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BRIEFING

LITHUANIA ON ITS WAY INTO THE EURO AREA

The opinions expressed are those of the authors and do not necessarily reflect the European Parliament's position

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Summary

This briefing note serves as background information for the ECON delegation to Lithuania, 8 to 9 December 2005.

The note gives a short overview of the procedure for Member States with a derogation to join the Euro area as well as practical aspects regarding the introduction of the euro in a Member State. The Maastricht convergence criteria are described against the background of Lithuania's possible adoption of the euro in 2007.

Some practical concerns in Lithuania as regards the adoption of the euro are described together with some measures designed to help Lithuania in the change-over. Furthermore, a short overview of Lithuania's preparations is added.

The note highlights some important aspects regarding the financial services sector in Lithuania.

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1. Introduction of the euro in EU Member States with a derogation

All new EU Member States having joined the Union on 1 May 2004 (as well as Sweden) currently have a derogation as regards their participation in the euro. This implies that these states have to introduce the euro when economic conditions for such a step are considered to be right.

1.1. Procedure

The procedure for the adoption of the euro by a particular Member State is set out in Articles 122 and 123 of the EC Treaty and provides for the following steps:

- At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB report to the Council on the progress made in the fulfilment by the Member States of the convergence criteria in accordance with the procedure laid down in Article 121 of the Treaty.
- On the basis of a proposal by the Commission and after consulting the European Parliament as well as after discussion in the Council in the composition of Heads of State or Government, the Council decides by a qualified majority whether or not the country in question will adopt the euro.
- If it is decided to abrogate the derogation, the Council, on a proposal from the Commission and after consulting the ECB, adopts with the unanimity of the Member States without a derogation and the Member State concerned the conversion rate at which the euro will replace the national currency.

If a Member State's convergence is assessed positively as fulfilling the Maastricht criteria and Council has decided to abrogate the derogation, the euro can then be introduced in the Member State concerned on 1 January of the following year. On the date of adoption of the euro the conversion rate becomes effective and responsibility for monetary policy is transferred to the European Central Bank.

1.2. Practical aspects of euro introduction

The national authorities are in charge of the co-ordination of all preparatory work for the introduction of the euro in their country.
For practical and logistical reasons the current Euro area Members introduced a transitional period of three years (one year in the case of Greece) between the adoption of the euro as the currency and the introduction of the euro banknotes and coins.
The alternative is the so-called Big Bang scenario in which entry into the Euro area coincides with the introduction of the banknotes and coins. This is followed by a period of dual circulation during which banknotes and coins in national currency are being withdrawn but still have legal tender status. This second scenario is clearly favoured by the countries wishing to join the Euro area.

Timetable for euro introduction in Lithuania[1]

Note: There will be no referendum on the introduction of the Euro in Lithuania.

	Preparation period
September 2005 – May 2006	Convergence of the economic indicators with the Maastricht criteria: observation of the indicators, submission of the proposals to end the derogation.
May – June 2006	Convergence Reports 2006 of the European Commission and the European Central Bank.
June – July 2006	Council Decision on the abrogation of a derogation regarding the use of national currency and the date of the euro adoption in Lithuania.
June – July 2006	Ecofin Decision on the irrevocably fixed conversion rate between the litas and the euro.
No later than in June - July 2006	Submission of the Law on the Adoption of the Euro in the Republic of Lithuania for the consideration of the Seimas.
No later than 2 November 2006	Obligatory dual display of prices both in litas and euro starts.
20 December 2006, at the latest	Frontloading of banknotes and coins to banks.
	Dual circulation period
1 January 2007	Introduction of the euro
16 January 2007	Euro becomes single legal tender.
	After the dual circulation period
1 March 2007	Obligatory dual display of prices both in litas and euro ends.
1 March 2007	Free-of-charge exchange of the litas into euro in commercial banks ends.

[1] Source: National Changeover Plan of Lithuania.

2. The Maastricht convergence criteria in the context of Lithuania

The convergence criteria are presented in Article 121(1) ECT and further clarified in the Protocol on the convergence criteria. They reflect the degree of economic convergence that Member States must achieve in order to join the Euro area.[2] The rationale behind these criteria is to ensure a high degree of sustainable convergence with the Euro area.

Lithuania aspires to join the Euro area on 1 January 2007. Taking into account that the convergence criteria can only be fulfilled once the Lithuanian currency, the litas, has participated for two years in ERM II, the evaluation of Lithuania in view of joining the Euro area is likely to take place in mid-2006.

Below each convergence criterion is presented together with the ECB's interpretation of the Treaty obligations as well as a short description of Lithuania's performance with regard to the criterion and certain risks for the country.

2.1. Price stability

Art. 121(1) ECT requires:
the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best-performing Member States in terms of price stability.

Art. 1 of the Protocol on the convergence criteria:
The criterion on price stability referred ... shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than $1^1/_2$ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions.

How will the ECB evaluate the inflation criterion?

- With regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate is calculated using the increase in the latest available 12-month average of the Harmonised Index of Consumer Prices (HICP) over the previous 12-month average.
- The notion of "at most, the three best-performing Member States in terms of price stability", which is used for the definition of the reference value, is applied by using the unweighted arithmetic average of the rate of inflation in the three countries with the lowest inflation rates, **given that these rates are compatible with price stability**.

How does Lithuania fare as regards the inflation criterion?
Price developments were stunning in 2003 when deflation was recorded amidst a period of GDP growth near 10%. The environment has significantly changed since. Inflation picked up sharply in the first half of 2005 after very low inflation and even episodes of deflation. Inflation peaked in February 2005 at 3.3%.

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[2] Fulfilment of the convergence criteria is often referred to as nominal convergence as opposed to real convergence which means XXX.

Contributing factors are believed to be:

- Balassa-Samuelson effect
- sharp rise in oil prices especially coupled with the appreciation of the US dollar against the litas, high energy prices and increases in utility prices[3]
- rising food prices
- EU accession related increases in administrative prices and indirect taxes, these factors fell out of the calculations by summer 2005
- rising wage costs due to a lack of skilled labour (fall of unemployment and emigration)

Balassa-Samuelson effect

Prices in poorer economies are typically lower than those in richer economies. Although the prices of tradable goods do not show significant differences, the prices of non-tradable goods, especially the prices for labour-intensive services, are significantly lower in the poorer economies due to the lower level of wages. The liberalisation of trade, increasing competition, direct investment and transfers induce a rapid increase in productivity in countries with comparatively low productivity in the tradables sector. This in turn leads to higher wages. In the non-tradables sector productivity rises much slower. However, also in this sector wages are rising with similar rates as in the tradables sector and with this in turn the prices of non-tradable goods rise. Due to this significant rise of prices in the non-tradables sectors inflation rates are higher during a catch-up process.

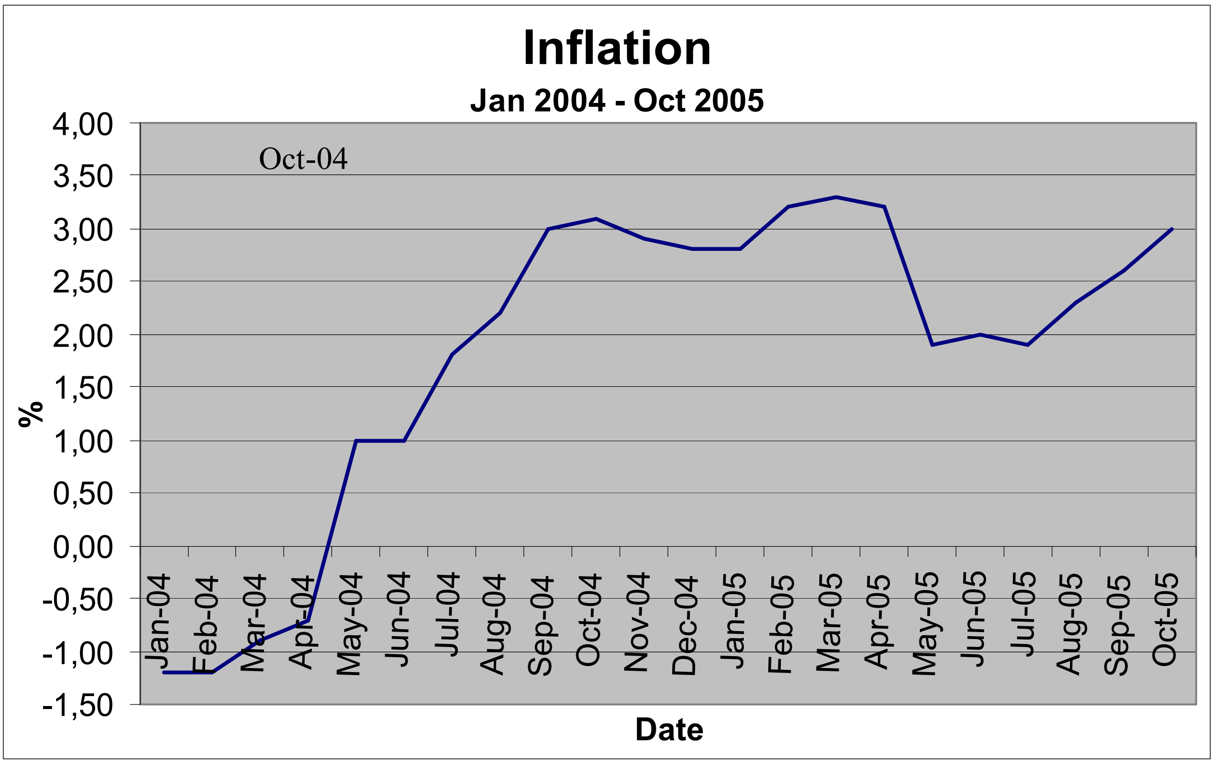
<u>Inflationary risks for Lithuania:</u>

- Possible sharp rise in the gas price as Russia's Gazprom exerts pressure on Lithuania to change its gas tariffs. In general, energy prices are still below Western European levels and a rise is inevitable given time even notwithstanding Gazprom going through with price changes.
- wage-induced inflation caused by a shortage of skilled labour
- greater disposable incomes due to an income tax reform that will kick in in 2006

Several economic forecasts see the fulfilment of the inflation criterion as the most difficult task for Lithuania as regards meeting the Maastricht criteria. However, most forecasts predict that Lithuania will be able to fulfil the criterion in mid-2006 even if just by a small margin.

Compared to neighbouring Latvia and Estonia inflation remained moderate. Much seems to be depending on how the criterion will be calculated at the time of the test, i.e. which Member States will be considered as best-performing in terms of price stability. The ECB has clearly indicated that **best-performing cannot be in contradiction to price stability** which is defined by the ECB as below but close to 2%.

[3] With rising oil prices the Consumer Price Index in Lithuania goes up faster than in benchmark countries due to the larger weight of fuels in Lithuania's HICP.



Source: Eurostat

2.2. Sustainability of the government financial position

Art. 121(1) ECT requires:
the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive, as determined in accordance with Article 104 (6).

Art. 2 of the Protocol on the convergence criteria:
The criterion on the government budgetary position referred to in the second indent of Article 121(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists.

How will the ECB evaluate the budgetary criterion?

- For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments in the relevant period, considers the outlook and challenges for public finances and focuses on the links between deficit and debt developments.

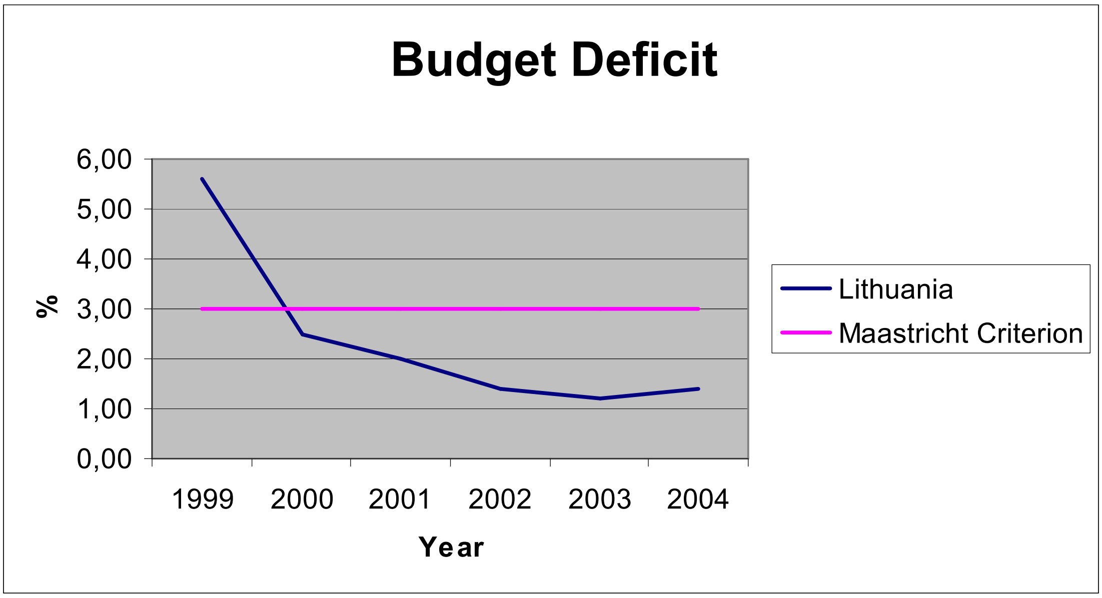
How does Lithuania fare as regards the budgetary criterion?
Lithuania's fiscal policy over the last decade can be characterised by moderate but persistent budget deficits. There is currently no excessive deficit. The fiscal imbalances were mostly structural in nature and reflected substantial public financing needs during the transition coupled with the eroding public income due to a shrinking tax base.

The deficit stood at 1.4 % of GDP in 2004 and is likely to rise relatively sharply in 2005 to 2.7%. However, most economic forecasts predict that Lithuania will be able to remain under the 3% ceiling for the deficit criterion.

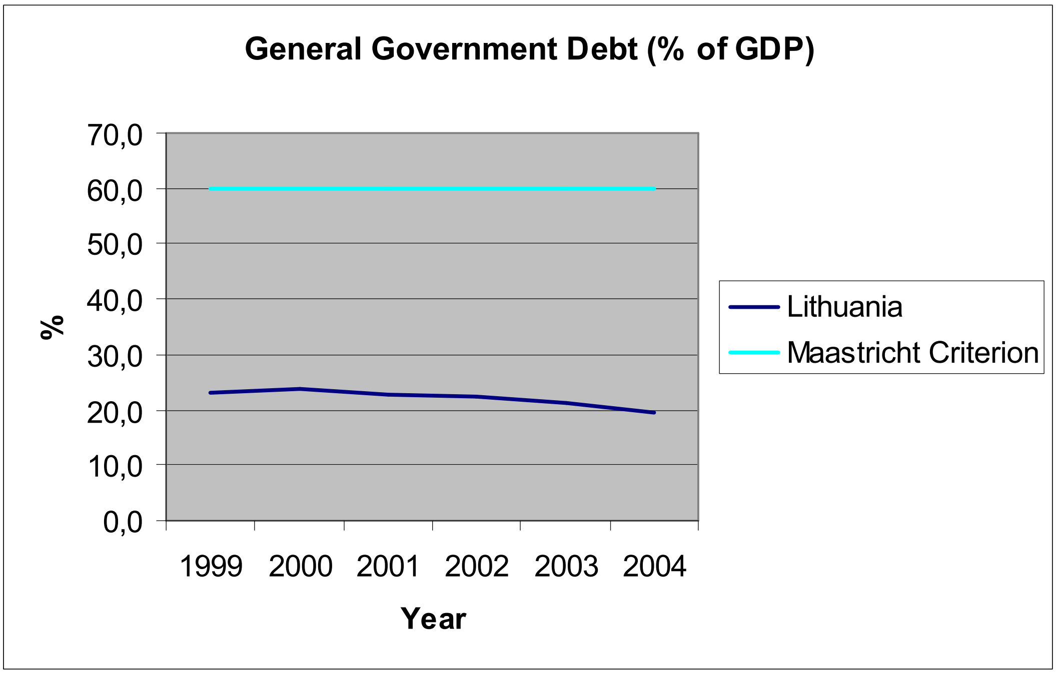
As regards the debt ratio, this is currently well below the 60% ceiling and expected to marginally increase in 2005 to 20.9%. The fulfilment of this criterion does not pose a problem for Lithuania.

Risks as regards the deficit criterion:

- additional pressure on fiscal expenditure due to the upgrading of administrative and military capacities in line with EU and NATO accession as well as requirements for the co-financing of EU-funded structural projects
- higher pensions and an increase in the minimum salary(affecting the public sector)
- agreed income tax reform is likely to reduce revenue



Source: Eurostat



Source: Eurostat

2.3. Exchange rate development

Art. 121(1) ECT requires:
the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State.

Art. 3 of the Protocol on the convergence criteria:
The criterion on participation in the exchange-rate mechanism of the European Monetary System ... shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

How will the ECB evaluate the exchange rate criterion?

- First, the ECB assesses whether the country has participated in ERM II "for at least the last two years before the examination", as stated in the Treaty.
- Second, with regard to the definition of "normal fluctuation margins", the ECB recalls the formal opinion that was put forward by the EMI Council in October 1994 and its statements in the November 1995 report entitled "Progress towards convergence".[4] Against this background, in the assessment of exchange rate developments the emphasis is placed on exchange rates being close to the ERM II central rates.
- Third, the issue of "severe tensions" is generally addressed by examining the degree of deviation of exchange rates from the ERM II central rates against the euro. This is done by using such indicators as short-term interest rate differentials vis-à-vis the euro area and their evolution and also by considering the role played by foreign exchange interventions.

How does Lithuania fare as regards the exchange rate criterion?
The litas joined ERM II on 28 June 2004. Consequently, the condition of having participated in ERM II for at least two years before the examination of convergence can be fulfilled by mid 2006. The litas has been pegged to the euro at a rate of LTL 3.4528 to EUR 1 since February 2002 when Lithuania re-pegged the litas from the US dollar to the euro. Economic forecasts expect this rate to be maintained until the euro is adopted. This implies that Lithuania is well on track to fulfil the exchange rate criterion.

The Lithuanian currency is tied to the euro in a currency board, which was previously, since 1994, established in relation to the US dollar, but re-pegged in 2002. By virtue of this arrangement Lithuania is already now a well-established *de facto* Member of the Euro zone.

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[4] The EMI Council's opinion of October 1994 stated that "the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM", that "the EMI Council considers it advisable to maintain the present arrangements", and that "member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfilment of the requirements set out in Article 121 (1) of the Treaty and the relevant Protocol". In the November 1995 report entitled "Progress towards convergence" it was recognized by the EMI that "when the Treaty was conceived, the 'normal fluctuation margins' were ±2.25% around bilateral central parities, whereas a ±6% band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to ±15%, and the interpretation of the criterion, in particular of the concept of 'normal fluctuation margins', became less straightforward". It was then also proposed that account would need to be taken of "the particular evolution of exchange rates in the European Monetary System (EMS) since 1993 in forming an ex post judgment".

Currency Board

A currency board is an exchange rate arrangement in which a country pegs its currency unilaterally to a foreign currency, the so-called anchor currency. A system of simple fixed exchanges rates differs from a currency board in terms of the strong institutionalisation of a currency board. This aims at building trust at the international financial and money markets in order to improve the integration into those markets and gain better conditions for debt. This can only be successful, if the currency board is considered to be credible.

Risks:

- If the government fails to tighten fiscal policy, the already sizeable current-account deficit could reach dangerous levels. The current-account deficit and the currency board are only sustainable as long as Lithuania continues to attract significant inflows of foreign capital. So far, foreign investors have not shown signs that they might be reducing financing to Lithuania. However, Lithuania should keep the current-account deficit down so that the external imbalance does not force a devaluation of the litas which could delay the adoption of the euro. It should be stated that such a scenario is considered unlikely.

2.4. Long-term interest rates

Art. 121(1) ECT requires:
the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels.

Art. 4 of the Protocol on the convergence criteria:
The criterion on the convergence of interest rates ... shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

How will the ECB evaluate the interest rate criterion?

- First, with regard to “an average nominal long-term interest rate” observed over “a period of one year before the examination”, the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available.
- Second, the notion of “at most, the three best performing Member States in terms of price stability” which is used for the definition of the reference value has been applied by using the unweighted arithmetic average of the long-term interest rates of the three countries with the lowest inflation rates.[5] Interest rates have been measured on the basis of

[5] It should be noted that in its interpretation of the criterion the ECB has not clarified - as opposed to the evaluation of the inflation criterion - that the lowest inflation rates are considered **as long as they are in line with price stability**.

harmonised long-term interest rates, which were developed for the purpose of assessing convergence.

How does Lithuania fare as regards the interest rate criterion?
The adherence to the currency board is displayed in an exemplary fashion by the low level of interest rates. With the prospects of accession to the euro, interest rates already started to converge to euro levels. A further decrease of short-term interest rates is likely if the Lithuanian economy does not overheat.

Due to the credible currency board arrangement economic forecasts expect Lithuania to fulfil this criterion.

Risks:

- Too strong domestic demand and an expanding current-account deficit might require abandoning the current parity with the euro. This would have severe repercussions for the conduct of monetary policy and thus interest rates. It should be stressed that this is considered an unlikely scenario.

Long-term interest rates - Development for 2005

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct
Euro zone	3.6	3.59	3.75	3.54	3.39	3.22	3.28	3.3	3.14	3.3
Lithuania	3.85	3.8	3.73	3.82	3.87	3.78	3.61	3.5	3.5	3.5

Source: Eurostat

3. Public opinion in Lithuania

The number of Lithuanians opposed to the introduction of the euro topped 50 percent in November for the first time, according to a poll published on 26 November 2005. 51 percent said Lithuania should not replace the national currency with the EU single currency, according to the poll conducted on November 4-7. A further 34 percent said that the euro should be introduced, while 15 percent expressed no view. A poll by TNS Gallup conducted a year ago showed 48 percent of Lithuanians supporting a switch to the euro and only 36 percent opposing it.

Already now, many Lithuanians fear a possible increase in prices. The main instrument to calm inflation fears in the public is fighting the cause of those fears. It seems therefore necessary to undertake campaigns in order to explain the situation and to present the experiences of old Euro zone members in an honest way.

4. Help at Community level for the change-over in Lithuania

One of the main areas where Lithuania can expect help for the change-over to the euro is communication and information. In this respect, the Commission signed a partnership agreement with Lithuania on 8 November 2005.

The Commission Communication on the implementation of an information and communication strategy on the euro and Economic and Monetary Union (COM (2004)552) provides the framework for communication activities at Community level. This strategy is governed by the principles of decentralisation, subsidiarity, coordination and partnership. The strategy includes:

- partnerships between the Commission and the Member States;
- twinning programmes (Lithuania is twinned with the Netherlands and Slovenia, the programmes build on the expertise of countries that have already introduced the euro);
- networking, information relays and other natural partners;
- conferences and seminars;

- opinion polls;
- external information activities;
- publications and other information products.

Various publications were prepared by the Commission on the euro and EMU, notably a guide for SMEs in the newly acceded Member States entitled “Fit for the euro!”, proposing good practices and advice for successfully preparing the changeover to the euro. A comprehensive series of training seminars for journalists was launched on EMU, the euro and its introduction and the Community’s economic policies in general. The Commission is also in the process of preparing a series of conferences in the new Member States. Furthermore, opinion surveys are being carried out providing important information on the public’s views on the euro and EMU. This will help the Commission and the Member State involved to further fine-tune their strategies.

5. State of practical preparations in Lithuania (September 2005)[6]

National target date for euro adoption:	1 January 2007
ERM II entry:	28 June 2004
National co-ordinating institution:	Commission for the Coordination of the Adoption of the Euro in Lithuania, established on 30/05/05
Approved National Changeover Plan:	The first version of the National Euro Adoption Plan was approved by the government on 27 Sept 2005.
Type of change-over scenario:	Big-Bang
Dual circulation period:	15 days
Exchange of national currency:	Commercial banks: free of charge during 60 days after €-day. Central bank: free of charge for an unlimited period.
Frontloading and sub-frontloading:	Frontloading of euro banknotes to commercial banks by 20 December 2006 at the latest and of euro coins by 1 October 2006 at the latest.
Dual display of prices:	From 60 calendar days before €-day until 60 days after €-day (compulsory)
Design of the national side:	Approved

No of different coin designs:	3 designs
National mint:	Yes
Estimation re need for banknotes and coins:	118.3 million banknotes and 290 million coins

[6] Source: European Commission, COM(2005)545 final.

National law adaptations:	The draft Law on the Adoption of the Euro is prepared.
Communication strategy:	Approved by the government on 27 September 2005
Partnership agreement:	Signed on 8 November 2005
Twinning agreement:	Between NL – SI – LT : communication and information strategy Under consideration: between BE – LT on tax and debt issues

6. Financial Services Sector in Lithuania

6.1. Banking

The introduction of a market economy in Lithuania has taken place in the last two decades, simultaneously with legal and structural reforms as Lithuania took on board the acquis communautaire in order to enter the EU. It has been more difficult to reform the financial services sector, since at the start of the reform; there were no relevant benchmarks for financial institutions. The banking system had to reconstruct financial independence from Moscow. After the hyperinflation of 1991, which had reduced the obligatory initial capital of commercial banks, a deeper banking crisis occurred throughout the Baltic States in the mid 1990's. The crises resulted in the bankruptcy and merger of banks as well as the arrival of foreign banks as strategic investors in Baltic banks.

- ➢ The high level of foreign penetration means that 11 out of 13 commercial banks are foreign owned

Main characteristics of new Member States' banking sector (in 2003)

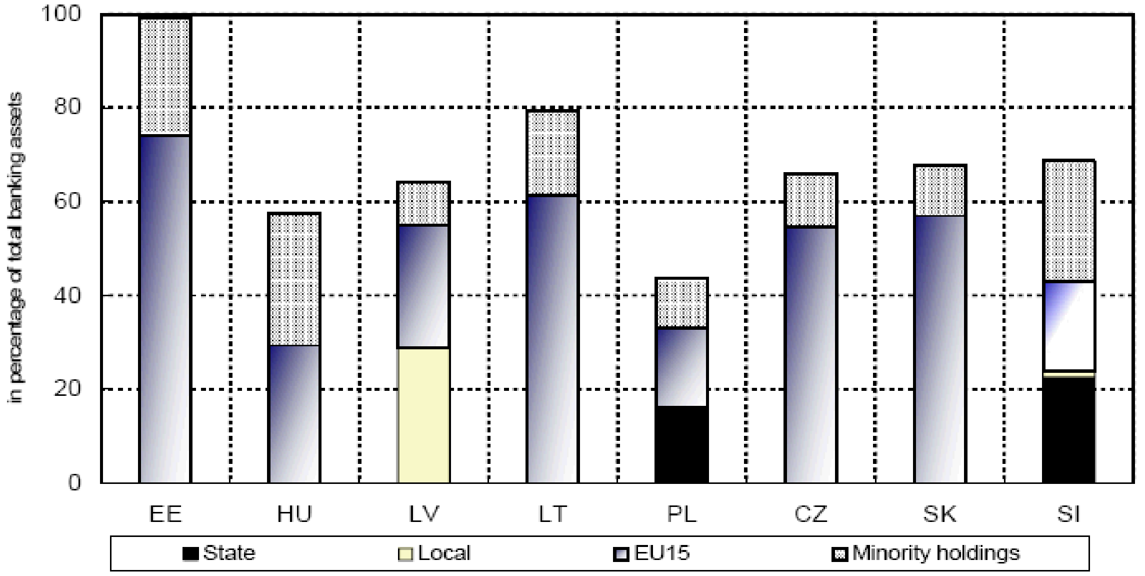
		Bank assets (% of GDP)	CR5 of assets (% of total assets)	Foreign ownership (% of total assets)
cz	Czech Republic	96,9	65,8	96,0
ee	Estonia	78,9	99,0	97,5
cy	Cyprus	234,9	88,4	12,3
lv	Latvia	84,9	63,1	46,3
lt	Lithuania	39,6	81,6	95,6
hu	Hungary	71,7	52,3	82,3
mt	Malta	405,7	82,0	67,6
pl	Poland	56,0	52,3	67,8
si	Slovenia	72,5	67,4	36,0
sk	Slovakia	86,8	67,5	96,3

- Source: ECB, *Banking structures in new EU Member States*

The crisis had as beneficial effect to clear the capital structures of banks and reform operational and risk management issues. Currently the growth of assets has exceeded GDP, however there is a catching-up process to be done, as banking assets in the Euro zone are at 260%of GDP compared to levels in the Baltic states of below 100%

- ➢ The banking sector is highly concentrated with 80%of all sector assets held by the three largest banks.

Share of the 5 largest banks in total banking assets of CEE-countries



Source: Bank Austria Creditanstalt

The high growth potential has translated in rapid expansion of credit. The expansion has been particularly strong in the years 2003/2004 especially to the private sector.

➢ Under the private sector credits the most rapid expansion is in household mortgage and consumer credit financing. The growth of loans to this sector averaged an increase of 73% in the last three years.

This has implications in hedging for banks and in risk management as banks are increasingly looking for funds abroad especially Euro based, and not much information is available on hedging. Special loan provisioning has not kept up with the credit growth but the percentage of non-performing loans has declined significantly. The strong growth in this sector has in line with the rest of the EU banking sector, seen reducing bank spreads and increasing maturities (40%of loans are over 3 years).Lastly the authorities have brought about significant changes in auditing and disclosure rules in order to bring them in line with IAS, ISA and EU directives.

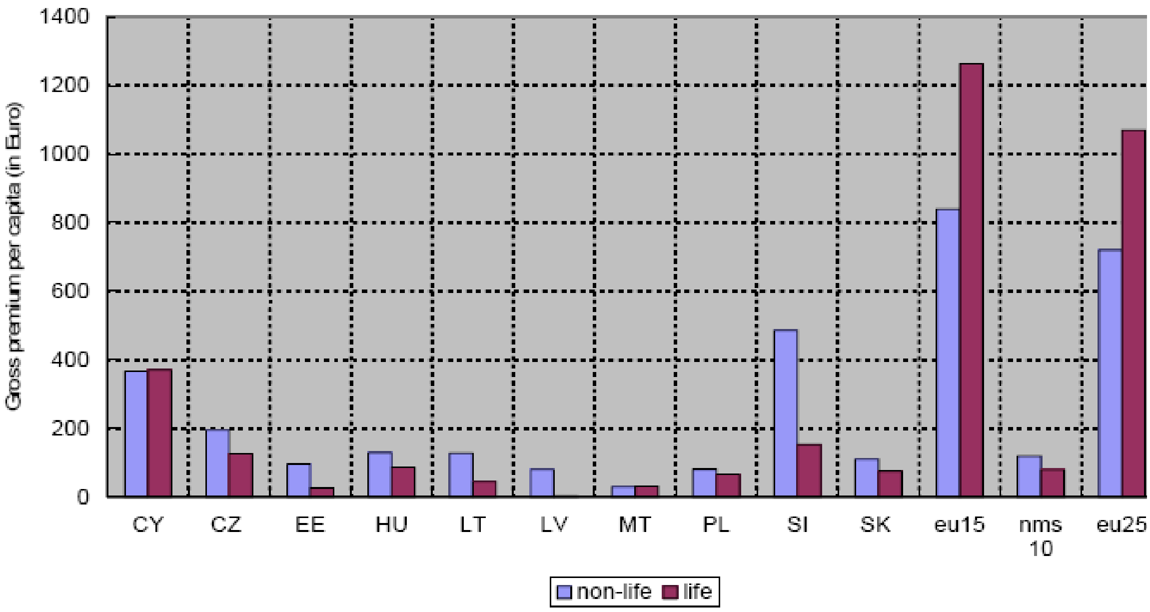
➢ Issues to monitor:

- Credit expansion to private sector
- Risk Management and communication between supervisory authorities of host and home countries, in the case of foreign shareholding
- Foreign Currency exposure for financial institutions with possible danger as positions might be under hedged

6.2. Insurance

In Insurance, Lithuania is in the second phase of development namely the establishment of a life insurance industry. However most premiums are in the non-life sector for motor vehicle insurances. In Lithuania over 90% of this segment is in the hands of foreign insurers.

Gross premium per capita in life and non-life sectors (2003-figures)



Source: CEA

The new pension law adopted in 2004 allows for the choice of making a full contribution to pay as you go system or diverting a progressively increasing percentage of pay as you go to pension funds and life insurance in pillars two and three.

- However one major issue to resolve in the pension reform, is that between 2015 and 2060, the dependency ratio will almost double as the active population will decrease to 30%. Authorities have set the goal of raising income replacement to 60% by 2010. It is also their intention to increase the funding by 2.5% of social security contributions of the 2nd pillar introduced in 2004, to 5.5% in 2007.

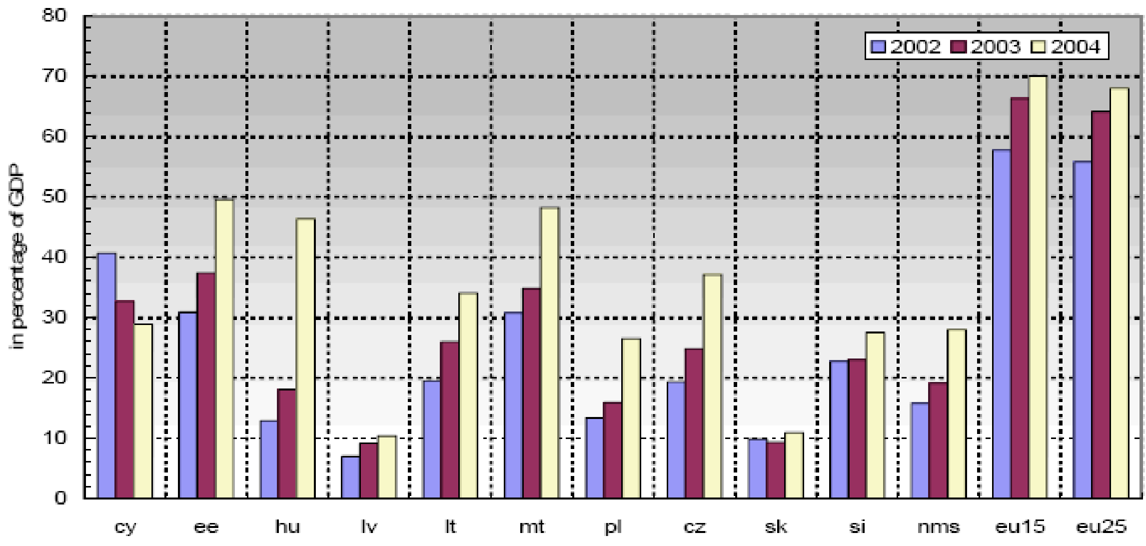
6.3. Securities

The National Stock Exchange of Lithuania (NSEL) was opened in 1993 and was the first in the Baltic Region. The majority of its trading is in government debt securities, which hampers liquidity.

The average stock market capitalisation in the new member states is around 28% compared to 70% in the old member states. For Lithuania the figure is above the average at 35%. It is regulated by the Lithuanian Securities Commission, which is a member of the Federation of European Securities Exchanges.

- Further deepening is needed with the development of the stock market for SME's and the development of derivatives.

Stock market capitalisation (2002-2004)



Source: FESE, Eurostat

6.4. Financial Services – Conclusion

- The opening of the financial markets has led to a high foreign presence in both insurance and banking. This represents for all inward FDI about 4% of GDP of which 20% is in the financial services sector. No less than 80% of inward FDI came from EU member states.
- The strong growth experienced in Lithuania is driven by increasing employment and higher income, as Lithuania is catching up in its convergence process. Stock prices and real estate assets have given an additional wealth effect as they are driven upward by capital inflows.
- Supervision and Risk Management is adequate however due to the overheating credit expansion the authorities need to supervise the levels of capital.
- In the pension sector, the development of 2nd and 3rd pillars will lead to sophistication of the life insurance and investment fund sector.