

“What are the Economic Arguments to Reject Lithuania’s Eurozone Bid?”

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Along with nine other countries, Lithuania joined the European Union in 2004, and it is now on the road to becoming part of the European Monetary Union. Lithuania had hoped to adopt the Euro in January of 2007. But that hope is now fading. Although Lithuania strictly meets most of the “convergence criteria” set out in the Maastricht treaty, it just barely fails to meet the inflation criterion. Recorded inflation for March stands at 2.72 per cent, just missing the criterion of 2.66 per cent. This criterion value is calculated from the CPI data provided by the Eurostat with two digits precision. The value of this criterion is 2.63 per cent if the inflation data of one digit precision is used. It seems quite likely that eurobureaucrats will use this 0.06 per cent of “unacceptable” inflation to bar Lithuania from adopting the euro, labeling the country as “not stable enough.” And a country with one of the highest GDP growth rates, one of the lowest fiscal deficits, and one of the lowest national debts in the EU will be turned away.

Notice that the idea of an “unstable” Lithuania is at odds with the opinion of the market: in 2006 Lithuania was able to borrow in international markets at the lowest rate among all the new EU members, a rate even lower than that of old EU member Greece. Notice also that, in judging Lithuania so strictly, the EU is holding the country to a standard most members do not meet. In January 1999, upon the inception of the euro zone, all member countries except Greece complied with the Maastricht inflation criterion. Only two years later, when the paper euro came into circulation, eight countries (Belgium, Denmark, Greece, Spain, Ireland, Luxembourg, Portugal and Finland) would have failed the inflation test. Despite this, the euro zone survived and prospered.

The great irony is that Lithuania’s predicament arises because it has adopted a policy that the EU should reward not punish. In February 2002, Lithuania adopted a currency board with the euro as its base currency. In so doing, Lithuania gave up all discretionary monetary policy and tied itself to the monetary policy of the European Central Bank. Thus Lithuania already implicitly belongs to the euro zone: the Litas is essentially the euro by another name. Although this arrangement works well for the time being, it imposes transaction costs on businesses and individuals. Moreover, especially in the real estate market, speculative behavior related to the eventual official changeover to the Euro imposes a further burden. Will the EU punish Lithuania for being too integrated into the euro zone?

There are only two countries in the EU that have currency boards: new members Lithuania and Estonia. Hong Kong and Bulgaria are among the other few in the world. Rarely do even economists invest the time to understand the nuances of this particular kind of monetary system. But such an understanding is essential for the evaluation of the macroeconomic stability of these countries. In a sense, Lithuania is more in tune with the euro zone than another candidate, Slovenia. The latter has had monetary policy instruments at its discretion, whereas Lithuania achieved economic convergence without such instruments. Perhaps some see denying a country with “uncurbed” inflation as a

way of disciplining other potential euro zone members. But it is odd indeed to use for such a purpose a country with a currency board.

A further irony is that the source of Lithuania's "excessive" inflation is the euro zone itself. Because the Litas is pegged to the Euro, Lithuania is passively importing inflation from the euro zone. Yet, the Maastricht criterion compares Lithuania's inflation to countries that do not belong to the euro zone – Sweden and Poland. Inflation levels could be lowered through contractionary fiscal policy. But during the past three years Lithuania has already had the lowest level of government expenditures as a share of GDP in all the EU. These low levels of fiscal spending incurred considerable cost. In the short run, low levels of inflation come at the expense of higher unemployment. The Lithuanian people have already paid a significant price for perfect compliance with all other Maastricht criteria.

When they joined the EU, the new member states were not given the choice of keeping their national currencies. The euro is mandatory. It is a complicated task for national governments to make the transition in an orderly and transparent way. If the European Commission and the European Central Bank do not recommend that Lithuania join the euro zone in January 2007, they must clearly state the policy recommendations that Lithuania should follow in order to comply. At this moment it seems that the most effective tactic would be to beg Sweden and Poland, whose low rates of inflation are driving the Maastricht criterion, to increase their money supplies so that Lithuania would qualify. So much for anti-inflation policy.

There is no economic justification for preventing Lithuania from joining the euro zone in January of 2007. Lithuania misses the inflation target by less than a tenth of a percentage point and more than complies with all other Maastricht requirements. If the EU really wants to expand the euro zone, there is no economic reason to delay Lithuania's membership. The new EU citizens deserve to know why euro policy makers are stalling the expansion of the euro zone and with it economic growth in their region. "0.06 per cent" cannot be the answer.