

## LITHUANIA'S DECISION TO JOIN THE EURO ZONE IN 2015: CORRECT AND TIMELY?

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### Abstract

*Being a member of the European Union Lithuania has an obligation to join the European Monetary Union. The first attempt to meet Maastricht criteria was done on the 1st of January, 2007. However Lithuania failed to fulfill the inflation target. Recorded inflation for March of 2006 (as it was the reference period) was 2.72 percent, given that the criterion was 2.66 percent (if using the CPI data provided by the Eurostat with two digits precision). So, Lithuania had 0.06 percentage point bigger inflation that was required. It was considered as a huge failure of economic policies as the major impact to the raising inflations was made due to the rise of the regulated prices of energy and transportation. In 2009 the major economic crisis hit, followed by the increase in the public debt and raising fiscal misbalances. At present Lithuania would not meet the criterion on fiscal deficit, the inflation could also be an obstacle.*

*The critics of the Lithuanian economic policies are strengthened by the fact that being in the worse condition in 2007 (did not meet criterions by the larger extent), the other Baltic State – Estonia - managed to meet the criterions and joined the euro zone as of the 1st of January, 2011. As Baltic States are competing for the investment, the euro in Estonia is considered as a big advantage for the investors, creating larger stability and credibility. Both countries had very strong links between national currency and the euro through the currency board arrangement, meaning the fixed exchange rate and 100 % reserves of foreign currency. That was considered as very similar starting positions.*

*Estonia joined the euro zone probably in the worst period for the euro itself. The stability of the euro is threatened by the debt crisis in Greece, Italy, Portugal, Spain and unsustainable social security policies in all EU countries. Newcomer in the Euro zone is the most disciplined country – Estonia has balanced the budgets and demonstrates the best economic results. Being a member Estonia will have to contribute to the Financial Stability Fund to bail out economies that were performing loose fiscal policies. Tax payers of responsible countries are paying for irresponsible and that creates moral problems in addition to financial. Moral hazard is encouraged.*

*The opaque future of the euro as a stable currency raises the question if the countries outside the euro zone should seek joining the EMU. The paper analyzes major benefits and drawbacks of the being inside and outside the euro zone, given the risks for the euro zone itself.*

In 2012 Social Democrats won the parliamentary elections in Lithuania and formed the center-left wing coalition government. Among the priorities parties decided to seek euro adoption since 2015. That raised many questions to the politicians, economists and general public such as whether the decision is correct in principle and timely given the turbulences in the Euro zone itself. General public is mainly afraid of the rising prices that followed the introduction of the euro in most euro zone countries. Economists are concerned about the financial cost –benefits issues. Politicians argue that Lithuania is committed to join the euro zone by the EU agreement.

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The political decision is mainly driven by the fact that Estonia has adopted euro since 2011, and Latvia is adopting it since 2014. However, the commitment is not defined in terms of time, but in terms of meeting Maastricht criteria. Thus, the main discussion follows the time issue – is the timing appropriate for the country. This paper is looking at the monetary zone issues from the broader prospective. Is the union viable as such and is membership justifiable from the moral principles and values of liberty.

### **Introduction**

Being a member of the European Union Lithuania has an obligation to join the European Monetary Union. The first attempt to meet Maastricht criteria was done on the 1<sup>st</sup> of January, 2007. Lithuania failed to fulfill the inflation target. Recorded inflation for March of 2006 (as it was the reference period) was 2.72 percent, given that the criterion was 2.66 percent (if using the CPI data provided by the Eurostat with two digits precision). So, Lithuania had 0.06 percentage point bigger inflation that was required. It was considered as a huge failure of economic policies as the major impact to the raising inflations was made due to the rise of the regulated prices of energy and transportation. In 2009 the major economic crisis hit, followed by the increase in the public debt and raising fiscal imbalances. At present (compliance period - March 2012) Lithuania would not meet the criterion on fiscal deficit; the inflation could also be an obstacle. The Government declared the membership as its priority therefore has already made efforts to limit the budget deficit. However, inflation criterion will be under the question for the coming compliance period – March 2014. Government incited business community to contribute to the achievement of this strategic goal and not to raise prices. This undermines the influence of market forces in the pricing process and therefore should be treated as soft intervention into it.

Neighboring Baltic country - Estonia - became a member of euro zone since 1<sup>st</sup> of January, 2011. This was considered as a huge achievement and a demonstration of having the national political priorities. Estonia joined the euro zone probably on the most complicated moment for the euro zone itself. Public debts in several member state of the euro zone created dangers for the stability of the monetary union. Different scenarios are under consideration: from Germany exiting the euro zone to Greece being thrown out of it.

Latvia took a decision to adopt the euro since 2014 and it is now obvious that Latvia succeeds in achieving that. However, Latvian case is different to that of Lithuania. Latvia has big and risk exposed banking sector, thus his main argument for joining the Euro zone is more of mercantilist. After establishment of the European Financial Stability Mechanism countries with weak financial sector may be eager to join the union in order to safeguard the stability of its weakening financial sector.

### **Why multinational monetary union?**

Multinational monetary union is close cooperation between monetary authorities of independent countries based on the fixed exchange rate or the use of a single currency. There are national monetary unions that operate within the borders of one state, which historically had several currency issuing banks (for example, British monetary union, Federal reserve banks).

Many multinational monetary unions were created in the history of global economic life. There are three main reasons for creating the monetary union (and interaction of these reasons):

- 1) political reasons;
- 2) economic reasons;
- 3) and cultural reasons.

(1) If the political unification takes place, the unification of monetary systems eventually follows. As a rule, the adoption of one currency is imposed by political bodies and even a

discussion on whether the union should be created or not is not admissible. The best example of the politically created monetary union is the ruble zone that was created for the 15 soviet republics, members of the soviet union.

- (2) The facilitation of free trade is the main economic reason that is advocated for the creation of monetary unions. Politically free countries surrender their currencies seeking closer economic integration. The reductions of the transactions costs comes as the first exposed benefit of the monetary union presented to people and businesses. However, the architects of the monetary unions foresee much deeper effects of the monetary union for the countries. These are the control over the inflation and unification of interest rates among the monetary union states. As there is a constant pressure from politicians, as well as from vested interest groups, particularly exporters, on the national central banks to keep the inflation higher than in export destination countries, this creates a kind of unfair competition, or currency wars, that at the end harms all countries involved. The interest rates require some single basis (basic interest rate set by the single central bank) due to free movement of capital. If this is not the case, capital dis-balances may occur.
- (3) Cultural reasons, such as language, history and religion also play an important role, however it mostly goes as an additional argument to the previous reasons. Culturally similar countries better adapt to a single monetary regime if some moral/cultural argument is attached to the economic and political ones.

The history demonstrates the comparatively little viability of multinational monetary unions created by political rather than market tools. Here needs to be mentioned that the only multinational monetary union that was market created is use of gold and silver to facilitate exchange. Gold and silver were chosen by people engaged in exchange by choosing: preferring the commodity that performs its monetary function and rejection the commodity that performs worse. Gold and silver were voluntary, not institutionalized monetary union, the most long-lasting: people used gold and silver money for approximately 3000 years.

I contrast to this, most of the artificially (by political decision) created unions dissolved much sooner. The major reason for monetary disintegration became the political disintegration (Soviet Union, Austro-Hungarian Empire, Yugoslavia and Czechoslovakia). There are also examples of the fall of monetary unions due to economic reasons. For example, the Bretton Woods, the “monetary union-like” system collapsed, because regulations and restrictions created huge economic imbalances.

## **EMU**

European monetary union is an example of multinational three-tier monetary union, from European exchange rate mechanism (ERM) II to a single currency. The euro was created as a single currency not only to facilitate exchange and to reduce transaction costs, but also to end the economic conflict conducted by the European countries in the currency arena. After the fall of Bretton Woods’s system in 1971, Central banks of Western European countries lost the control over the money supply. Huge exchange rate fluctuations harmed international trade and capital movement. German exporters (especially automotive companies) were most unsatisfied with the strong Deutschmark. Something had to be done to stop the currency wars, and Europe opted for the euro. The founding fathers of the euro understood that economic rivalry among countries may be moved from the currencies arena to the debt arena. That is why the criteria to adopt the euro, the Maastricht criteria, were designed to prevent countries from manipulative games in the single currency field. However, since there are no legal or economic consequences for the countries that break the Maastricht criteria (only the existing mechanisms, such as EU excessive deficit procedure, were applied, but in very soft way, only Hungary received stricter penalty, also said, due to other reasons, mainly Constitution), the fear of fiscal wars became the present reality.

While countries lost the possibility to issue unlimited amount of national currency, they engaged in large scale borrowing, and single currency euro even facilitated this.

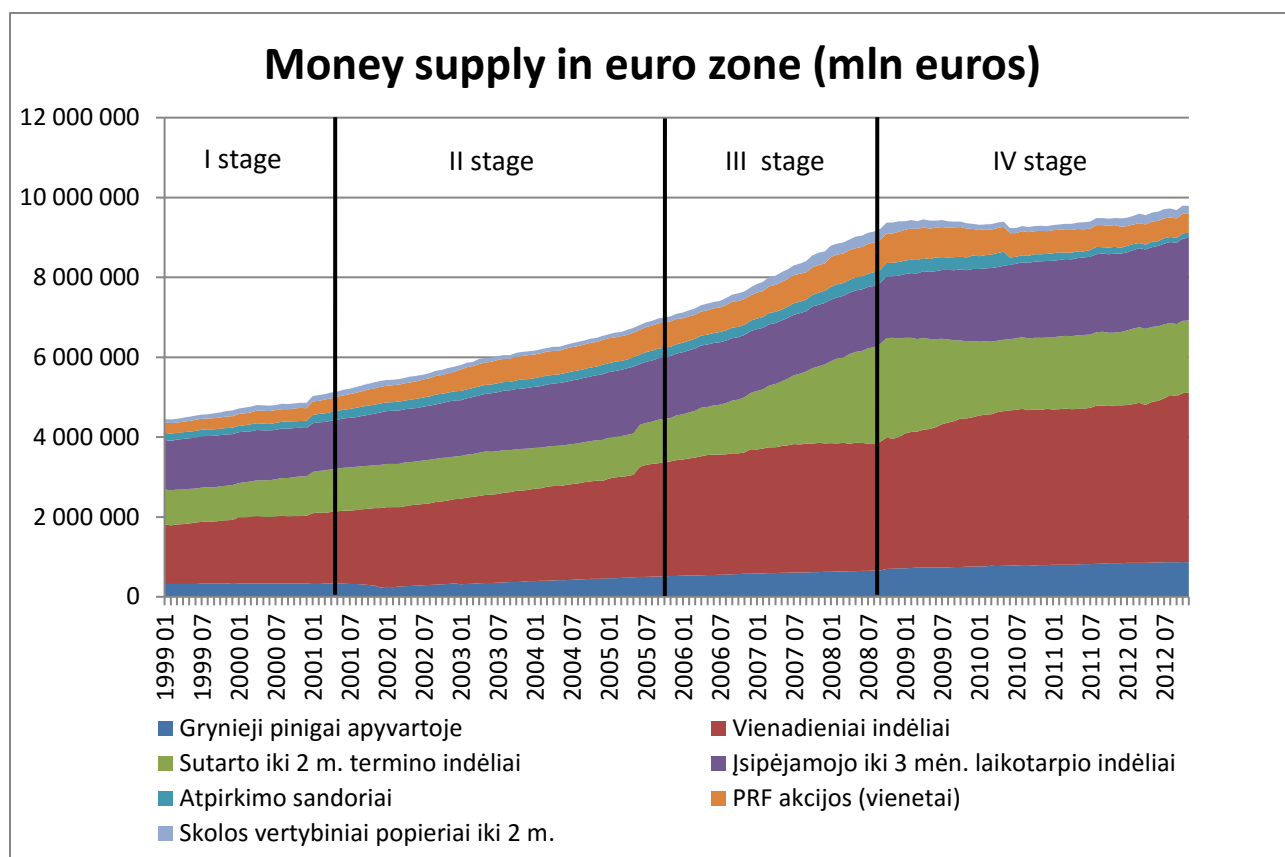
Today the euro has been weakened by attempts of some irresponsible governments to cover public deficits or to finance public debt via monetary means, i.e., to monetize the debt. Irresponsible fiscal policies create huge public debts which cannot be repaid, thus put pressure on governments and central banks to monetize these debts. Currently, there is no direct monetization; instead, monetization is being conducted indirectly through the lending facilities of the European Central Bank (ECB) and emergency lending facility of the central banks that belong to the ECB system. Commercial banks have huge incentives to lend to the governments since sovereign bonds are less risky assets and they can use these bonds as collateral with the ECB. This is indirect and, of course, quite limited way to monetize the debts, therefore irresponsible countries would demand larger scale of intervention. This process increases the supply of money and thus weakens the euro's purchasing power.

Monetization of debt means that disciplined countries take the burden of undisciplined ones, and that the citizens and businesses of disciplined countries bear the burden of decisions made by undisciplined governments. This redistribution takes many forms but in addition to its economic outcomes causes moral hazard and public dissatisfaction. Such a system is not sustainable from a more general point of view than just the economic ones.

In addition, the official public debt figures hardly capture the scope of the present debt problem because they do not include the long term obligations of the state social security (welfare) systems; this is invisible debt. This debt will reveal itself in the years to come as its obligations come due. If current policies continue, economic tragedy is inevitable: the euro will lose value, or government will default on their debt instruments and social security obligations, or both.

The single currency also allowed large scale international cross-subsidizing and redistribution to emerge. The euro provided credibility to economically weaker countries, allowing them to cheaper finance their public deficits. That created an illusion that economic prosperity can be easily achieved by cheaper financing alone. Essential economic reforms of welfare systems and the improvement of the business climate were not addressed in a timely manner. These unsolved tasks will inevitably require attention as the monetary means for stimulating economic growth have already been exhausted. Economic prosperity can only be achieved by effective production, by competitiveness that is reached through production rather than redistribution.

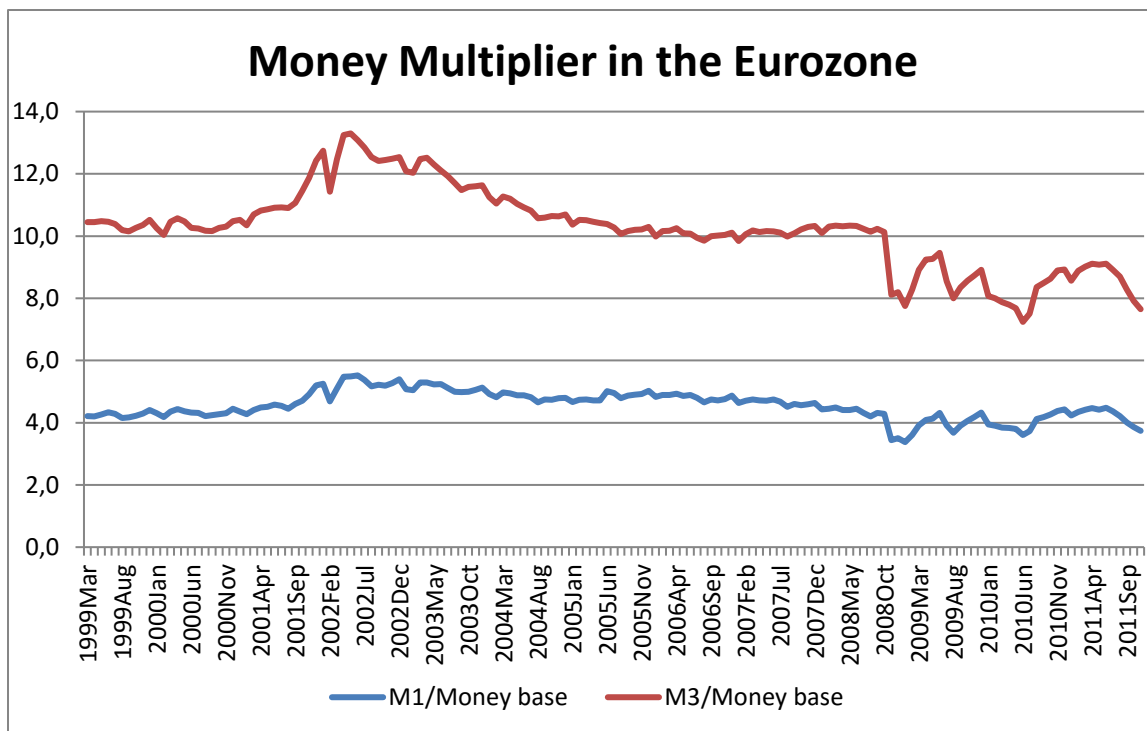
The public debt component in the euro crisis is crucial; however it should not overshadow the other weaknesses of the euro, i.e. credit expansion and fractional reserve system that creates the money multiplier. The ECB issues euros by granting credits to commercial banks at an arbitrary interest rate (which is misleadingly called the "basic interest rate"). That creates an increase in the money supply which damages the economy due to monetary and general price inflation, redistribution of wealth and by malinvestment. Despite the fact that the ECB monetary policies have been more disciplined than the Federal Reserve's it is still engaged in monetary expansion. The ECB's has increased the money supply more than 2 times since its single monetary policy began in 1999. See the graph below.



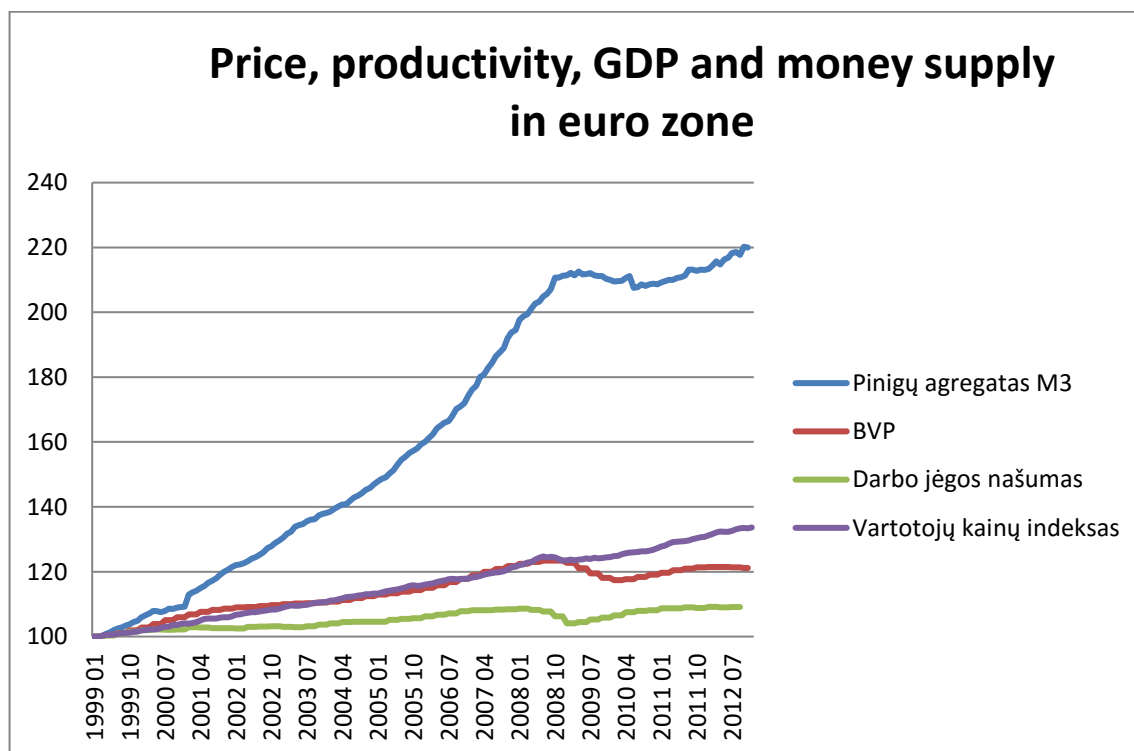
**Source: ECB<sup>2</sup> (Cash in circulation; Term deposits up to 2 years; Repo; Debt securities up to 2 years maturity; One day deposits; Deposits up to 3 years; Shares)**

After money is issued, commercial banks can increase the money supply through the fractional reserve system. The ECB required a minimum reserve on only 2 % for demand deposits and that allows the money supply to multiply, in theory, by a maximum of 50 times. Moreover for the first time in the euro history ECB lowered required minimum reserve ration down to 1 per cent and that cause the release of 1 trillion euros in the banks' balances. The actual money multiplier in the euro zone is 3.7 for M1 and 7.7 for M3. See the graph below. The constantly deteriorating purchasing power of money depreciates savings and income and thereby encourages society to indulge in "fast living". People tend to spend their money as fast as possible (to consume), and neither people, nor businesses should be blamed for that. These processes are not country specific; they are general and fundamental reasons in choosing the monetary regime.

<sup>2</sup> <http://sdw.ecb.europa.eu/browse.do?node=2120791>



Source: ECB<sup>3</sup>



(money aggregate M3; GDP; Labor productivity; Consumer price index)

The euro is facing problems now not because the euro zone’s 17 countries are too different to have a single currency. The world is much more diverse than the euro zone, but most of the globe

<sup>3</sup> <http://sdw.ecb.europa.eu/browse.do?node=2018810>

was once comfortable with single currency - gold and silver. The Neither does the euro zone suffer from its lack of financial integration (as proponents of financial integration point to the euro zone's lack of single budget, harmonized taxes, Eurobonds, etc) as well. Economic integration comes from free trade, free movement of people, capital, goods and services. If someone wants more integration, they should focus on these 4 liberties that were initial goals of the EU. If euro crisis is solved in a timely manner, then real European integration, based on free trade, can proceed.

In sum, the main reason for the euro crisis is that the single currency is no longer scarce and this harms the current membership. The constantly increasing supply of euros redistributes wealth among member countries and generations, destroys prices and savings, and causes malinvestment which leads to the consumption of capital and, in the long run, - the general impoverishment of the euro zone society. The euro's problems stem from its lack of the anchor, that European nations lost after the fall of Bretton Woods system in 1971 (which, it should be acknowledged wasn't a perfect system either).

### **Currency board arrangement**

Within the EU there are currency board-like systems, in Lithuania and Bulgaria, which issue national currencies with the peg to euro. Estonia began a currency board system when it introduced the Estonian kroon (EEK) in 1992. Lithuania followed Estonia's lead and introduced a currency board system on April 1, 1994. The IMF initially opposed the introduction of these systems, but later could not deny the success of the Estonian currency board. The IMF extended a credit to the Bank of Lithuania to strengthen its reserve base before pegging Lithuanian national currency Litas to the US dollar. Lithuania successfully repaid the debt. At present, after more than 19 years of existence of the currency board, the amount of Litas in circulation is covered by over 120,1 % with foreign reserves and gold at the end of April 2013<sup>4</sup>.

Currency board-like systems protect the market from the domestic source of inflation; however they suffer from the inflationary policies of the reserve currency countries. Currency Board allows the national currency to have the same qualities of the peg currency; however, there is a safe distance to watch if the anchor currency still meets the requirements of stability. If the peg currency is quickly losing its value, there is a possibility to re-peg national currency to a new anchor unit. For example, Lithuania re-pegged the Litas from the US dollar to the euro on February 2, 2002 without causing any problems to the market. (In this case Lithuania re-pegged national currency due to political reasons, i.e. joining the EU.) Therefore, currency board arrangement is a balanced monetary regime for those who want to avoid internal inflation, to have a credible peg, especially in times when the anchor currency is under uncertainty.

### **Benefits and disadvantages of being in euro zone**

The main benefits that are usually presented in favor of euro zone are the following:

1. Smaller transaction costs to businesses, easier price comparisons for consumers. As EU trade integration is rather deep, the main trading partners are members of the euro zone (for Lithuania – 1/3 of total exports in 2012<sup>5</sup>), businesses would have costs savings due to absence of currency exchange operations. They will also avoid exchange rate risks and costs related to the risk management.
2. Cheaper debt financing. If the country used to be carrying additional risk related to inflation and monetary expansion, which was expressed in risk premium on loans, euro zone integration will eliminate the risk and make loans cheaper to

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<sup>4</sup> Data source: The Bank of Lithuania, [http://www.lb.lt/stat\\_pub/statbrowser.aspx?group=7269&lang=lt](http://www.lb.lt/stat_pub/statbrowser.aspx?group=7269&lang=lt)

<sup>5</sup> Data source:

<http://www.verslilietuva.lt/uploads/file/PREKI%C5%B2%20eksporto%20tendencijos%202012%20%28gruodis%29%20PRIEDAI.pdf>

businesses, as well as to government. Cheaper debt financing is not an advantage as such. It is a short sighted advantage from the investor's view. However, it may lead to more risky projects and finally to malinvestment. Interest must be based on market conditions, not on expectations that somebody will cover the debt. Lower interest rates are even damaging for governments, as it creates excessive borrowing incentives.

3. Increased competitive advantage and additional FDI. It used to be considered that euro increases competitive advantage due to the first 2 reasons and attracts more investment. The first 2 advantages being correct, there are realistic doubts if the euro is the crucial criterion to choose the country for investment. Investors look at small corruption, favorable general business conditions, and predictable, stable and small taxes, good infrastructure. Therefore, this advantage should not be overestimated. It is only an additional reason to much bigger scope of reasons that investors consider.
4. Reduced political risk of national currency devaluation and inflation. As ECB follows the comparatively strict monetary policy, joining the euro zone provides for lower inflation and comparative stability. The currency board allows achieve the same task, however the risk that the currency board arrangement itself may be eliminated, or the national central bank may change the fixed exchange rate remains under the currency board system. Being a member of the euro zone fully eliminates the domestic inflation factor and this is definitely the biggest advantage of being in the euro zone.
5. The goal to joint euro zone creates more fiscal discipline, as countries must comply with Maastricht criteria. However, the fiscal discipline can be achieved without joining the euro zone.

The main disadvantages that are usually presented in favor of euro zone are the following:

1. Uncertainty of the euro zone related with undisciplined budgetary policies of member states, as well as discretionary monetary policies of ECB. Euro is *fiat* currency which supply is defined by the decisions of the ECB. ECB sets the base interest rates, engages in open market operations and that keeps constant stability risk.
2. Moral hazard. Single *fiat* currency creates room for moral hazard, i.e. irresponsible behavior of national governments and free-riding. Even most disciplined countries, like Germany, failed to meet Maastricht criteria. See the table below.

#### Deficit as Percent of GDP 1999-2011<sup>6</sup>

<b>Euro zone countries</b>	<b>Years of compliance</b>	<b>Years not in compliance</b>
Germany	6	7
France	6	7
Italy	4	9
<b>Non-euro zone countries</b>		
U.S.	7	6
Britain	5	8
Japan	2	10

3. Additional costs related to the contributions to European Financial Stability Facility. Given the budgetary constraints in each member state, and given the local needs, each contribution to EFSF will create an additional pressure on national public finances.

<sup>6</sup> Source: The Washington Times. Dec 13, 2011

Taxpayers of responsible countries cover the bills of irresponsible ones. One can hardly find any justification to that. As P. Bagus notes, “While it is still unclear where future developments will lead the EMU, the costs and risks of remaining within the system are already immense and rising. The risks of the project keep increasing day by day”.<sup>7</sup>

4. Transfer of the decision making from national to the EU bodies due to Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.
5. More incentives for price increase. As P. Bagus notes “The euro is a misconstruction as several independent governments can finance their deficits through one (central) banking system. The incentive is to run higher deficits than other states of the EMU. The setup of the euro system made interest rates converge and enabled monetary redistribution. Due to its incentives there is a tendency for price inflation”.<sup>8</sup>

The single monetary unit reduces competition among currencies. Competition of currencies is needed when the currency is produced by the state central bank and the money issue is discretionary. Therefore, the competition provides broader choice of currencies for those who demand stable money.

### Conclusions

Gold used to be single global money; however global single paper money is a different issue. The contemporary paper money is issued exclusively by governments (state central banks) and therefore is money chosen for people, not by people. The main advantage of being in the euro zone is the abolishment of the national inflation component and national political risk of devaluation (under the currency board monetary regime). The euro may be like leading-rein for undisciplined central banks. However, as we experienced from Greek example, loose discipline is exercised on the budgetary field then. Advantages, such as cost savings and easier price comparisons are minor, therefore are inadequate to ground the need for a single currency. The advantage of better investment climate is poorly grounded, as the investment climate is much broader understanding. Besides, stable national currency may be achieved through other means and ways.

Main disadvantage of being a member of euro zone stems from the opaque future of the euro and euro zone itself. A country like Lithuania, having euro as an anchor currency, is in a close, but safe distance to observe the developments in the euro zone. If euro is failing to serve as stable reserve money, the country may escape from the zone of trouble within short period of time.

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<sup>7</sup> Bagus, Philip. 2011. „Practical steps to withdraw from Euro.“

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