



Preparations for the Euro: Strategy and Perspectives

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Outline

- I. Rationale for joining the euro area
- II. Economic convergence with the EU
- III. Convergence of the financial sector
- IV. Fulfilling Maastricht criteria
- V. Conclusions



I. Rationale for joining the the euro area

- Lithuania – country with a small, flexible and open economy conducting highly integrated trade with the EU – is the prime candidate for benefiting from common currency area. Membership in the euro area would reinforce macroeconomic stability and foster real economic convergence with the euro area
- Membership in the euro area would be an ultimate outcome of Lithuania's European integration process which started more than fifteen years ago
- Lithuanian economy operates within the framework of fixed exchange rate regime for more than twelve years including more than four years peg to the euro. Therefore Lithuania does not have to sacrifice discretionary monetary policy and alter exchange rate framework to join the euro area

II. Economic convergence with the EU (1)

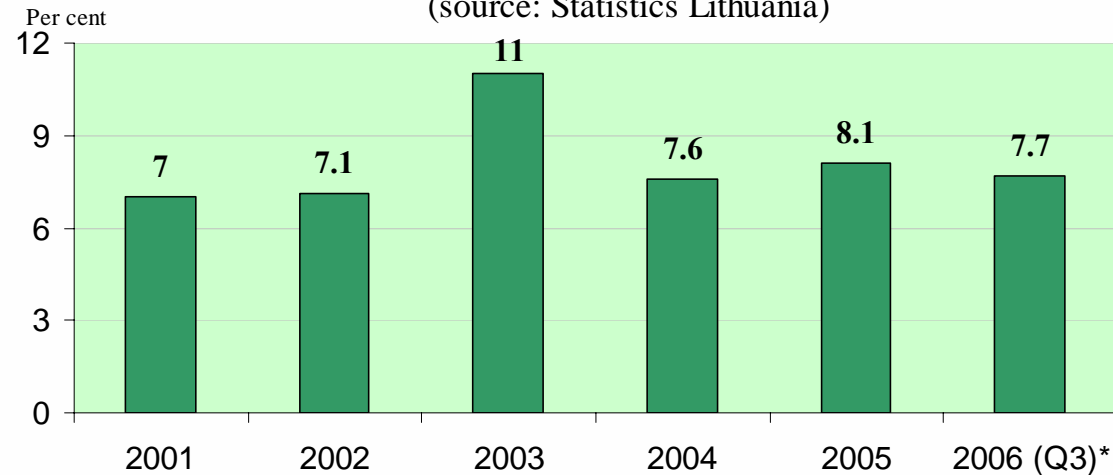


Robust economic growth is leading to fast real economic convergence with the EU...

...and income gap is closing fast

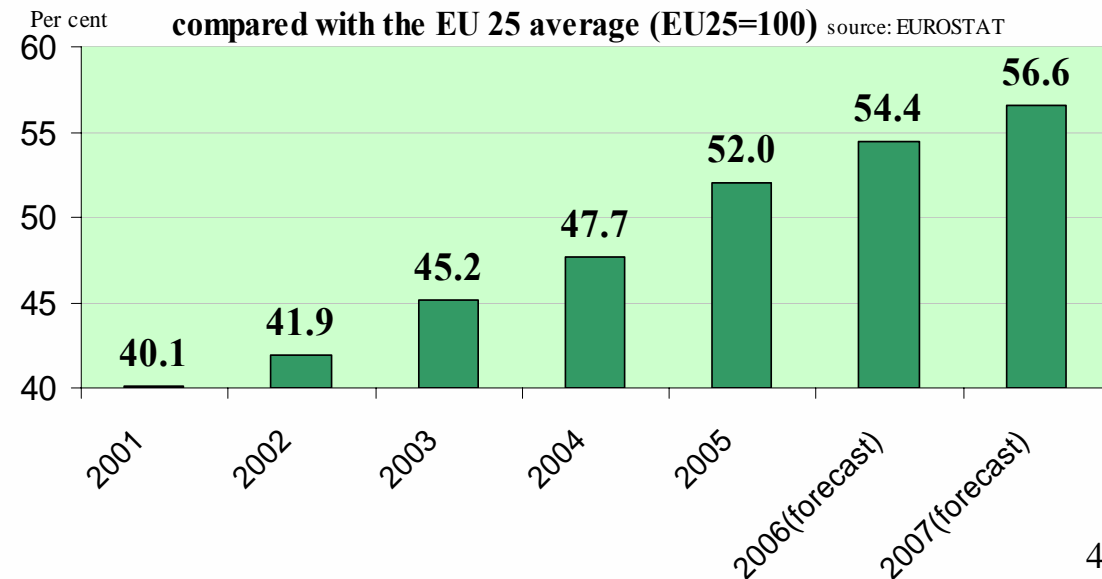
Annual changes in GDP per capita at constant prices

(source: Statistics Lithuania)



Lithuania's GDP per capita in purchasing power standard

compared with the EU 25 average (EU25=100) source: EUROSTAT



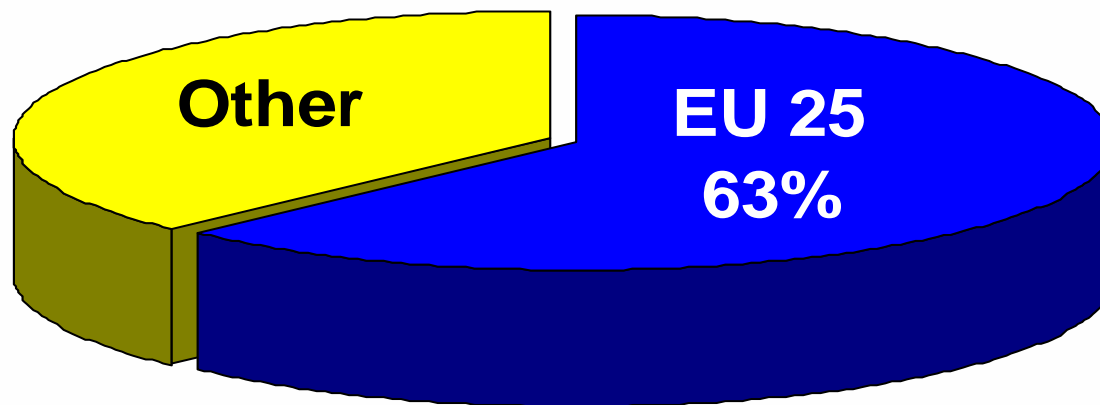
II. Economic convergence with the EU (2)

Shares of Exports and Imports

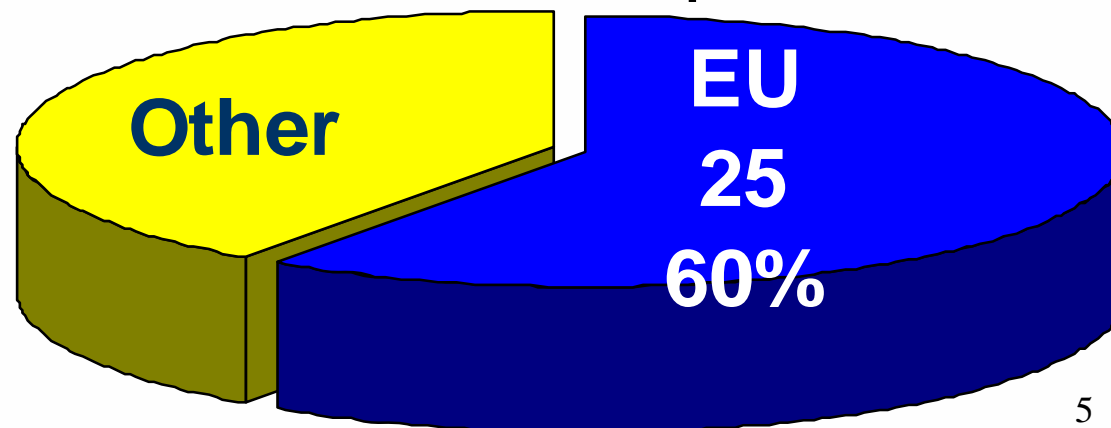
As at August, 2006

source: Statistics Lithuania

Share of Exports



Share of Imports



UK shares:

➤ **Exports 4.2 %**

➤ **Imports 2.5 %**

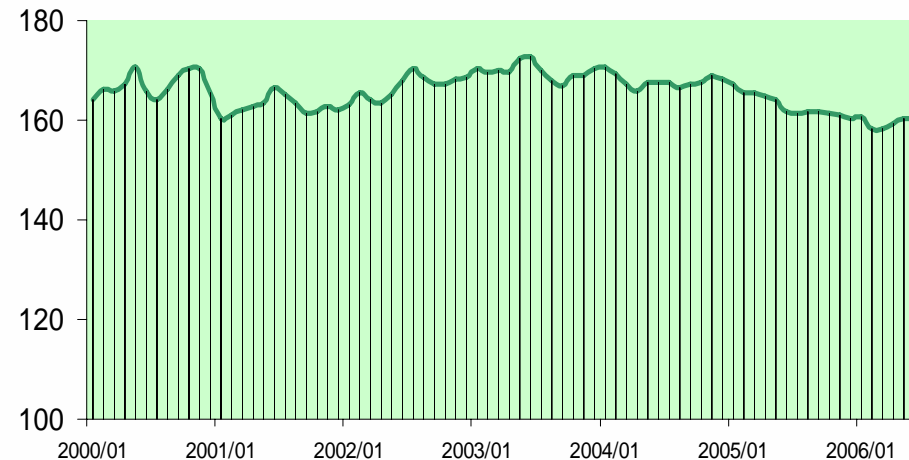


II. Economic convergence with the EU (3)

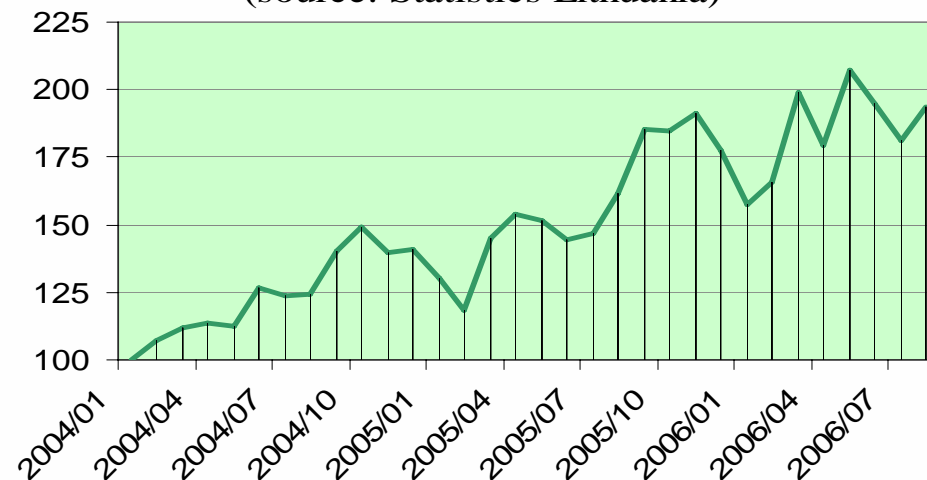
Fixed exchange rate regime does not impede competitiveness. REER indices stay at more or less the same level

Lithuania is moving up the export ladder in value added goods and exports continue to grow at robust rates

Real effective exchange rate indices of the litas
1993/06 = 100 (source: Bank of Lithuania)



Export growth in euro 2004/01=100
(source: Statistics Lithuania)





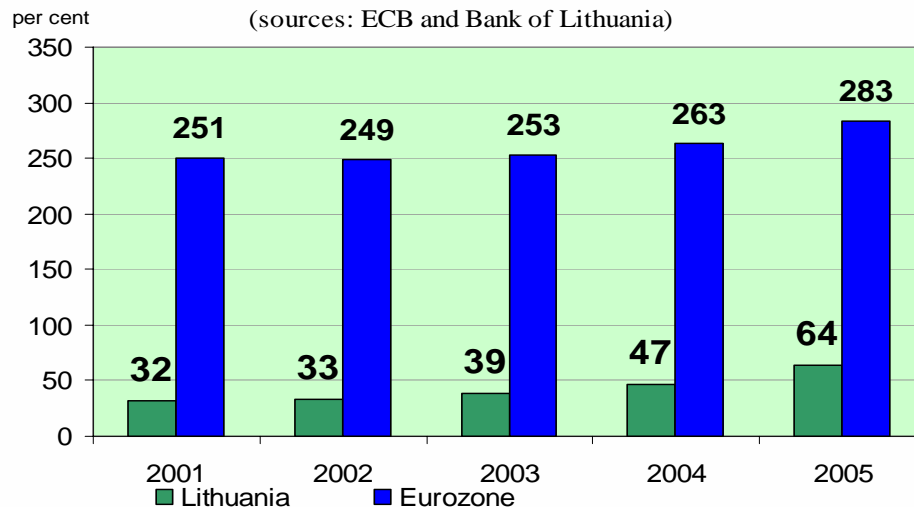
III. Convergence of the financial sector (1)

Assets of credit institutions, including credit to the private sector, are growing at a fast pace, however, appropriate ratios remain at low levels compared with the euro area

Banks dominate the financial sector. They are well supervised and profitable with non-performing loans currently constituting only 1.1 percent of total loans

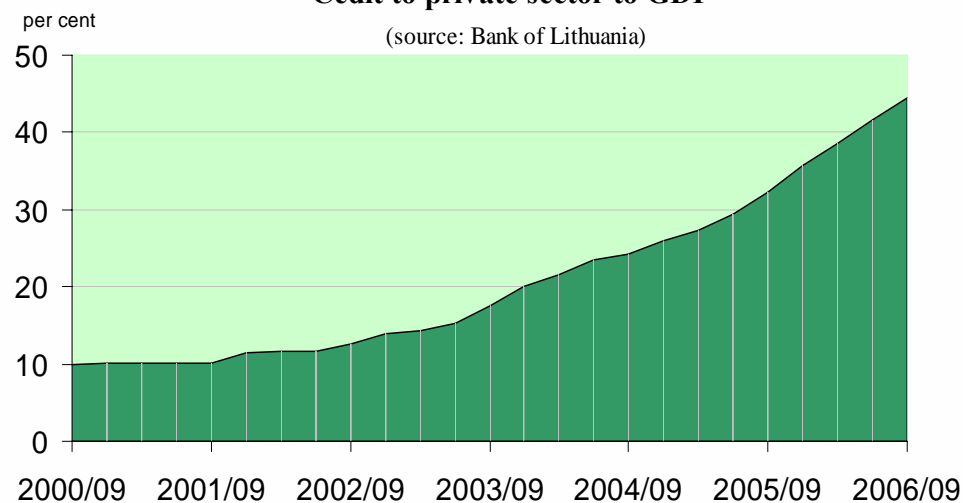
Assets of credit institutions to GDP

(sources: ECB and Bank of Lithuania)



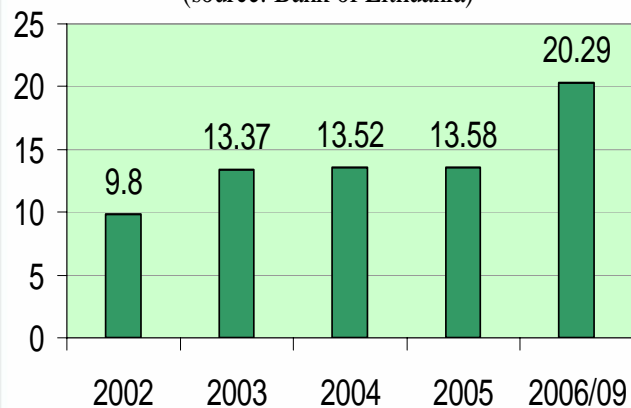
Credit to private sector to GDP

(source: Bank of Lithuania)



RoE of commercial banks

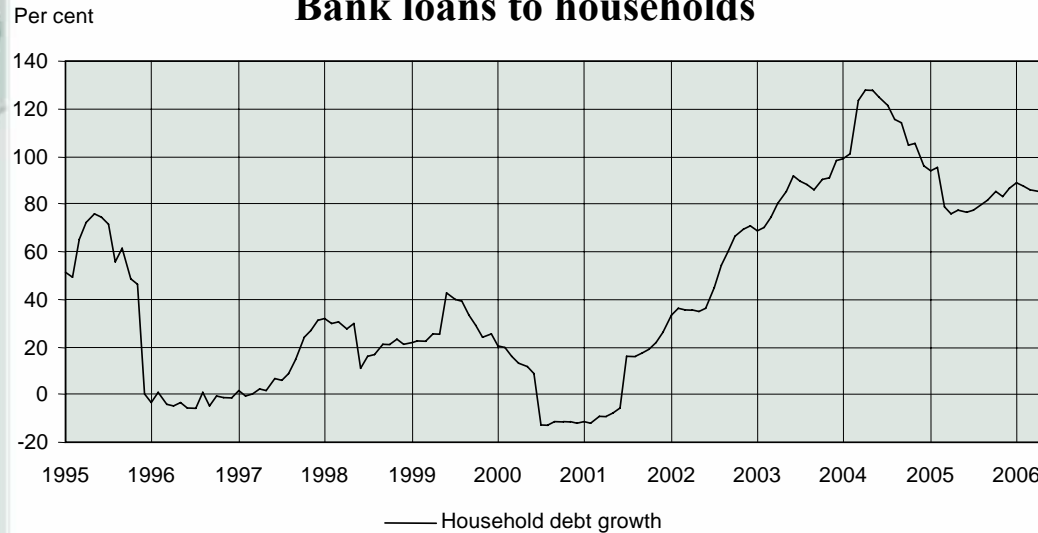
(source: Bank of Lithuania)





III. Convergence of the financial sector (2)

Bank loans to households



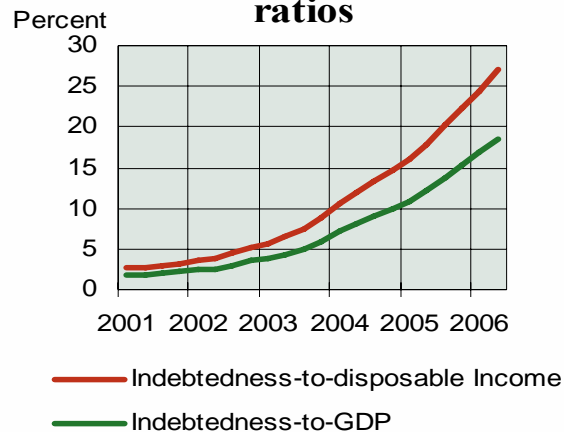
Source: Bank of Lithuania

Credit growth has peaked, but remains strong.

Household indebtedness is rising fast, however, stays well below the the euro area levels

Therefore robust credit growth could continue for some time

Households' indebtedness ratios



Source: Estimates of the Bank of Lithuania

Households' indebtedness ratios in percent of GDP (source: ECB 2005):

- the euro area - 54
- UK - 100
- US - 80



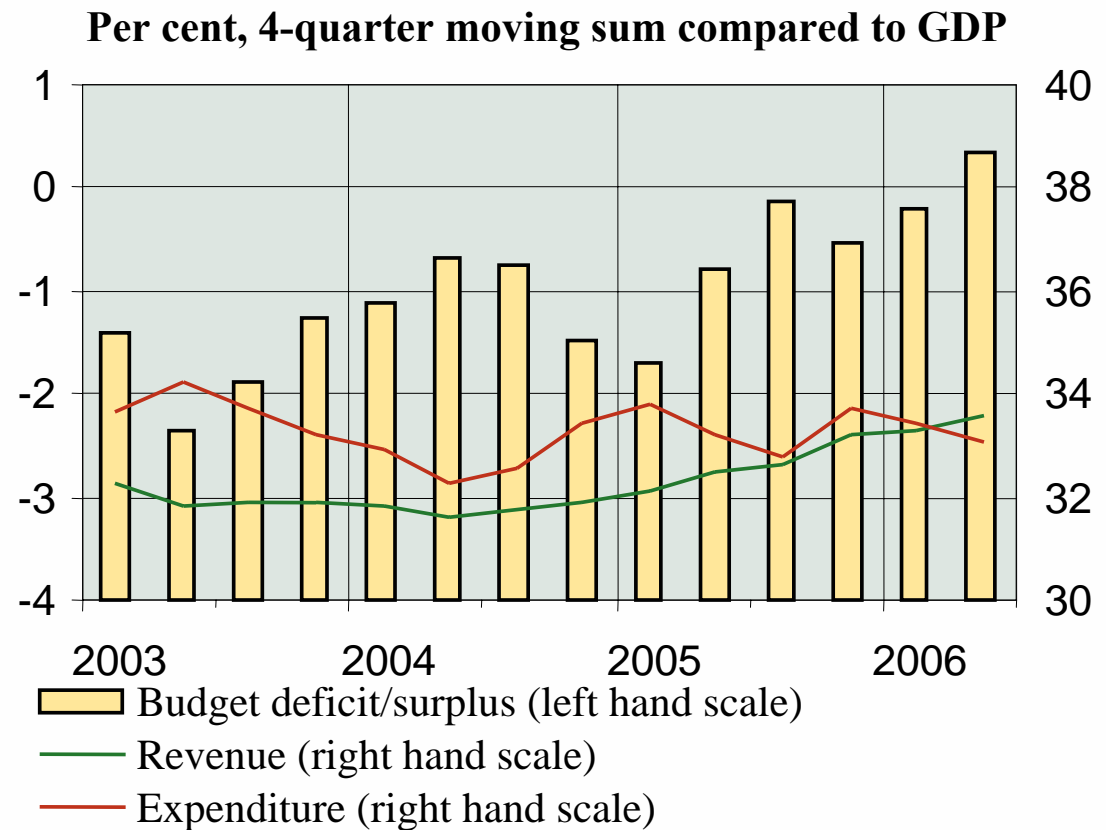
IV. Fulfilling Maastricht criteria (1)

	Definition	Current ref. value	Lithuania (2006 / 09)
Exchange rate	Normal fluctuation margins ($\pm 15\%$) without severe tensions were respected (for at least 2 years)	3.4528\pm 15%	3.4528 Participant in ERM II for more than 2 years
Debt	Ratio of government debt to GDP does not exceed the reference value	60%	17.5%
Budget deficit	Ratio of government deficit to GDP does not exceed the reference value	3%	+0.4% Q2
Long-term interest rate	Average long-term interest rate does not exceed the rate of 3 best performing (in term of price stability) member states +2 p.p.	6.1%	3.9%
Inflation	Average inflation over 1 year does not exceed the rate of 3 best performing member states +1.5 p.p.	2.8%	3.5%

IV. Fulfilling Maastricht criteria (2)



Fiscal stability criteria are being fulfilled within comfortable margins



Sources: Statistics Lithuania and calculation of the Bank of Lithuania



IV. Fulfilling Maastricht criteria (3)

Strong economic performance and careful fiscal policy led to continued upgrade of Lithuania's sovereign debt ratings...

Date of rating action	Long-term rating / outlook		Short-term rating	
	Foreign currency	Local currency	Foreign currency	Local currency
MOODY'S				
2006 09	A2 / neutr.	A2	P-1	
2003 12	A3 / pos	A3	P-2	-
2003 03	Baa1 / pos	Baa1	-	-
2002 11	Baa1 / neutr	Baa1	-	-
2002 02	Ba1 / pos	Baa1	-	-
STANDARD & POOR'S				
2006 05	A / neutr	A	A-1	A-1
2005 12	A / pos	A	A-1	A-1
2005 02	A- / pos	A-	A-2	A-2
2004 02	A- / neutr	A-	A-2	A-2
2003 07	BBB+ / pos	A-	A-2	A-2
2003 02	BBB+ / neutr	A-	A-2	A-2
2002 04	BBB / neutr	BBB+	A-3	A-2
FITCH RATINGS				
2006 10	A / neutr	A+	F1	-
2005 02	A-/pos	A	F2	-
2004 07	A-/pos	A	F2	-
2004 01	BBB+ / pos	A	F2	-
2003 11	BBB / pos	A-	F3	-
2002 12	BBB / neutr	A-	F3	-
2002 02	BBB- / pos	BBB+	F3	-

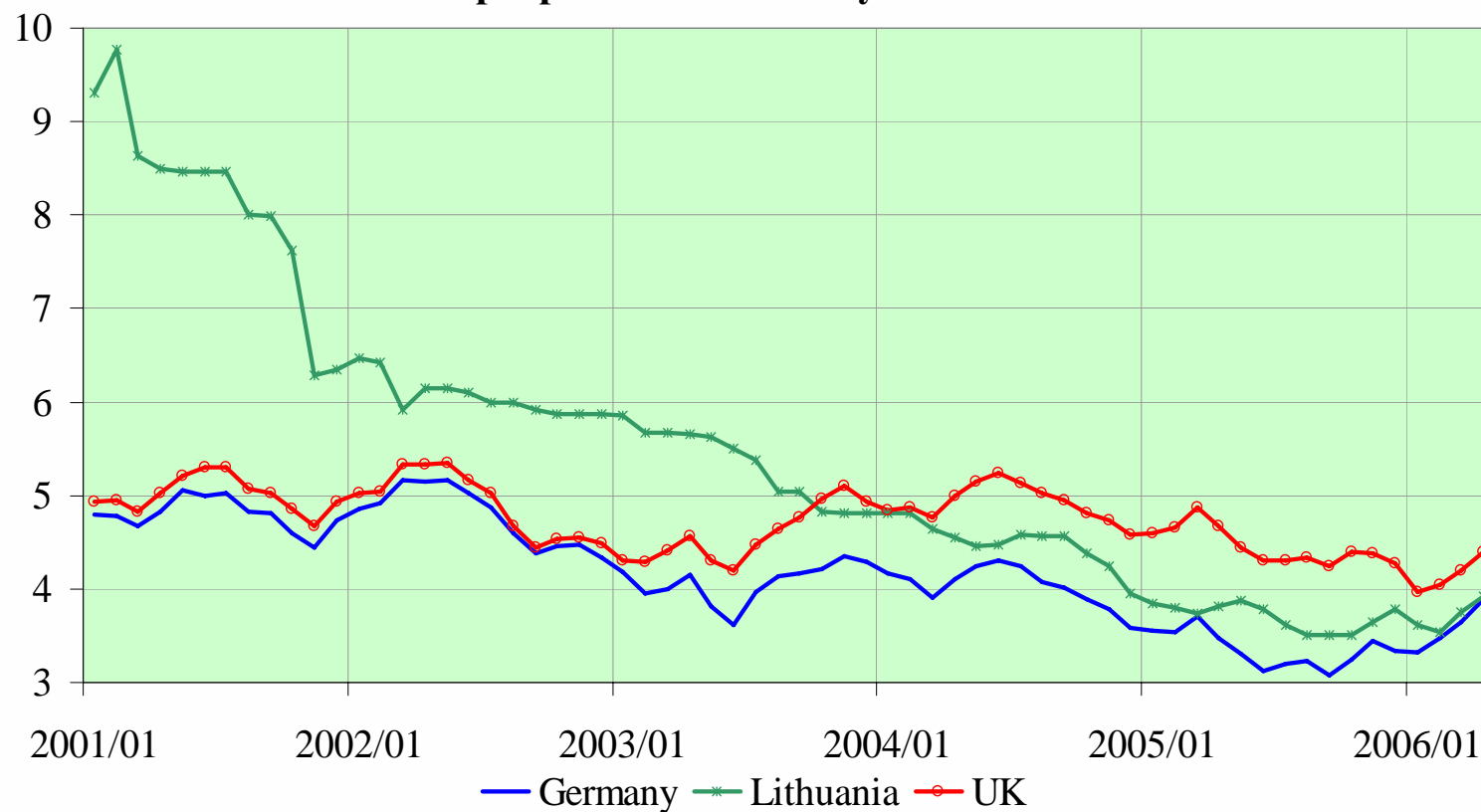
Source: Ministry of Finance

IV. Fulfilling Maastricht criteria (4)

... and falling spreads



Harmonised long-term interest rates for convergence assessment purposes calculated by the ECB*



* The monthly average interest rates for long-term government bonds issued by each country quoted as percentages per annum. For description, see <http://www.ecb.int/stats/money/long/html/index.en.html#data>

IV. Fulfilling Maastricht criteria (5)

All Maastricht criteria for joining the euro area have been met except price stability criterion. This spring the European Commission and the ECB concluded that price stability criterion was missed by only 0.1 percentage point, thus Lithuania missed historic opportunity to join the euro area from January 2007

Main challenges in meeting price stability criterion:

- Lithuania's commitment to raise excise taxes to the EU level over the next couple of years complicates the containing of inflation in a short period
- Economy is growing above its long-term growth potential, therefore putting additional stress on growth of prices
- Given the fixed exchange rate, the convergence of price level should be achieved mostly through higher inflation in Lithuania compared with the the euro area, therefore adding to the inflationary pressures
- Tightening labour market leads to growth of nominal wages
- Increases in natural gas prices by Russian suppliers could have negative effect on price stability



IV. Fulfilling Maastricht criteria (6)

Measures to maintain price stability:

1. Careful phasing of increases in excise taxes
2. Tightening fiscal policy
3. Maintaining flexible labour market to avoid automatic wage indexation

V. Conclusions

- The economic policies pursued by Lithuania laid down sound macroeconomic foundations for the adoption of the euro. High degree of openness of the economy, expanding trade with the euro area countries, relative wage and labour market flexibility, and increasing integration of domestic financial sector allow it to absorb economic shocks without currency devaluations, and together with sound public finance policy prove that country's economy is ready for the euro
- Markets have not perceived a postponement of the euro adoption as a major economic setback. Lithuania remains one of the front running candidates for the early adoption of euro
- Fast economic convergence poses a challenge for meeting of the Maastricht inflation criterion, but careful phasing of tax policy measures, tighter fiscal position should help to pave the way to the adoption of the euro



Thank you for your attention