, to achieve fiscal consolidation and fulfil the fiscal criteria. Yet the most important and interesting difference between the former two was Latvia's display of a greater willingness and a firmer commitment than Lithuania displayed to adopt the euro during and after the Great Recession (although the determination to seek euro adoption increased in both countries during this time). Latvia's willingness translated into specific policy actions that, in the end, meant that Latvia acceded to the Eurozone before Lithuania. Latvia adopted the euro before its southern neighbour despite the fact that Latvia faced tougher economic challenges than Lithuania and had to put in more effort to achieve Eurozone accession.

In this article, we aim to answer why the willingness to adopt the euro varied over time and between the two countries, a difference that resulted in their different dates of euro accession despite sharing similar economic, historical, social, and political conditions. To answer this research question, we draw on the most popular approaches in economic and political-economic literature to explain preferences for euro adoption. Further, we use aggregate economic cost-benefit calculation of joining the Eurozone based on optimum currency area (OCA) theory and we consider the impact of a collective identity and of geopolitics, of interest group pressures, and of societal opinion. We adopt a perspective that focuses on domestic political processes to determine why Latvia acceded to the Eurozone before Lithuania did. Finally, we also take into account a factor that has not been explored extensively in the literature: the role of the economic crisis. We find that the fluctuations in the willingness to adopt the euro (and the ultimate dates of Eurozone accession) in Latvia and Lithuania cannot be accounted for fully by aggregate economic arguments, interest group pressure, societal opinion, or identity and geopolitical factors. Instead, our explanation of changes in the values of our dependent variable is based on domestic political developments. First, we argue that the timing and results of elections in Latvia enabled the Latvian government to consistently focus on its euro adoption strategy. Second, the economic crisis was more profound in Latvia, which led to a higher sense of vulnerability and a desire to seek perceived safety within the single currency zone. Finally, Lithuanian authorities were less willing to make a strong commitment to a specific euro adoption date, partly due to Lithuania's failed first attempt to join the Eurozone.

1. FLUCTUATIONS IN LATVIA AND LITHUANIA'S WILLINGNESS TO ADOPT THE EURO: VALUES OF THE DEPENDENT VARIABLE

It is necessary to first look at the dynamics of Latvian and Lithuanian positions vis-à-vis euro adoption over time—in other words, to describe the values of the dependent variable. Our period of analysis starts in 2004, when Latvia and Lithuania acceded to the EU and made a commitment to adopt the euro at some point in the future. The cut-off point of our period of analysis is 2014, Lithuania received its official invitation to join the Eurozone on 1 January 2015.

At the beginning of this period, prior to 2007, Lithuania was more active in seeking to adopt the euro than Latvia was. Between 2004 and 2013, Latvia and Lithuania each underwent four evaluations. In 2006, only Lithuania applied for evaluation as it had joined the ERM II earlier than Latvia. The differences between Latvia and Lithuania's pursuits of the euro at the beginning of this period can largely be attributed to exogenous factors, namely, the ability to meet the Maastricht criteria, and more specifically, to meet the inflation criterion (all other criteria were comfortably met by both countries during that period). Prior to 2007, Lithuania's inflation level was fluctuating around the reference value, while in Latvia it was well above the reference value (see Figure 1).

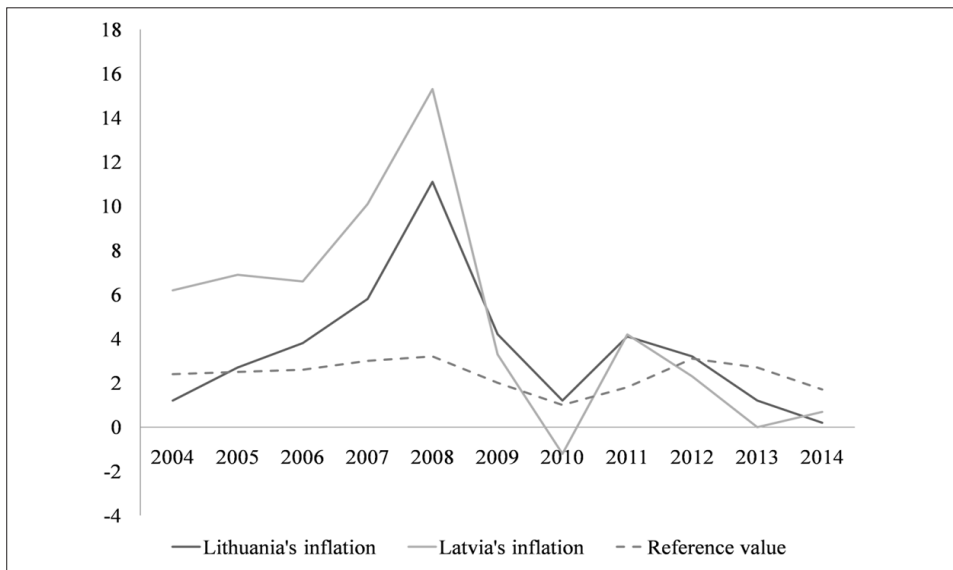


FIGURE 1: Inflation in Latvia, Lithuania (twelve-month average inflation rate), and the Maastricht reference value, in percent.

Sources: for national inflation rates, Eurostat database; for the reference value, Convergence Reports, (European Central Bank, 2013; European Central Bank, 2014).

Although both Latvia and Lithuania were experiencing economic overheating driven by EU aid inflows, credit bubbles, and excessive optimism at the time, the differences in inflation between the two countries can be explained by the fact that the process of economic

'overheating' had started earlier and advanced more rapidly in Latvia. Thus, one could conclude that a willingness to adopt the euro at the beginning of the analysed period was similar in Latvia and Lithuania. Overall, both countries were, in principle, in favour of euro adoption, but did not see it as a priority and were not willing to sacrifice other objectives (such as growth) or write specific policy actions—in terms of government expenditure, tax policies, or price regulation policies—to achieve their euro adoption goals. This is well illustrated by Lithuania's failed attempt to join the Eurozone in 2007.

In March 2006, Lithuania submitted an application to adopt the euro, despite it being "already clear that the risk to breach the inflation criterion was high" (Vilpišauskas, 2014, pp. 225–226). Slovenia also submitted an application in March 2006. EU institutions confirmed Slovenia's application and rejected Lithuania's due to its breach of the inflation criterion. The decision was controversial; Lithuania's inflation was only 0.1 percentage point higher than the reference value, but the decision was additionally justified by judging Lithuania's inflation unsustainable (European Commission, 2006, p. 9). According to Vilpišauskas (2014, p. 226), "it is possible that Lithuanian politicians had not delved deeply [enough into the situation] and followed the suggestions [made] by diplomats and higher officials, which was in contrast to the opinion prevailing in EU institutions and informal forecasts regarding the possible negative evaluation of Lithuania".

Although Lithuania declared its eagerness to adopt the euro, it did not pursue a policy that was coordinated enough to achieve this goal. Specifically, it conducted a procyclical fiscal policy that contributed to inflation. Furthermore, inflation increased in Lithuania not only because of external circumstances, but also due to deliberate policy decisions, such as hikes in regulated prices (Vilpišauskas, 2014, p. 228). In summary, Vilpišauskas concludes that Lithuania's failure to achieve euro accession was due to the "ambivalent stance of the political elite, uncoordinated actions in several functionally related fields of economic policy, as well as a very strict evaluation of Lithuania provided by the EU institutions" (Vilpišauskas, 2014, p. 228).

The Great Recession changed the stances of the Baltic governments towards euro adoption. In response to the economic downturn, Latvia and Lithuania (as well as Estonia) sought to defend their currency pegs with the euro and implemented rapid fiscal consolidation. As fiscal revenue contracted, public deficits soared (see Figure 2). In contrast to Estonia, neither Latvia nor Lithuania had accumulated fiscal reserves, and they were forced to borrow to cover governments financing. They did this in different ways. Lithuania turned to the bond market, Latvia applied for international financial assistance from the International Monetary Fund and the EU. This difference can be attributed to the collapse of Latvia's important domestic bank, Parex, in late 2008, an event that further complicated Latvia's situation.

In both Latvia and Lithuania, euro adoption was seen as part of a crisis exit strategy. However, in Latvia, the willingness to adopt the euro was firmer and clearer throughout the crisis and post-crisis years. The head of Latvia's central bank, Ilmārs Rimšēvičs, "in nearly every public statement insisted on the fixed exchange rate and a budget of 3 percent of GDP in 2012 to qualify for euro adoption in 2014" (Åslund and Dombrovskis, 2011, p. 68). In a co-authored book written in 2014, Dombrovskis argues that the Latvian government's 2009 plan

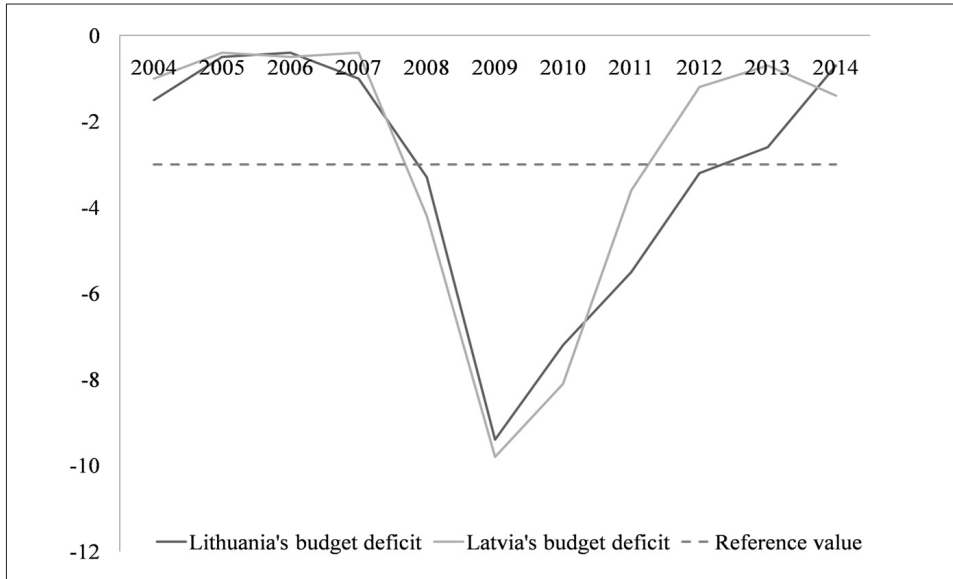


FIGURE 2: Public deficits in Latvia and Lithuania, in percent of GDP, and the Maastricht reference value (three per cent of GDP).

Sources: for public deficit data for Lithuania up to and including 2012, (European Central Bank, 2014, p. 134); for Latvia up to and including 2012, (European Central Bank, 2013, p. 54). For 2013 and 2014, Eurostat database. Different data sources were used because the methodology of calculating the budget deficit was changed in 2014, and earlier figures were recalculated.

and commitment to adopting the euro in 2014 seemed realistic (Åslund and Dombrovskis, 2011, pp. 109-110). In his annual report in 2012, Dombrovskis emphasizes that the country's foreign policy was focused on the EU, that further euro integration was in line with Latvia's interests, and that the government's goal was to garner support for Latvia's euro accession from other EU countries (Dombrovskis, 2012a). According to former Lithuanian Minister of Finance Ingrida Šimonytė, Latvia displayed a stronger willingness to seek euro adoption during the crisis and recovery periods. Šimonytė (2014) argues that, in Latvia, euro adoption had been seen and discussed as a key part of the anti-crisis program since the start of the crisis. Not only was the Latvian government clearer on its public commitment to the euro, the government also took concrete policy steps to achieve euro adoption. First, the Latvian government pressed more forcefully for fiscal consolidation, and as a result, its budget deficit was already well below the Maastricht reference value by 2012 (see Figure 2). Furthermore, Latvia's strategic tax policies—cutting the VAT rate in 2012 to slow inflation—maximized Latvia's chances for a positive evaluation of its 2013 Eurozone application (Seputyte, 2012; Bukovskis, 2014).

The Lithuanian case was different. The so-called crisis government of Kubilius, which came to power at the end of 2008, declared euro adoption as its goal. It even sought to meet the public deficit criterion of three per cent of GDP in 2009 and planned the budget accordingly,

but those plans were abandoned due to a much more dramatic economic contraction during the crisis than expected (Šimonytė, 2014). Later, the government was less clear about Lithuania's euro adoption date, although it argued that euro accession remained its goal. During an interview in 2012, President Grybauskaitė stated that despite earlier plans to adopt the euro in 2014, there was no specific date of adoption set (BNS, 2012). To preserve Lithuania's chance to join the Eurozone, Kubilius's government had also planned the 2012 budget so that the deficit would be below three per cent of GDP (Šimonytė, 2014). However, by 2012, the deficit was 3.2 per cent of GDP (see Figure 2). The new government, led by Social Democrats, came to power in 2012. Before the elections and immediately after the new coalition was formed, the new government was silent on euro adoption until early 2013 when Prime Minister Butkevičius named introducing the euro the government's strategic goal (Vilpišauskas, 2014, p. 231). Vilpišauskas observes that, "increasingly intensive efforts for euro introduction. . . [and] political rhetoric strengthened with the culmination in January 2014 when the Prime Minister declared he would resign if Lithuania does not adopt the euro from 2015" (Vilpišauskas, 2014, p. 231). All in all, during the crisis and post crisis years, Lithuania did not pace itself as consistently as Latvia did, opting instead for a more cautious, "wait and see" approach towards euro adoption.

The values of our dependent variable are summarized as follows: At the beginning of the analysis period, both countries were in favour of euro adoption, but did not set it as a priority and were not willing to take concrete policy steps or make significant sacrifices to adopt the euro. The crisis years prompted a change in both countries' policy stances and euro adoption emerged as an important goal and as part of their crisis exit strategies. Nevertheless, euro adoption was communicated more clearly and sought more strongly and consistently in Latvia. Lithuania's stance was vaguer, and less firmly committed. As a result of these differences, Latvia joined the Eurozone a year earlier than Lithuania.

2. AGGREGATE ECONOMIC COSTS AND BENEFITS

According to the aggregate economic costs and benefits perspective, a willingness (or reluctance) to adopt the euro should stem from how well (or poorly) a country's economy "fits" with the single currency zone. This perspective builds on the optimum currency area (OCA) theory (Mundell, 1961; McKinnon, 1963) and holds that countries will be willing to enter the Eurozone if the aggregate economic benefits of membership—increased trade, higher efficiency, and lower transaction costs—exceed the aggregate costs of membership, such as losing exchange and interest rate policy as a tool to respond to asymmetric shocks and improve competitiveness (Caporale, Ciferi and Girardi, 2011, p. 432; Frieden, 2002, pp. 831–832). In general, a country should be reluctant to join the Eurozone if it faces different (asymmetric) shocks than other members of the currency union, or if it will take a long time for a country to adjust to those shocks without recourse to monetary and exchange rate policies. Hence, the following factors should *ceteris paribus* make countries more eager to adopt the euro: economic openness, a large share of trade and a high degree of business cycle synchronization with other members of the currency union, flexible prices and wages, mobile capital and

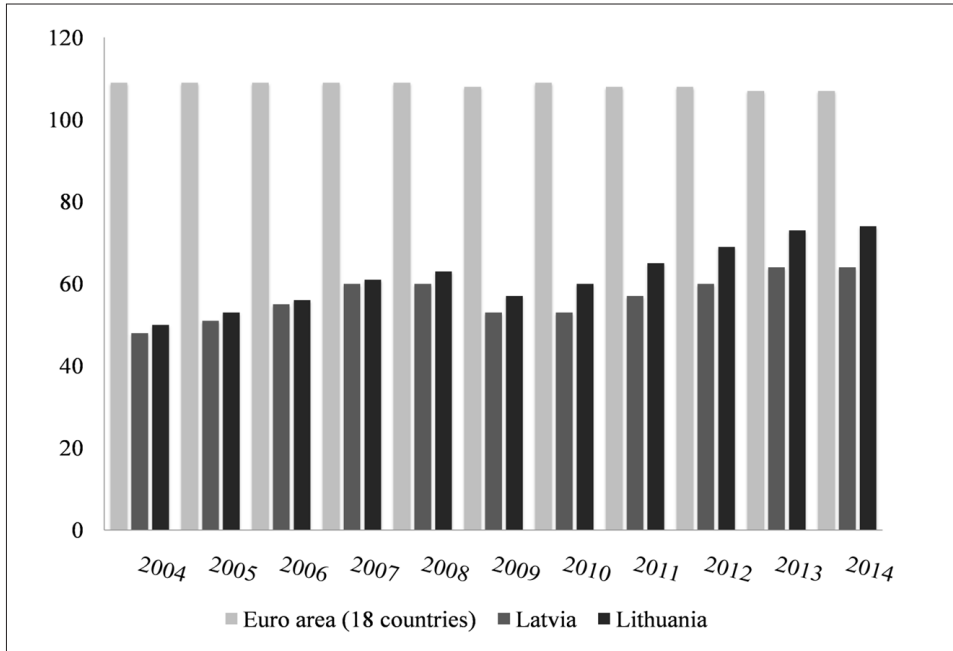


FIGURE 3: Real GDP per capita in Latvia and Lithuania from 2004 to 2014, in Purchasing Power Standards (PPS), Index EU 28=100.

Source: Eurostat database.

labour, and economic convergence with other members of the currency zone as reflected in real GDP per capita, labour productivity, and economic structure (Angeloni, Flad and Mongelli, 2007; José and Larribe, 2008)².

From this vantage point, were Latvia and Lithuania good candidates for membership in the Eurozone? On the one hand, both Latvia and Lithuania lagged markedly behind the Eurozone in terms of economic development (see Figure 3) and labour productivity; furthermore, their business cycles were not synchronized well with the Eurozone's, as revealed by very large booms and busts in the two countries during their decade of EU membership. On the other hand, both countries were exceptionally flexible, an important factor in overcoming the crisis of 2008 to 2010 (Purfield and Rosenberg, 2010; Kuokštis, 2015). Apart from nominal wage flexibility, this also encompasses labour mobility and firms' abilities to adapt to changing circumstances (Kuokštis, 2015). Besides, Latvia and Lithuania both have relatively small and open economies (and Lithuania's, despite its larger size, is actually more open).³ As for trade with Eurozone countries, Latvia and Lithuania's shares comprised a substantial, but not a dominant part of

² In this section, we focus on the so-called real convergence factors as nominal convergence criteria are already covered in the Maastricht criteria.

³ For instance, in 2007, the exports of goods and services to GDP ratio in Latvia and Lithuania stood at 39 and 50 per cent respectively; in 2012, this measure was 61 and 82 per cent respectively, (Eurostat).

the two countries' overall trade—with 32 per cent and 30 per cent, respectively, during the analysis period of 2004 to 2012.⁴

Overall, OCA theory has a hard time explaining variation in the values of our dependent variable, especially the divergence in Latvia and Lithuania's willingness to adopt the euro at the end of the analysed period. First, whether or not Latvia and Lithuania were, or have become, good candidates for participating in the euro area is debatable. Although it is true that both countries saw rather rapid real convergence towards the Eurozone throughout the analysed period (see Figure 3), the very high volatility of Baltic economies—as manifested by their massive booms after entering the EU and large contractions during the Great Recession—revealed the dangers of sticking to exchange rate pegs and common monetary policy. In hindsight, it is evident that the European Central Bank's (ECB) monetary policy was not in line with the needs of the Baltic economies.

Furthermore, Lithuania actually met OCA criteria *better* than Latvia did. Throughout the period of analysis, Lithuania had a higher GDP per capita and also converged more quickly to the Eurozone than Lithuania did (see Figure 3). Secondly, Lithuania's economy was arguably more flexible; during the last recession, the country dealt with the crisis more successfully. This flexibility was manifest in Lithuania's substantially faster growth in exports.⁵ Thirdly, the pre-crisis boom was less pronounced in Lithuania. Thus, based on a country's "fit" with the Eurozone, Lithuania should have been the more willing one to adopt the euro, but empirically this did not turn out to be the case.

3. IDENTITY AND GEOPOLITICS

An alternative explanation of a country's willingness to adopt the euro is based on the importance of a country's collective identity (Risse, et al., 1999; Risse, 2003). Currency affairs have always been closely tied to issues of national identity and statehood (Helleiner, 1998). Thus, according to Risse, et al. (1999, pp. 148–149), only those countries whose elites treat euro integration as part of the country's national identity will move forward with euro adoption, especially since there are often good economic arguments both for and against becoming a Eurozone member. Risse, et al. (1999, p. 148) argue, "the Euro is about European union and political order rather than only lowering transaction costs or creating exchange-rate stability".

Turning to the empirical cases of Latvia and Lithuania, it would be hard to completely dismiss this identity-based argument. In the Baltic countries, European integration has always been at the core of their external economic and political orientation (Austers and Bukovskis, 2013, p. 30), and entering the Eurozone could be regarded as yet another step towards returning to the West—two key steps in this process were attaining memberships in the EU and NATO. This stemmed from these countries' geopolitical anxieties, their relatively small sizes, and being vulnerable states close to traditionally hostile Russia, but is also related to both states' identities being built on a

⁴ Calculations based on data on Latvia and Lithuania, (Statistics Lithuania; Central Statistical Bureau of Latvia).

⁵ Between 2007 and 2013, Latvian exports grew by 56 per cent and Lithuanian exports grew by 95 per cent (authors' calculations based on statistical data from Eurostat database).

sense of Europeaness. According to Bukovskis (2014), “Latvia has traditionally been very pro-European, at least on the elite level”. Feldmann (2008, p. 247) agrees, “in the second half of the 1990s European integration became the main focus of policymaking. Full membership of the EU was the main goal, and most political activity was subordinated to this objective”. Furthermore, on an even more pragmatic level, entrance into the Eurozone was also associated with the desire to have a stronger voice at the EU decision-making level, to be at the core of this project (Austers and Bukovskis, 2013, p. 31). All in all, for the Baltic countries, euro accession has always been as much about foreign policy considerations as it was about economic objectives.

However, this foreign policy orientation of “returning to” and integrating with the West has been present in both countries ever since they regained independence. Thus, it cannot explain why the desire to adopt the euro increased during the last economic crisis or why it intensified more in Latvia than it did in Lithuania. Of course, one could also point out that an identity-based perspective in general has a hard time accounting for short-run shifts in policy views and actions, as “collective nation-state identities are usually rather sticky and only gradually subject to change” (Risse et al., 1999, p. 156).

A related, although distinctive, explanation could be based on the changing perceptions of the *intensity* of geopolitical threats due to Russia’s actions in Ukraine in 2014. Vilpišauskas explains that euro adoption could satisfy ‘the need to be in the group (core) of most integrated EU countries, thus aiming to increase the economic and political (institutional) relations with EU countries with the expectation that this could bring more security in the case of Russian threat’ (Vilpišauskas, 2014, p. 210). Austers (2014) also argues that efforts to increase security against Russian threats motivated euro adoption. Furthermore, politicians in both countries publicly named geopolitical security as a reason to enter the Eurozone. For example, during his term as Latvia’s Finance Minister, Andris Vilks stated, “We are in a very fragile geopolitical situation. We should be as deeply integrated as possible into European institutions” (Milne, 2013). However, the timing of changes in the values of the dependent variable does not fit this explanation well, as the firm commitment to adopt the euro emerged in Latvia well before Russia’s actions in Ukraine. Second, from this vantage point, it is not clear why Latvia had a firmer commitment despite Lithuania sharing a similar sense of geopolitical threat. In fact, Lithuania arguably showed more concern regarding an increased Russian threat, as revealed by its more vocal opposition and the decision to reintroduce conscription.

4. INTEREST GROUP PREFERENCES

According to Frieden (2002), an explanation of a country’s position regarding euro adoption should take into account the preferences of its most powerful interest groups. This argument builds on the notion that while adoption of the euro (as a form of fixed exchange rate) is often difficult to evaluate from an aggregate efficiency point of view, the distributive consequences for different groups in a country are usually much clearer. In particular, import-competers and exporters (especially those specializing in the production of standardized goods) stand to benefit from the flexible exchange rates that could be used to boost their competitiveness, and thus are expected to oppose euro adoption. On the other hand, cross-border investors,

the financial sector, and exporters of specialized manufacturing should favour euro adoption due to greater certainty, the elimination of exchange rate volatility, and favourable effects on financial and trade flows (Frieden, 2002). One could further expect that countries with more influential sectors interested in euro adoption will be the countries more willing to accede (the influence is usually proxied by sector's share of employment or value added).

Certain predictions of this interest group explanation are corroborated by the Lithuanian and Latvian cases. The banking sectors unequivocally supported euro adoption; this was due to lower balance sheet risk (most loans were in euros, while most income came in national currencies) and due to unlimited access to ECB liquidity resources (Šimonytė, 2014). In addition, one could also point out that the importance of the financial sector in the economy has been higher in Latvia than in Lithuania.⁶ However, one problem with this explanation is that it cannot account for the timing of changes in preferences in both countries—in fact, the share of the financial sector was higher in both Latvia and Lithuania before the crisis than it was during the downturn.

Other businesses have also been mostly supportive of euro adoption in both countries (Feldmann, 2008, p. 251; Swedbank Analysis, 2012, p. 15; on Latvia (Bukovskis, 2014); on Lithuania (Besagirskas, 2014; Arlauskas, 2014)). According to Besagirskas (2014), both Latvian and Lithuanian firms adopted a pragmatic position which posited that euro adoption was economically beneficial, as businesses “made calculations related to the benefits this would bring, [and] how much lower the risk and borrowing costs would be”. It should be noted that there was also some opposition to euro adoption. Negative opinions towards euro introduction were expressed mainly by smaller firms concentrating on the domestic market, and were largely due to currency switching costs (Arlauskas, 2014; Bukovskis, 2014) and an element of patriotism (Besagirskas, 2014). Furthermore, to the extent that euro adoption risk was related to the possibility of currency devaluation during the economic downturn of 2008 to 2010, the business community was slightly less enthusiastic about euro adoption in Latvia as there were more voices calling for currency devaluation in this country, while no businesses expressed support for such a move in Lithuania (Kuokštis, 2013, p. 77).

To summarize, the Latvian and Lithuanian business communities in general, and especially their financial sectors, supported Eurozone membership. However, their stances or relative influence did not change markedly throughout the period of analysis or between the two countries. Therefore an interest group based perspective does not lead us to an answer to our research question.

5. SOCIETAL OPINION

Another factor that could potentially explain the willingness (and eventual decision) to adopt the euro is societal opinion. After all, in a democracy, government policies should be influenced by the preferences of the majority. Flash Eurobarometer surveys provide information about several

⁶ Over the period of 2006 to 2015, the share in value added in GDP fluctuated between 3.0 per cent and 5.0 per cent in Latvia, and between 1.9 per cent and 3.1 per cent in Lithuania (authors' calculations based on statistical data from Eurostat database).

questions pertaining to society's views towards the euro. The general picture that emerges from these data is that Lithuanians and Latvians have been largely sceptical of euro introduction. Except for a brief period during the last crisis in Lithuania, the proportion of respondents who thought that euro accession was negative for their countries was higher than those who held the opposite opinion. Asked about whether they were generally in favour of euro adoption in April 2012 (European Commission, 2013, p. 65), 46 per cent of Latvians were "very much" or "rather in favour," and 53 per cent were "very much" or "rather against" euro adoption. In Lithuania, the corresponding figures were 44 per cent and 51 percent. Last but not least, when asked specifically about the desired timeframe of euro adoption, both Latvians and Lithuanians overwhelmingly preferred to delay euro introduction for as long as possible. In March 2012, 49 per cent of Latvians and 41 per cent of Lithuanians said they wanted the euro introduced "as late as possible"; as few as 9 per cent of Latvians and 14 per cent of Lithuanians wanted to adopt the euro "as soon as possible" (European Commission, 2013, p. 68).

Politicians understood this scepticism regarding euro adoption. In fact, this could have been one of the factors affecting the lack of willingness to press for euro accession at the beginning of the period analysed, when sacrifices to achieve this would have been necessary in Lithuania (on Lithuania (Vilpišauskas, 2014, p. 230); on Latvia (Bukovskis, 2014; Austers, 2014)). It is also telling that in both Latvia and Lithuania, the government refused to hold referendums on euro adoption. Nevertheless, societal opinion does not explain shifts in the willingness to adopt the euro during or after the crisis. First, Latvians and Lithuanians did not generally become more supportive of euro adoption—most importantly, both countries' citizens preferred to delay euro adoption for as long as possible. Second, the prevailing societal opinion was similar in Latvia and Lithuania, and thus cannot account for the subsequent divergence. Third, in the Baltic countries, euro integration policies are generally an elite-driven affair, as has been the case generally in other countries (Dyson, 2008a, p. 3). In the Baltic States, this is generally true of economic affairs and of macroeconomic policy in particular.

6. DOMESTIC POLITICS: ELECTIONS, CRISIS, AND RISK-TAKING

According to Dandashly and Verdun (2010, p. 3), "for a complete understanding of the euro adoption strategy in NMS [new member states] one needs to look at the domestic political situation." (see also Dandashly, 2012). Specifically, they name "government policies, elections, electoral cycles as well as constitutional rules" as potential driving forces of euro adoption (Dandashly and Verdun, 2010, p. 3). As Dandashly and Verdun notice, this perspective might be particularly helpful in explaining "the *timing* of euro adoption" (2010, p. 8; see also Dandashly, 2012, p. 5). Drawing from this perspective, we outline how domestic politics played out in Latvia and Lithuania, leading to different levels of commitment towards euro adoption.

To begin with, one should take into account their divergent developments in terms of election dates and results. The first "crisis" government in Latvia, led by Prime Minister Godmanis, was formed in December 2007 and collapsed in March 2009 following massive protests over the government's policies. Subsequently, Dombrovskis took over as Prime Minister and won the 2010 elections as the leader of the Unity (*Vienotība*) alliance. According to Salines and Bērziņš

(2012, p. 155), “notwithstanding these stringent measures [the austerity program], Prime Minister Dombrovskis was re-elected in October 2010 with an even stronger parliamentary majority”. In the 2011 Parliamentary election, Dombrovskis’s party lost seats and took third place, while the ethnic Russian party, Harmony Centre (*Saskaņas Centrs*), won first place. Despite this, Dombrovskis’s Unity alliance formed a coalition with a party recently founded by former President Zatlers and Dombrovskis remained Prime Minister. He remained in this position until the beginning of 2014. Thus, Dombrovskis had an opportunity to introduce the euro during his reign and claim it as his own achievement. It should also be noted that Dombrovskis was a rather exceptional figure in the Latvian political context— he was generally regarded as an honest and competent politician when politicians were generally perceived as incompetent and corrupt. Dombrovskis’s re-election can be considered an approval of the government’s policy. According to Šimonytė (2014), while “there had been a lot of tension with creditors and also domestically in 2009 to 2010 . . . the elections gave new breath and a new mandate to the Latvian government to finish the job”. In Bukovskis’s opinion, the fact that Dombrovskis kept his position and the same government remained in power after the elections greatly influenced Latvia’s achievement of euro adoption in 2014 (Bukovskis, 2014). Austers and Bukovskis (2013, p. 31) observe, “Eurozone membership began to be advocated as the ‘prize’ for overcoming financial and economic problems through austerity”. In 2012, Dombrovskis himself writes, “one of the lessons we have learned is that in every crisis situation one has to have a clear exit strategy. For us the exit strategy was and still is joining the Eurozone in 2014” (Dombrovskis, 2012b, p. 7).

In contrast, in Lithuania’s first post-crisis elections in 2012, the ruling coalition that had presided over the austerity program lost to the opposition. As a result, Prime Minister Kubilius was replaced by Social Democrat Butkevičius. The prospect of the 2012 elections also led Kubilius’s government to be less enthusiastic about pressing for more expenditure cuts and less willing to focus on euro adoption; given the very low approval ratings of the government and of the Prime Minister the possibility of losing power was very realistic (Swedbank Analysis, 2012, p. 2). As mentioned above, although Kubilius’s government planned the 2012 budget with a deficit of under three per cent of Lithuania’s GDP, it eventually turned out to be higher. Tauraitė (2013) observes, “Kubilius’ government, although pro-euro, was rather reserved. Apparently, the upcoming Parliament elections and associated doubts about the continuity of policy course was one of the reasons for this”. Furthermore, Social Democrats, as mentioned before, were also reluctant to give a firm opinion on euro accession before the elections and they committed to adopting the euro only after they secured power. By contrast, when Latvia applied for euro membership, some Eurozone members doubted whether Latvia should be allowed to join, and thus “[Latvia’s] entry was far from assured” (Milne, 2013). It is also noteworthy that Kubilius’s and Butkevičius’s governments essentially did not differ in their stances regarding euro adoption, except for some radical public declarations made by certain members of Butkevičius’s coalition (Šimonytė, 2014; Besagirskas, 2014).

Another factor that contributed to differing opinions regarding euro adoption in Latvia and Lithuania was a difference in how the crisis impacted them. It is true that both countries were among the hardest hit during the crisis, in 2009 their real GDPs contracted by double digits. But

the crisis in Latvia was harsher due to its higher pre-crisis vulnerabilities and the collapse of its important domestic bank, *Parx*. As a result, Latvia was forced to apply for international financial assistance, while Lithuania tested the bond market. Furthermore, Latvia was the primary object of discussion in financial circles and in the media. Paul Krugman (2008) even dubbed Latvia the “new Argentina”. Political repercussions were also more pronounced in Latvia; protest activities were more intense there and their effect on the Latvian political system was greater. According to Salines and Bērziņš (2012, p. 164), “the crisis was so severe that it went beyond the economic realm to revive political fears. Many felt that the very survival of the nation was at stake, not least due to the accelerating emigration trend.” Besides, “the crisis reinforced the existential doubts about the future of the nation which had fought so hard for regaining its independence and sovereignty” (Salines and Bērziņš, 2012, p. 164). The risk of devaluation and financial meltdown in Latvia was more substantial than in Lithuania, the austerity program significantly more painful. Dombrovskis (2012b, p. 8) remarks, “introduction of the euro will put an end to all speculations about devaluation of the lats”. Both the objective and subjective impacts of the crisis were greater in Latvia, leading to a greater sense of vulnerability, which induced a stronger determination to seek safety within the single currency zone. Interestingly, Spendzharova has argued along similar lines on a related integration dimension, transferring the regulatory power of the financial sector to the EU level. She hypothesises that “the economic vulnerability of the region may prompt new EU Member States to be more open to supranational solutions” (Spendzharova, 2012, p. 324).

Finally, there is one more factor that dampened Lithuania’s enthusiasm for adopting the euro. Lithuania’s failure in its first attempt to join the Eurozone back in 2006 made Lithuanian authorities relatively more risk averse and they sought to avoid another potential embarrassment (Vilpišauskas, 2014, p. 233). To this day, Lithuania remains the sole country to have been denied Eurozone membership upon initial application. It is worthwhile to point out that, until the beginning of 2013, it was not clear whether Lithuania would meet the inflation criterion (Tauraitė, 2013). The fact that Lithuania eventually complied with the inflation criterion, beginning in September 2012, was due to two factors: the fall of oil prices and the EU institutions’s decision to exclude Greece’s inflation from their criterion value calculations (Tauraitė, 2013). Thus, Lithuanian authorities were only willing to commit to euro adoption when the probability of another failure was sufficiently low.

CONCLUSIONS

While economics sets boundaries and creates opportunities for euro adoption, ultimately the decision to enter the single currency area depends on political will. Latvia and Lithuania’s experiences during the decade following their EU entrances shows that this political will—driven by opportunities created by economic conditions and by political developments, which can also to some extent influence economic conditions—wax and wane over time. While Lithuania was more eager to join the Eurozone in the early years of EU membership than Latvia was—largely as a result of favourable, though exogenously granted, economic circumstances—the economic crisis of 2008 to 2010 changed the stances of the two Baltic countries in two important ways.

First, both Latvia and Lithuania became more committed to euro adoption. Second, and even more interesting, this commitment was more evident and firmer in Latvia throughout the crisis and post-crisis years. As a result of its faster and stronger fiscal consolidation, and due to other specific policy steps, Latvia joined the Eurozone in 2014. Euro adoption served as Latvia's "exit" strategy from the harsh crisis and years of austerity. Lithuania only joined a year later, in 2015. Prior to the beginning of 2013, Lithuania made no firm commitment to an exact euro adoption date; furthermore, Lithuania did not undertake "precautionary" measures to maximize its chance to adopt the euro.

This empirical case of the Baltic countries demonstrates the limits of: economic-structural arguments based on OCA theory, interest group preference interpretation, the influence of identity, and geopolitical considerations. These factors are by no means irrelevant. In fact, one could make a strong case that the relative smallness and openness of the Baltic economies, their generally Western orientations, and their geopolitical insecurity explain why Latvia and Lithuania (and Estonia) have generally been more in favour of euro adoption than most other new member states. Nevertheless, these approaches do not explain Latvia and Lithuania's fluctuations in their willingness to adopt the euro; and most importantly, do not uncover Latvia and Lithuania's different euro adoption paths during and after the economic crisis of 2008 to 2010. To reach a convincing explanation, one needs to look at domestic politics, namely electoral processes combined with the impact of the crisis. Our conclusions are thus in support of those authors who call for more focus on domestic political situations to explain preferences for and the timings of euro accession (Dandashly and Verdun, 2010; Dandashly, 2012; Dyson, 2008b).

Based on our analysis in this article, we suggest focusing more on the roles of crises in future scholarship. Economic crises can affect euro adoption in a complex manner. First, and most obviously, they can shape the nature of bids for euro adoption. As the Latvian and Lithuanian cases demonstrate, the economic crisis made it much easier for these countries to meet the inflation criterion, but at the same time, a new challenge of fulfilling fiscal requirements arose. Second, economic crises can strengthen a country's resolve to accede to the Eurozone. Both Latvia and Lithuania demonstrated a firmer willingness to adopt the euro during the crisis, and Latvia was the more eager of the two. This could in turn be attributed to the more substantial impact of the crisis in Latvia. In contrast, other countries—such as Poland and the Czech Republic—who suffered much less from the downturn have since communicated reluctance regarding Eurozone membership (Vilpišauskas, 2014, p. 208; Dandashly, 2012, pp. 252–254). Third, economic crises can bring about the need for fiscal consolidation. Austerity enables a country to fulfil euro adoption criteria by reducing public deficit, debt, and possibly inflation—with euro entrance as both a prize for the political leaders in power and a marking of the end of anti-crisis policy.

REFERENCES

- Angeloni, I., Flad, M., Mongelli, F.P., 2007. Monetary Integration of the New EU Member States: What Sets the Pace of Euro Adoption? *Journal of Common Market Studies* 45(2), pp. 367–409.
- Åslund, A., Dombrovskis, V., 2011. *How Latvia came through the Financial Crisis*. Washington: Peterson Institute for International Economics.
- Austers, A., Bukovskis, K., 2013. Latvia's Socio-Economic and Political-Institutional Challenges in the Context of the Eurozone Accession. In Austers, A., Bukovskis, K., Lang, K-O., Sprūds, A. *Baltic-German Strategic Engagement: Realignment after the Eurocrisis?*. Latvian Institute of International Affairs, Friedrich-Ebert-Stiftung. Retrieved from http://liia.lv/site/docs/StrategyTalks2013_A5_GALA.pdf
- BNS, 2012, January 2. D.Grybauskaitė: Lietuvai nerealu 2014 metais įsivesti eurą [D.Grybauskaitė: euro adoption in 2014 is unrealistic for Lithuania]. *Delfi.lt*. Retrieved from <http://www.delfi.lt/verslas/verslas/dgrybauskaite-lietuvai-nerealu-2014-metais-isivesti-eura.d?id=53635625>
- Caporale, G.M., Ciferri, A., Girardi, A., 2011. Are the Baltic Countries ready to adopt the Euro? A generalized purchasing power parity approach. *The Manchester School* 79(3), pp. 429–454.
- Dandashly, A., 2012. *Domestic Politics Comes First – Euro Adoption Strategies in Central Europe: The Cases of the Czech Republic, Hungary and Poland* (Doctoral dissertation). University of Victoria, Canada. Retrieved from http://dspace.library.uvic.ca:8080/bitstream/handle/1828/3828/Dandashly_Assem_PhD_2012.pdf?sequence=1
- Dandashly, A., Verdun, A., 2010. The Slow Trip to the East: The Domestic Politics of Euro Adoption in the Czech Republic, Hungary and Poland. Paper presented at the 2010 Annual Canadian Political Science Association (CPSA) Conference, Montreal. Retrieved from <http://www.cpsa-acsp.ca/papers-2010/Dandashly-Verdun.pdf>
- Dean, J.W., 2004. Adopting the Euro: tradeoffs and challenges facing the new EU-ten. *Journal of Policy Modeling* 26(7), pp. 759–767.
- Dombrovskis, V., 2012a. *Annual Report by the Minister of Foreign Affairs on activities performed and planned in national foreign policy and European Union matters*. Retrieved from Ministry of Foreign Affairs of the Republic of Latvia website: http://www.am.gov.lv/data/foreign_policy_report_for_2012_eng_2301.pdf
- Dombrovskis, V., 2012b. Why Fight for Euro? *The Riga Conference Papers (Collection of Essays and Articles)*, pp. 7–9. Retrieved from http://liia.lv/site/docs/The_Riga_Conference_Papers_20121.pdf
- Dyson, K., 2008a. The First Decade: Credibility, Identity, and Institutional 'Fuzziness'. In Dyson, K. ed. *The Euro at 10: Europeanization, Power, and Convergence*. Oxford: Oxford University Press.
- Dyson, K., ed., 2008b. *The Euro at 10: Europeanization, Power, and Convergence*. Oxford: Oxford University Press.
- European Central Bank, 2013. *Convergence Report: June 2013*. Retrieved from European Central Bank website: <https://www.ecb.europa.eu/pub/pdf/conrep/cr201306en.pdf>
- European Central Bank, 2014. *Convergence Report: June 2014*. Retrieved from European Central Bank website: <https://www.ecb.europa.eu/pub/pdf/conrep/cr201406en.pdf>
- European Commission, 2006. 2006 Convergence Report on Lithuania (Special Report No. 2). *European economy*. Retrieved from the European Commission website: http://ec.europa.eu/economy_finance/publications/publication465_en.pdf
- European Commission, 2013. *Flash Eurobarometer 377. Introduction of the euro in the more recently acceded member states*. Retrieved from the European Commission website: http://ec.europa.eu/public_opinion/flash/fl_377_en.pdf
- Feldmann, M., 2008. Baltic States: When Stability Culture Is Not Enough. In Dyson, K., ed. *The Euro at 10: Europeanization, Power, and Convergence* (pp. 243–257). Oxford: Oxford University Press.
- Frieden, J.A., 2002. Real Sources of European Currency Policy: Sectoral Interests and European Monetary Integration. *International Organization* 56(4), pp. 831–860.
- Helleiner, E., 1998. National Currencies and National Identities. *American Behavioral Scientist* 41(10), pp. 1409–1436.
- International Monetary Fund, 2004. Adopting the Euro in the New Member states: the next step in European integration. Transcript of an IMF Economic Forum, Washington DC, 4 May. Retrieved from <http://www.imf.org/external/np/tr/2004/tr040504.htm>
- José, M., Larribe, R., 2008. Is economic convergence in New Member States sufficient for an adoption of the Euro? *The European Journal of Comparative Economics* 5(2), pp. 269–290.
- Krugman, P., 2008, December 23. Latvia is the new Argentina (slightly wonkish). *The New York Times*. Retrieved from http://krugman.blogs.nytimes.com/2008/12/23/latvia-is-the-new-argentina-slightly-wonkish/?_r=0

Kuokštis, V., 2011. Vidinio prisitaikymo politinė ekonomija Baltijos šalyse: valstybių reakcijos į krizę aiškinimas [The Political Economy of Internal Adjustment in the Baltic States: Explaining Responses to the Crisis]. Doctoral Dissertation, Vilnius University. http://vddb.laba.lt/fedora/get/LT-eLABa-0001:E.02~2013~D_20130416_130826-54294/DS.005.0.01.ETD

Kuokštis, V., 2015. Jingle bells and struggling GIPS: Comparing the Baltic and the southern euro zone's crisis experience using the varieties of capitalism framework. *Acta Oeconomica*, 65(1), pp. 39–64.

Milne, R., 2013, April 23. Latvia: Reaching for the euro. *Financial Times*. Retrieved from <http://www.ft.com/intl/cms/s/0/5df14d34-a776-11e2-bfcd-00144feabdc0.html?siteedition=intl#axzz2VlJryNbQ>

McKinnon, R., 1963. Optimum currency areas. *The American Economic Review* 53(4), pp. 717–725.

Mundell, R., 1961. A theory of optimum currency areas. *The American Economic Review*, 51(4), 657–665.

Purfield, C., Rosenberg, C., 2010. *Adjustment under a Currency Peg: Estonia, Latvia and Lithuania during the Global Financial Crisis 2008–09* (IMF Working Paper No. 10/2013). Retrieved from International Monetary Fund website: <https://www.imf.org/external/pubs/ft/wp/2010/wp10213.pdf>

Risse, T., Engelmann-Martin, D., Knope, H- J., Roscher, K., 1999. Union To Euro or Not to Euro?: The EMU and Identity Politics in the European. *European Journal of International Relations* 5(2), pp. 147–187.

Risse, T., 2003. The Euro between national and European identity. *Journal of European Public Policy* 10(4), pp. 487–505.

Salines, M., Bērziņš, K., 2012. Fiscal austerity, structural reforms and re-election: explaining the 'possible trinity' in the case of Latvia. *European economy*, pp. 155–181. Retrieved from the European Commission website: http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp120_en.pdf

Seputyte, M., 2012, August 28. Lithuania to Adopt Euro When Europe Is Ready, Kubilius Says. *Bloomberg*. Retrieved from <http://www.bloomberg.com/news/articles/2012-08-28/lithuania-to-adopt-euro-when-europe-is-ready-kubilius-says>

Spendzharova, A., 2012. Is More 'Brussels' the Solution? New European Union Member States' Preferences about the European Financial Architecture. *Journal of Common Market Studies* 50(2), pp. 315–334.

Swedbank Analysis, 2012. *Fulfilling the Maastricht Criteria – mission possible for Latvia and Lithuania?*. Retrieved from Swedbank website: https://www.swedbank.lv/files/analitiskie_materiali/swedbank_petijums/Swedbank_Analysis_2012_08_EN.pdf

Tauraitė, V., 2013, July 3. Trūko tik noro [Only the willingness was lacking]. *IQ*. Retrieved from <http://iq.lt/komentarai/truko-tik-noro>

Vilpišauskas, R., 2014. Lietuvos narystė euro zonoje – pokyčių Lietuvos politikoje ir stojimo laiko pasirinkimo analizė [Lithuania's accession into the euro zone – analysis of institutional and political changes in Lithuania and the choice of the timing]. *Politologija* 76(4), pp. 200–245.

INTERVIEWS

Arlauskas, D. Interviewed by: Markevičiūtė, A. (24th April 2014)

Austers, A. Interviewed by: Markevičiūtė, A. (16th April 2014)

Besagirskas, S. Interviewed by: Markevičiūtė, A. (4th March 2014)

Bukovskis, K. Interviewed by: Markevičiūtė, A. (15th April 2014)

Šimonytė, I. Interviewed by: Markevičiūtė, A. (26th March 2014)