



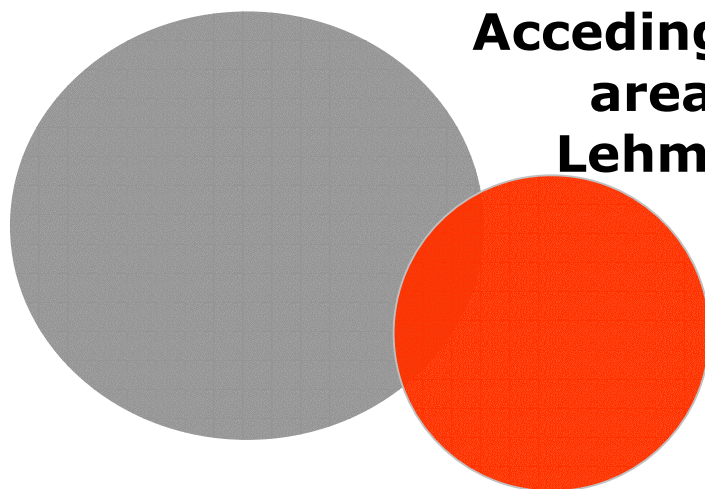
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## Country Report LITHUANIA

# **Economic and Political Challenges of Acceding to the Euro area in the post- Lehman Brothers' World**



**Economic and Political Challenges of Lithuania  
Acceding to the Euro Area**

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The publication comprised of nine Country Reports and a Summary Report is available on the website of the European Policies Initiative: [www.eupi.eu](http://www.eupi.eu)

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The European Policy Initiative (EuPI) aims at stimulating and assisting the New Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society level. As a new priority area of the European Policies and Civic Participation Program of Open Society Institute – Sofia, EuPI will contribute to improving the capacity of New Member States to effectively impact common European policies through quality research, policy recommendations, networking and advocacy.

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**About the publication**

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EuPI aims at stimulating and assisting new Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society levels ([www.eupi.eu](http://www.eupi.eu)).

The project was implemented from September 2008 to September 2009. The main outcome of the project is a publication comprised of nine Country Reports and a Summary Report.

Following a uniform structure, and addressing a set of similar questions, the nine Country Reports (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovenia) present stylized facts about the patterns of real and nominal convergence with the euro area in nine new EU members, outline the setting and the implementation of the accession policies in those countries and emphasize the incidence of the current crisis on the strategy to adopt the common currency.

Comments are relevant to policy developments until 20 May, 2009 – the cut-off date for the submission of the last revised version of the Country Reports.

The Summary Report reviews the results of the Country Reports and systematizes some of the dominant trends they reveal. The Summary Report checks the countries’ experience in dealing with the complicated concentric monetary structure inside the EU (euro area; ERM II; non ERM II countries) and pays particular attention to the evidence gathered about the political economy of the procedures in the different countries.

Each Country Report and the Summary Report include an Appendix, containing Tables that summarize significant data provided in accordance with a standardized set of indicators.

The results of the Project are correctly intelligible only if all its pieces (ToR, Summary Report, Country Reports, Appendix) are considered together.

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The project was able to benefit from the insights of a distinguished Advisory Board. As the Boards’ mandate was limited to advice and comments on the methodology and the Summary report, responsibility for the findings and statements rests solely with the authors of the Country and the Summary reports.

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## EXECUTIVE SUMMARY

Lithuania's integration into the European Union (EU) has formed an important element of country's transformation, which has taken place since the beginning of 1990s. Convergence of the economy and reaching the level of welfare of the EU member states has been one of the key goals of integration into the EU and being its member.

The actual trend of economic development has been one of fast economic convergence with the EU average. For example, while in 1995 the country's GDP per capita equalled around 35% of the EU average, according to Eurostat, recently the respective figure increased to over 60%. Although the trajectory of economic recovery and growth after the initial economic decline of the early 1990s was interrupted by the financial crisis in Russia in 1998, in 2000 Lithuania's economy recovered. From that point until 2008 it was one of the fastest growing economies in the EU with an average annual growth rate of around 7-8%.

Euro area accession has been seen as a part of the broader process of joining the EU, and according to the Accession Treaty, the country committed itself to introducing the euro as soon as the relevant convergence criteria are met. It should be noted that 15 years ago Lithuania adopted a currency board arrangement which is based on several pillars, including a fixed exchange rate in relation to an anchor currency. Although, at the beginning, the US dollar was chosen as an anchor due to its importance to the country's economy, in 2002 it was replaced by the euro. Thus, already before Lithuania's accession to the EU in 2004, the country's monetary policy was anchored to the euro area, even though the country continued to use its national currency, the litas. Several months after accessing, Lithuania joined the Exchange Rate Mechanism II (ERMII), which did not impose any significant changes on its monetary regime. Soon afterwards, the goal of joining the euro area in 2007 was set.

Although at the time of its application to join the euro area the country met all the Maastricht criteria, accelerating inflation became an obstacle to introducing the euro as planned. Although accelerating inflation was, to some extent, a result of global economic changes, the decisions in the areas of fiscal and regulatory policy that were inconsistent with the goal of introducing the euro have also contributed to the inflationary tendencies. In the spring of 2006, the European Commission (EC) and the European Central Bank (ECB) decided that Lithuania was not ready to adopt the euro in the beginning of 2007. The decision was based on the judgment that the country was missing the inflation criteria at the moment of evaluation by a margin of 0,1%, and that it was not sustainable. Since then, inflation has accelerated to reach double digit levels in 2008. Although for some time it was hoped to introduce the euro in 2010, soon this goal was also abandoned because of relatively high inflation that exceeded the Maastricht reference.

The situation changed after the global economic slowdown began to impact Lithuania in 2008 and 2009. Not only has economic growth slowed down, but in the last quarter of 2008 the country's GDP declined for the first time after almost a decade and was followed by a recession. This has also impacted the price level dynamics, with inflation starting to decline and forecasted to come down significantly in 2010 and 2011. However, as the country did not manage to accumulate a budgetary surplus during its time of fast economic growth, and with the budgetary revenues declining coupled with the overall decline of the economy, maintaining the budget deficit within the limits of 3% of GDP became challenging. The growing country risk premium also led to interest rates exceeding the Maastricht criteria.

In the beginning of 2009, the prospects for adopting the euro remain unclear. Although inflation might soon (in 2010-11) come down to the levels compatible with the

convergence criteria, state debt will also remain far from reaching the 60% of GDP limit (in 2008 it was around 15% of GDP). Both the budget deficit and interest rates pose important challenges for Lithuania's efforts to join the euro area as soon as possible.

There is a broad political consensus that the country must maintain its currency board regime with a fixed peg to the euro and join the euro area as soon as possible. The accession into the European Monetary Union (EMU) is seen as a key pillar of the current economic policy at a time of economic downturn. Thus, fiscal policy, in particular, cutting budgetary expenditures, flexibility of the labor market (in particular adjusting wages downwards), and the future trends of the main export markets will be the key factors to determine the prospects for joining the euro area. The maintenance of the budget deficit close to 3% of GDP, however, it will be politically difficult if the current economic recession continues for some time to come. It is also an important test of the Lithuanian economy's flexibility, which at the same time is a real test of readiness to be in the single currency area.

## I. Country's Economic Convergence

Fast real convergence with the EU economy could be described as a key feature of Lithuania's economic development during the last decade. Due to consistently higher than EU (and in particular euro area) GDP growth, the country's GDP per capita has been converging from around one third of the EU's average level in 1995 to more than 60% in 2007 (for the economic data, see the statistical annex)<sup>1</sup>. However, it should be noted that despite this fast economic growth, Lithuania's GDP per capita remained comparatively low, exceeding only Romania, Bulgaria, Latvia and Poland.

The opening of external trade in the early 1990s and the integration into the European economy, in particular the free trade regime with the EU in 1994, leading to Lithuania's eventual accession in 2004, provided an important factor behind the economic restructuring and the increase in economic activity. Although financial crisis in Russia in 1998 briefly reversed this trend of economic growth, with a decline in 1999 and deteriorating budgetary situation in the country, it actually acted as an additional impetus to restructure the country's economy to become more competitive in the European markets.

Thus, the five years preceding Lithuania's accession to the EU could be characterized by economic recovery and the restructuring of trade flows in addition to declining levels of unemployment and inflation. Actually, in 2003, the country experienced deflation, while GDP growth reached double digit levels. Interest rates came down several years before the country's accession to the EU, reflecting positive expectations related to the integration process. The removal of barriers to trade and economic activity with the EU also affected economic trends already before the date of accession to the EU. An increasingly larger share of trade has been with the EU (and euro area) economies; foreign direct investment (FDI) flows have also increasingly originated from EU member states, in particular Nordic countries and Germany.

Most of these trends continued after EU accession in May 2004. Average annual economic growth remained at high levels of 7-8%, significantly exceeding the average growth rates of the euro area (also exceeding the income convergence rates of most other new member states). Unemployment levels went down to their lowest levels since the early 1990s and reached 4,3% in 2007 (when the EU-27 average exceeded 7%), affected both by the expanding economy and migration opportunities to wealthier EU member states that opened up their labor markets from the first day of accession (mostly Ireland and Great Britain, less so to Nordic countries, Spain).

As the economy grew, the budgetary revenues also were on the rise, allowing for the reduction of the budgetary deficit and state debt levels. However, there has been a lack of political consensus regarding the anti-cyclical fiscal policy. Most likely, there has also been too little understanding of the importance of a prudent fiscal policy in the country with a monetary regime based on currency board. Despite impressive rates of economic growth since 2000, budgetary revenues and expenditures have not been balanced, although coming close to a balance in 2006. The growth of budgetary expenditures, reaching in recent years 25%, prevented from accumulating surpluses which could be used to soften the adjustment to the current fast economic slowdown and deteriorating budgetary revenues.

Moreover, rapidly growing budgetary expenditures together with EU funding, remittances from migrant workers abroad, salaries growing on average at around 20% annually, and the overall positive expectations of consumers willing to take credits amidst a growing economy contributed to the acceleration of price growth in Lithuania. Inflation reached

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<sup>1</sup> Also see <http://www.stat.gov.lt/>.

the Maastricht criteria in 2006 and exceeded it afterwards, effectively preventing the introduction of euro in 2007. It should be noted that for Lithuania, with its currency peg to euro, joining the EU soon allowed for a formal opportunity to join the ERMII where it remains until now. However, after almost two years of EU membership when the country met all nominal convergence criteria, inflation became the main obstacle to introducing the euro.

It should also be noted that the share of trade with the EU countries stabilized at the time of Lithuania's accession in 2004, constituting around two thirds of Lithuania's exports and remained at these levels, which were lower than in 2000-2001 when it exceeded 70%. Interestingly, export growth was among the highest in the EU even in 2008, thus illustrating the competitiveness of Lithuanian exports despite higher than EU average inflation in recent years. In absolute terms, Lithuania's exports to Russia and other non-EU countries have been growing rapidly, reflecting the growing demand in these markets. Another feature differentiating Lithuania somewhat from other member states, was the relatively low share of FDI. Although the country declared the attraction of FDI as its priority, most of it came during the process of privatization (in particular, in the fields of infrastructure and financial services) with little green-field investment. While some of its industries, in particular banking, have been well integrated into the Nordic markets, the overall level of FDI remained comparatively low. Inside the country, there has been a shift from value-added creation from manufacturing to the services sector, although compared to the other Baltic states, Lithuania preserved its strong manufacturing and agricultural basis.

These trends of relatively high economic growth and real economic convergence halted in 2008. Although the country's economy still grew at a rate of around 3% in 2008, its decline started in the third quarter (estimated at 0.3%) and accelerated to 1.3 to 1.4% during the last quarter of 2008. This decline will continue in 2009 (exceeding 12% in the first quarter of the year) and most likely in 2010. Currently, GDP decline is forecasted at around 10.5% for the whole of 2009, although the downward revision of economic trends has been one of the main features of economic forecasts during the period that followed September 2008<sup>2</sup>.

This decline is already affecting the main fiscal indicators used to evaluate the country's readiness for adoption of the euro. Budget deficit increased in 2008 to reach 3.2 % of GDP (instead of the expected 0.5%). It is possible that even with significant adjustments on the expenditure side equal to 4% of GDP, it might exceed 3% of GDP in 2009. The state debt levels are also likely to increase to reach 20% of GDP, although high interest rates have prevented Lithuania from relying too much on external borrowing. Besides, the level of state debt is and most likely will remain comparatively low in Lithuania, in particular, compared to the euro area members.

The rapid decline in economic activity (although still growing in December 2008, industrial production dropped by 15% in February 2009 compared to the same month in 2008) and retail trade (a fall of 32% in February 2009 compared to February 2008), rapidly increasing numbers of unemployment (reaching around 8% at the start of 2009) and a very low level of confidence (the industrial confidence indicator was minus 30%, retail trade confidence indicator minus 58% in February 2009) are likely to bring inflation levels down in 2009. These factors have already significantly reduced the current account deficit, which has been relatively large throughout this decade, reflecting the previously high domestic demand and credit boom.

Prices increased after changes to taxation levels at the beginning of 2009 (in particular, increase in excise and VAT rates). For example, according to the Bank of Lithuania,

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<sup>2</sup> For example, the estimates of 1.5 percent GDP growth for 2009 provided in October 2008 were seen as conservative at the time, several months later they have been revised to 0 percent growth and in December 2008 cut down to a decline of 4.8 percent.

average annual inflation in February 2009 was still 10,8% in the country, while the Maastricht reference value was 3,8%<sup>3</sup>. However, this is likely to be a short-term effect and a decline in prices is expected later in 2009 (forecasted at 5,4%), and in 2010 the country might experience deflation. The closure of Ignalina nuclear power plant is likely to add to the overall level of inflation in 2010, but its effects are likely to be less significant than previously thought due to lower prices of natural gas, which will replace nuclear energy as the main source of electricity production.

To sum up, the current economic slowdown has interrupted more than a decade-long process of Lithuania's fast real economic convergence with the euro area. Although the effects of the global economic recession were felt relatively late in Lithuania, the actual economic decline might be larger and last longer than the EU average. At the same time, it should be noted that it will depend on the flexibility of domestic economy and external economic conditions. In this respect it will be the first real test of country's readiness to join the euro area. If Lithuania proves to be flexible enough to react to declining competitiveness through the adjustment in domestic wages and cutting of public expenditures, it could be ready to join the euro area in 2012.

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<sup>3</sup> <http://www.lb.lt/lt/euras/konvergencija.htm#infl>. – 2009.04.07.

## II. National Goals and Strategies for the Euro Adoption

### 1. Before the Global Crisis

From both political and legal points of view, joining the EU implied joining the euro area at some point in time when the convergence criteria are met. Differently from Denmark and Great Britain, Lithuania and other Central and Eastern European (CEE) countries could not opt out of adopting the euro. The only issue was the question of time, because from the day of acceding to the EU all new member states were formally given a derogation from adopting the euro until they meet the convergence criteria.

For Lithuania, the introduction of the euro as soon as country meets the Maastricht criteria has been one of the key goals of European policy after accession to the EU. The currency board regime, with the national currency's fixed peg to the euro, formed the basis for a strategy for adopting the euro. Formal accession into the ERMII on June 28, 2004 (less than two months after joining the EU), formed the basis for the monitoring of how the country stood with respect to the nominal convergence criteria. It should be noted that at the time of joining the ERMII, Lithuania committed "to secure a balanced budget over the medium term" as well as undertake structural reforms aimed at further enhancing economy's flexibility and adaptability "in a timely fashion"<sup>4</sup>. However, these aims have not been achieved during the years of high economic growth, despite the fact that EC and local expert community have routinely criticised the government because of its pro-cyclical fiscal policy, inability to balance the budget and the lack of structural reforms.

It should be noted that although accession to the ERMII soon after joining the EU was swift and non-controversial, the subject of countries with currency board arrangements joining the EMU was the subject of intense debate toward the end of the 1990s. It was far from obvious to EU institutions and the International Monetary Fund (IMF) that the currency board arrangement could be seen as the best instrument for joining the euro area. For example, in 1997 the Bank of Lithuania was deliberating whether to abandon the currency board arrangement in the coming years, and only after intense discussions was it agreed that the currency board arrangement could be usefully employed during the process of preparing to join the EMU<sup>5</sup>. For example, only after the analysis of economic trends in Lithuania and other countries with currency boards did IMF analysts come to the conclusion that the currency board arrangement could satisfy all the requirements of a regime heading towards accession into the EMU and could be the first-best policy for these countries<sup>6</sup>. Importantly, it was noted that if countries wished to preserve the viability of their currency board arrangement during their preparations for the introduction of the euro, they had to maintain fiscal policy discipline and preserve flexible labour markets.

The position of the EU, namely the ECB, was spelled out in April 2000 at the Press Conference the ECB when the President briefly presented the position of the Governing Council on the appropriateness of the use of euro-based currency board arrangements (CBAs) as a strategy for introducing the euro. In particular, it was concluded that "the appropriateness of CBAs will be assessed on a case-by-case basis. Therefore, the Governing Council neither encourages nor discourages the adoption of euro-based CBAs. In any event, such arrangements cannot be regarded as a substitute for two years' participation in ERMII. Accession countries which have operated a euro-based CBA deemed to be sustainable might not be required to go through a double regime shift in their strategies to adopt the euro. Thus such countries may participate in ERMII with a

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<sup>4</sup> From the Communique, available at [http://ec.europa.eu/economy\\_finance/publications/publication6170\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication6170_en.pdf).

<sup>5</sup> Kropas, S., Kropiene, R. *Europos pinigai*, Vilnius: Lietuvos bankas, 2005, p. 312.

<sup>6</sup> Gulde, A. M., Kahkonen, J., Keller, P. *Pros and Cons of Currency Board Arrangements in the Lead-up to EU Accession and Participation in the Eurozone*, IMF Discussion Paper No. 1, January 2000.

CBA as a unilateral commitment augmenting the discipline within ERMII. However, it should be clearly understood that a common accord would have to be reached on the central parity against the euro.<sup>7</sup> This position cleared the way for the maintenance of Lithuania's currency board that proved itself successful at achieving macroeconomic stability and providing foundations for economic growth in the run-up to the EU accession and thereafter. It was also allowed to join the ERMII promptly after the accession to the EU.

It seemed that in 2005-06 that there was a window of opportunity to swiftly join the euro area together with Slovenia (who joined in 2007). Lithuania met all the nominal criteria at that time, although as the time of formal application and the evaluation of country's compliance with Maastricht criteria approached, inflation had been picking up. However, differently from Estonia, which decided to withdraw its application to be evaluated for the readiness to introduce euro in 2007, Lithuanian policy makers maintained their determination to introduce the euro. In March 2006, Lithuania applied to be evaluated in terms of its readiness to introduce the euro.

However, despite the formal readiness to be assessed and the official position that the country was ready to join the euro area there lacked a well-articulated political consensus regarding this goal. Although it was stated in the strategic programs and strongly supported by the institutions responsible for the preparations as well as the community of analysts, some key figures of the government have been reluctant to advocate for the introduction of the euro both at home and in conversation with EU institutions. To some extent, this was a reflection of a rather reluctant public that was not as supportive of membership in the euro area as compared to their relatively strong enthusiasm for membership in the EU. The main concern for the public, judging from the these surveys, had to do with a fear of the price increases that were expected to follow the introduction of the euro<sup>8</sup>.

It should also be noted, that the reluctance of some political leaders to publicly support the goal of joining the euro area was also reflected in a lack of consistency and viability of euro-oriented policies. The lack of budgetary discipline as well as certain decisions in the area of regulated prices (energy, transport) contributed to the acceleration of inflation during the period of 2005-08. The continuous expansionary policy during times of fast economic growth and rising wages contributed to the acceleration of inflation. Although global market trends - in particular the rise of energy and food prices, and the one-off effects of joining the EU customs union - impacted price increases in Lithuania, domestic demand pressures have also been shown to contribute to this inflationary trend<sup>9</sup>. The decision to allow for the indexation of assets owned by energy companies in 2004, which increased the room for regulated prices to be raised as well as the regulatory policy measures allowing for an increase in public transport prices, also added to the inflationary pressures which came into effect not only in 2005 but also later.

Thus, while monetary policy has clearly targeted adoption of euro as soon as two years of membership in the ERMII are complete, other economic policies, budgetary policy and certain regulatory decisions in particular have been inconsistent with this goal. The contradicting public statements of some ministers of the government and the late diplomatic efforts in the spring of 2006 to mobilize the political resources trying to convince EU institutions that the country was ready to introduce the euro illustrate the

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<sup>7</sup> ECB Press Conference, Introductory Statement by Willem F. Duisenberg, President of the European Central Bank, and Christian Noyer, Vice-President of the European Central Bank, Frankfurt am Main, 13 April, 2000.

<sup>8</sup> See [http://ec.europa.eu/public\\_opinion/euro\\_en.htm](http://ec.europa.eu/public_opinion/euro_en.htm). Interestingly, the share of population favoring the adoption of euro increased after the failure to introduce it in 2007, although it has still been below 50 percent.

<sup>9</sup> See Ohnsorge, F., Igan, D., Lugaresi, S., Republic of Lithuania, Selected Issues, IMF Country Report No. 06/163, May 2006. They emphasize the importance of the nontradable inflation which points to the importance of regulated price increase and growing domestic demand. It was recommended at the time to adopt a conservative fiscal stance in order to contain future inflationary pressures in Lithuania.

hesitancy of the political elite and the gap between the officially declared goal and actual policy efforts.

With a two year period of membership in the ERM II approaching in spring 2006, Lithuania's compliance with the Maastricht criteria was evaluated by the EC and the ECB. The conclusion that both institutions came to and that was submitted to the European Council in June 2006 was that "Lithuania meets all the convergence criteria except the one on inflation. The average rate of inflation has been slightly higher above the reference rate value since April 2005 and is expected to rise gradually until the end of the year"<sup>10</sup>. The recommendation was that there should be no change in Lithuania's status as an EU member state with a derogation. Although Lithuania's leaders attempted to convince the heads of other member states at the June 2006 summit that this was not an obstacle for the adoption of the euro in 2007, since the difference was less than 0,1% (the average inflation rate in Lithuania was 2,7% while the reference value was 2,6%), the conclusions of the summit confirmed the negative opinion of the EU institutions.

Although afterwards the goal of joining the euro area in 2010 was voiced, with accelerating inflation and the prospects for euro adoption becoming more distant, it was abandoned for a more flexible formula of "as soon as country meets convergence criteria". It should be noted, that the Law of Fiscal Discipline, which has been advocated for by some analysts for number of years, was finally adopted in November 2007 with a view to facilitating the achievement of the cyclically balanced budget and the introduction of the euro. But it was a step taken too late and when the time came for it to be tested (the intention was to have a balanced budget in 2009), the start of economic decline made this law largely obsolete due to its emphasis on restricting expenditure growth. Although the failure to introduce the euro did not result in political resignations, it had an important effect on policy makers. It is quite possible that a fear of a similar failure with regard to the country's accession into the Schengen area of free movement of people was behind the intensified efforts to prepare the country and convince the EU to enlarge the Schengen area at the end of 2007.

The current reluctance to set a concrete date for the adoption of the euro is also most likely a result of the previous failure to do so, which is seen by some as the main failure of Lithuania's European policy since accession to the EU. Currently, both fiscal policy and regulatory policies are more in line with the monetary policy targeted towards the adoption of the euro, although the closure of the second reactor at the Ignalina nuclear power plant at the end of 2009 is likely to have a short-term effect on the increase of electricity prices. On the other hand, the increase of excise duties in the beginning of 2009, although motivated by fiscal objectives, removes the need to raise them again in the coming years to reach the minimum levels set by the EU norms because this has already been done.

However, the deteriorating external economic conditions, increasing country risk premium pushing interest rates higher, and the worsening budgetary situation have become the new obstacles on the path towards introduction of the euro. For example, in February 2009 the long-term interest rates norm in Lithuania was 7,2% while the Maastricht reference value equalled 6,2%<sup>11</sup>. Lithuania also saw its credit ratings reduced several times since September 2008, while its credit default swaps have increased significantly. The budget deficit, which exceeded 3% of the GDP limit by the end of 2008 after more than five years of being close to 0,5 to 1,5%, will be difficult to maintain close to this Maastricht Treaty target<sup>12</sup>. The ex-post revision of the budget figures increasing the deficit from 2.9% to 3.2% for the year of 2008 after the announcement of last year's economic data for Lithuania has already further complicated efforts to maintain it within

<sup>10</sup> Commission assesses the state of convergence in Lithuania. – IP/06/622, Brussels, 16 May 2006.

<sup>11</sup> <http://www.lb.lt/lt/euras/konvergencija.htm#paluk>. – 2009.04.07.

<sup>12</sup> For example, some analysts expected it to reach minus 4,5 percent in 2009. See Lithuanian Macroeconomic Review, SEB, March 2009, No 35.

the 3% limit in the coming years<sup>13</sup>. This is also reflected in the updated EC forecasts that set Lithuania's budget deficit figure at 5.4% for 2009 and at 8% for 2010, assuming that no further policy measures are adopted that aim to curtail it<sup>14</sup>.

## 2. The Impact of the Global Crisis

As maintained above, the deteriorating global economic conditions since September 2008 have had a visible impact on the country's prospective for introducing the euro. Although the economic decline is likely to reduce inflation to the levels compatible with Maastricht criteria within one to two years time, the main load of adjustment under the currency board regime is likely to fall on the budgetary policy and labour market. This implies significant cuts in budgetary expenditure and a downward revision of wages in both private and public sectors to maintain competitiveness under the fixed exchange rate.

This is made even more challenging by the deteriorating situation in Lithuania's main export markets which are either facing rapid economic decline (forecasted to reach 12% in Latvia and 5% in Germany in 2009), or depreciating their national currencies (for example, during the half year that followed August 2008, Poland, Russia and some other countries devalued their currencies by 30 to 40% with regard for the euro, and consequently the litas). For example, according to the Department of Statistics, in the period of January to February 2009, Lithuanian exports fell by a margin of almost 22% compared to the same period in 2008. With declining domestic demand, the worsening situation in the export markets adds to the difficulties of Lithuanian businesses and complicates maintaining the stability of public finances.

At the same time, it should be noted that declining domestic consumption corrected some previous external imbalances – in January to February 2009, imports to Lithuania declined by 45% compared to the same period in 2008, with the trade deficit decreasing by 87%. This implies a significant decrease of the current account deficit, which during the years of rapid economic growth was highlighted by external observers as one of the key concerns. The most recent data from the Bank of Lithuania shows that the current account has for the first time in the last five years become positive and registered a 70.7 million litas surplus, which means that the previous external imbalances were corrected much faster than expected.<sup>15</sup>

Domestic politics also contributed to the deteriorating economic situation by leaving policy makers less prepared to withstand the external shock. A fiscal policy of significant expansion was undertaken in 2007-08 (including increases in public sector wages and social expenditures – in particular pensions and maternity benefits – as well as introducing automatic indexation) that was, to a large extent, motivated by the approaching parliamentary elections that took place in October 2008. The coincidence of Parliamentary elections with the process of debating the next year's budget further complicated the whole process of adjusting the country's economic policy to the rapidly changing external economic environment.

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<sup>13</sup> The Lithuanian Department of Statistics, data released in April 22, 2009. According to the revised data, Lithuania's state deficit in 2008 reached 3.2 percent of GDP while the state debt equaled 15.6 percent of GDP. The public debt is expected to reach 18.7 percent of GDP in 2009.

<sup>14</sup> See Commission's Spring 2009 Economic Forecasts released on May 4th. It should be noted that Commission's forecasts take into the second budget revision which has been undertaken in April-May 2009, despite the fact that at the time of releasing them the outcome of the Parliamentary vote was still unclear. The Commission also forecasts Lithuania's general government debt to reach 22,6 percent in 2009 and 31,9 percent in 2010.

<sup>15</sup> It has reached about 14 percent of Lithuania's GDP in 2007, coming down to 11.6 percent in 2008. Interestingly during its mission to Lithuania at the end of 2008 the IMF expected it to come down to 6 percent in 2009 which now seems like an excessively high figure. European Commission's May 2009 Economic Forecasts put Lithuania's current account deficit at 1,9 percent and see it turning positive in 2010 at 0,7 percent.

The newly formed right-centre government, which replaced the left-centre minority government that had ruled the country since 2006, significantly revised the FY 2009 budget. The revisions were undertaken on both taxation and expenditure sides and aimed at saving around 2 billion litas while collecting another 2 billion litas for the budget (or 4 to 5% of country's GDP). The general VAT rate has been increased by 1 percentage point from 18 to 19% and all VAT exemptions (reduced rates of 5 or 9% on certain products such as frozen meats, vegetables and fruits, hotel services, periodicals, medicine, etc.) have been abolished; excise duties on fuel, alcohol and cigarettes have been increased. Profit tax increased from 15 to 20%, and certain changes made to personal income tax and social security contributions aimed at bringing professions into the taxation system who were previously exempt from paying these taxes (artists, farmers). On the expenditure side, the basic wage that is used to calculate public sector salaries has been decreased and a number of investments have been cut<sup>16</sup>.

However, in March 2009 with budgetary revenues decreasing more than anticipated amidst the global economic decline (the gap between the planned and actual state budgetary revenues during the first two months of 2009 equalled around 13,5% or 380 million litas), the government announced its intention to undertake another round of expenditure cuts of around 3 billion litas, or more than 17% of total budgetary expenditure<sup>17</sup>. These cuts include reducing the wage fund by 10% and a temporary decrease in salaries for the higher ranks of public administration employees as well as cuts in public investments.

The government maintained that in the absence of such cuts in budgetary expenditure the budget deficit would reach 8% of GDP. If the necessary revisions are undertaken, it is expected to limit the budget deficit to 2,94% of country's GDP (under assumption that Lithuania's GDP will fall by 10% in 2009). This second round of budget expenditure cuts has been adopted by the Parliament on May 7, 2009, and there have been talks of yet another budget revision in June (after the Presidential elections). Altogether, these two budget revisions result in a budget adjustment equal to approximately 7% of the country's GDP. The government is determined to maintain the stability of public finances while preserving the fixed peg to euro, which is the main argument behind these massive budget cuts<sup>18</sup>.

At the same time, using the rhetoric of "crisis as a window of opportunity to reform," the government is undertaking several structural reforms in the areas of high education and research as well as public administration (the Sunset Commission). A reform of high education could become the area of long expected structural changes after the Parliament passed a Law on Science and Education on April 28, 2009, foreseeing a reform of financing and governing high education in Lithuania. The law has been presented by the coalition government as one of the key priorities although its adoption has been complicated by a strongly opposed centre left opposition in Parliament. The government has also adopted an economic recovery package to restore economic growth and competitiveness by reducing the administrative burden to business by 30 % in two years (Sunrise Commission), streamlining the use of EU structural funds and allocating European Investment Bank money for the co-financing of projects and providing credits to business, investing in energy efficiency, and facilitating investments and exports. After nearly half a year of internal discussion, the government also finalized a law on fiscal sustainability that aims at preventing a banking crisis and provides the instruments that

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<sup>16</sup> By the end of April, 2009, when the fiscal indicators for the first quarter became available, the Government claimed that the effect of the tax reform in the first quarter of 2009 came to additional 330 million Litass, while it was expected to contribute around 1,3-1,5 billion Litass of additional budgetary revenue (Ministry of Finance data provided on April 20, 2009, by [www.marketnews.lt](http://www.marketnews.lt))

<sup>17</sup> <http://www.delfi.lt/archive/print.php?id=21358328>. - 2009.04.07.

<sup>18</sup> It should be noted that on May 7 it was reported that Lithuania's 5 year debt credit default swaps (CDS) came down to 4,87 percent or 487 points - the lowest since November 11, 2009 after reaching 850 points on February 24, 2009, which could be associated with the markets approving the second round of budget cuts.

will help respond to a bank that faces difficulties. This law, however, had not yet been adopted by the Parliament at the beginning of May, 2009.

Although there have been debates about the possibility of accepting financial assistance from the International Monetary Fund (IMF), so far the government has refrained from officially applying for such assistance. It has been argued that Lithuania is able to maintain the stability of public finances without external assistance. It is also argued that the IMF would probably insist on additional unpopular measures that might have uncertain political consequences for the presidential elections. However, this issue is still provoking intense public debates and it might soon re-emerge as a possible option, provided that the economic situation deteriorates further (after the elections take place)<sup>19</sup>. An agreement with the IMF is more likely if the country's financial institutions are faced with serious difficulties, which so far has not been the case. Although the share of bad loans has been growing during the last half a year and banks had to adjust their lending practices accordingly, they so far managed to avoid serious problems.

At the same time, there is a strong consensus among policy makers and expert community regarding the importance of maintaining the current monetary policy regime (the euro-based CBA under the current exchange rate) and seeing the eventual introduction of the euro as an "exit strategy" from the current situation. Thus, the fiscal policy is aimed at maintaining the budget deficit close to the level of 3% of GDP as defined by the Maastricht Treaty, and the current exchange rate of litas to euro is expected to be maintained until the introduction of the euro<sup>20</sup>. The importance of being in the euro area to ward off volatility stemming from global economic instability is now being stressed by policy makers. The positive impact of a fast introduction of the euro is also acknowledged by local and external analysts<sup>21</sup>. However, so far the public has remained quite sceptical regarding the adoption of the euro as a shield from the financial and economic crisis. According to the Eurobarometer, Lithuanians have been among the most sceptical in this respect with a strong majority convinced that the euro would not have protected them in the face of the crisis and that the process of euro adoption should be slowed down rather than accelerated<sup>22</sup>.

Labour market flexibility is another important factor in addition to political efforts to maintain the stability of public finances, which is being tested during this economic decline. As country has been ruling out the option of currency devaluation, the depreciation via the reduction of wages is the main scenario of adjustment under these conditions of economic decline. Although according to the World Bank Doing Business indicators, Lithuania together with other Baltic States rank relatively unfavourably in terms of the rigidity of its labour regulations, other surveys seem to indicate that Lithuania has a very flexible labour market with relatively low collective agreement coverage and flexible wage share that is quite high, putting Lithuania among the most

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<sup>19</sup> This possibility of Lithuania turning to the IMF after the Presidential elections has also been voiced by external analysts, for example, see *The Economist*, "Still afloat in the Baltic, just", April 8<sup>th</sup>, 2009, [http://www.economist.com/world/europe/displaystory.cfm?story\\_id=13447331](http://www.economist.com/world/europe/displaystory.cfm?story_id=13447331).

<sup>20</sup> It should be noted that, legally, it is possible that as Lithuania comes closer to meeting all convergence criteria, leading the European Commission and the ECB to recommend that it terminate the derogation and introduce the euro, there might be suggestions to set a different conversion rate between litas and the euro from the one currently in use. Such a move is very unlikely because this would cause a lot of uncertainty and could damage the credibility of future policy. Furthermore, a decision setting an irrevocable conversion rate would be made unanimously by Lithuania and the member states that have adopted the euro.

<sup>21</sup> For the restatement of the Lithuania's motivations to join the eurozone see the presentations at the conference "Euro day in Vilnius" on 1 April, 2009, organized by the European Commission delegation, Bank of Lithuania and Ministry of Finance. See [http://ec.europa.eu/lietuva/news\\_hp/news/01042009\\_euro\\_diena\\_lt.htm](http://ec.europa.eu/lietuva/news_hp/news/01042009_euro_diena_lt.htm). According to the analysts of Morgan Stanley, as quoted by the Baltic News Service, delay to introduce euro in the Baltic states might cost them a devaluation of their currencies (BNS, April 27, 2009).

<sup>22</sup> See [http://ec.europa.eu/public\\_opinion/archives/eb\\_special\\_en.htm](http://ec.europa.eu/public_opinion/archives/eb_special_en.htm). This is a surprising taking into account that increase of prices in Lithuania in 2007-2008 took place in the context of failure to introduce euro.

flexible economies in the EU-27<sup>23</sup>. This contrast between the World Bank surveys and the labour market flexibility studies might result from a gap between quite strict legal rules of the Labour Code (in particular part time and temporary employment) and their application on the ground, when businesses seem to be able to find the ways around these restrictions. Most analysts, however, tend to agree that Lithuania and other Baltic states have relatively flexible economies, allowing them to adjust the changes in the market without the use of an exchange rate instrument.

Moreover, there is a recent history of similar adjustments, including the structural changes at the beginning of transformation reforms and more recent Russian financial crisis, which provide the impetus for expecting relatively flexible adjustments in the labour market, even though it is still too early to judge. Significant wage cuts in the private sector are so far based on unofficial evidence, while the reduction of public sector wages has been much more complicated and accompanied by public protests. However, the government seems determined to continue with its adjustment efforts under the assumption that this is particularly important for preserving the stability of the national currency and maintaining Lithuania's prospective for a fast-tracked introduction of the euro.

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<sup>23</sup> See, for example, presentation at the DG ECFIN Seminar "Economic policy challenges in the Baltics", Brussels, 25 March, 2009, by Rosenberg, Christoph "Assessing the Boom and its Aftermath – re-establishing Competitiveness", and by Rutkaste, Uldis "External competitiveness of Latvian economy: developments so far and challenges ahead" ([http://ec.europa.eu/economy\\_finance/events/2009/20090325/presentations-list\\_en.pdf](http://ec.europa.eu/economy_finance/events/2009/20090325/presentations-list_en.pdf)).

### III. Institutional and Policy Environment regarding the Euro adoption

#### 1. Before the Global Crisis

The case of Lithuania's attempt to adopt euro in 2006-07 is probably one of the most debated cases in the history of euro area enlargement. The rejection of its application by the European Commission and the ECB on the basis of missing the inflation criteria has been discussed by analysts and policy makers, leading to more general debates about the nature of convergence and the meaning of the Maastricht criteria as applied to new member states. Although certain arguments regarding the supposed reluctance of the euro area members to accept new members to the "euro club" have become less convincing now that Slovenia and Slovakia have been accepted (in 2007 and 2009, respectively), some other issues merit attention because they are likely to resurface during debates on the future enlargements of the euro area.

Inflation was the contentious issue when Lithuania's application to introduce euro was evaluated. Several arguments were voiced regarding the application of the inflation criteria to new EU member states that decided to join the euro area<sup>24</sup>. One argument has to do with the very nature of convergence: due to the faster economic growth of the poorer new EU member states, inflation rates will, on average, be higher in the coming years<sup>25</sup>. Thus, it casts some doubt regarding the applicability of the inflation criteria for countries that have differing income levels (a fact not originally considered by the monetary union's founding fathers). However, one could respond to this criticism by referring to the 1,5% premium that is added to the basis (the three best performing countries of the EU) when calculating the reference rate for the applicant country. It could be maintained that this premium is sufficient to take into account the effect of convergence.

The other criticism pertains to the manner in which the method for calculating the inflation criteria was defined. It could be argued that euro area member states - rather than all EU members - have to form the group from which the three best performing countries that form the basis for calculating the Maastricht criteria are selected. Currently even those countries which are not members of the euro area can affect the outsider's chances of meeting inflation criteria. Other questions have to do with the notion of "best performance" and what could it mean - the lowest inflation rate (and related concept of outlier), being close to the target rate set by the ECB (which is 2 %) or some other reference, how many (one, two or three) of those countries is used as a reference should be selected, and what the concept of sustainability implies. The concept of price sustainability, which can be applied both in backward and forward looking perspectives, could be called into question because it is very open to interpretation, in particular under the conditions of high economic uncertainty.

Finally, a very strict interpretation of the convergence criteria are applied to the new member states (in particular, Lithuania which exceeded inflation criteria only by 0,1 %) in the context of a number of the founding euro area members who are seen as having breached the criteria at the time of the creation of the EMU (in particular, budgetary deficit and state debt criteria) and the recent relaxation of the Stability and Growth Pact provoked claims about the application of double standards and avoiding the fundamental

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<sup>24</sup> For a review of the main issues see Vilpisauskas, R. "The Political Economy of Eurozone Enlargement: the Motives, Prospects and Implications for the EU and its Member States", in *The Euro and the Dollar in a Globalized Economy*, Roy, J., Gomis-Porqueras, P. (eds.), Aldershot: Ashgate, 2007, pp. 149-162.

<sup>25</sup> The so-called Balassa-Samuelson effect resulting from divergent increase of productivity have been estimated by different sources to add between 1.0 and 3.0 percentage points to the inflation rate (de Grauwe, P. and Schnabl, G. (2004), "Nominal versus Real Convergence with Respect to EMU Accession. How to Cope with Balassa-Samuelson Dilemma", EUI RSC Working Paper No. 2004/20). Though more recent estimates, for example, the Bank of Lithuania, set this indicator at a lower range of 0.3-0.9 percentage points.

principle of equal treatment<sup>26</sup>. It was argued that the Maastricht convergence criteria are political instruments that are used in arbitrary ways to pursue political objectives - first to create the monetary union, and now, paradoxically, slowing down its enlargement. The European Commission, has, however, indicated that when a euro area member violates the criteria, relevant procedures such as the excessive budget deficit procedure should be initiated. Moreover, Slovenia and Slovakia's accession seems to show that the widely-held expectation that poorer EU countries have no chance of being accepted to the rich country club until they achieve real convergence has been disproved<sup>27</sup>.

The subject of real convergence has also been closely linked to the debates on the actual integration of the new EU members with the euro area economies, and the synchronization of their business cycles with their main trade partners in the euro area. Since most CEE countries are small and open economies and most of their foreign trade and investment flows are with the other EU countries, this issue has not been seen as a serious obstacle to the euro area enlargement. Besides, there have been studies that argued that there is or will soon be a sufficient degree of business cycle synchronization between the euro area and, for example, Slovenia, Estonia, and Lithuania - three countries that have been considered potential candidates in 2006<sup>28</sup>. Accession into the EMU itself is seen as an important factor in facilitating real convergence. It could also be said that, although the optimum currency area concept has remained until now the key instrument in assessing the readiness of countries to adopt a common currency, academic debates and statements about the lack of such readiness were to some extent been disregarded during the creation of the EMU as well as during the process of its enlargement.

However, despite the wave of debates which took place in 2006 regarding the application of Lithuania and the enlargement of the euro area, the European Commission and the ECB did not indicate that they were leaning towards the revision of convergence criteria. Their reluctance could probably be explained by concerns that any revisions required amendments to the Treaty, which is complicated politically and could result in the watering down of criteria and weakening of the euro area's monetary policy credibility.

## 2. The Impact of the Global Crisis

After September 2008, while most European economies plunged into recession and some experienced serious difficulties with the financial sector, debates about the state of the euro area and its further enlargement were revived. Some observers raised doubts about the viability of the euro area itself as Ireland, Greece, Spain and other members of the group experienced difficulties and now face rapidly rising budget deficits<sup>29</sup>. At the same time, attention shifted to CEE countries as Hungary and Latvia received financial assistance packages from the IMF and EU and other countries experienced declining economic activity, a drop in confidence and an increase in risk premiums.

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<sup>26</sup> Willem Buiter has been among the most vocal critics of the strict interpretation of the Maastricht criteria by the ECB and the European Commission in case of Lithuania (see his blog <http://blogs.ft.com/maverecon/>). For a similar criticism see Begg, I. *Economic Governance in an Enlarged Euro Area*, European Economy, Economic Papers 11, March 2008, and for the most recent criticism see De Grauwe, P. *The politics of the Maastricht convergence criteria*, April 15, 2009, <http://www.voxeu.org>. On the application of the convergence criteria for the new members see Ahearne, A., Pisani-Ferry, J. (2006) *The euro: only for the agile*, Bruegel Policy brief, 2006/01.

<sup>27</sup> Probably the best known example of such an argument has been provided by Munchau, W., "Monetary Union Is Not for the Poor", *Financial Times*, January 30, 2006, p. 15. For an opposite view see Mody, A. and Rosenberg, C., Letters to Editor: Why Lithuania and Estonia Could Fare Well in Eurozone, *Financial Times*, February 8, 2006, p. 14.

<sup>28</sup> Walter, N. *et al.* (2006), "Estonia, Lithuania, Slovenia: Poised to Adopt Euro. Views on Medium and Long-Term Convergence", *Deutsche Bank Research*, April 3, 2006.

<sup>29</sup> See Pisani-Ferry, J. The sore test that may await euro, *European Voice*, January 26, 2009.

These concerns with the state of the financial sector in the CEE region led to debates about the importance of euro area membership, and the possibilities of "fast track" accession, or other measures that the EU could use to help these countries to cope with the economic downturn<sup>30</sup>. The ideas floated at the time included reducing the required duration of membership in the ERMII for countries like Poland or Hungary, and unilateral Euroisation without formally joining the EMU and without gaining ECB board representation for countries with pegs or currency boards such as the Baltic States<sup>31</sup>.

The strategy of unilateral Euroisation has also been discussed by some analysts including Standard and Poor's rating agency and Lithuanian analysts. Additional proposals include the adoption of euro as a joint legal tender alongside the national currency, thus avoiding coming into direct conflict with the EU Treaty<sup>32</sup>. These ideas, however, have not only been rejected by the European Commission and ECB, but also by some CEE countries (for example, the Czech Republic and Estonia). The main arguments against such a scenario are mostly political and include the incompatibility with EU institution policy and being relegated to second-class membership without a seat on the ECB board. EU institutions (the ECB, for example) have repeatedly said that "there will be no relaxation of the criteria laid out in the Treaty"<sup>33</sup>. There is a tacit agreement in Lithuania that, for political reasons, Euroisation is not a feasible option<sup>34</sup>.

The EU's response to the economic recession has focused on increasing the fund which could be used to stabilize the finances of its members to 50 billion euro (and from which Hungary, Latvia and most likely Romania benefited), although it has been seen so far only as an additional support to what is provided by the IMF which also leads the process of providing financial assistance in setting the conditionality attached to the funds. The EU also adopted changes to allow for a more flexible use of EU structural funds to stimulate the economies of its member states and provided additional funds from the European Investment Bank (together with EBRD and the World Bank). Although there have been calls before the informal March 1, 2009, EU summit by Hungary and Austria appealing to the EU to provide additional funding specifically for the new EU members as well as stressing the responsibility of parent banks from old EU members for their subsidiaries in CEE, the EU has not come up with new specific instruments or ways to speed up the enlargement of the euro area as an insurance against possible default of Central European countries. The strategy of evaluating every country individually has been stressed.

In Lithuania, the focus has been on preserving the currency board regime despite speculations by some external observers that such regimes in the region looked "unsustainable". However, most concerns had to do with Latvia's economy and its agreement with the IMF since, at the start of negotiating the agreement, there were

<sup>30</sup> See Darvas, Z. Pisany-Ferry, J. The looming divide within Europe, 18.01.2009, on the website of the Eurointelligence <http://www.eurointelligence.com/Article.599+M50b56b27b24.0.html>

<sup>31</sup> The latter idea has been leaked from the IMF to the Financial Times, Wagstyl, S. IMF warns of strains exerted on east Europe, *Financial Times*, April 5, 2009.

<sup>32</sup> Willem Buiter in 2007 argued for unilateral adoption of the euro as a joint legal tender until membership in the EMU is achieved by the EU member states with currency boards as a way to enhance the credibility of their exchange rates and strengthen nominal convergence (Buiter, W. H. *Strengthening convergence: the euro as joint legal tender*, unpublished paper, 2007.02.10). It should be noted that, in Lithuania, the euro can be used as a joint legal tender provided that both parties to the contract agree on this, but this is not a standing obligation. Some local analysts also discussed unilateral euroisation, provided that the use of euro would be the only legal tender rather than a joint one with the national currency (see Lithuanian Macroeconomic Review, *SEB*, March 2009, No 35).

<sup>33</sup> This position was formulated before EU enlargement and maintains that "no additional criteria for the adoption of the euro by the new member states will be introduced, while at the same time there will be no relaxation of the criteria laid out in the Treaty" (Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries, *ECB*, 18 December 2003). On May 7, 2009, Commissioner J. Almunia talking about Latvia also rejected the possibility of Latvia' unilaterally introducing euro.

<sup>34</sup> The other reasons mentioned in public include the possible loss of interests from the reserves of foreign currency that Lithuania accumulates, which currently constitute around 300-400 million litas annually, and the fear of EU sanctions by restricting the flows of EU funding to Lithuania (Lithuanian officials quoted on April 14, 2009 by the Market news at <http://www.marketnews.lt>).

some rumours that the IMF had suggested devaluing the Latvian currency when talks on the assistance package started in the Autumn 2008<sup>35</sup>. If this happened, it could have increased the pressure on the currencies of Estonia and Lithuania and posed risks to the stability of their currencies' pegs to euro. On the other hand, even in the unlikely event that this situation occurs, it does not automatically result in a contagion and a domino effect; under the currency board arrangement, all national currency in circulation must be fully covered by foreign exchange and gold reserves. In Lithuania, the ratio of coverage is even higher (in March 2009, it amounted to around 120% of litas in circulation). Thus, if people rushed to the banks to buy euros, the most likely outcome would be an informal Euroisation of the country, without having to change its exchange rate regime.

There have been domestic debates in Lithuania among policy makers regarding the strategy of joining the euro area in this changing global economic environment. Initially attempts were made to stress the exceptional situation of Lithuania and some other non-euro area EU members in terms of having to cope with higher risk premiums and interest rates, while at the same time having currency pegged to euro. There has also been some positive response from the government to the ideas floated by the IMF regarding fast-track euro adoption under relaxed entry criteria. However, the dominant view among the institutions responsible for the introduction of the euro don't seem to be calling into question the convergence criteria and to target the budgetary policy in such a way as to be able to meet the fiscal criteria as soon the inflation comes down. Knowing the reluctance of the European Commission and the ECB to reconsider the relevance and application of the Maastricht criteria that they showed in 2006 and repeated again recently, it seems that the most effective strategy of accession into the euro area is one of meeting the criteria by prioritizing this goal and making other domestic policies consistent with it as much as possible (including a campaign to explain the benefits of joining the euro area to the public).

As previously mentioned before, meeting the Maastricht criteria implies the need for constant revision of budgetary expenditures as the economy declines and budgetary revenues fall faster than forecasted. Taking into account that Lithuania already recorded a deficit of 3.2% of GDP at the end of 2008, and that the speed of economy's contraction exceeded even the most pessimistic predictions (according to the preliminary data, Lithuania's GDP declined by 12.6% in the first quarter of 2009), maintenance of budget deficit in line with Maastricht criteria will prove to be extremely difficult and politically controversial.

The second pillar of such a strategy (in addition to fiscal adjustment) is labour market flexibility. The private sector has been fast to adjust, and the coming years will most likely see a significant downward revision of wages with the Ministry of Finance forecasting a distant recovery of wage growth in 2012. There have also been legal amendments prepared for the further increase in the flexibility of working arrangements, although they have caused intense debates and the disagreement of trade unions. In April, 2009, the government presented Parliament with legal amendments to the Labour Code aimed at liberalising labour relations by simplifying the procedures of firing and hiring employees, allowing for a lower rate of compensation and others. It is, however, unclear what the eventual content of these amendments will be after they are debated and adopted by Parliament<sup>36</sup>.

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<sup>35</sup> Such opinions have been expressed by some outside analysts, reported by Bloomberg, for example, O'Brien, E. Latvia May Lead 50% devaluation in Baltic Currencies, BBH says, *Bloomberg*, February 12, 2009. For an opposite view supporting the currency peg in Latvia see IMF Senior Regional Representative Rosenberg, Ch. Why the IMF supports the Latvian Currency Peg, January 6, 2009, at [http://www.rgemonitor.com/euro-monitor/254975/why\\_the\\_imf\\_supports\\_the\\_latvian\\_currency\\_peg](http://www.rgemonitor.com/euro-monitor/254975/why_the_imf_supports_the_latvian_currency_peg). The uncertainty on this issue was also increased by a new Latvian Prime Minister Valdis Dombrovskis who mentioned at the end of March 2009 the possibility of devaluation.

<sup>36</sup> The rapidly growing unemployment rate which reached 15,5% in March 2009 according to Eurostat (the third highest in the EU) and increasing at a rate of 11.2% since the same month in 2008 (the fastest rate in the EU)

An overall strategy for joining the euro area as soon as possible without questioning the criteria, but targeting the current economic policy for meeting them has been adopted by the government. Politically controversial budget cuts, in particular two rounds of reductions of public sector wages and investments, have been advertised to the public based on the need to preserve currency stability, while currency stability itself has been the cornerstone of the strategy for adopting euro in next couple of years<sup>37</sup>. Thus, there seems to be a rather strong political consensus that the adoption of euro is seen as an exit strategy from the current economic downturn. In addition, there has been a return to the debate on setting a concrete target date for the adoption of the euro which is, to some extent, a spill-over effect from the other EU countries that aspire to introduce the euro (for example, Estonia) and set a target date of 2011<sup>38</sup>. This subject will most likely resurface in public debates after the Presidential elections.

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could actually make it somewhat easier for proponents of liberalizing labor relations to convince trade unions to support those measures as an alternative to businesses going bankrupt due to excessively rigid labor regulations. It should be noted that the level of unemployment depends on the methodology of calculation. For example, the Labor Exchange provides significantly smaller numbers - according to its records the level of unemployment at the end of April 2009 reached only 8,7%.

<sup>37</sup> It should also be said that maintaining currency stability and the current peg is based on the clear understanding that the costs of devaluation would certainly exceed its benefits. This is not only due to the structure of private and state borrowing with a majority of credits denominated in euros, and a high share of imports (mostly non substitutable) in the economy, but also because a change in the peg regime would highly damage public trust and the credibility of institutions.

<sup>38</sup> The initiative is primarily led by the Ministry of Foreign Affairs but viewed cautiously by the Ministry of Finance, the Bank of Lithuania and the Prime Minister. For example, the Minister of Foreign Affairs publicly suggested setting a "working date of introducing euro" while the Prime Minister preferred talking about the time when Lithuania "will be close to meeting Maastricht criteria" which he sees in the second half of 2010 (Baltic News Service April 28, 2009, and April 29, 2009). Meanwhile external observers, for example, credit rating agency Fitch, see Lithuania (as well as Estonia and Poland) being able to introduce euro only in 2013 at the earliest (quoted by news portal DELFI on April 17, 2009, at [www.delfi.lt/](http://www.delfi.lt/))

## Conclusion: Progress, Perspectives, Recommendations

Lithuania's strategy for joining the euro area has been characterized by a formal prioritization of this goal but actual ambivalence on the part of some political actors and a lukewarm public attitude for most of the time following EU accession. Although the currency board regime with a national currency pegged to the euro has formed a good basis for joining the EMU next month after joining the EU in 2004, the mix of rather inconsistent fiscal and regulatory policies together with market trends, including the convergence effect, contributed to the inflation higher than the reference rate, preventing Lithuania from joining the EMU in 2007. The pro-cyclical fiscal policy that contributed to the acceleration of inflation has also complicated the possibilities of the current government for manoeuvre in looking for the ways to soften the negative impact of global economic slowdown and to keep the budget deficit within the limits of the Maastricht criteria.

Thus, the currency board arrangement provides a strong basis for the adoption of the euro in terms of monetary policy and maintaining the stability of the exchange rate. A shift from the currency board to euro area membership involves minimum change in terms of monetary policy (contrary to the conventional central bank models, it might even give the central bank additional powers). However, the monetary policy based on a currency board is not enough for a swift and effective adoption of the euro. It should be accompanied by a prudent and sound fiscal policy that aims to accumulate a budget surplus during times of high economic growth, and a flexible labour market that can adjust to the economic downturn in times of economic recession. Labour market flexibility will become even more important after joining the euro area when the possibility of devaluation is made much more unlikely.

The current economic downturn might trigger adherence to economic policies that are both feasible under the currency board arrangement and conducive to euro adoption. In particular, if the current government is able to use the economic recession as an incentive to move ahead with structural reforms (high education and research, public administration, health care) which have been lacking following EU accession when conditions of high economic growth prevailed, this might result in a mix of policies targeted towards reconciling nominal and real convergence. In other words, meeting the convergence criteria and creating conditions for an economic recovery and growth.

Both EU and euro area members reacted differently to the worsening global economic situation. Responses ranged from cutting taxes and allocating money to stimulate economies and rescue financial institutions to raising taxes and cutting significantly budget expenditures. These responses reflect differing economic situations and are likely to have different outcomes on the prospective recovery trajectories and the future state of public finances. This has two important implications for the future functioning of the euro area and its enlargement. First, if the timing and the speed of recovery diverges significantly, this might revive the debates about the actual convergence of business cycles of the EMU members and the effects of common monetary policy. Second, as the importance of inflation seems to be decreasing, the state of public finances will return to the agenda of the EU and will test the viability of the Stability and Growth Pact (in particular, how the notion of "exceptional circumstances" allowing states to have higher deficits will be interpreted).

Countries like Lithuania have an interest in maintaining the principles foreseen in the EU Treaty and the Pact. It is more than a political slogan to state that it is in the interest of the euro area as a whole and its member states to preserve the criteria and credibility of commitments and to respect them. Only if the euro area itself is functioning well with its

members, who implement prudent and sound economic policies, will benefits result for its current and prospective members. Relaxation of certain criteria is also likely to reduce the benefits of EMU membership. Therefore, the most effective strategy of accession into the euro area is that of meeting the criteria by prioritizing this goal and making other domestic policies consistent with it as much as possible (in additional to educating the public about the benefits of joining the euro area).

Finally, it will be interesting to see what type of economic policy thinking and culture bring the new euro area members into the debates and decisions of the ECB. Although Slovenia and Slovakia have already become part of the EMU institutional setup, it is too early to make such generalizations. So far the only assertion that can be made is that CEE countries are too heterogeneous in terms of their monetary policy regimes and their preferences, so similarly to dynamics inside the EU, there will be no coherent and stable sub-group of these countries in the euro area with interests that differ from the "old" members.

## Appendix

Yearly data, 1999-2008 (for countries that joined EU in 2004); 2002-2008 (for countries that joined EU in 2007)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
HICP (EU harmonized inflation index)	1.5	1.1	1.6	0.3	-1.1	1.2	2.7	3.8	5.8	11.1
Budget deficit/surplus - % of GDP (General Government Budget Balance)	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.2	-2.9
General Government Gross debt, % of GDP	22.8	23.7	23.1	22.3	21.1	19.4	18.4	18	17	15.3
Long-term interest rates (10-year government bonds) – end of year	-	-	8.2	5.97	5.22	4.43	3.73	4	4.58	4.6
Exchange rate - % change against the Euro	4.2641	3.6952	3.5823	3.4594	3.4527	3.4529	3.4528	3.4528	3.4528	3.4528
Price level compared to the EU average (Eurostat)	46.8	52.6	54.1	54.2	52.3	53.5	54.8	57.1	59.6	-
GDP per capita at PPS as % of EU average (Eurostat)	38.7	39.3	41.5	44.1	49.1	50.5	52.9	55.5	59.5	60,5 (f)
GDP growth	-1.5	4.2	6.7	6.9	10.2	7.4	7.8	7.8	8.9	3
Employment rate (15-64)	61.7	59.1	57.5	59.9	61.1	61.2	62.6	63.6	64.9	64.3
Export growth (in 1 000 million of ECU/EURO)	2.58	3.85	4.78	5.54	6.16	7.48	9.49	11.26	12.51	16.07
Current account - % of GDP	-11	-6	-4.7	-5.1	-6.8	-7.7	-7.1	-10.6	-14.6	-13
FDI - % of GDP (+ % of FDI coming from EU countries, if data exist)	-	-	-	-	-	2.3	2.6	5.1	3.6	3.1
% of FDI coming from EU countries, if data exist	60	64	-	78.2	76	76.5	76.3	66.1	84.4	80.3

External debt (private + public) - % of GDP (+ net external debt, if data exist)	-	-	43.3	39.4	40.4	42.3	50.7	60.2	72.3	67.8
Trade with EU countries, % of total:										
Share of imports from EU in total imports (%)	60.3	54.8	54.7	56.8	56.1	63.5	59.5	62.8	68.3	57.3
Share of exports to EU in total exports (%)	73.8	74.7	73.3	69.3	62.8	67.2	65.7	63.6	64.8	60.3
Bank credit growth (% change)	-	-0.9	17.8	22	52.5	39.7	53.6	48.9	43.9	18.9
M2 (% change)	-	17	21.5	19.4	19.4	25.3	30.6	22.7	22.3	12.8
Interbank interest rates, monthly averages for the corresponding year	11.73	7.51	5.27	3.25	2.56	2.2	2.25	2.99	4.9	5.27
Share of deposits and credits denominated in Euro	-	-	-	-	-	-	-	-	56	65
EU banks ownership of local banks, % of total assets	35	58	81	88	89	87	85.8	90	87	85
Stock market index	-	-	-	12.2	105.8	68.18	52.93	9.78	4.38	-65.14
World bank doing business ranking	-	-	-	-	45	40	17	15	16	28

**Monthly (starting from June 2008) and quarterly (starting from IQ 2008) data. According to the frequency (monthly; quarterly) of their issue**

	06/2008	07/2008	08/2008	09/2008	10/2008	11/2008	12/2008	01/2009	02/2009
Industrial production, % change from the same period of the previous year	5.96	0.86	0.96	5.89	1.32	-1.64	-3.87	-6.19	-12.18
Unemployment rate	5.2	5.9	6.4	6.5	7.2	8.3	9.7	11.6	13.7
HICP (EU harmonized inflation index), % change from the same month of the previous year	12.7	12.4	12.2	11.3	10.7	9.2	8.5	9.5	8.5

Exchange rate - % change against the Euro, monthly	3.4528	3.4528	3.4528	3.4528	3.4528	3.4528	3.4528	3.4528	3.4528
Government debt - % of GDP									
Long-term interest rates (10-year government bonds)	5.33	5.49	5.47	5.45	5.4	8.16	9	13.95	14.5
Export growth – monthly data compared to the same period of the previous year	35.6	35.2	26.4	40.8	23.9	17.2	-3.2	-14.6	-
Current account - % of GDP									
Bank credit growth, % change from the same period of the previous year									
M2, % change from the same period of the previous year	13.3	13.4	11.8	10	5.9	4.2	-0.3	-0.2	-1.2
Interbank interest rates	6.64	6.83	6.7	6.85	7.63	8.85	10.2	9.27	8.9
Indicator of country risk premium (monthly since January 2007)									
5-years CDS for Government debt (monthly since January 2007)					287	420	555	600	650

	<b>IQ 2008</b>	<b>IIQ 2008</b>	<b>IIIQ 2008</b>	<b>IVQ 2008</b>
GDP growth, % change from the same quarter of the previous year	7	5.2	2.9	-2.2
Current account - % of GDP	-18.7	-15.2	-9.7	-3.8
Stock market index	466.88	424.34	320.76	179.25
FDI - % change	22.7	8.5	3	-3