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Euro adoption policies in the second decade – the remarkable cases of the Baltic States

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ABSTRACT
The second decade of Economic and Monetary Union (EMU), starting with the financial crisis morphing into the sovereign debt crisis, had diverging effects on member states. The Baltic States were hit particularly hard. Faced with an immediate collapse of their economies, the Baltic States were advised by international organisations to float their currencies; instead, these countries chose to speed up their commitment to join the euro including the choice to keep the exchange rate fixed. Why? In this paper, we argue that the main reason for this decision needs to be found in the domestic politics of these three Baltic States. The domestic actors we look at include, among others, monetary authorities, government and opposition. Even when faced with strong international criticism, the three Baltic State governments chose their own path, which in this case included continuing their planned euro adoption policies even in the face of costly domestic adjustments.

KEYWORDS
Baltic States; domestic politics; Economic and Monetary Union; euro adoption; financial crisis; sovereign debt crisis

Introduction

Despite the start of the financial crisis in 2007–2008, the first decade of Economic and Monetary Union (EMU) (1999–2008) turned out to be better than critics predicted (Enderlein and Verdun 2009). In 2009, at the onset of the second decade, Euro Area countries quickly found themselves confronted with a major sovereign debt crisis (see Howarth and Verdun 2020). It had diverging effects on EU members: those in the Euro Area were reasonably protected from exchange rate volatility, but those with large debt burdens – such as Greece – were experiencing difficulties refinancing their sovereign debt (see Pagoulatos 2020).[1]

Many (but not all) EU member states outside the Euro Area experienced a strong decline in economic growth, exports and international capital inflows (Lane 2013). Those that were hard hit included Hungary, which faced economic difficulties in part due to the economic and fiscal policies of consecutive governments in office prior to the crisis. The Baltics experienced a particularly strong decline. This experience was due in part to the drying up of foreign bank lending on which the Baltic economies were extremely dependent (Jočienė 2015). This boom-bust cycle affected Estonia, Latvia and Lithuania more than the larger EU-2004[2] member states due to their open economies (cf. Staehr

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2013). In 2009, the Baltic States ended up experiencing a double-digit Gross Domestic Product (GDP) per capita contraction (see Table 1), whereas no other European member states experienced more than 9 per cent contraction with the EU average in 2009 being 4.6 per cent (European Commission 2012, table 4). Poland was the only EU member state that did not experience economic decline during this crisis.

Given these dire economic circumstances, how can one understand that the Baltic States still wanted to plan towards adopting the euro as soon as possible? Their stance is remarkable given that three of the four Visegrád countries (the Czech Republic, Hungary, and Poland) decided to push their decision to join the euro further into the future (Dandashly and Verdun 2015, 2018).[3] To join the euro involved meeting the so-called 'convergence criteria'.[4] Although the Baltic States had met the public debt criterion, meeting the other criteria would still be very difficult in the midst of the crisis. It also meant that doing so involved adhering to policies that could possibly further contract the economy, passing on significant costs to segments of society, a process referred to as *internal devaluation* (Moses 2016, 245; Weisbrot and Ray 2010, 2011). International organisations and other commentators thus recommended that the Baltic States change their policies of currency boards and exchange rate pegs (*Financial Times* 2009; Kajaks 2012). During the depth of the crisis, the International Monetary Fund (IMF) saw advantages in a possible devaluation of the currencies of the Baltic States (Purfield and Rosenberg 2010, 13; Aslund and Dombrovskis 2011). To heed this advice could have caused severe delays in euro adoption timetables, as meeting the so-called Exchange Rate Mechanism-II (ERM-II) conditions is part of the convergence criteria.

How can we explain why none of the Baltic States' governments were in favour of following this advice? This contribution examines why the Estonian, Latvian and Lithuanian governments decided to join the euro in the midst of the financial and the sovereign debt crises. The decision of the governments of the Baltic States is puzzling because many economists argued that these countries needed exchange rate flexibility to address the crisis. Furthermore, the adjustment could be made via *external devaluation* by allowing the domestic currency to depreciate or to devaluate; a strategy used successfully by some countries during the late 1990s Asian financial crisis (Wade 2000). Economists highlighted that without devaluing the currency, it becomes close to impossible to get out of the crisis. For instance, a country such as Argentina devalued its currency to get out of its crisis (*Financial Times* 2009). Instead, keeping the currency pegged during such a crisis would imply the need to use *internal adjustment measures*, implying a downward pressure on wages and prices, which is politically hard to manage (Blanchard, Griffiths, and Gruss 2013; Moses 2016; Rosenberg 2011).

There are several theoretical approaches that we could adopt to examine this question. A political economy approach could provide a cost-benefit analysis as to whether fixed or flexible exchange rates are most attractive for a given country at a given time (Frieden 2014; Hausmann et al. 2000; Krugman 2014; Poeck, Vanneste, and Veiner 2007). However, these considerations are not central to understanding the speedy euro adoption during times of crisis and the conventional macroeconomic assessment was refuted by domestic actors, in particular by central banks and governments. Another possible approach would be to argue that governments followed public opinion (Banducci, Karp, and Loedel 2009; Braun and Tausendpfund 2014; Hobolt and Wratil 2015; Banducci and Loedel 2020). In fact, the opposite occurred: public opinion in the Baltic States was almost equally divided

Table 1. Annual Growth Rate (Real GDP) (% Change)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Estonia	6.3	9.4	10.3	7.7	-5.4	-14.7	2.3	7.6	4.3	1.9	2.9	1.7	2.1	4.9
Latvia	8.3	10.7	11.9	10.0	-3.6	-14.3	-3.8	6.4	4.0	2.6	2.1	2.7	2.0	4.5
Lithuania	6.6	7.7	7.4	11.1	2.6	-14.8	1.6	6.0	3.8	3.5	3.5	1.8	2.3	3.8

Source: Eurostat (2019)

with regard to the benefits and costs of euro adoption (European Commission 2009, 31) and Eurobarometer data suggest that on the whole people in all three Baltic States were unhappy with the prospect that the euro would replace their national currency (see Table 2). Yet the governments of the Baltic States were keen to join the Euro Area and took the necessary steps to prepare for euro adoption even without strong public opinion support (European Commission 2010, 45).

In this contribution, we look at various domestic actors as well as political and institutional factors to understand the Baltics' policy towards euro adoption. These actors include the central bank, the ministry of finance, the competition between government and opposition. We also consider other factors such as the role of the constitution or legal institutional environment and the role of foreign banks. The research is based on various sources: interpretation of primary and secondary sources and on 20 semi-structured face-to-face interviews with key informants held in October 2009 on location. Our main argument is that one needs to understand that domestic actors, in particular the government, is able to make its own choices for the choice of the policy regime (euro adoption) even in the face of external pressures and high internal costs.

The structure of the contribution is as follows. The next part reviews the economic and political science literature on exchange rate regimes and euro adoption policies and examines the policies from which one might expect the Baltic States to choose. The third looks at the financial crisis and EMU followed by the experience of the Baltic States in the financial crisis. The fourth examines the government policies in the three countries. The fifth section concludes.

Understanding euro adoption

There are various explanations that can help understand the decision-making process within countries with regard to economic and monetary policies. Some scholars focus on the degree of openness of the economy and the exchange rate regime to understand the monetary and economic policies and whether a country is well equipped to join a currency union (Buiter 2000; De Grauwe and Schnabl 2005; Schadler 2005). Such an analysis however does not address the political processes that may contribute to a better understanding of the rationale behind macroeconomic policies and why countries decide to give up their exchange rate.

Some of the International Political Economy (IPE) literature suggests that a choice for any exchange rate regime may be influenced by either 'policy demanders' (e.g. interest groups, economic groups, and voters) or 'policy suppliers' (e.g. political parties, legislatures, bureaucracies) (Bernhard, Broz, and Clark 2002). Groups that deal with international trade such as banks, exporters and investors are more inclined to push for a fixed

exchange rate regime as it leads to the needed stability that those groups seek. Other groups who focus on the local economy (such as importers) prefer a floating exchange rate regime (Frieden 1991; Frieden 2014). There is also a connection between political regime and political institutions and exchange rate policy with countries that have less

Table 2. Comparative Table of the three countries

	Estonia	Latvia	Lithuania
ERM2	28 Jun 2004	2 May 2005	28 Jun 2004
Euro adoption	1 January 2011	1 January 2014	1 January 2015
Financial crisis effect	Applied strict austerity measures Did not ask for support from IMF/EU	Asked for support from IMF and the EU. Cut budgetary spending and increase taxes	Swedish banks intervened Declined early assistance offered by the EU In the beginning, Lithuania never applied for structural European financial support but later, applied for several European structural funds for job creation and trainings Cut budgetary spending and increase taxes
Government	Strong commitment to euro adoption Ignored the recommendations of the IMF to relax the exchange rate peg (drop the currency board) and have floating exchange rates. The Estonian government and with strong support of the central bank decided to stick firm to their commitment to the euro adoption process Electoral cycles favoured a pro-euro consecutive governments (ensured stability)	Strong commitment to euro adoption Ignored suggestions by the IMF to let go of the fixed exchange rate Electoral cycles favoured a pro-euro consecutive governments	Strong commitment to euro adoption Ignored recommendations by the IMF and economists to take the devaluation route and let go of the fixed exchange rate
Central Bank	Pro Euro	Pro Euro Highlighted the long-term pros of adopting the euro	Pro Euro
Constitutional structure and legal provision	Needed an amendment that was recommended by the central bank, but ignored by the government and euro adoption was passed. The Constitutional Review Chamber declared that it was possible to adopt the euro without constitutional amendment	Constitutional Amendments were adopted during the preparation to join the EU and right afterwards by the Saeima of the Republic of Latvia paving the way for adopting the euro and becoming part of European System of Central Banks.	Constitutional Amendments were adopted during the preparation to join the EU and right afterwards. In terms articles that relates to the euro, Art. 125 (2) of the Constitution (Bank of Lithuania's 'exclusive right to issue bank notes', which was not in line with the rights of the European Central Bank) was amended in 2006 by the Parliament by simply abolishing it.
Public opinion in 2010. 'happy the euro will replace their national currency' Eurobarometer	54% unhappy 37% happy	58% unhappy 30% happy	47% unhappy 42% happy

Source: Authors (based on Eurobarometer data European Commission 2010, 45; and various sources)

democratic credentials being less likely to have fixed exchange rates (Bearce and Hallerberg 2011; Bernhard and Leblang 1999). Under fixed exchange rate regime, governments lose the ability to use monetary policy a tool to gain more electoral support. Therefore, in countries with less established democratic systems, political elites are less committed to a floating exchange rate to ensure their ability to use the exchange rate policy in electoral cycles (see Bernhard and Leblang 1999).[5]

Political scientists have studied the euro adoption process in the EU-2004 Member States by focusing on collective identity, policy learning, ideas and knowledge transfer among central bankers, the role of discourse among political elites, as well as adjustment to global pressures and Europeanisation (Dyson 2006, 2008; Epstein and Johnson 2010; Johnson 2006; Pechova 2012). These studies have focused less on actual dynamics of how the domestic political environment influences the decisions taken regarding euro adoption and coping with the financial crisis.

We build on some of this existing literature on exchange rates and on the literature on EMU, which has emphasised the importance of the domestic setting and domestic actors. Many of these earlier studies do not explicitly address the question of how to understand different euro adoption strategies among EU-2004, nor why member state governments change their position on euro adoption, without any major change in trade flows or other macroeconomic fundamentals. Building on the existing domestic politics approaches we seek to understand better why a government chooses one policy over another, and thereby explain the *specific timing* of policies (on domestic politics approaches see inter alia Bulmer 1983; Huelshoff 1994; Dandashly 2015; Dandashly and Verdun 2015; Heipertz and Verdun 2010). Dyson and Featherstone highlight three main institutional arrangements: (1) the constitution's impact on the way '"core executive" politics was played'; (2) strength and independence of central banks; and (3) role of the Ministry of Finance (Dyson and Featherstone 1999, 25). The degree of domestic competition between the government and the opposition 'affects the benefits and sustainability of international cooperation' (Lohmann 1993, 1390). Furthermore, there is considerable evidence that domestic political factors influence the work of the central banks (Mukherjee and Singer 2008).

In sum, we argue that to understand euro adoption in the Baltics in the midst of the crisis, a domestic politics approach serves best to explain euro adoption policies. We examine the role of government and opposition and that of the central bank in addition to various specific domestic institutional factors including the constitutional structure of the country and the legal provisions that need to be met to adopt the euro in due course (including some sectoral interests).

Financial crises and EMU

One of the motivations for those who supported EMU had been currency stability and avoiding the risk of intense exchange rate or currency volatility. Policymakers hardly spent time worrying about the fact that participation in the Euro Area would reduce room for manoeuvre. Throughout most of the 2000s, few were considering as very likely the prospect of a global financial crisis, particularly one that might impact the Euro Area countries (Underhill 2011). Indeed, even as the year 2007 had been characterised by financial turbulence, a 2008 European Commission's publication about the first ten years of EMU did not signal a great concern about the lack of policy instruments to deal with the

financial crisis that had already taken hold of major parts of Europe. Instead, the first ten years of EMU were celebrated by many as having led to job creation, price stability, cheaper costs of borrowing money and modest economic growth (Dyson 2008; European Commission 2008; Enderlein and Verdun 2009; Warin 2010).

As the crisis worsened, the impact of not having the exchange rate instrument as a tool for adjustment became clearer although the impact of the financial crisis upon Euro Area member states differed depending on the domestic situation. The countries in Europe that initially felt the impact of the crisis the most were those in which the financial sector made up a relatively large part of the economy: Belgium, Central and East European Countries (CEECs), Iceland, Ireland, Latvia, Netherlands, and United Kingdom. But the impact of the crisis on those member states with a relatively large financial sector heralded only the start of the crisis. The crisis impacted trade, production and public spending. EMU members faced a situation in which they had limited tools to overcome the economic and financial turbulence that took hold of Europe, in particular, a selection of countries such as the case of Greece in 2010 and 2011 followed by Ireland, Portugal and to a lesser extent Spain and Italy (for discussions of Greece see Pagoulatos 2020; on Italy see Notermans and Piattoni 2020). Such crises pushed other EMU members (mainly Germany and France) and the IMF to create bailout plans for those countries and facilitate more favourable conditions to refinance their public debt.

The Baltic States and the financial crisis

Most of the EU member states that had not yet adopted the euro had experienced strong economic growth in the years before the financial crisis. The Baltic States' economies had enjoyed very strong economic growth after acceding to the EU in 2004 (see Table 1), which is often attributed to having led to huge credit, consumption and housing booms (see Darvas 2009). Estonia, Latvia and Lithuania were more affected by the crisis than other countries due to their large exports sectors and their open economies. Consequently, the lower consumption and investment demand hit the countries hard. This situation led to high current-account deficits and high private and high external debt (Darvas 2009). Real Gross Domestic Product (GDP) of each of these countries declined in 2009 by almost 15 per cent and would decline about 25 per cent over the three-year period 2008–2010 (see Table 1). Officials of the Estonian, Lithuanian and Latvian ministries of finance in interviews confirmed that one of the reasons to target a speedy euro adoption was to ensure to be closer to the core of Europe. They also indicated that they felt it was important not to lose the credibility and political cost of having maintained fixed exchange rates (respectively their currency boards). Finally, there were citizens indebted in foreign currency; a devaluation would be costly for all those citizens and companies that had taken out loans in a foreign currency under the assumption that the government would keep the national currency stable. We examine each of the three countries in turn.

Estonia

Since joining the EU in 2004, Estonia prioritised euro adoption and saw it as the only exit strategy from the dangers resulting from its currency board (Lättemäe and Randveer 2004). In addition, there has been a broad consensus in support of European integration

since Estonia became an independent country again and joining the euro was a major attraction of European integration. Most of the convergence criteria were easy for Estonia to meet, but it had the most difficulties meeting the inflation criterion. Once Lithuania received the assessment of the ECB (2006) and the European Commission (2006a) that it did not meet the inflation criterion in 2006, the Estonian government did not await the formal assessment of the European Commission (2006b) but postponed its euro adoption target. Notwithstanding this short-term setback, it was nevertheless planning to join at the first possible opportunity (interviews with Estonian officials, 6,7,8, October 2009). With the outbreak of the financial crisis, euro adoption became an even more salient issue and a way to avoid the risks of not being able to maintain the currency board under all circumstances.

The financial crisis affected Estonia in many ways similarly to how it affected the other two Baltic States (see Table 1): Estonia was much worse off than other EU member states. Although this country had gone through a boom in the run-up to the financial crisis, the advent of the crisis meant a sudden stop in economic activity – a sharp decline in GDP. It meant a strong reduction in the inflow of capital, a decline in the export sector and a hit of consumer confidence (Staehr 2015).

Estonia was recommended – as were the other two Baltic States – to relax its exchange rate peg (drop the currency board) and adopt floating exchange rates. Rather than heed the advice of the IMF, the Estonian government – with strong support of the central bank – decided to maintain its firm commitment to the euro adoption process (Ministry of Finance Estonia, 2009). Estonia had, at the same time as Lithuania, in 2006 been hoping to adopt the euro sooner rather than later, but knew it had more difficulty than Lithuania to meet the inflation criterion. Seeing that inflation was the main concern, by the end of 2008, the Estonian government used the financial crisis to implement the needed reforms to ensure it would meet the convergence criteria. The financial crisis aided this goal as inflation dropped, and even went into negative territory. The only other challenge (to meeting the convergence criteria) would be that the financial crisis would have negative impact on the budgetary deficit (which was not to exceed 3 per cent of GDP). Compared to Latvia and Lithuania, however, Estonia had more fiscal room due to prudent fiscal policies prior to the crisis. Thus, following the crisis, the government embarked on significant austerity measures (cuts in government spending, increasing of taxes and other measures that would increase government revenue) so as to increase the likelihood that the budgetary deficit would not be exceeded. GDP contracted by 5.4 per cent in 2008 and 14.7 per cent in 2009. In light of that situation, it is truly a remarkable feat that Estonia had budgetary deficits of less than 3 per cent in 2009 and even a (slight) surplus in 2010. When Estonia applied for Euro Area membership in 2009 it was approved. Eventually, the other two Baltic States took lessons from the Estonian experience for their own efforts to join (Staehr 2015).

With the elections only in 2011, the government of Andrus Ansip (second cabinet after his first from 2005 to 2007) had enough time to implement the austerity measures to tackle the crisis without worrying much about the next elections. The 2011 elections resulted in Andrus Ansip forming his third cabinet (2011–2014) (Kattel and Raudla 2013, 437; Kuokštis and Vilpišauskas 2010, 17). Therefore, one can notice that the electoral cycle increased the success of adjustment policies by pre-empting the temptation of increased pre-electoral spending and by further stabilising the government.

There was one issue that could theoretically have derailed Estonia's adoption of the euro. It was the matter of the constitution which dated back to 1992 and had not been changed – even when joining the EU. Politicians and civil servants and various legal scholars differed on amending the constitution that contained a clause that stipulates that the Estonian Bank issues Estonian currency ('The Bank of Estonia has the sole right to issue Estonian currency. The Bank of Estonia shall regulate currency circulation and shall uphold the stability of the national currency' (paragraph 111 of the Estonian Constitution)). Thus, it would have been better to change the Constitution officially, which is also what the ECB recommended (ECB 2004: 36). However, it was feared that the minority government in power would fail to garner the necessary support to pass a Constitutional amendment (interview with a legal scholar, 9 October 2009). A change to the Constitution requires a referendum, and a 3/5 majority in two successive parliaments (called the 'Riigikogu') or only once, but then has to have passed with a 4/5 majority. In the end, the Constitutional Review Chamber was asked whether the Constitution could be interpreted so that the euro could be introduced in Estonia without a change to the Constitution. The Constitutional Review Chamber declared that it was the case.

One domestic issue to be highlighted is that the main divide between parties was not a left-right cleavage, but rather an ethnic one. These considerations pre-empted partisan ideological conflicts about what policies to pursue. The main opposition party, the left-leaning Centre Party, was mainly supported by ethnic Russians, constituting 31 per cent of the population (Saarts 2011, 96). While the Centre Party criticised the governments' adjustment policies, it could not provide a credible alternative to the majority of the voters, as it was perceived as a Russian minority party and therefore tended to be kept at arms' length (Levy 2010; Pettai et al. 2011, 162). Moreover, while the Social Democratic Party was for a time part of the government coalition, its role tended to be marginal (Saarts 2011, 94). At one point in coalition negotiations about a supplementary budget during the first months of 2009, it attempted to resist the reduction of unemployment benefits.

Lithuania

Since its accession to the EU, Lithuania was keen to join the euro as soon as possible; the government set the date for 1 January 2007. Lithuania pushed, both rhetorically and with various policies, for euro adoption. A respondent from the Lithuanian central bank stated in an interview in autumn 2009: 'There is 100% consensus on euro adoption. Of course, there are some radical parties, but they do not even have seat in parliament' (interview with a Lithuanian central bank official 9 October 2009). In the run-up to the first attempt to join the euro, in 2006, the Lithuanian government sought to meet the convergence criteria. As in the case of Estonia, the most difficult criterion for the government to meet was the inflation criterion. However, the Lithuanian government was initially adamant to try to join the Euro Area as soon as possible (interview with a Lithuanian official 9 October 2009).

The historical experience with this early attempt is important in this regard. In March 2006 Lithuania asked the European Commission and the European Central Bank to assess their request to join the euro. The assessments' reports found that Lithuania met all but the inflation criteria (ECB 2006; European Commission 2006a). With the 12-month average rate of Harmonised Index of Consumer Prices (HICP) inflation of 2.7 per cent, it

was just 0.1 per cent higher than the average of the best three performers (2.6 per cent) which included Poland and Sweden – two countries that were not even members of the Euro Area and thus missed the threshold. However, the concern by the EU institutions was that the long-term trend was not pointing to lower inflation but rather to continued inflation. Interviewees suggested that the EU was concerned not only about Lithuanian inflation performance in the future but also what would happen if they would be implementing the convergence criteria too loosely. Rather than being worried about the impact it would have on the Euro Area if hypothetically Lithuania had joined and its inflation rates would have been contributing to overall inflation rates in the Euro Area, the EU officials, according to various Lithuanian interviewees, were much more concerned about the precedent it would set and whether Poland would seek to be treated with more flexibility (interviews with Lithuanian officials 9 October 2009 and 14 October 2009). Various interviewees pointed out that the government had not been very strategic in trying to ensure that the inflation target would be met. The aim to join the euro did become more difficult because Lithuania subsequently experienced a strong upward pressure on inflation in 2007 (Kareivaite and Tamašauskienė 2008).

The failure to join the euro gave Lithuania a learning opportunity as regards how to meet the convergence criteria. An interviewee from the central bank of Lithuania put it in the following way: 'we are in a better position because we know how the inflation is calculated.' '[In 2005] [P]oliticians did not have a good idea about how all this worked. What is monthly inflation, what is annual inflation? Which one is used for the decision? So basically, the central bank knows more, how to exploit the data. (. . .) It made clear why you have to listen to the central bank.' (interview with an official of the Lithuanian central bank, 9 October 2009).

Lithuanian economic growth slowed at the beginning of 2008. At this time, the banking sector of Lithuania was divided between 73 credit unions, 8 branches of EU banks and 6 privately held chartered banks. Three of these banks were subsidiaries of Scandinavian banks (SEB, Swedbank and DNB) accounting for about 90 per cent of the banking sector by the end of 2016 (OECD 2017, 8). Therefore, the Swedish Banks had to intervene to reduce their losses due to the expensive lending policies prior to the crisis. The government in effect contributed to a real estate boom by subsidising mortgage loans through a government set fund, which later had to be bailed out. Furthermore, in the immediate preceding months, there was less pressure on the Lithuanian litas than on the Latvian currency – both of which were at the time in a currency board and a system like a currency board and thus effectively pegged to the euro (Leitner 2009, 64).

Despite that the Lithuanian government declined an IMF/EU loan-package its crisis management strategy was similar to that of Latvia as both cut budgetary spending and increased taxes. The government of Andrius Kubilius focused on keeping the budget deficit of 2009 below the 3 per cent, to seek to meet that convergence criterion although this goal was abandoned later that year. However, the economic decline proceeded forcing the government to adopt more radical measures (Leitner 2009, 64); such as increasing the Value Added Tax (VAT); lowering wages, retirement pensions and unemployment benefits (Gruževskis and Blaziene 2013, 13). Moreover, Lithuania applied for several European structural funds to obtain support to tackle the further increase of unemployment rates (which stood at 16 per cent in 2010).

To summarize, the Lithuanian government was heavily scarred by the 2006 experience. Nevertheless, the government did not fully abandon the goal for euro adoption right after but took a longer time perspective. Eventually, when the financial crisis hit, the recommendation from the IMF and other economists was to embrace currency devaluation. The Lithuanian government, supported by the central bank, did not heed that advice but instead pressed ahead with its plan to adopt the euro. Eventually, it joined in 2015 – as the last of the three Baltic States to join – but not long after the others.

Latvia

Since joining the EU in 2004, the Latvian government nominally was keen to join the euro but in practice did not prioritise its policies effectively towards meeting the convergence criteria early on. Independent of the experience in Lithuania in 2006, it was not a surprise to insiders that Latvia missed the 2008 self-proclaimed euro adoption target date the government set the date for itself (interview with official of the Latvian central bank, 15 October 2009). A respondent from the Lithuanian central bank stated in an interview in autumn 2009: '[t]he policy itself, basically the government knows it's the ultimate goal; it has to be done. But the government this election doesn't really care about the details. And that's why probably we missed that target in 2008 (…). [B]ut anyway the government's action didn't show they have policy of euro introduction. They had other policies' (interview with a Latvian central bank official 15 October 2009). By contrast, the central bank had conducted studies to demonstrate the long-term benefits of joining the euro. The challenge was the electoral cycle and government feeling the need to deliver on things that they might be re-elected for (interview with a central bank of Latvia official 15 October 2009).

Before the crisis, Latvia had, after Estonia and Luxembourg, the lowest debt levels with a public debt of only 9 per cent of GDP. However, due to the crisis the national debt increased. The central government debt rose from 19.8 per cent to 44.4 per cent of the GDP from 2008 until 2010 (European Commission 2013). To stop this trend, increase financial stability, regain market confidence, the Latvian government implemented restrictive fiscal policies in 2008 (Dovladbekova 2012, 1) in order to boost growth and investments. These adjustment strategies and the aim to keep the exchange rate stable led to severe contraction of the economy (Groenendijk and Jaansoo 2015; Kattel and Raudla 2013, 429).

Although there had been many warnings by local financial and economic experts, the Latvian prime minister at that time, Ivars Godmanis, did little to respond proactively to the early signs of an upcoming recession and only took action to reduce public spending by the end of 2008 (Kajaks 2012). However, the planned measures by the government were insufficient. The government in late 2008 applied for financial support from the IMF and the EU (Aslund and Dombrovskis 2011, 33–47). One of the reasons was to preserve the fixed exchange rate with the euro (Banincova 2010, 188). Economists and experts such as Rory MacFarquahar, an emerging markets expert at Goldman Sachs, questioned the rationale behind Latvia's crisis management strategy and its sustainability without devaluing its currency (*Financial Times* 2009). With several subsidiaries of major Swedish banks present in the Baltic states, the issue was also pertinent to the Swedish parent bank. Therefore, Sweden recognised the need to provide Latvia with financial support until the IMF program was finalised (Koyama 2010, 46).

The rescue package was finalised at the end of December 2008 and consisted of 7.5 billion euros, supported by the IMF, the EU and six other actors. Consequently, before Latvia could obtain a tranche, they had to consolidate the government's budget, stabilize its financial sector and progress in structural reform. The Latvian anti-recession programme adopted at the end of December 2008 (Banincova 2010, 188) demanded a reduction of public sector workforce by 15 per cent. The volume of public purchasing had to be cut by 25 per cent. The VAT had to be increased by 3 per cent from 18 to 21 per cent. Apart from that, the excise duties on fuel, coffee, alcohol and other beverages should be increased as well (Kajaks 2012). As most of the tax hikes fell on the poor in addition to the high levels of corruption, this led to social discontent and riots, which forced Prime Minister Ivars Godmanis to resign on 20 February 2009 (Kriesi 2012). Valdis Dombrovskis became the new prime minister of Latvia and served till 2014. Despite the unpopular measures, Dombrovskis, pro-European in orientation, was supportive of the policies agreed with the EU and the IMF as he was very keen to avoid a currency devaluation which he knew would have meant a significant delay for euro adoption.

In June 2009 the recession worsened despite the structural reforms. International donors demanded further cuts in public spending (Kajaks 2012, 8). The government had to choose between receiving international help by accepting the budget or causing insolvency of the country. The Latvian government decided to make further cuts in social and tax benefits in addition to reforming the public sector so as to secure the financial support. Latvia's measures served in increasing the growth rate from −14.40 per cent in 2009 to 6.38 per cent in 2011 (see Table 1).

By the time the European Commission and the IMF visited Latvia in autumn 2009 to deal with the effects of the financial crisis, Latvia basically had two options: it could let go of the fixed exchange rate and float the currency or it could keep the exchange rate fixed (and down the road adopt the euro). With the crisis being as serious as it was at that point, the Latvian government supported by its central bank opted to ignore suggestions by the IMF and leading economists to float the currency and instead to stick to the fix (Weisbrot and Ray 2010, 2011). The Latvian government chose the option of internal devaluation. It meant making prices and wages internal to the country lower because other options were unavailable to adjust to the crisis. How can we understand the continued commitment by the government to the euro adoption strategy?

One important factor that influenced euro adoption strategy was the government coalition and the electoral cycles. At the beginning of the crisis, PM Ivars Godmanis' right-wing government coalition was not able to implement a timely crisis response and adjustment measures, since serious coalition disputes blocked any policy-making (Aslund and Dombrovskis 2011, 23). President Zatlers nominated Dombrovskis, the leader of the right-wing opposition party New Era, as new PM who formed a right-wing coalition government, and rapidly began to implement stringent adjustment policies (*Latvijas Valsts Prezidents* 2010). However, in the run-up to parliamentary elections in October 2010, political instability and coalition conflicts resurfaced again resulting by the People's Party leaving the government coalition and further delaying adjustment processes (International Monetary Fund 2010, 4). The 2010 elections resulted in Latvia's prime minister Dombrovskis' party emerging as the largest political party – therefore strengthening the position of the PM who addressed the Latvians stating that the voters have prioritised economic stability.

However, the early 2011 elections' results were not favourable to Dombrovskis whose party came in third and was facing the possibility of not being part of the ruling coalition. But due to the division in one of his main coalition parties (ZRP) following the September 2011 elections, Dombrovskis was again named Prime Minister who formed a coalition government and continued with the needed economic reforms to get out of the crisis and push for euro adoption. One could notice that the divisions among the various political parties resulted in a pro-euro PM leading the governments and implementing the reforms and euro adoption strategy.

The view of the central bank of Latvia and financial regulation officers and other government officials that throughout the first decade of the 2000s was that euro adoption should occur as soon as possible for two reasons: economic (risk premium, transactions costs) and other part of the story is that Latvia (and other Baltic countries) have already fixed their exchange rates (highly integrated into European markets) and given up monetary policy and thus there is very little to give up (there are more benefits than costs) (interviewees at the Latvian Central Bank, 15 and 16 October 2009). It was clear in autumn 2009 that Estonia was on track to adopt the euro. It was perceived that if one of the Baltic States were to adopt the euro, that would make that country more attractive to investment than the other two Baltic states. Furthermore, Latvian political elites were aware that Lithuania was also still keen to join; thus, staying outside was not attractive for regional reasons. The next consideration was the political capital already spent on arguing that Latvia had fixed its exchange rate. With the historical past and the indebtedness of the population, having to make adjustments if that national currency were to devalue would not be easy.

While the government and the central bank supported euro adoption policies, the population was lukewarm about the idea (Table 2). The elites did not worry about public opinion, however. They felt a population that was not adamantly opposed could be persuaded by strong information campaigns (interviews with Latvian officials on 15 and 16 October 2009). Moreover, many of those concerned about euro adoption were worried about rising inflation as a result of the changeover. The officials felt that best practices could be learnt from those member states that had introduced the euro recently and these concerns could be mitigated (interviews with Latvian officials 15 and 16 October 2009).

Conclusion

This contribution asked the question why the governments of Estonia, Latvia and Lithuania opted to work towards joining the euro during the sovereign debt crisis. Early on these member states had been keen to join the euro, but in 2006 Lithuania just missed the inflation criterion by a slight margin and was refused by the Council. At that point with Lithuania not permitted to adopt the euro this country and the other two Baltics delayed the decision to a later date, in the hope of finding a time when inflationary pressures would be lower.

With the arrival of the financial crisis, the governments decided to try to meet the convergence criteria. While the inflation was the most difficult criterion to meet when catching up, it became less of a problem during a recession. At first glance, the Baltic governments' stance is puzzling because they went against IMF recommendations (see Table 2). However, we find that the governments were unwilling to compromise their stance on fixed exchange rates and their intention of joining the euro, which they had had

for some time. There was also a considerable level of private debt in foreign currencies held by citizens and companies so there would also be some 'winners' if devaluation did not happen. The governments of all three Baltic States chose for a number of reasons to heed the advice to devalue and instead move towards faster euro adoption.

We argued in this contribution for a domestic politics explanation. These Baltic governments took the steps necessary to meet the convergence criteria at a time when a number of other CEECs who were still outside the euro area decided not to focus on euro adoption at all. Our domestic politics approach focuses on the government choices, the electoral cycle, the role of central banks, and constitutional restrictions. In these three country cases, national governments decided to stick to their decisions on stable exchange rates (currency board) to ensure government credibility and in full awareness of the cost of debt in foreign currencies (mostly private debt) (see Table 2). This result is remarkable as it shows that small member states are able to act in light of their own choices, rather than being pushed by others. It also indicates that there is not 'one' response to how the financial crisis affected euro adoptions policies; it depends on what governments decide. These governments appreciated among other things that being in the Euro Area would bring these countries closer to the core centre of gravity of power in the EU. We showed that an explanation that emphasizes domestic political and institutional factors is particularly useful to explain why these governments – in the midst of the financial crisis – took these decisions that made joining the euro possible.

Notes

1. An earlier version of this paper was presented at the 49th Annual UACES conference in Lisbon 1–4 September 2019, and at the 'EMU at Twenty workshop' at Leiden University (16–17 November 2018) https://www.uvic.ca/interdisciplinary/europe/eu-grants/network/eurosem-18-21/the-emu-at-twenty/index.php. The latter conference was supported by the Institute of Political Science at Leiden University and launched the Jean Monnet Network entitled 'The Politics of the European Semester: EU Coordination and Domestic Political Institutions (EUROSEM)' Agreement number: 600,110-EPP-1-2018-1-CA-EPPJMO-NETWORK (Grant agreement nr 2018–1359), cofounded by the Erasmus+ programme of the European Union." The authors would like to thank Edgars Eihmanis, Sebastian Heidebrecht, David Howarth, Geoffrey Underhill, Ramūnas Vilpišauskas, the journal editors and two anonymous referees of this journal for their valuable comments. This research was supported by the Social Sciences and Humanities Research Council of Canada.
2. This refers to the EU Member States that joined in 2004, i.e. the New Member States. However, we do not use the term 'New Member States' but rather we refer to them as 'EU-2004' for short, because from a present-day perspective, these member states are no longer very 'new'.
3. In spring 2008 Slovakia, the fourth Visegrád country, had already requested to be considered to adopt the euro by 1 January 2009.
4. These criteria are sometimes referred to as the 'Maastricht criteria'. They refer to meeting low levels of inflation, budgetary deficit, public debt, longterm interest rates, and maintaining stable exchange rates.
5. In the case of EU member states planning for euro adoption, choosing for a floating exchange rate would result in this member state falling behind on the convergence criterion regarding the exchange rate.

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