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TOWARDS SUSTAINABLE ECONOMIC CONVERGENCE: COMPARATIVE ANALYSIS OF MACROECONOMIC SITUATION IN LITHUANIA, NEW AND OLD EURO ZONE COUNTRIES

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─Abstract ─

This article represents the study of macroeconomic dynamics of Lithuania in 2004 - 2010, new (Slovakia and Estonia) and old Euro zone members. It was found that some countries had furiously tried to improve macroeconomic situation before introduction of the euro. When countries switched to, euro has been suspended due to extensive measures to improve economic situation. It was also found that in Estonian case the convergence was coherent and after switching to euro zone, economy of this country escaped the disruptive changes. This study is important not only for economic countries' analyses but also for Lithuania and other countries which seek to introduce euro in the coming years.

Key Words: criteria of the Maastricht agreement, Euro zone, sustainable convergence.

JEL Classification: E42 - Government and Monetary System.

1. INTRODUCTION

Euro – one of the most world currencies which fluctuation depend on economic changes and from the year 2011 it is used by 17 Euro zone countries. The financial crisis that started at the end of the year 2007 pointed the Euro zone problems: expansion of common currency was created regardless of great differences between its members, hoping that common currency will help to offset those imperfections. Twelve years ago the European Union was not so strict in evaluating convergence indexes of countries. Countries such as Greece or Italy have never approached to the Maastricht criterion do not have higher than 60% GDP of public debt**.** Over the past few years new members had to encounter to scrupulous requirements of the Maastricht criterion – in summer 2006 Lithuania was not accepted due to one tenth per cent overrun inflation rate. A financial management strategy, suitable for Germany which was touched by crisis easily, as it happens, completely does not fit for the Euro zone ‘weak link’ balancing near the brink of bankruptcy. Therefore, further euro fluctuation in the year 2011 is an inevitable reality. In spite of it, euro is an objective of Lithuania and other European Union countries.

The statistics show that over the past two years, Lithuania’s economy moved further away from its objective, but economists and government representatives say that in the year 2011 – 2013 indexes satisfying Maastricht criterion should improve while many analysts predict that Lithuania will be ready to join common currency from the year 2014.

Government securities which were sold in the market last year showed, that membership in the Euro zone does not guarantee benefits for its members. For example, at the beginning of this year when Greece was considered riskier than Lithuania, it spread its bonds’ emission for lower interests than the government of Lithuania managed to do. However in the autumn, investors realized that Lithuania is more reliable therefore it got better terms for borrowing. Thus, you can’t adopt euro only if you want it. Euro is a set of certain financial rules which enables strong management of public sector, effectively using public finances. This means is good to ensure countries economical sustainability.

In recent years the European Union countries, one by one, experience financial difficulties, but timely solution of these problems, keeping of liability and purposefully controlled interest rates by the European Central bank allows us to think, that euro is a trustworthy currency.

Despite rather strict conditions of the Maastricht criterion, there are many countries wishing to join the euro ‘club’; however the way these countries have to overcome is different due to various initial conditions, economic development, government decisions and gained experience in dealing with existing problems. Therefore it is important to analyse other countries’ reached goal – adoption of euro – development of economic situation and to take adequate solutions.

2. COUNTRIES' JOINING THE EURO ZONE ASSESSMENT CRITERIONS

Currently eight European Union countries members have a reservation of possibility to join the Euro zone. They are: Bulgaria, Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. In the European Union article 140 1st parts is required that commission and ECB or countries members which have a request, would inform the Council about countries members' progress in their commitment to participate in economic and monetary union.

Sustainability of convergence is evaluated by analysing and comparing stability of prices, discipline of the government budget, sustainability of the capital market, policy and development of exchange rate with normative indexes (Montvilaitė, Ruplienė, 2008). Condition of countries' reaching the convergence of euro is assessed according to Maastricht criterion, in 1992 adopted by the representatives of the EU countries. So, every country reaching to become competent member of the EU and wanting to join the euro zone, have to correspond to Maastricht agreement convergence indexes, which, according to T. Ganusauskas (2001) are:

1. The inflation rate of member one year before it is checked shouldn‘t be more than 1,5% higher than the average inflation rate reached by three members which have the most stable prices i.e. inflation rate is the lowest.

2. Government finance. Annual government deficit, whether, it‘s planned or real shouldn‘t be higher than 3% of GDP. Only exceptional and temporary excesses would be granted for exceptional cases.

Debt of government sector shouldn't be higher than 60% GDP, except cases when this proportion is very small and is approaching an auditoria dimension.

These two indexes best reflect country's financial sustainability.

3. Exchange rate of the member, not less than two years before evaluating it shouldn‘t overpass nominal currency rate balancing limits of European money system. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. Especially it‘s important that the member during this period wouldn‘t devalue the main currency rate regarding other member currency.

4. One year before evaluating the member, its average nominal long-term

interest rate shouldn‘t be higher than 2 interest-bearing items for the three members, where prices are the most stable, average long-term interest rate.

There‘s an opinion that Maastricht indexes describe countries nominal convergence. According to C. Scheinert (2004) the first three requirements are defined with the nominal dimensions. By applying these requirements countries which do not try hard enough to keep the stability of prices, are forbidden to become competent EMU (European money union) members. After becoming them they would encounter export competitive ability problems. Government has these requirements for the state of budget (deficit and debt) to check countries' readiness to hold lasting fiscal policy.

At least once in two years countries members' progress is assessed in carrying out their commitments to participate in economic and monetary union. It is also evaluated how national legislation, including regulation of national central bank, corresponds the treaty's 130 and 131 articles functioning in the EU, European System of Central Banks (ECBS) and the regulation of the ECB.

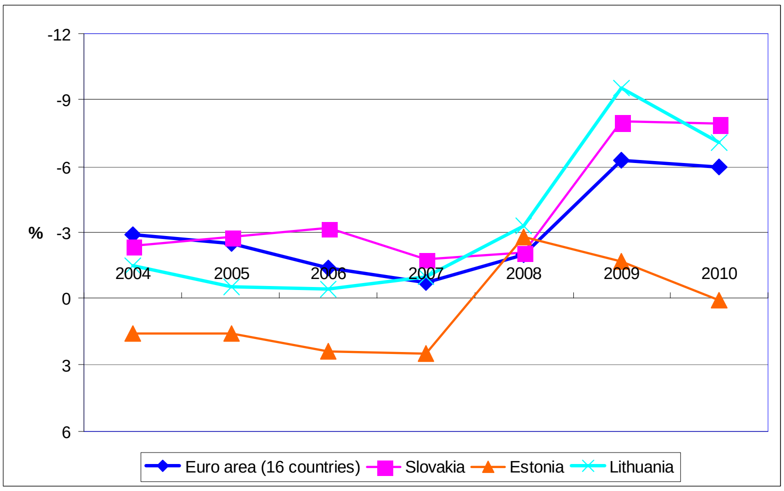
We can also imply that indexes of convergence can be kept as means which help to increase homogeneity of economic system, but research Euro zone countries last year's financial difficulties suggest that monetary integration can be successfully implemented in countries with similar economical and farm maturity. Some countries find it difficult to reach Maastricht criterion, but the right choice of proper means enable to reduce public debt, ‚control' inflation and reach financial stability.

3. EURO ZONE COUNTRIES AND LITHUANIA CONVERGENCE SUSTAINABILITY CHANGES IN THE YEAR 2004 – 2010

16 Euro zone countries were selected for analysis, and also separately analysed two countries the latest adopted euro (Slovakia and Estonia) and Lithuania's convergence indexes. The period of analysis (2004 – 2010) is important not only for Lithuania but for Euro zone countries aiming for euro or encountering financial difficulties. In the year 2004 ten countries joined the European Union, but only in five of them euro became the official currency. Efforts of these countries aiming for euro gave different results: the first to adopt euro was Slovenia (2007), later, in 2008, Cyprus and Malta and in 2009 Slovakia joined them. Estonia adopted euro on January 1st, in 2011. Economic boom and recession periods were natural for this time, when countries' macro economical indexes

grew rapidly or declined. According to EUROSTAT data, in the year 2004 – 2008 Euro zone countries' GDP average growth rate was 2, 45 per cent. New Euro zone countries' economy grew much faster: from 5, 25 per cent (Slovenia) to 8,525 per cent (Estonia). However, the decline of GDP in these countries, in the year 2008 – 2009, also was much higher, e.g. in all 16 Euro zone countries GDP fell averagely 1, 85 per cent, while in Estonia slowdown reached 9,5 per cent. Although changes in GDP do not refer to the convergence sustainability indexes and, as the analysis show, have no direct impact on countries' preparation aiming for euro, but this period is marked by new economic challenges which influenced the adoption of important decisions. Slowing economy caused less income to the national budget, wages decreased; increased unemployment required an urgent solution of social problems and the reduction of expenses in public sector. This had a direct impact on national budgets. In this position Euro zone countries handled it perfectly in the year 2004 – 2007 when their budget deficit was below or slightly higher than 3 per cent, but in the year 2008 – 2010 only Estonia managed to keep this index in the requested limit (fig.-1), by applying appropriate financial management.

Figure-1. Euro zone countries and Lithuania's Annual government deficit in the year 2004 – 2010.



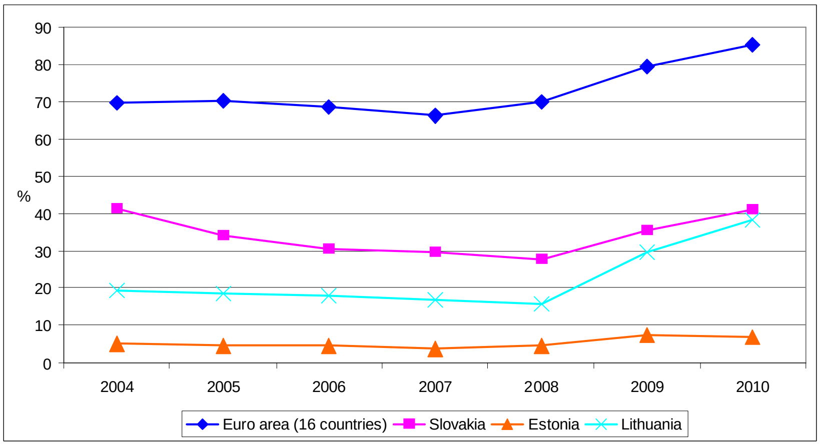
Source: EUROSTAT data.

Governmental enterprises dividend's transferring to the budget increase of VAT and other taxes, cuts on budget expenses and on public debt serving, ensured the reduction rate in 2009 from almost 10 per cent at the beginning of the year to 2 per cent at the end of the year. Other Euro zone countries had 3, 2 per cent excessive deficit. Lithuania budget's deficit in 2008 rose to 3, 2 per cent from

GDP and in 2009 – to 9, 5 per cent, though significant fiscal consolidation measures were taken. In the year 2010 all analysed countries' budgets declined. That trend should continue, but Lithuania's ambition, in 2014, to adopt euro will require substantial effort managing public finances in order to reach 3 per cent fiscal deficit from GDP controlled level.

Sustainability of economic convergence is evaluated due to the general government debt. This criterion is related to the index of budget deficit and reflects countries' financial state. There's a paradox in assessing Euro zone countries debt's dynamics: old Euro zone members' countries debt is significantly higher than the new ones or Lithuania's (fig.-2). In the year 2011 Belgium, Italy, Ireland, Greece and Portugal's debts reach 100 per cent these countries' GDP.

Figure-2. Euro zone countries and Lithuania's government debt in the year 2004 – 2010.

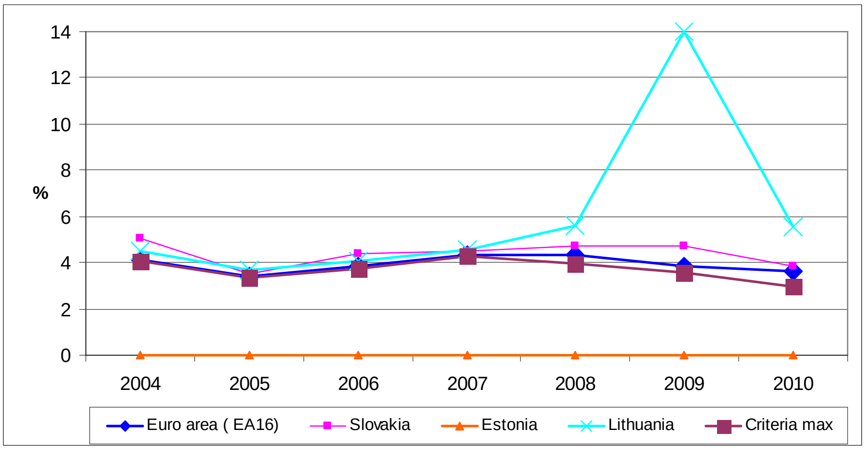


Source: EUROSTAT data.

This situation causes many problems not only in the Euro zone but also in the entire European Union. Lithuania and new Euro zone countries still have 10 – 20 per cent 'reserve' that can melt very quickly if they won't manage to balance national budget's deficit.

Estonia's public debt over the analysis period did not exceed 10 per cent GDP and during recession it has increased just 2, 2 per cent. Such situation has been sealed not only by the reduction of public – sector expenses, but during the period of economic growth accumulated financial reserve which guaranteed country's economic independence and savings without any costly loans. Lithuania initiated different solution and in the year 2004 – 2008 there was a decline in public debt, in 2010, debt increased to 38, 2 per cent GDP, due to expensive credits in foreign capital markets (fig.-3). It is predicted that the current account deficit and general government debt continue to grow, and this can cause problems seeking membership in the Euro zone.

Figure-3. Euro zone countries and Lithuania's long – term interest rates in the year 2004 – 2010.



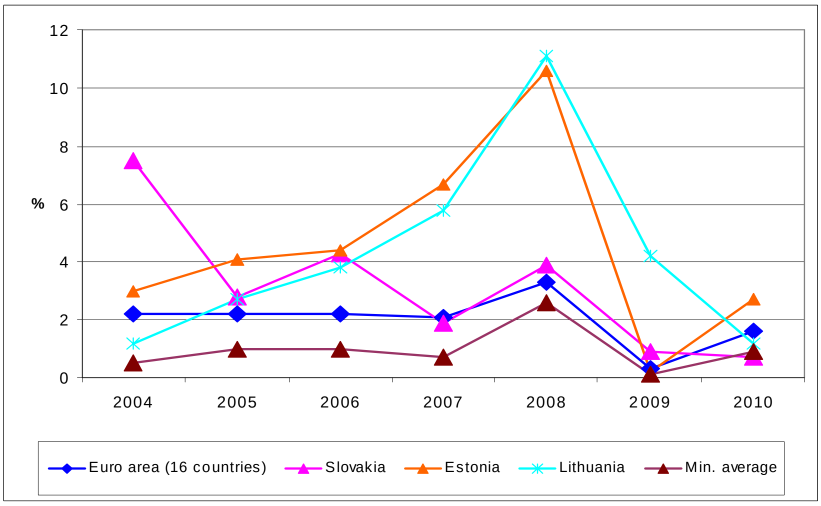
Source: EUROSTAT data.

Long-term interest rates reflect country's convergence, its participation and sustainability in the exchange rate mechanism. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. In the year 2009, in analysis period, only Lithuania exceeded this indicator's control value (6%). Global financial crisis damaged Lithuania's external financing: there was a decrease in country's commercial transactions and as a consequence increased risk of taking loans rose up interest rates. In the year 2010 situation stabilized and higher level borrowing ratings were set for the country. Recovering economy in all countries reduces the risk of borrowing and at the same time interest rates of lending, but previous debt service for Lithuania increased the need of borrowing much more.

Lithuania's economy is very open and highly integrated into the European Union. There are particularly strong trade and investment ties with other countries members while Lithuania's financial system is very integrated into the European Union's financial system. For low – volume consumer market and fixed exchange rate, Lithuania could not improve its economic situation flexibly responding to the external changes. Estonia, over the period of analysis, faced similar problems, but because of low public debt, practically avoided the effect of interest rate changes for its economy.

One of the most pressing problems in the Euro zone despite of countries growing debt is inflation. This convergence criterion, during the period of analysis, changed irregularly and all Euro zone countries exceeded their control value (fig.-4). Standard declension of this index from the average, which is close to 3 per cent, showed that countries had problems to control inflation. In the year 2010 inflation reference value was 1 per cent, and tolerated declension – 1, 5 per cent.

Figure-4. Euro zone countries and Lithuania's inflation rates in the year 2004 – 2010.



Source: EUROSTAT data.

Therefore, we can imply that neither new Euro zone countries nor Lithuania, in the long period, corresponded to this criterion, although in different year's countries were able to control inflation. For example, Slovakia managed to embody Maastricht inflation requirement at the beginning of 2008, i.e. in the period of economic recovery, however for this aim Slovakia revaluated its national currency more than once. Lithuania did not have such opportunity as it is involved in the currency board model and national currency (Litas) exchange rate is linked to euro.

Inflation rate in Estonia in the period 2004 – 2007 was higher than in Lithuania, but in this case there was made an appropriate solution to use lower prices due to economic decline. Pricing and flexibility of wage – setting processes ensured the equivalence of inflation criterion in this country in 2009. Lithuania, one might say, did not use this situation due to fall of inner market in the period of decline and consumption structure: population's consumption basket of foodstuff and other essential goods accounted for almost twice more than in Euro zone - 26,6%

and 15,4%, but their prices did not decline or just declined slightly. Other goods (not for daily use) with reduced prices did not encourage their demand, that's why inflation index in 2009 exceeded the control level. Thus, these countries now have to solve different problems: for Estonia it is important to ensure further stability of prices, while Lithuania should pay more attention to products pricing, promotion of the demand and regulation of public debt.

4. CONCLUSION

Global financial crisis and recession changed rapid economic growth and economic development in many countries. European Union governments had to make important decisions to uphold financial stability and solvency. This situation left some marks for countries wanting to adopt euro: some of them, like Slovakia and Estonia, applied relevant financial regulations and coherent saving, ensured the compliance of convergence criteria and adopted euro. Unsuccessfully trying to adopt euro in 2006, Lithuania is still pursuing its goal, but economic downturn increased long – term interest rates and uncontrolled inflation delayed the membership in the Euro zone. Old Euro zone countries, also, did not escape financial problems – a threatening increase of national debt demanded immediate appliance of fiscal consolidation measures.

In the future, countries will have to deal with different levels of goals: for new Euro zone countries it is important to ensure further stability of prices and sustainability of low inflation; old Euro zone countries will have to make decisions enhancing fiscal responsibility discipline of countries members in order to reduce public debt; Lithuania and other countries seeking for euro will have to pursue responsible budget and fiscal policy reaching for equivalence of convergence criterion.

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