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KATARZYNA TWAROWSKA

The role of the exchange rate policy in the Latvian economy

Rola polityki walutowej w gospodarce Łotwy

Keywords: exchange rate, inflation, economic growth

Słowa kluczowe: kurs walutowy, inflacja, wzrost gospodarczy

Introduction

The focus in this paper is put on Latvia with comparison to other Central and Eastern European countries (CEE)[1]. Latvia is one of the emerging economies, which is a small, open and net debtor country [Schnabl, 2007, p. 4]. Latvia furthermore experienced a strong boom period, for which it was called 'Baltic tiger', supported by high capital inflow especially in the real estate and financial sector from the mid 1990s until 2007, and a bust phase in 2008 with high loses in output, employment and capital outflow. This country has overcome the economic difficulties and joined European Monetary Union (EMU) on January 1, 2014.

The aim of the paper is to assess the impact of Latvia's exchange rate policy on two main goals of monetary policy: price stability and economic growth. The applied research method is a time-series analysis of various economic indicators, such as exchange rates, GDP growth, inflation rate, exports and imports, current account balance and unemployment rate. The analysis involves the period of 1990–2013 and

[1] The group of Central Eastern European countries includes: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia.

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is based on statistical data and research carried out by International Monetary Found, European Commission, central banks and other research groups.

1. The role of exchange rate policy in small open economies

The debate regarding the role of exchange rate policy in macroeconomic policy, long-run growth occupies a important position in economic research [Lane, 2001, pp. 235–266]. The optimum exchange rate system is in principle determined by five main economic criteria: openness and size, inflation policy and preferences, financial integration, the structure of production and the probability and source of asymmetric shocks, labour mobility and nominal wage flexibility [Pentecost, 2004, p. 7].

The problem of choosing exchange rate policy is particularly important for small countries. The question becomes whether to float or fix the exchange rate. There are structural features peculiar to small countries that explain why the benefits of floating the exchange rate are few, in particular [Imam, 2010, pp. 12–15]:

1) problem of an independent monetary policy is that the transmission mechanism in small countries occurs mainly through its impact on the exchange rate and through balance sheet effects, not the lending channel, since financial markets are underdeveloped. In other words, monetary policy will be largely driven by exchange rate considerations;
2) because of central bank's lack of credibility, monetary policy in small states is likely to be procyclical, meaning that it cannot be used to smooth the business cycle or more generally for stabilization policies [Calvo, Reinhart, 2002, pp. 379–408]. In practice, when external financing is abundant capital inflows surge, leading to exchange rate appreciation, and interest rates fall to minimize the appreciation. During crises, with capital flowing out the exchange rate depreciates and interest rates increase to support it. These procyclical swings in interest rates and the availability of external financing explain procyclical swings in capital inflows and are the opposite of how monetary policy should ideally work;
3) the volatility of the exchange rate can be excessive because foreign exchange markets are illiquid. As the foreign exchange market for domestic currencies in small states is often narrow and illiquid, it is subject to spikes if a large transaction takes place.

Another possibility for small countries is the choice of fixed exchange rate system (currency board, dollarization, monetary union) or intermediate exchange rates system (crawling band, pegged exchange rate within horizontal band, crawling peg, conventional pegged arrangement) [IMF, 2013a, pp. 14–16 and Tymoczko, 2013, pp. 11–24]. A fixed exchange rate has some advantages for small countries, but it is not optimal in each case.

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By fixing the exchange rate, a hard peg benefits small states by allowing them to import credibility. Fixed exchange rates are seen as providing a nominal anchor that lowers inflationary expectations and helps the central bank achieve the inflation objective.

Another reason hard pegs are popular is that they contribute to policy discipline and, therefore, credibility. Unlike a float, a hard peg will be less beholden to short-term political interests or industry lobbying. In many small states well organized manufacturing industries like textiles will be tempted to pressure the monetary authorities to depreciate the currency during tough times, taking hostage the general interest of the country. With a hard peg this cannot be done easily without opposition from competing interests that would suffer from a devaluation [Imam, 2010, p. 16].

Openness and size are important for exchange rate policy since small, open economies are likely to be price-takers on world markets. If this is the case then changes in the nominal exchange rate will be passed through quickly into domestic prices. There will therefore be no gains in competitiveness from exchange rate changes. Indeed, exchange rate depreciation only results in a rise in domestic inflation and puts upwards pressure on money wage rates, as suppliers of labour attempt to maintain their real wage rates. McKinnon argues therefore that in the case of a highly open, price taking economy then a fixed exchange rate policy is to be preferred for macroeconomic stability, since these economies are unable to influence their external terms of trade [McKinnon, 1963, pp. 717–725].

In contrast to this view, however, Frankel and Rose have pointed out, that causality may also run in the opposite direction, with membership of the same trade area actually stimulating trade between members because of closer market integration, and hence a greater degree of openness between the member states [Frankel, Rose, 1998, pp. 1009–1025]. If this is the case then membership of the euro-zone will result in a greater degree of openness for all member states, which will be aided by a common currency. This view, however, probably attributes too much weight to exchange rate volatility, as a barrier to trade, as other studies seem to show that exchange rate volatility and the uncertainty that it generates, has only a very small effect on the volume of trade [Rose, 2000, pp. 7–46].

2. Floating exchange rate in Latvia (1992–1994)

In the early 90s the process of leaving by Latvia the Russian ruble zone took place in two stages. Latvia introduced a new currency already in 1992, which was a step in the direction of gaining independence from Russia and the whole Soviet Union.[2] From 7 May 1992, a temporary currency, the Latvian ruble (LVR), was put into circulation

[2] Latvia regained independence in 1991 and in the first four months of the year 1992, Latvia was adversely affected by inflation of the Russian ruble. In addition, the outgoing cash payments surpassed the

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as a legal tender parallel to the existing ruble notes. It was declared equal in value to the Russian ruble. The national currency – the lats (LVL) – was introduced in 1993, replacing the ruble at the ratio of 1 lats = 200 rubles [Żuchowska, 2012, p. 263]. Latvia has adopted a strategy of adjusting the monetary base M_2. The exchange rate could fluctuate freely on the market and amount of money in circulation was regulated. Formally, the use of floating exchange rate was declared[3], but analysts define the exchange rate system during this period as *de facto* fixed [Lainela, Sutela, 1994, p. 56].

After the introduction of the national currency, there were frequent fluctuations on the foreign exchange market, but since the second quarter of 1993, lats stabilized (Fig. 1). The stabilization of the exchange rate had a significant relationship with reducing inflation (Tab. 2).

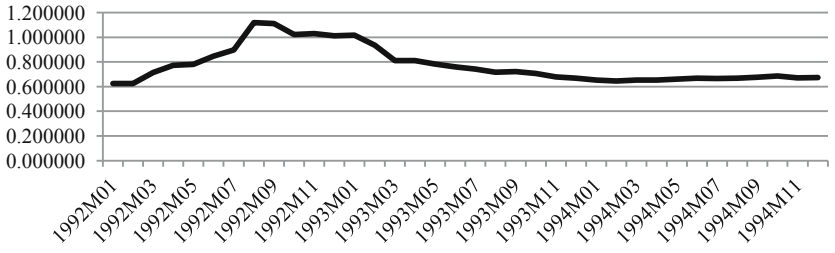


Figure 1. Exchange rate of Latvian national currency to ECU in the period 1992-1994

Source: [Eurostat, 2013]

In 1992, the inflation rate was at the level 951%, while in 1993 was reduced to 109.2% (annual average). In December 1993 inflation rate (yoy) was only 34.8% [Żuchowska, 2012, p. 265]. This result was the best of the Baltic countries (in December 1993 inflation rate (yoy) was 188.55% in Lithuania, and 37.9% in Estonia). IMF experts assessed the monetary reform carried out in Latvia, as the most efficient among all the countries of the Eastern bloc [Bochańczyk-Kupka, 2004, p. 49].

Table 1. Main macroeconomic indicators in Latvia in the years 1992–1994

Macroeconomic indicators	1992	1993	1994
Gross domestic product, constant prices (percent change)	n/a	-11.4	2.2
Inflation, average consumer prices (percent change)	n/a	109.2	35.9
Current account balance (percent of GDP)	-0.323	11.886	-3.549

Source: [IMF, 2013b]

incoming money, thus causing a very serious shortage of cash. Since the money was issued by Russia, the Bank of Latvia was unable to improve the cash circulation in the country.

[3] Due to limited foreign exchange reserves, the authorities suspected that they could not defend the assumed level of the exchange rate.

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The case of Latvia does not provide arguments that the use of floating exchange rate system contributes to reducing inflation. Reducing inflation was not reached under free evolution of the exchange rate, but the stabilization by the monetary authorities. In addition, a change of exchange rate regime was made and a fixed exchange rate system was chosen, which is associated with a lower risk of foreign exchange for domestic entities and the entire economic system.

3. Conventional pegged arrangement in Latvia (1994–2013)

In 1994 Latvian lat was pegged to special drawing rights (SDR), including US dollar, the German mark (later the euro), the pound sterling and the Japanese yen, at the rate of 0.7997 Latvian lats for 1 SDR [Kazandzinska, 2013, p. 13]. In January 2005 the lat was pegged to the euro[4]. The Bank of Latvia's foreign exchange reserves back every lats in circulation (the monetary base), therefore it is capable of maintaining a stable lats exchange rate even in case of any external disorders [Bank of Latvia, 2013].

A fixed exchange rate strategy was chosen because Bank of Latvia considered this strategy as one of the most effective instruments for reducing inflation, stabilising the macroeconomic environment and strengthening the public's confidence in the national economic policy during the initial phase of the economic reforms in transition economies. Therefore Latvia and some of CEE countries, chose a fixed exchange rate strategy at the initial stage of the economic reforms (see Tab. 2).

Ensuring price stability is the best way to contribute to the objective of the central bank's monetary policy, which is to facilitate favourable macroeconomic environment for growth of the national economy in the long term[5]. The course of the global economic development suggests that the monetary policy can best contribute to the economic growth, employment and financial stability by ensuring low inflation rate. By maintaining price stability, the central bank creates a stable and predictable business environment [Gerdesmeier, 2011, p. 29]. For this reason, Bank of Latvia and the majority of sovereign central banks across the world have declared maintenance of a low and stable long-term inflation rate as their principal goal.

[4] Latvia became a full member of the EU on May 1, 2004 together with nine other European countries.

[5] More about the arguments of Latvian monetary authorities to justify a policy of fixed exchange rates is presented in [Przybylska-Kapuścińska, 2007, p. 439].

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Table 2. CEE's exchange rate regimes

Country/Exchange rate regime	Monetary union	Currency board arrangement	Conventional pegged arrangement	Horizontal bands	Crawling peg	Crawling band	Managed floating	Independently floating
Bulgaria		1997					1994	1991
Czech Republic			1991	1996			1997	2008
Estonia	2011	1992						
Hungary			1990	2001		1995	2009	2008
Latvia	2014		1994					1992
Lithuania		1994						1992
Poland			1990		1991	1995	2010	2000
Romania						2001	1998 2004	1992
Slovak Republic	2009		1993	1996 2005			1998	
Slovenia	2007			2004		1996	1991	

Source: Author's compilation based on: [IMF, 2013a, pp. 14–16] and [Tymoczko, 2013, p. 49].

The introduction of the conventional pegged arrangement has stabilized exchange rate of the Latvian currency, which contributed to a significant reduction in price increases. The appreciation of lats (Fig. 2) was caused by the inflow of foreign capital in the conditions of free capital movement, unlimited convertibility of the national currency, fix exchange rate system and effectively implemented the stabilization program.

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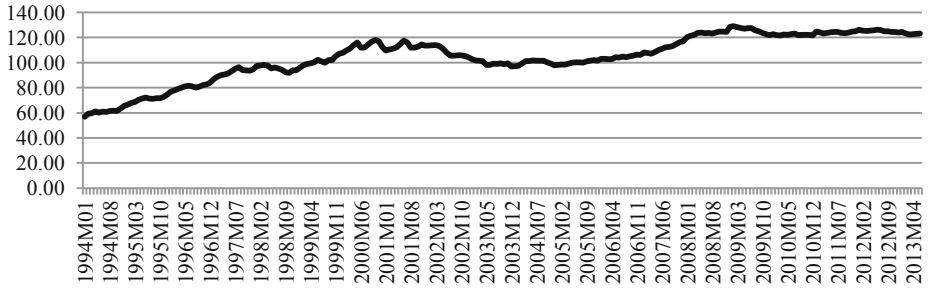


Figure 2. Real Effective Exchange Rate of lat (deflator: consumer price indices – 17 trading partners – Euro Area, Index, 2005=100) in the period January 1994 – June 2013

Source: [Eurostat, 2013]

Since the second half of 1994 there was a period of disinflation. In December 1994 the inflation rate was 26.36% (yoy) and to the end of 1997 inflation fell to 6.36% [Eurostat, 2013]. In the first years of transformation Latvia was the leader among the Baltic countries in terms of effectiveness in the fight against inflation.

Since 1994, the average prices increase in the CEE countries was higher than in Latvia (Fig. 3). This difference is particularly increased in 1997 due to the very high inflation in Bulgaria, which was 1061.2% (average inflation in CEE without Bulgaria was 28.8%). The reason for this situation was the currency crisis in Bulgaria – inflation has increased due to the depreciation of the Bulgarian lev (BGN), which lost value of 3500% in the period 19.04.1996–14.02.1997 [Żuchowska, 2012, p. 248].

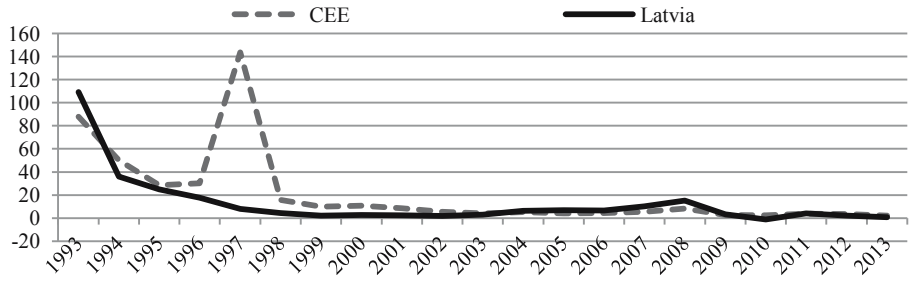


Figure 3. Inflation in Latvia and in Central and Eastern Europe* in the period 1993–2013 (average consumer prices, annual percent change)

*Bulgaria, Czech Republic (since 1996), Estonia (since 1994), Hungary, Latvia, Lithuania, (since 2000) Poland, Romania, Slovak Republic (since 1994), Slovenia.

Source: Author's calculation based on: [IMF, 2013b]

Economic growth remained at a similar level as in the other Baltic countries and Central and Eastern Europe (Fig. 4). Until 1995, economic growth in Latvia was lower

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than the average in CEE, but since 1996 remained at a higher level. Disinflationary trend in Latvia, enhanced by low food prices, remained strong despite the economic growth rate in the period 1996–1998. In 1999, inflation was reduced to 2.1% (yoy).

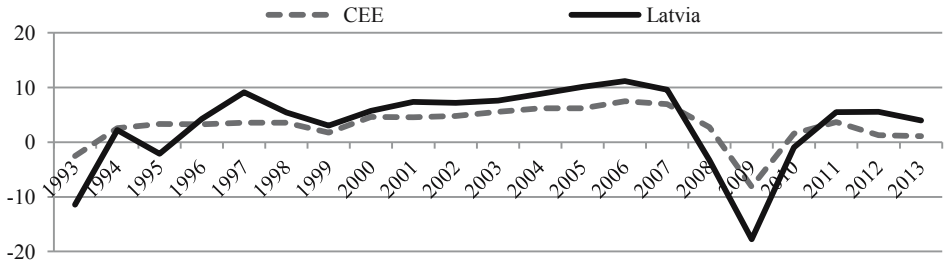


Figure 4. Gross domestic product in Latvia and in Central and Eastern Europe* in the period 1993–2013 (constant prices, annual percent change)

*Bulgaria, Czech Republic (since 1996), Estonia (since 1994), Hungary, Latvia, Lithuania, (since 1996) Poland, Romania, Slovak Republic (since 1994), Slovenia.

Source: Author's calculation based on: [IMF, 2013b]

Despite reduction in the rate of inflation in Latvia, its level was significantly higher than in the major Western trading partners. This resulted in appreciation of lats. This trend was continuing until the end of 2000, which had an impact on the deterioration of the international competitiveness of the Latvian economy and a decline in the profitability of export. In 1999 the volume of Latvian export decreased significantly (a drop of 6.6% yoy), when Lithuania's exports fell by 16.4% and Estonia's export fell by 3.6% (Fig. 5).

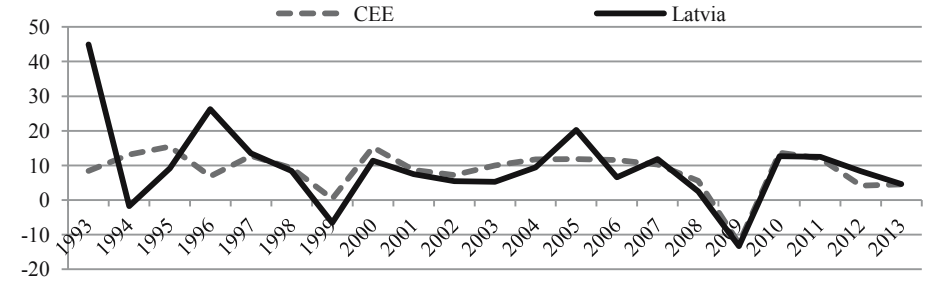


Figure 5. Volume of exports of goods and services in Latvia and in Central and Eastern Europe* in the period 1993–2013 (annual percentage change)

*Bulgaria, Czech Republic (since 1996), Estonia (since 1994), Hungary, Latvia, Lithuania, (since 1996) Poland, Romania, Slovak Republic (since 1994), Slovenia.

Source: Author's calculation based on: [IMF, 2013b]

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Since 1994 there was the current account deficit, which increased during the period 1998–1999 (Fig. 6), which was associated with a decrease in exports to Russia in response to the Russian crisis. In 2000, the deficit decreased to -4.9% of GDP, but in the following years grew (in 2004 exceeded -12% of GDP and in 2006–2007 exceeded 22% of GDP). In 2009–2010, there was a surplus, but in subsequent years the deficit reappeared.

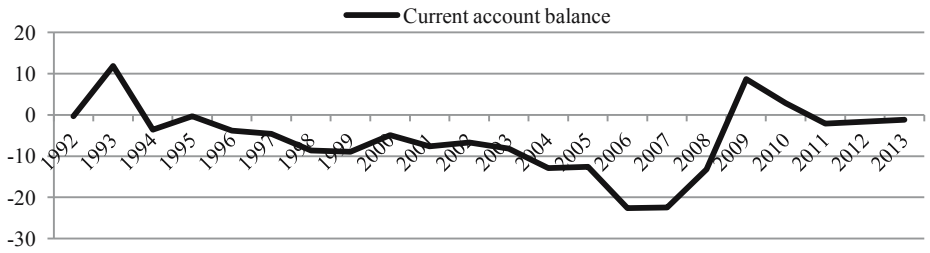


Figure 6. Current account balance in Latvia and in the period 1993–2013 (percent of GDP)

Source: [IMF, 2013b]

Because of the strict rules of exchange rate policy and a commitment to stabilize the exchange rate, the monetary authorities of Latvia could not devaluate their currency, which would be an impulse to improve the competitiveness of the economy.

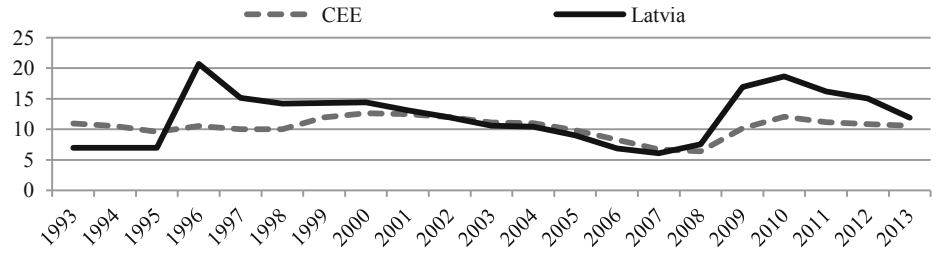


Figure 7. Unemployment rate in Latvia and in Central and Eastern Europe* in the period 1993–2013 (percent of total labor force)

*Bulgaria, Czech Republic (since 1995), Estonia, Hungary, Latvia, Lithuania, (since 1999) Poland, Romania, Slovak Republic, Slovenia.

Source: Author's calculation based on: [IMF, 2013b]

Despite the Russian crisis at the beginning of the first decade of the twenty-first century, economic performance of Latvia was good. Inflation has stabilized at a low level, the GDP growth was high, unemployment continued to decline (Fig. 7), exports grew and foreign capital flowed to Latvia. In 2004, the Latvian GDP grew by 8.86%,

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which was the fastest growing economy among the countries of the European Union [Żuchowska, 2012, p. 228].

Accession to the EU implied preparation for the participation in the Economic and Monetary Union (EMU) and introduction of the euro. One of the criteria for joining the EMU implies participation in the Exchange Rate Mechanism II for two years. Latvia joined ERM II on May 2, 2005. ERM II means that, for at least two years prior to the introduction of the euro, the lats had to be pegged to the euro, with the fluctuation margins of the lats exchange rate against the euro not exceeding ±15% against the lats/euro peg rate. The Bank of Latvia committed to ensure narrower fluctuation margins against the euro than the prescribed maximum (±1%), thus maintaining higher stability of the lats against the euro [Bank of Latvia, 2013].

Exchange rate was set at 1 euro = 0.702804 lats. This course was established at the time of the appreciation of the euro relative to other currencies, which was a positive stimulus for the Latvian exporters on the one hand, but on the other hand, caused a increase in the prices of goods imported from the European Union [Bank of Latvia, 2005].

In the second year of participation in ERM II, Latvia failed to meet only one of the criteria for joining the EMU – price stability criterion[6]. Inflation in 2004–2006 was at the level of 6%, but in 2007 increased to over 10%, and in 2008 was over 15%. A similar trend occurred in other countries in the region. A significant increase in inflation after the accession to the EU was driven by rapid GDP growth[7] and was a sign of overheating and business boom [ECB, 2008, p. 40].

After accession to the EU, the lack of exchange rate risk led to an increase in lending in euro (in 2006 the growth rate of loans was at the level of 70%), followed by an increase in internal demand and the inflation pressure. Monetary policy instruments were ineffective due to import of interest rates from euro area and the persistently high inflation. Real interest rates were negative. As a consequence of the financial crisis and an increase of risk aversion, there has been an outflow of foreign capital from CEE countries. This led to the destabilization of the financial sector in Latvia and a sharp reduction in lending [Weisbrot, Ray, 2010, p. 6].

The threat of abrupt devaluation of lats became a matter-of-fact. That situation had negative consequences on the cost of foreign debt servicing. This problem was mitigated by financial assistance from the IMF. Providing support depended on fulfillment of the condition of cuts in government spending, which could have an impact on the deepening recession and led to the collapse of the government. The pressure of lats devaluation appeared again in 2009 after a failed attempt of Latvian treasury bond issues. There was a panic on the financial markets. According to estimates by

[6] From April 2007 to March 2008, Latvia recorded a 12-month average rate of HICP inflation of 12.3%, which was considerably above the reference value of 3.2% stipulated by the Treaty.

[7] Additional reasons for the growth of inflation: an increase in domestic demand, high wage growth, increases in indirect taxes and administered prices.

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the European Commission, the Bank of Latvia lost on defense the lats exchange rate about 25% of its foreign exchange reserves in the first half of 2009 [NBP, 2009, p. 57]. The situation stabilized after the fulfillment of the conditions for obtaining the aid from EU and IMF (reduction of budget expenditures by 10%) and receiving the next credit tranche. Latvia managed to avoid the devaluation of the lats, but it was necessary to carry out the internal devaluation, i.e. the reduction of labor costs, which improved the competitiveness of the economy [Weisbrot, Ray, 2011, p. 8].

Latvia was the hardest of all CEE countries affected by the global financial crisis. In 2008, GDP fell by -3.3%, in 2009 -17.7% and in 2010 by about -1% (in the same period in Lithuania: 2.9%, -14.8%, 1.5%; in Estonia: -4.2%, -14.1% and 2.5%). In the following years Latvia's GDP grew by 5.5% per year (2011), 5.6% (2012) and 4% (2013)[8].

The crisis could also affect the decision to introduce the euro in EU countries that remain outside of the EMU [Mucha-Leszko, Kąkol, 2009, pp. 17–31]. Economic openness gives advantages in terms of strong growth, but also causes a greater risk of external shocks in times of crises. Small and narrowly specialized economies are most exposed to shocks. When speculative attacks on currencies of emerging economies will also be taken into account, then it becomes reasonable to consider the adoption of a common currency by the new member states [Mucha-Leszko, 2010].

Latvia fulfilled the criteria and joined the Eurozone on January 1, 2014 [European Commission, 2013, pp. 2–9]. The Latvian economy has been reckoned as one of the fastest growing economies in the European Union. Rating agencies rated the Latvian economy up, with the Latvian government predicting that its economy would go up to an 'A-category', once it adopted the euro. It is noticed, however, that there was little interest in the "Euro starter kits", contrary to the queues in Estonia in 2011. Possible reasons for that named, are prices that have gone up in neighboring Estonia (a Eurozone member since 2011), and the feeling of losing independence.

Conclusion

To summarize, the economic structure of small states explains why choosing a flexible exchange rate has major disadvantages (need for a costly central bank, limited gains from exchange rate flexibility, limited independent monetary policy, high exchange rate volatility). On the basis of the analysis it can be concluded that a fixed exchange rate policy can be less costly than floating for small countries with an open economy, where foreign trade plays a very important role. A smaller economy is dependent on changes in the global financial and commodity markets, and its chances to influence them are limited.

[8] European Commission's forecast [Eurostat].

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The case of Latvia indicates that the system of fixed exchange rates also can become risky for the economy. Although effective process of reducing inflation in 1994–1999, the long-term stabilization of prices in this country was not possible under conditions of total liberalization of capital movements and the limited autonomy of monetary policy. Latvian economy fell into the fixed exchange rate trap. Absence of exchange rate risk caused problems with excessive inflow of foreign capital, credit growth and the appreciation of the currency. The period of business prosperity after the accession to the European Union characterized by high inflation, which decreased only during the recession.

The above analysis allows to conclude that the long-term fixed exchange rate regime is not an effective tool in the fight against inflation and may contribute to serious economic problems.

Latvia, since the beginning of 2014, has become euro zone member, which creates new opportunities for this country, but it can also bring some risks. Some researches show that currency unions have significant advantages over less strict fixed regime. In particular, currency unions are long-lived whilst less strict fixed regimes, such as narrow bands or pegs, are rather transient [Breedon et al., 2011, p. 21].

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The role of the exchange rate policy in the Latvian economy

The aim of the paper is to assess Latvia's exchange rate policy and its impact on two main goals of monetary policy: price stability and economic growth. The paper presents the role of exchange rate policy in small open economy such as Latvia and the effects of applying different exchange rate regimes in Latvia.

At the beginning of transformation Latvia adopted a floating exchange rate system due to lack of sufficient foreign exchange reserves. Empirical analysis showed that during the period of functioning floating exchange rate system formally in Latvia, inflation rate has been reduced, but in the stabilization of the nominal exchange rate that is achieved by central bank intervention on the currency market. In order to accelerate the process of stabilizing the economy and achieve greater credibility of the financial markets, Latvia has adopted a fixed exchange rate system, which enabled the import of external validity. Economic performance, particularly price stability, reached in Latvia in the years following the change in the exchange rate, allows to conclude that the decision was right. The empirical analysis confirmed that in the initial period of the fixed exchange rate system in Latvia, the fight against inflation has been effective. However, in subsequent years, in terms of growing openness, Latvia has experienced the problem of increasing foreign capital inflows and the appreciation of the currency, which led to the decision of currency devaluation that caused inflation. From this it follows that the use of fixed exchange rate as an anti-inflationary anchor is effective only for a limited time.

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Rola polityki walutowej w gospodarce Łotwy

Celem opracowania jest ocena polityki walutowej Łotwy i jej wpływu na stabilność cen oraz wzrost gospodarczy. W opracowaniu została przedstawiona rola polityki walutowej w małej otwartej gospodarce, której przykład stanowi Łotwa. Wskazano również efekty stosowania różnych reżimów kursowych w Łotwie.

W początkowym okresie transformacji Łotwa, z powodu braku wystarczających rezerw dewizowych, przyjęła system kursu płynnego. Jak pokazała analiza empiryczna, w okresie obowiązywania oficjalnego kursu płynnego nastąpiło ograniczenie tempa inflacji, ale w warunkach stabilizacji nominalnego kursu walutowego, osiągniętej dzięki interwencjom banku centralnego na rynku walutowym. W celu przyspieszenia procesu stabilizacji gospodarki oraz osiągnięcia większego zaufania rynków finansowych Łotwa przyjęła system kursu stałego, co umożliwiło import wiarygodności zewnętrznej. Wyniki gospodarcze, w szczególności w zakresie walki z inflacją, osiągnięte na Łotwie w kolejnych latach po zmianie systemu kursowego pozwalają twierdzić, że była to decyzja słuszna. Analiza empiryczna potwierdziła, że w początkowym okresie stosowania systemu kursu stałego udało się za jego pomocą prowadzić skuteczną walkę z inflacją. Jednak w późniejszym okresie, w warunkach coraz większego otwarcia, Łotwa doświadczyła problemu wzmożonego napływu kapitału zagranicznego i w konsekwencji aprecjacji waluty, co doprowadziło do proinflacyjnych decyzji dewaluacyjnych. Pozwala to na stwierdzenie, że wykorzystanie systemu kursu stałego jako kotwicy antyinflacyjnej jest skuteczne jedynie w ograniczonym czasie.