Rūta Kropienė, Stasys Kropas, Arūnas Dulkys*
University of Vilnius

The Problem of Asymmetry in Euro Area Enlargement

In May 2006, the European Commission and European Central Bank assessed, at the request of Lithuania, the convergence progress of the Republic of Lithuania and stated that the country fails to meet the convergence criterion for price stability. Thus, the country had to abandon the plans to join the euro area membership from early 2007. The reason for the negative assessment was that the annual average inflation rate in Lithuania measured as the Harmonised Index of Consumer Prices (HICP) was just slightly above the reference value of criterion for price stability defined in the Maastricht Treaty. Such a decision revealed some problems and new features of the euro area enlargement, which were not observed while creating the euro zone. This drew the attention of many economists and political experts of the European Union, which led to in-depth discussions on various issues of the euro area enlargement.

The authors suggest the hypothesis that the asymmetry in the actual convergence level and political power of the states, which is much higher than that while creating the euro area, results in uncertainty as to the enlargement with respect to some countries. This article aims to discuss the major problems in relation to the current euro area enlargement process and their consequences. At the outset, the authors analyze the features of the asymmetry of the euro area enlargement and political economy highlighting their essential differences at the time of the creation of the euro area and now. Then, they present the analysis of the institutional framework of the euro area enlargement, which was formed after the largest ever number of new states altogether entered the European Union in 2004, and considers the efficiency of the Exchange Rate Mechanism (ERM) II. Furthermore, the article deals with various aspects of the Lithuanian request to assess the convergence progress in anticipation of the positive result and analyses the reasons for and consequences of postponing the expectations for the euro adoption. Finally, it presents general conclusions and proposals as to how the asymmetry matters should be tackled with in pursuit of seamless enlargement of the euro area.

* *Dr. Rūta Kropienė* is an associated professor of Department of Economics, University of Vilnius. Address: Saulėtekio av. 9-2, LT-10222, Vilnius, Lithuania, tel: +370 5 236 61 43, e-mail: ruta.kropiene@ef.vu.lt, website: http://www.kruta.lt; *Dr. Stasys Kropas* is an associated professor of the International Relations and Political Science, University of Vilnius. Address: Vokiečių 10, LT-01130 Vilnius, Lihuania, tel: +37052514142, e-mail: skropas@gmail.com, website: http://www.kropas.lt; *Arūnas Dulkys* is a PhD candidate, Department of Economics, University of Vilnius. Address: Saulėtekio 9-2, Saulėtekio av. 9-2, LT-10222, Vilnius, Lithuania, tel. +370-5-2366147, e-mail: arunas.dulkys@vkontrole.lt

1. Peculiarities of Euro Area Enlargement

The historic EU enlargement in 2004 created a totally new environment with wide-ranging political, economic and social characteristic features. One may ask: how did it affect the euro area enlargement process and what particularities did it contain in comparison to the euro area creation period?

Due to potentially greater benefit, the immediate adoption of the euro is seen by the new EU member states more favourable than it was seen by the states signatories of the euro area at the outset:

- First: the main reason for this is that the well-functioning euro diminished the mistrust of the single currency and doubts about the risks of the euro area effective functioning. With the euro project turning into a success story the possibility to join the project now looks much more attractive.
- Second: it is becoming obvious, that in the integrated global world, more economic benefit and attraction seems to be offered by the so-called marginal monetary models – monetary unions or a fully flexible exchange rate regimes.
- Third: former transition economies now contain a higher exchange rate volatility risk than the euro area states at the time of creation of euro zone, so the adoption of the euro is a particularly attractive way of eliminating this risk.
- Finally, the adoption of the euro increases the potential for integration and benefit from trade development as well as accelerates financial integration and results in potentially faster pace of the economic growth after the euro adoption[1].

Consequently, no sooner had they entered the European Union than almost all new member states declared without hesitation their wish to adopt the euro at the first opportunity after the two years of staying in the ERM II. Many of them, unfortunately, had to significantly postpone the adoption date (Table 1).

Table 1. **Euro adoption dates foreseen and being planned by the new EU member states[2*]**

State, accession to ERM II	November 2004	Septem-ber 2005	October 2006	2007	Monetary regime used
The Czech Republic	2009–2010	1 January 2010	Not identi-fied	2012	Inflation target
Cyprus, 2 May 2005	2007	1 January 2008	1 January 2008	1 January 2008	Fixed rate

[1] Ahearne A., Pisani-Ferry J., „The Euro: Only for the Agile“, *Bruegel policy brief*, 01 02 2006. Schadler S., Drummond P., Kuijs L., Murgasova Z., Elkan R., „Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration“, *IMF Occasional Paper* 234, 2005.

[2*] The table was drawn up with reference to the reports by the European Commission on preparations to introduce the euro and statements by the governments of the countries

Estonia, 8 June 2004	2006–2007	1 January 2007	1 January 2008	2011	Currency board system
Hungary	2009–2010	1 January 2010	Not identified	2012 m.	Inflation target
Latvia, 2 May 2005	1 January 2008	1 January 2008	1 January 2008	2011–2013 m.	Fixed rate
Lithuania, 28 June 2004	1 January 2007	1 January 2007	2010[1*]	1 January 20102**	Currency board system
Malta, 2 May 2005	2008	1 January 2008	1 January 2008	1 January 2008	Fixed rate
Poland	2009	Not identified	Not identified	2012	Inflation target
Slovakia,	1 January 2008	1 January 2009	1 January 2009	1 January 2009	Inflation target
Slovenia, 28 June 2004	1 January 2007	1 January 2007	1 January 2007	Euro adoption on 1 January 2007	

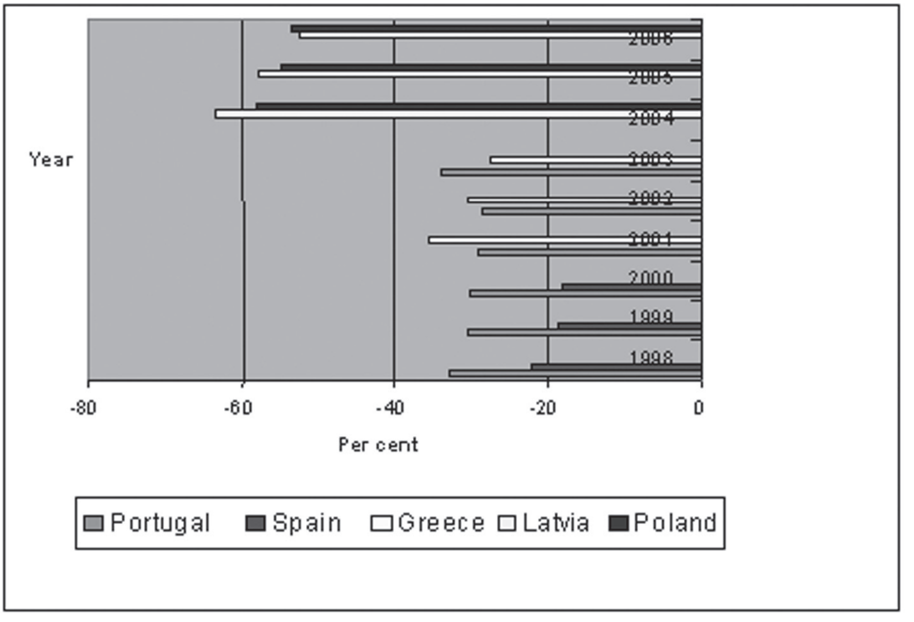
In the same vein, as during the process of creation of the Maastricht Treaty, it is expected that all states of the European Union will have to join the euro area. The Maastricht convergence criteria remained unchanged for all countries joining the euro area. Yet, economic, political and social conditions of the enlargement actually differ if compared to the time when various questions were negotiated and decision was being made as to what countries should first join the euro membership club.

The basic new specific feature of the economics and politics in the enlarged European Union is the increased asymmetry. This problem was among the most discussed issues upon preparations to introduce the single currency, however, a political will was expressed and a consensus was reached not to wait for higher symmetry *ex anti,* but rather achieve it *ex post*[3]*.* The theory of optimum currency areas proclaims that countries willing to set monetary unions must fulfil certain criteria, which predetermine symmetry in external shocks or shakes and the country's capacity to overcome them[4]. Economic shocks must be symmetric and the response of the economy to them must be in a similar vein;

[3]Frankel J. A., Rose A. K. "Is EMU More Justifiable *ex post* than *ex ante*?", *European Economic Review* 41 , 1998, p.753–760.

[4]Mundell R. A., "A Theory of Optimum Currency Areas", *American Economic Review* 51, 1961, p. 657–665.; Mundell R. A., „Uncommon Arguments for Common Currencies" in Johnson H., Swoboda A., eds., *The Economics of Common Currencies*, London: Allen and Unwin, 1973: Kenen P., "The Optimum Currency Area: an Eclectic View" in Mundell R. A., Swoboda A., eds., *Monetary Problems of the International Economy*, Chicago, 1969; Krugman P., „Lessons of Massachusetts for EMU" in Torres F., Giavazzi F., eds., *Adjustment and Growth in the European Monetary Union*, Cambridge: University Press, 1993, p. 241–269; Krugman P., "Lessons of Massachusetts for EMU" in Torres F., Giavazzi F., eds., *Adjustment and Growth in the European Monetary Union*, Cambridge: University Press, 1993, p. 241–269; Alesina A., Barro R., Tenreyro S., "Optimal Currency Areas", *NBER Working Paper* 9702, 2002.

otherwise, symmetric shocks may cause undesirable divergence of the economic development. A higher level of real convergence causes greater asymmetry. Our assessment shows that asymmetry increased markedly following the latest EU enlargement stages (see Figure 1).



Source: Eurostat data

Figure 1. **Gross domestic product per capita; largest negative deviations from the euro area average in per cent**

In the new EU member states affected by the so-called Balassa–Samuelson effect deriving naturally in the course of real convergence, the inflation rate throughout the entire real convergence is normally relatively higher than the average of the euro area states. Since tradable sectors attracting more foreign investments for new technologies record faster labour productivity growth than in sheltered sectors, a rise in the wages affects the increase in the wages in non-tradable sectors. To maintain profit margin in non-tradable sectors, prices should inevitably rise. The impact of the Balassa–Samuelson effect manifests itself in the rise of internal inflation, appreciation of the real exchange rate in respect of the exchange rate as an "anchor" and finally it predetermines the difference in inflation in individual countries. The studies of the International Monetary Fund (IMF) and some other institutions suggest that the Balassa–Samuelson effect may cause under the ERM II conditions an increase in inflation in the new EU member states in the range of 1 – 2 per cent[5]. Other studies show slightly smaller impact[6]. Still, in general, this effect evidently takes on a particular importance, since it influences the fulfilment of price stability criterion. The Balassa–Samuelson effect is a real convergence phenomenon. It shows that a probability of fulfilment of the price stability criterion for the euro adoption is inversely proportional to the level of real convergence.

For some time labour productivity in Lithuanian tradable and non-tradable sectors has been rising in a very similar line, the impact of this effect, therefore, was not of great significance[7]. Its impact, however, has been increasing of late.

As a result, asymmetric shocks may affect the new EU member states to a much greater extent. It only adds to the arguments of real convergence advocates and to the scepticism about the possibility to adopt the euro, since many EU newcomers under the impact of the mentioned effect are, at the same time, in absolutely different phases of the business cycle[8]. Different levels of real convergence and more rapid economic convergence process of countries with lowest income lead to higher growth rate of gross domestic product (GDP) and labour productivity and a little higher level of inflation and current account deficit. Naturally, supporters of this viewpoint tend to think that some regulation of the currency exchange rate is necessary at a certain point with a view to slow down the economic growth. They believe that early membership in the euro area would heavily burden the regulation of economy. These arguments concerning real convergence, though, have not prevented the current euro countries from introducing a single currency. Nor are they diminishing the wish of the states to join the euro area. On the other hand, these arguments are thought to form a sceptical attitude towards the possibilities of the countries with low real income level to join the area[9].

Such opinion prevails not only within academic circles, but it also influences the mind of some decision-takers in the European Central Bank. Jean-Claude Trichet, The president of the ECB, presented a similar position, while visiting Bulgaria in 2006, and warned against entering of some countries the euro area at an insufficient development. Quoting the President, "while it is fully understandable for a young, ambitious and talented sportsperson to want to join the champion's league as soon as possible, this person might

[5] Schadler S., Drummond P., Kuijs L., Murgasova Z., Elkan R., "Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration", *IMF Occasional Paper* 234, 2005.
[6] Balasz E., "Assessing Equilibrium Exchange Rates in CEE Acceding Countries: Can We Have DEER with BEER without FEER? A Critical Survey of the Literature", *Focus on Transition* 2, 2003.
[7] Kuodis R. "Dėl narystės ekonominėje ir pinigų sąjungoje siekiančių šalių valiutos kurso pasirinkimo strategijų" ["On the Choice of the Exchange Rate Strategy by Countries Seeking EMU Membership"], *Pinigų studijos* 1, 2003, p. 5–22 (in Lithuanian).
[8] Babetski J., Boon L., Maurel M., "Exchange Rate Regimes and Supply Shock Asymmetry: the Case of the Accession Countries", *CERGE-EI Working paper* 206, 2003.; Frenkel M., Nickel C., "How Symmetric are the Shocks and the Shock Adjustment Dynamics between the Euro Area and Central and Eastern European Countries?", Washington, D. C.: *IMF Working Paper* 222, December, 2002.
[9] Munchau W., "Monetary Union is not for Poor", *Financial Times*, 29 01 2006.

sometimes be better off taking a bit more time for training in order to further develop and strengthen his talents in a favourable environment."[10]. A similar position has been also expressed by Jürgen Stark, member of the ECB Governing Council[11]. Obviously, the common market of the euro area states will see growing tendencies for specialization, those countries, therefore, will still face asymmetric shocks. The divergence of inflation norms and external positions is likely to carry on regardless of whether a country will or will not join the euro area. New challenges that may emerge in this context will largely depend on the flexibility of the structure of a country's economy.

Unfortunately, based on such arguments concerning real convergence, consideration is not given to the most important features of economic and monetary unions: the economies of their members must be quite flexible in order to reap the benefits of a stable monetary environment. The assumption that economies of states, potential euro area members, are not flexible enough collides with empirical facts. Many new EU member states having adopted the so-called currency board system have not used a nominal effective exchange rate as a means of restoring economic balance, this though long since they successfully retained a high level of competition. So, in the future, this should not be an insurmountable obstacle for these countries[12]. Besides, such an interpretation of real convergence criteria contradicts the logic of economics, for absolutely no analysis is made as to the countries' capability to participate in the area of the single currency. Lithuania's capability to efficiently withstand shocks without using the nominal effective exchange rate is among the strongest economic arguments in favour of Lithuania's successful participation in the euro area. Regrettably, the interpretations give priority to the mechanical application of the formal Maastricht criteria. Due to such interpretations, Lithuania could not expect, even if it meets the criteria, to adopt the euro. It is important; therefore, to seek that for in the future the assessment concerning the capability to participate in the euro area should be more based on the economic logic.

In many cases, the Balassa-Samuelson effect will result in a higher equilibrium inflation rate compared to the average in the euro zone. But in other cases, in trade and telecommunications, this effect will predetermine lower real effective exchange rate. Any way, the divergence of inflation rates does not signify any weakness. Yet, it would be unfair to ignore the fact that the Maastricht criterion for price stability is ever changing in a less homogenous and a more asymmetric European Union and its fulfilment is becoming ever more complicated.

---

[10] Trichet J. C., "Looking at EU and Euro Area Enlargement from a Central Banker's Angle: The Views of the ECB", Speech by President of the European Central Bank, Diplomatic Institute Sofia, 27 02 2006.

[11] Stark J., "Economic and Monetary Policy Challenges of Euro Area Enlargement", Diner speech at Conference the changing landscape of FDI in Europe, Oesterreische Nationalbank, Vienna, 20 11 2006.

[12] Mody A., Rosenberg C., "Why Lithuania and Estonia could Fare Well in Eurozone?", *Financial Times*, 08 02 2006.

2. Changes of the Institutional Framework

The creation of the euro area and recent EU enlargement stages has, in essence, changed the institutional framework of the decision-making process for the euro area. Before the creation of euro zone the institutional arrangements for the politics of the European Union were rather symmetric and economics and finance ministers of member states and heads of national central banks equally represented their countries at the Committee on Economic and Monetary Affairs, Economic and Financial Affairs Council or Ecofin and all other forums. With the appearance of the euro area, the politics of the European Union became asymmetric. Now, the decisive word belongs to the ministers of the euro area states having the possibility to discuss their position in the circle of representatives of the area. In this way, they would have a decisive word in the decision adoption process at the Ecofin, where representatives of the new EU member states are rare guests. Furthermore, being of various i.e. two (full and limited) make-ups and three compositions the Economic and Financial Committee and the Economic and Financial Affairs Council are set up in such a way, that quite often the heads of national central banks cannot efficiently represent their countries when discussions are held on important issues of the euro area enlargement directly pertaining to the state interests. Such a practice notably differs from that at the time of the creation of the euro area, when all economics and finance ministers and governors of national central banks had equal rights in the mentioned forums dealing with the issues of the euro zone. It is more important that heads of national central banks were key architects of the institutional frameworks for the economic and monetary union. The Jacques Delors' Commission, having designed a model of the economic and monetary union, included heads of national central banks from all Community countries. Regrettably, with the adoption of the euro, the competition of some big EU states as well as institutional and political interests, in fact, 'courteously' expelled central bank governors from the intense activities at the Ecofin. In this respect, the selection process for the first euro zone members was an example of symmetric political negotiations, since all voices were equally heard and votes were important. The European Commission could better perform its function as a mediator in safeguarding the interests of the Community as a whole. To the contrary, the euro area enlargement is characterized by an asymmetric system, where the outcome of negotiations or discussions entirely depends on economics and finance ministers of the states of the area.

Before the euro area was created, the EU member states had already experienced a long, almost 50 year period, of monetary integration with certain success and crises. The euro introduction was, by then, the third attempt to build a monetary union after the signature of the Rome Treaty. As a result, the member states were inclined to show more solidarity and flexibility in interpreting the formulations of the Maastricht Treaty. All the more so that most of the criteria and indicators were interpreted for the first time offering, thus, much greater possibilities for manoeuvring in and and accommodation of the interests of the member states the most effective as possible. In addition, the countries then showed more solidarity for many of them expected, for the sake of a common goal, an easier solution of certain economic, political and social issues at home.

Conversely, today's euro area enlargement process actually witnesses a different economic environment. The old member states have undergone a rather lengthy period of high inflation and economic shocks and the euro adoption preconditioned low inflation not merely in the euro zone, but also in other countries of the European Union. Rates of economic growth in individual states markedly differ, so do real income and macroeconomic conditions. The enthusiasm of the current members of the euro area about the enlargement is very different from the eagerness in the last decade, at the time of creation of the area. To be truthful, although the political resolution of the governments in the new EU member states is to adopt the euro is overall, these countries face severe democratic deficit and the support of their citizens for the euro introduction is largely not strong enough.

With the economic and institutional environment conditions changed after the establishment of the euro area, the decision-making process should most importantly retain the content and spirit of the principle of equal treatment with respect to all member states of the European Union. In the Community countries, non-members of the ERM II, the inflation may be affected by asymmetric shocks, including the currency exchange rate movements. In regard to all EU member states, the principle of equal treatment may mean that the candidate countries for the euro area have imposed stricter conditions and more stringent requirements compared to the first members of the area. This was actually, the main obstacle for Lithuania to meet, in a sure and unchallenged manner, the inflation convergence criteria. The assessment being made taking into account the indicators of the three best-performing countries, two of which, namely, Sweden and Poland, are not participating in the ERM II. Consequently, a different interpretation, though, absolutely in the spirit of the Maastricht Treaty, was to expect.

The recent stages of the EU's enlargement also highlighted some differences in the process of the political economy of individual states. One cannot but understand the concern expressed by the big EU countries over the adoption of decisions, which upon the compromise provisions under the Nice Treaty entering into effect turned out to be rather ineffective with their power decreasing in the decision-making process[13]. The big countries, EMU 'signatories', therefore, enhanced the role of the Euro group at the Ecofin and *de facto* took informal power in hand. Practically, the new countries of the European Union are isolated and their participation is limited in the decision-drafting and making process, though *de jure* they are members of the EMU, although with the derogation not to adopt the euro. Robert A. Mundell, founder of the theory of

[13] Baldwin R., Wyplosz C., *The Economics of European Integration*, London: McGraw-Hill, 2006.

optimal currency areas, put forward very sound arguments suggesting that the new countries of the European Union should not be excluded from the EMU development matters[14]. There is irrationality in that the issues of importance to these countries are discussed in their absence. The new member states should be represented at least when matters directly pertaining to them are considered. A constructive dialogue between the new EU member states and Community institutions is also a necessity.

Institutions of the European Union should pursue, by their inherent function, to reduce asymmetries of various types, first of all institutional. Lithuania has been sent by the European Commission, mostly through public relations, adverse signals concerning potential participation in the euro area; regrettably an open dialogue and proposals on the problem solution were missing. Naturally, the European Commission was expected to have figured more prominently taking into account both: the Portugal lessons and experience in the euro adoption. In the 2004 conference held in Portugal, also visited by José M. Barosso, the then Commissar of the European Commission, prof. Anibal Cavako Silva, Prime Minister of Portugal, underscored the vital role of the European Commission in this process. He emphasized that the European Commission was particularly active in defending the interests of the small countries in the context of the euro membership of Portugal[15]. As we know, Lithuania received no such support. Following the negative decision of the institutions of the European Union efforts were made to intensify relations with them by setting up a working group to assist in preparations for the euro adoption. Yet, the group has not demonstrated any particular results so far. In conclusion, one may say that the recent EU enlargement stages spotlighted the transformation of economic and institutional conditions from symmetric to asymmetric with lesser solidarity.

3. Exchange Rate Mechanism II: Is it Really a “Waiting Room”?

The European Union enlargement has significantly added value to the Exchange Rate Mechanism II. Its purpose is to perform two major functions. First and foremost, it is a criterion of currency stability while assessing convergence. Then, this mechanism must be an important instrument for coordination and harmonization of the monetary policy. The number of participating member states has risen to ten. The European Union institutions stress the importance

---

[14] Mundell R. A., ”Exchange Rate Arrangements in Central and Eastern Europe“ in Arndt S., Handler H., Salvatore D., *Eastern Enlargement: the Sooner, the Better?*, Vienna: Austrian Federal Ministry of Economic Affairs and Labor, 2002, p. 168–165.

[15] Cavaco Silva A., ”The Portuguese Experience in the Integration Process“, Special Address at the Millennium Bankers Seminar for the new EU Member States and Candidate Countries, Lisbon, February, 2004.

of participation in the ERM II[16]. These circumstances should encourage the improvement of its operation. Right after the creation of the euro area the only participant in the mechanism was Denmark, and Denmark was not intending to adopt the euro thus far. This essential institutional measure for monetary integration was 'neglected' both in academic and political circles. At the same time, the ERM II, though actually different from the monetary system of the earlier ERM, inherited from the latter some deficiencies and not a very good reputation among finance markets players. At the backstage, the economists often refer to the ERM as a 'waiting room' for the euro adoption.

Economists largely acknowledge that the reason for the crisis of the 1992–1993 ERM was the unwillingness or inability of the states participating in the monetary system to coordinate the economic policy. Currently, the European Union has a sufficient arsenal of monetary policy instruments. Here, the updated Stability and Growth Pact, Lisbon Strategy and Luxemburg Process make up an integral institutional system of coordination and friendly cooperation. Additionally, the European Central Bank also has certain institutional measures. It discusses, twice a year, the report on coordination of monetary policy and once a year the annual report on the ERM II operation. These ECB measures, however, cover only the issues of the monetary policy, while honouring major commitments is within the competence of governments. On an institutional level, these, unfortunately, are not good communicating vessels**.**

The recent experience of the ERM II suggests that possibilities of cooperation and peer pressure are not used to the full. As it concerns Lithuania, the entire two-year period of participation in the ERM II has not actually seen any significant considerations and discussions on carrying out of the commitments assumed upon joining the mechanism or implementation of relevant political measures. What is more, the Lithuanian Government was forced in an effort to present its attitude, to use foreign policy channels in order to present their views to the European Union institutions and governments. In other words, measures of foreign policy dialogue had to be employed, even though this issue is a matter of the EU internal market.

One can hardly wonder then, that with the two successful years in the ERM II past, the assessment in the progress report on convergence, stating that Lithuania failed to comply with the requirement of price stability, was unexpected to some extent. International financial institutions took the prevailing attitude that participation in the ERM II is appropriate only upon sufficient preparations and the euro is very likely to be adopted after two years. In this respect, the successful joining of Lithuania, Slovenia and Estonia to this mechanism has naturally raised positive expectations for a favourable result.

Consideration of various difficulties and the fulfilment of commitments while in the ERM II, should become a relevant element of the entire coordination process of the economic policy. Its participants should form much clearer

[16] ECB, "Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries", 18 12 2003.

expectations and policy recipes, and also enhance the monitoring of monetary integration. It should be, if not more intensive and efficient, at least similar to the prevention programmes developed earlier together with the IMF, when the states now within the ERM II wished such programmes in pursuit of a closer dialogue and benefit from international consulting. It would be appropriate to periodically update the formulations of the commitments. The agreement on the Exchange Rate Mechanism II, which was signed on behalf of Lithuania by the Chairperson of the Board of the Bank of Lithuania and Minister of Finance under the authority of the Government, provides the commitments of our country with their formulation in a very abstract way, declaration form and for the unlimited term. They remained unchanged even after the two years of participation in the mechanism, when new topical issues and problematic areas emerged. Furthermore, no monitoring is provided to ensure proper fulfilment of the commitments and there is no guarantee that even if the commitments were met the country would be 'honoured' with a favourable assessment or at least uniform interpretation of the Maastricht criteria.

The form of the EMR II is not as effective as it could be and really can remind us more of 'a waiting room'. Therefore, it is appropriate to change the current situation in order to prevent the mechanism from further losing its reputation. It is also important to use in a more efficient manner its possibilities to coordinate the monetary policy, and to strengthen the mechanism of monetary integration in the preparations for participation in the euro zone.

4. Postponed Expectations for Euro Adoption: Why and for How Long?

Lithuania's request to assess the convergence progress and interpretation of some assessment moments brought to light many new nuances in the enlargement of the euro area. When preparing a decision, many of them were named more specifically and the discussion in the EU institutions provided answers to numerous questions. Still, there are quite a lot of uncertainties. The logic of assessment and the analysis of the discussion suggest a conclusion that the euro expectations may be postponed not solely for Lithuania, but for other countries applying to the currency board system as well, and this for an indefinite term. The crucial question remaining unanswered is – for how long? We can but regret that the answer to this question is becoming ever more unclear as it was before the convergence assessment. So far, market players have been tolerant towards such indefiniteness. This notwithstanding, the level of such tolerance is obscure and is to be tested in the future.

Although the European Commission used to repeat, that the convergence assessment of Lithuania is more of a technical exercise, the later course of events revealed this to be apparently a coordinated solution of some political type. Joaquin Almunia, European Union Commissioner for Economic and Monetary

Affairs, marked in his address to the Belgian Royal Society for Political Economy on 19 January 2006, that the most important criteria is that of inflation and warned that inflation in Lithuania pursuing the euro area membership is too high[17]. Karl-Heinz Grasser, the Minister of Finance of the then Austrian Presidency, declared at the 23 January 2006 EP Committee of Economy, that the single currency of the euro area will be adopted in 2007 only by Slovenia, while Lithuania will most probably face too high inflation[18]. *Deutsche Bundesbank*, one of the most influential members within the European central bank system, struck another blow for the EU newcomers in its monthly report: it encouraged members not to hurry with the euro area enlargement[19].

The first official signal indicating that Lithuania fails to fulfil the criterion of price stability came from the EU Commissioner Almunia on 22 February 2006[20]. This might have been an expression of the preliminary opinion being formed about the future negative assessment, which caused the wonder on the part of Reinoldijus Šarkinas, Chairperson of the Board of the Bank of Lithuania. He claimed that such assessments were premature, since those and the decision on meeting the price stability criterion by Lithuania should be announced, upon the proposal of the European Commission, by the Ecofin[21]. Based on the experience of positive and transparent cooperation with the IMF, the head of the Bank of Lithuania could not have expected that the decision had already been discussed and formulated in advance, without participation of the Lithuanian representatives and even without offering them possibilities to present their arguments and listen to the opinion of opponents. Eventually, the decision of the Ecofin was strict: Lithuania failed to satisfy the price stability criterion.

Some analysts of the European Union stressed that Lithuania became the first victim of a tougher treatment of criteria for the euro area enlargement[22]. One can but agree with it. Although the inflation rate in Lithuania was officially, at the time of assessment, just slightly (0.07 basis points) higher than the set criterion of price stability, it is obvious that compliance with the same principles applied upon the development of the euro area would have permitted non-infringement of the legal framework of the Maastricht Treaty and adoption of the decision in favour of Lithuania. One may say that if the assessment of the fulfilment of the Maastricht criteria were that strict, as it was in respect to Lithuania, many of the current states would not enjoy the euro membership.

---

[17] AFP-BNS, *Lietuva ir Estija nevykdo Mastrichto kriterijų, perspėja ES komisaras* [*Lithuania and Estonia does not Meet Mastricht Criteria, Warns the EU Commissioner*], 20 01 2006 (in Lithuanian).

[18] Reuters-ELTA, *K. H. Graseris: Estijos ir Lietuvos infliacija greičiausiai bus per didelė įsivesti eurą* [*K. H. Graser: Excessive Inflation in Estonia and Lithuania is Expected to Prevent the Euro Introduction*], 24 01 2006 (in Lithuanian).

[19] BNS, *Vokietijos centrinis bankas ragina neskubėti plėsti euro zonos* [*Germany's Central Bank Urges not to Hurry with the Extension of the Euro Zone*, 24 01 2006 (in Lithuanian).

[20] Komisaras J. Almunia: "Lietuva neatitinka infliacijos kriterijų" ["Lithuania does not Meet Inflation Criteria"], *Respublika,* 23 02 2006 (Based on the press conference of 22 February 2006) (in Lithuanian).

[21] "R. Šarkinas eurokomisaro vertinimą vadina neetišku" ["R. Šarkinas Considers the Euro-Commissioner's Assessment to be Unethical"], *Lietuvos aidas*, 25 02 2006 (in Lithuanian).

[22] "Lithuania Set to Become Victim of Tough EU Single Currency Stance", *Financial Times*, 13 03 2006.

Before the request to assess the convergence progress was submitted, it had been underlined not once that inflation in Lithuania, in respect of the criterion, will be higher or lower (in terms of figures) very slightly, the difference being as small as hundredths. The inflation in March 2006 in our state made up 2.63 per cent, while the inflation stability criterion was 2.72 per cent. Lithuanian representatives put forward arguments not without reason that the country would satisfy the price stability criterion, if paradoxically as it may sound, we used more precise calculation methods. If a more exact rounding-off mechanism were applied and the lowest inflation in the three member states were calculated in hundredths percent and, in rounding-off, merely its average would be computed, the inflation in Lithuania would run at 2.66 per cent and would not exceed the criterion[23].

Of course this would be a different, yet a more accurate, assessment method as has been used up till now. However, this was also the first case in the history of the European Union, when the difference in the figure values was so insignificant that it would be absolutely lawful to employ a more exact assessment method. On the other hand, there were quite numerous possibilities for manoeuvring both upon identifying the states with the lowest inflation and in interpreting the definition of the lowest inflation. The first indent of Article 121(1) of the Treaty, establishing the European Community expands on this issue as follows: the achievement of a high degree of price stability "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"[24].

A precedent was created when Lithuania in the 2004 progress report on convergence stating 0.2 per cent negative inflation was considered as an "outlier", an exception. A very low inflation, even if it fulfils the criterion of price stability, is not regarded as a good performance. Given the argumented critique of analysts, the Governing Council of the ECB revised the objective of the monetary policy and set a target to retain inflation below, but close to 2 per cent. In case of Lithuania, the reference inflation level was influenced by the choice of Sweden as one of the best performing country. But Sweden participates neither in the euro area nor ERM II. Its inflation level was below 1 per cent. Sweden, therefore, pursuing price stability, compromised its own target, the lowest limit of inflation tolerance. Keeping in mind the fact that Sweden is applying the inflation-targeting monetary policy regime, it is difficult to assess inflation in the country as the best result in terms of price stability. Besides, the inflation criterion should not necessarily mean the average inflation of the best performing countries, even if such practice prevailed before. Finally, quoting the explicit opinion of the Lithuanian institutions, a much better assessment period would have been April rather than March. It is difficult to explain the fact that the progress report on convergence was announced just one day be-

[23] Krikščiūnas R., "Enlargement of the Euro Zone – Why and When for Lithuania?", Brussels: Center for European policy studies, 10 05 2006.
[24] *Europos Bendrijos steigimo sutartis* [*Treaty Establishing the European Community*], Art. 121.

fore the inflation figures of the EU member states in April were released. And they showed that the criterion for price stability went up to 2.7 per cent. Then, Lithuania has fully satisfied the price stability criterion. In this way, we see that the Maastricht Treaty allows some freedom for interpretation in defining the lowest inflation and in case of Lithuania this could have come in handy.

In interpretation of criteria fulfilment, a solidarity aspect is very important. Certainly, new countries could not have expected less demanding requirements; yet, imposing requirements stricter than those for the current euro area members came as a surprise for the many. If such criteria had been set for the old states, the European Union could scarcely now enjoy the primary public good, namely a single currency, the euro. Many current members of the euro zone felt the great solidarity demonstrated by the fellow countries: Italy and Belgium were allowed to adopt the euro, even though their level of debt exceeded the 100 per cent GDP; France and Germany offered each other particularly substantial political concession in an effort to meet not only the membership criteria, but also domestic requirements of political powers; Italy and Finland adopted the euro having participated in the ERM for less than the required two years; Greece was given a favourable decision regardless of its submission of incorrect data on the budget deficit. Yet, the most significant concessions were won then due to the solidarity of the countries, candidates to the euro area, undertaking a liberal assessment of fulfilment measures for the budget deficit criterion. There was not the slightest idea about a stricter assessment of the sustainability in respect of this factor. It is no wonder then that after the adoption of the euro, this led to chronic non-compliance with the budget deficit criteria by many states.

Accordingly, a closer analysis of the assessment of the evaluation in regards to the ability to fulfil the inflation criterion in Lithuania suggests a conclusion that there were quite good possibilities to give the situation a favourable interpretation also complying with the all legal requirements of the European Union. In the spirit of the Maastricht Treaty and sticking to the principles of equal treatment and solidarity of the states that have long been declared till now, it would have been just to make a positive decision concerning the Lithuanian membership in the euro area, even more so, that the country has fulfilled, fully and unquestionably, all other economic and legal convergence criteria.

What is more important, it might have been the first time that the decision-making process included the aspect of sustainability of inflation. In other words, a new component of the criterion for price stability appeared which was not applied for the states, founders of the euro area. Much about fulfilment and sustainability of some criteria is suggested by our assessment presented in Table 2. It shows the time the euro members had been fulfilling convergence criteria.

Table 2. **Time (in per cent) of fulfilment of the Maastricht criteria by the member states of the euro area in 1999–2006**[25]

State	Price stability	Budget deficit	Debt of state sector	Interest rates
Austria	100	100	0	100
Belgium	91	100	0	100
Finland	88	100	100	100
France	92	43	57	100
Germany	100	43	14	100
Greece	6	14	0	100
Italy	73	43	0	100
Ireland	28	100	100	100
Luxemburg	46	100	100	100
Netherlands	65	100	0	100
Portugal	30	71	86	100
Spain	23	100	71	100

The table shows that none of the countries having adopted the euro fulfilled of all of the convergence criteria throughout the period of the adoption of the single currency. Still, following the economic logic, one must agree that this is not needed. Rimvydas Baltaduonis and Marius Jurgilas, young scientists of Lithuania, while analyzing a hypothetical monetary union proved that some regions in the USA would not have satisfied convergence criteria throughout the entire period between 1997 and 2005[26].

The convergence report of December 2006 interprets the meeting of the criterion of inflation sustainability as follows: "The requirement of sustainability implies that a satisfactory inflation performance must essentially be achieved by the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflect the influence of temporary factors. Therefore, the convergence examination includes an assessment of the underlying factors of inflation and of medium-term prospects. It is also assessed whether the country is likely to meet the reference value in the months ahead."[27] The Maastricht Treaty does not provide a precise definition of the concept of inflation sustainability. It does not clarify the period (in respect of both - the past and future) acceptable in terms of sustainability and it raises the issue of applying the sustainability principle also when identifying states with

[25] Authors' calculations based on Eurostat data

[26] Baltaduonis R., Jurgilas M., "Lithuania and the Euro", Presentation, Department of Economics. University of Connecticut, 02 05 2006, http://www.sp.uconn.edu/~rib01002/LTeuro.pdf, 30 04 2007.

[27] Commission of the European Communities, "Convergence Report December 2006 (COM 762)", EUR-Lex. http://eur-lex.europa.eu/lt/prep/index.htm, 03 05 2007.

the lowest inflation. Most probably, it should apply symmetrically meaning in respect to a country under assessment and reference countries.

Though assessment of sustainability is quite a subjective process, it becomes a legal argument when deciding on the euro adoption. Such interpretation of the criterion of price stability poses very serious challenges for the states that have adopted a currency board system and have been taken hostage by an existing unfavourable environment. The strategy of a fixed exchange rate strategy chosen by Lithuania, also by Estonia and Bulgaria, and implemented in a form of a currency board contributed to stabilization of the macroeconomic situation and inflation expectations. A transparent transition of litas from the US dollar peg to the euro allowed a struggling to achieve inflation convergence with other euro area countries. The specifics of a currency board system do not allow making use of any possibilities of exchange rate fluctuations trying to affect the inflation factor for a longer period and slightly strengthening the national exchange rate. Thus, these countries have little option to fulfil the price stability criterion interpreted in this way. Such a moment in all likelihood may not come before the end of the real convergence, that is, more than one decade[28]. The longer Lithuania stays out of the euro zone, the stronger the probability that shocks with adverse influence or unfavourable one-off economic changes will unreasonably even more alienate the country from participation in the euro area. On the other hand, staying outside the boundaries of the euro area increases the inflation risk. At present, the difference between the perceived and real inflation in Lithuania, is among the highest in the European Union[29]. It is partly explainable through the fact that the perception of the price growth relating to the euro adoption is based on the examples of the euro area countries. The prevailing public opinion in European Union countries is that the euro adoption raises the prices.

Such interpretation of criteria fulfilment does not take into account the specifics of a currency board system. The states, founders of the euro area, used the exchange rate to a great extent as an important means of coordination with respect to the convergence process. Naturally, specialists from these countries and bureaucracy from the European Union institutions consider that only the convergence process can provide conditions for a natural equilibrium level of a nominal exchange rate, while certain fluctuation can contribute to easier achievement of the required price stability. It is not incidental that for the new EU member states, it is advised to employ the inflation-targeting monetary policy regimes. In such a case, it will be necessary to switch to a more flexible regime of the currency exchange rate. Yet, it is unclear why certain applications of the means of exchange rates should be more advantageous against inflation measu-

[28] Lewis J., "Hitting and Hoping? Meeting the Exchange Rate and Inflation Criteria During a Period of Nominal Convergence", *CESifo Working Paper* 1902, January, 2007.

[29] European Commission, *Business and Consumer Survey Results*, Directorate-general for Economic and Financial Affairs, April, Brussels, 2007, http://ec.europa.eu/economy_finance/indicators/businessandconsumersurveys_en.htm, 07 05 2007.

res. Furthermore, this view is characterized by a particular lack of institutional memory. In the preparation period for the EU membership, this opinion of the officials of the Community institutions was so persistent that Lithuania had no other choice but to resolve and adopt a flexible exchange rate. In this respect, the Bank of Lithuania drafted and approved the three-year monetary policy programme with the plan to abandon the currency board regime[30]. However, just the first stage of the programme was implemented, since it became evident that there is not an organized and orderly way how to change the regime, and it would require considerable costs and may cause some instability risks. Moreover, the assessments demonstrated that following the argument of the economic logic a natural entry to the euro area is really possible without activating the currency exchange rate as an instrument of the monetary policy. Hence, the only possibility left was to merely initiate wide international discussions on the matter and look for the most acceptable solution. In this process, the role of the IMF as a mediator came in very handy, since its specialists supported the discussions by their professional and in-depth researches. Several conferences held in Tallinn, Brussels, Prague and Dubrovnik helped the attendees to arrive at a common understanding. Immediately afterwards, the ECB Governing Council made a very important decision, which provided a possibility to join the euro area retaining a currency board system[31]. We believe, a renewed expert dialogue including not only politicians and bureaucrats of the European Union institutions would be of great value.

Analyzing the lessons of Lithuania's fulfilment of the price stability criteria, we think that it is essential to consider not merely the fact that the Maastricht criterion for price stability was not satisfied technically, but also the entire complex of macroeconomic and institutional reasons.

First, the formation of final opinion should have been affected by the fulfilment of the criteria for an optimal currency zone. Though, as mentioned before, the flexibility and resistibility of the Lithuanian economy against shocks has been tested in practice in the context of unrest in the banking sector, influence of the crisis in Russia and other shocks, with the labour market regarded as one of the most flexible in the EU. In general, meeting of the criteria for an optimal currency zone by our national economy very likely is one of the worst among the EU newcomers. The economic structure is dominated by agricultural and industry sectors, at the same time as the GDP part in the services sector lags behind by 10 basis points than in the euro zone. Empirical studies show that there exists a tight correlation between trade integration and shock asym-

---

[30] "Dėl Lietuvos banko pinigų politikos priemonių taikymo krypčių" (Concerning Applications of Monetary Policy Measures of the Bank of Lithuania), Ruling No. 101 of the Board of the Bank of Lithuania, 1 July 1999, Vilnius, *Valstybės žinios (Official Gazette)* 10-197, 1997.

[31] Duisenberg W., Noyer C., "Introductory Statement", Press Conference, Frankfurt am Main, ECB, 13 04 2000.

metry[32],[33]. The Lithuanian trade relationship with the European Union is low according to both the general indicators of trade level with the EU and intra industry trade. A correlation between the euro area and Lithuanian business cycles is even negative[34]. Definitely, the assessment methodology of meeting these criteria is far from perfect and may be questionable, one should not think however, that these data are not instrumental in forming the opinion of politicians on Lithuania's readiness to participate in the euro area.

Secondly, having joined the ERM II, Lithuania assumed the following commitments: "Sound fiscal policy and a determination to contain domestic credit growth, assisted by effective financial supervision, will contribute to ensuring the sustainability of the current account position. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and to maintain the overall competitiveness of the economy"[35]. Alas, Lithuania's progress of honouring commitment while within the ERM II was not impressive enough. Even though the commitments in a declaration form were not actually analyzed in detail at the assessment time, more progress could have had more positive influence in hope for a favourable decision.

Thirdly, one may understand the arguments forwarded by the states of the euro area concerning stricter requirements for CEE countries. The governance of the European Union, which is now based on a Nice Treaty compromise, is not as effective as it should be. Before the biggest EU enlargement started, anxieties were expressed as to that if the Constitution for Europe were not adopted, the governance would become very inefficient and complicated. Disapproval of the draft Constitution in some countries led to worse conditions of political economy for the enlargement not only in the European Union, but also the euro area. The so-called Polish plumber syndrome preconditioned in some EU member states a rather sceptical attitude towards further integration measures in respect of the new countries and negative domestic political economy in the major states of the euro area. This encourages the politicians in the euro countries to be more cautious. The non-adoption of the Constitution for Europe precluded the operationalization of the new voting procedure as prescribed in it, under which the major states of the euro area would have gained a greater weight in the decision-making process in the enlarged Community. This encourages the politicians of those countries to transfer the preparation of the major decisions to a close. A very influential club of the ministers from the euro area increases the natural resistance of the old member states letting in "the plumbers" from the new EU member states. In this way, the above asym-

[32] Maurel M., "On the Way to EMU Enlargement Towards CEEC's: What is the Appropriate Exchange Rate Regime?", *CEPR Discussion Paper* 3409, 2002.

[33] Frankel J. A., Rose A. K., "The Endogeneity of the Optimum Currency Area Criteria", *Economic Journal* 49/449, 1998.

[34] Fidrmuc J., Korhonen I., "A Meta-Analysis of Business Cycle Correlations between the Euro Area", CEECs and SEECs – What do we now?, *Focus on European Economic Integration* 2, 2004, p.76–94.

[35] Commission of the European Communities, Communique, Brussels, 27 06 2004.

metry in the institutional framework affects, within a certain period of time, the asymmetry in the interpretation of various Community rules. Regarding the economic drive of the new EU member states, who could deny the likelihood that economic competition also has a role to play? Such a situation poses a logical question: what can be expected, if entry of the states with currency board systems to the euro area would take indefinitely long time?

5. What Would the Consequences of a Long-Term Postponing of the Euro Adoption be?

With the existing approach to the euro area enlargement, there is quite a high probability that the current exchange rate regime in Lithuania, which is not optimal from the point of view of the economic theory and practice, may prevail much longer than expected. This, at first sight, should not be a problem, as it is the second decade that we have been living with the currency board system, and the non-adoption of the euro did not have considerable impact for the Lithuanian economy. The interest rates of the Government securities remain the same low levels, and rating agencies have not lowered ratings of country's risks either. Nonetheless, longer uncertainty about the euro adoption may change the situation. Although this is quite subjective, a legal assessment of "sustainability" has been taking the form of an economic conclusion increasing the risk of Lithuania's economic development even more than legal non-fulfilment of the price stability criterion.

Lithuania's participation in the ERM II under the unilateral commitment to retain exchange rate stability does not, in fact, change the exchange rate regime historically formed in the country. On the other hand, participation in the ERM II does not build up more trust on the part of international markets and investors, for this mechanism does not enjoy a good reputation within markets resulting from the last decade crises. It stands to reason that countries should seek as short of a participation in this mechanism as possible. With the EU membership and market expectations of the euro adoption formed, the flow of financial resources among the states has markedly improved. Lithuania basically lacks the measures of an macroeconomic policy to limit them. And limitation while in one market, at the expense of the economic growth restriction, would be quite unreasonable[36]. The world monetary system is currently marked by a very high liquidity. Deep and effective world financial markets and the Lithuanian banking system very tightly integrated in the European Union foster increasing financial flows across the state borders. It is likely, thus, that at a certain moment rapid economic growth and inter-state financial flows

[36]Buiter W. H., Grete C., "Anchor, Float or Abandon Ship: Exchange Rate Regimes for Accession Countries", Presentation at the Eighth Dubrovnik Economic Conference Monetary Policy and Currency Substitution in the Emerging Markets, Dubrovnik, June 27–29, 2002.

may result in a larger number of macroeconomic temporary imbalances that may cause concern of investors and creditors from abroad, which in its turn, would predetermine the rising costs of non-participation in the euro area. This means that such a non-optimal situation offers no other political method as to merely keep the optimal and fair course of economic and structural reforms reducing asymmetries and increasing fulfilment of criteria for the optimal currency zone.

We should not forget that a currency board system is particularly demanding with respect to the conditions of fiscal and structural policy. The EU membership has slightly decreased the disciplinary function of markets and cautiousness of the country's politicians in this respect. The 2007 World Economic Outlook expressed concern about the slower pace of reforms in the states of central Europe[37]. The IMF research suggested that the convergence between long-term interest of those countries and the relative rates of the euro area by 50–100 basis points is not to be explained by economic "fundamentals"[38]. This has happened, most probably, due to the expectations that the euro will be adopted. But if the expectations are not matched, this achievement should disappear. In the long-term perspective, great losses in trade volumes are likely resulting from poorer conditions and less attractiveness of the country, and therefore decreasing potential GDP would make up round 20–30 per cent in the long-term run[39]. Similar assessments are presented by the *Deutche Bank AG* as well. More so, the loss of competitive advantages for a small peripheral EU state would be a great disadvantage and could lead to stagnation tendencies.

Economically, the decision of the EU institutions regarding Lithuania is not easy to explain and transfer to markets. Such a situation adds uncertainty and causes tension between the expectations of the market participants about the euro area membership and possibility to satisfy the criteria interpreted so inflexibly. This unreasonably increases the risk of a currency crisis.

Lithuania's request to assess the convergence progress opened considerable discussions of international experts. From the economic point of view, the absolute majority of the economists and experts held such decision of the EU institutions to assess the Lithuanian convergence progress illogical and unfair. In addition, the IMF unambiguously said that Lithuania and Estonia could very successfully function in the euro area. This organisation has, definitely, the best experience in monetary regime issues. It is hard to understand, why the European Union, which is interested in the enhancement of efficiency of the IMF, is rather cautious, in this case, about its position. Nor any consideration was

[37] International Monetary Fund, *World Economic Outlook. Spillovers and Cycles in the Global Economy*, Washington, D. C.: IMF, April 2007, p. 71.
[38] Schadler S., "Anchoring Policies in Uncertain Times. Regional Outlook: New EU Members from Central and Eastern Europe", Presentation in Vilnius, 2006, http://www.lb.lt/lt/apie/presentation101106.pps, 12 11 2006.
[39] Schadler S., Drummond P., Kuijs L., Murgasova Z., Elkan R., "Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration", *IMF Occasional Paper* 234, 2005.

given to the opinion of the European Parliament, which was roughly rejected by the Council of the European Union. Decisions that are not well based on the economic logic are rather difficult to transfer to the market participants and investors, and the Government finds it rather complicated to quietly accept the decisions without reasonable economic foundations, with all this contributing to indefiniteness.

The assessment of the fulfilment of the Maastricht criteria must refer to the economic logic, yet the final decision has to be taken on political level. The current situation is not an advantage to the European Union either. Lack of communication and indefiniteness may further provoke the resistance of the new members discussing how to improve the governance and the external representation of the Community. The European Union apparently needs improvement of the EMU governance and external representation this, however, should not be done at the expense of smaller states, which would lose the valuable public good. Let us say that Lithuania and other countries are interested in keeping an opportunity to efficiently consult the IMF.

What rational steps could be taken in such a situation? First and foremost, it is necessary to patiently and slowly try to reduce the asymmetry both in the economics and institutional framework of the euro area enlargement. In this respect, the new member states should be interested in pursuing to adopt the Constitution for Europe as soon as possible, which would allow significantly improve the management structure of the EMU, thus, minimising the concern of the major states of the Community about ineffective decision-making process. Then, one might also expect more favourable conditions of political economy for the euro area enlargement and interpretation of Maastricht criteria.

A more effective ERM II should also be pursued by strengthening the dialogue and transparency of decisions concerning the euro area enlargement. It should become a rule to discuss matters related to the states only in their presence. This cannot be the sole competence of the representatives of the euro area countries, since it evidently leads to a conflict of interests. One may not disregard the fact that the old member states of the European Union may find it useful slightly reduce the competitiveness of the newcomers and its attractiveness for investments. Such an approach as uttered by Pervenche Beres, Chairwoman of the Committee on Economic and Monetary Affairs of the European Parliament, might have been not quite accidental[40]. In an attempt to prevent potential speculations, the assessment process of the states' convergence progress should include competent independent experts, e.g. from the IMF. This would favour taking decisions close to normative. Finally, the European Commission has to perform its inherent role and help the small countries with poorer administrative capacities to find the best solutions. Besides, a note should be taken of the realities of the new countries: the Balassa–Samuelson Effect, real convergence and a currency board system. The attitude of the countries

[40] Beres P., "The Euro-zone hasn't the Capacity to Absorb New Member States", *Europolitics*, April, 2006.

that have adopted the currency board system was expressed very precisely by Ivan Iskrov, Governor of the Bulgarian National Bank of Bulgaria, which joined the EU membership during the last enlargement round. He said during the meeting with the economic and financial elite of Greece, in Athens in 2006: "Considering this strongly restrictive inflation criterion and the uncertainties about determining its level, we expected that the ECB and the European Commission would show greater flexibility in assessing the compliance with this criterion. Unfortunately, Lithuania's assessment published in the Convergence Report in May this year suggested that the expected flexibility would not be demonstrated. A very bureaucratic approach has been used, neglecting the fact that each economy is affected by a large number of internal and external influences and this very much hinders the fulfilment of the heavily restrictive inflation criterion, especially with the absence of an autonomous monetary policy."[41].

It is also crucial that the principle of equal treatment of the member states would be retained during the future enlargement of the euro area after the biggest EU enlargement. Uniform requirements must be applied without exceptions in respect of all new and old members. In the 2000 Convergence Report, the European Commission underlined that there exists an interpretation problem, which may hinder additionally the further euro area enlargement. Considering the fact that the 2004 Convergence Report used the outlier concept one might have expected a more reasonable and modern interpretation of the Maastricht criteria. Logically, questions arise as to why the same principle is not applied to all criteria and why some of them lend themselves to an economic explanation to justify deviations, while others do not. For example, strengthening of the exchange rate due to "the real convergence effect" is acceptable; at the same time as the inflation criterion for the same reason or impact of one-off effects do not use such logic. As the above analysis of conditions shows, they have essential differences, which is why it is not easy to apply the principle of equal treatment for the member states. It is crucial that interpretations of certain issues would not differ considerably. Equal treatment of the member states has, in the first instance, to be based on similar interpretations.

While deciding on the fulfilment of the Maastricht criteria, attempts should be made to follow the economic arguments and principles of transparency and solidarity. In case of Lithuania, one can but agree with the opinion that the decision was economically wrong and politically motivated[42]. No wonder, therefore, the European Parliament questioned the assessment criteria, which predetermined the "disqualification" of Lithuania[43]. Many market analysts,

[41] Iskrov I., "Bulgarian Economy on the Road to EU and EMU Membership", Lecture by Governor of the BNB before the Greek economic and financial elite, Central Bank of Greece, Athens, 14 07 2006.

[42] "Lithuania's EMU Bid Encounters Resistance", KBC Market Research Desk, http://www.csob.sk/data/ft/flash/2006-05-17.pdf, 27 01 2007.

[43] "Parliament Sets Out its Hopes for the Eurozone", *Europolitics* 3187, November 2006.

institutions and academic society critised this decision as well[44],[45] and spoke in favour of different interpretation of the criteria [46],[47].

The IMF has one of, definitely, the best expertise and experience on the exchange rate issues and it advise given to Lithuania was operational before the ERM II membership and respectively played the right signalling role to the markets. At the end of the intensive cooperation period under the programmes, much was expected of its Warsaw-based Regional Office set up specifically for the CEE countries, since its principal objective was to help the countries of the region to prepare for the euro adoption. Establishment of the Office with such objectives did not meet any objections by the EU member states either. Still, these options were not fully utilized and during the Euro area or European Union member country consolations with the IMF the issues of the euro zone enlargement are largely missing among organisation's conclusions. The presented arguments should dispel unnecessary doubts about whether the euro area enlargement is more an expression of the political will rather than assessment of real convergence.

Now, the mechanical assessment process is an essential impediment to the entry to the euro area of the states with a currency board system. The euro adoption reminds us more of a success in the lottery. The inflation criterion of the Maastricht Treaty is ever more changing following the existing interpretation, and the countries with a strictly fixed exchange rate are more likely to have one-off price jumps. States with the lowest inflation may always include one country, which does not participate in the ERM II or fails to satisfy the other criteria. Therefore, there will always be some questions to answer, being, whether low inflation has been reached resulting from higher convergence and more discrete monetary policy allowing the strengthening of the exchange rate and whether this is not a short-term phenomenon. At the outset of the ERM II, Lithuania sought to adopt the euro in two years. A longer stay in the mechanism increases the probability that negatively impacting shocks or unfavourable one-off changes will unreasonably reduce the Lithuania's options to keep the macroeconomic stability, notably due to potential external shocks.

Participation in the ERM II has been accompanied by unreasonable myths that must inevitably be dispelled. The conceptually wrong myth says that small countries need to have more stringent requirements imposed to avoid setting a precedent to bend the rules and to show the other countries, namely Poland, Hungary and the Czech Republic, that strict assessment will apply to all[48]. Such an approach enables the criteria be treated differently for

[44] Munchau W., "Monetary Union is not for Poor", *Financial Times*, 29 01 2006.

[45] Ahearne A., Pisani-Ferry J., "The Euro: Only for the Agile", *Bruegel policy brief,* 01 02 2006.

[46] Buiter W. H., Sibert A., "Europe Must Relax its Inflation Test for Euro Entrants", *Financial Times*, 04 05 2006.

[47] Atkins R., Schieritz M., "Estonia and Lithuania Ready for the Eurozone", *Financial Times*, 05 03 2006.

[48] Lynn M., "Europe's Currency won't Work as Rich Man's Club" http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFNSgWNw_Djw, 12 06 2006.

various countries, thus, as asymmetric, and should be decisively rejected. In fact, it is wrong to believe that the euro area is a club that has a right to set its own rules[49]. One must consider the fact that after the last enlargement of the European Union all countries are the EMU members, just with a temporary derogation not to adopt the euro. So, no attitude must be created that the euro area is a closed club choosing friends according to certain criteria (income level, geography or any other reasons).

Conclusions

The current euro area enlargement is no less complex and complicated than the creation of the euro zone. The new EU members' motivation wish to join the euro is high because of potential economic benefits resulting from the membership. However, the asymmetry enhanced for economic, institutional and political reasons after the last EU enlargement forms a more complex economic background and more diverse standpoints and interests of the players in the decision-making process regarding the euro membership. The institutional decision – making framework prior to the adoption of the single currency was utterly symmetric, each state having been equally represented by its finance minister and governor of the national central bank. On the contrary, the decision-making process concerning the euro area enlargement totally changed the situation, for the finance ministers of the euro states *de facto* have acquired considerable powers to formulate the decisions. This process excludes not only the governors of the central banks of the acceding countries, but also the finance ministers. Greater involvement of the renewed EU institutions is missing in order to reduce asymmetries and pursue that fulfilment of the convergence criteria be assessed in a way less politicised and more economically grounded instead.

The ERM II, whose significance grew after the latest enlargements of the EU, is still not without reason referred to by the economic specialists is treated as "the waiting room". The analysis of its functioning and Lithuania's experience of participation in it suggests that the possibilities of economic policy coordination and friendly cooperation are not exploited fully. The coordination of the monetary policy and measures of the EU and ECB could enhance the monitoring of how the commitments are assumed before the ERM II are fulfilled, and discuss their honouring by authorities, along with giving specific advice for one or other state.

The convergence progress assessed at the request of Lithuania fuelled talks about the interpretation of the inflation criterion. A more detailed analysis of non-fulfilment of the inflation criterion supposes that following the principle of equal treatment of the member states the assessment could have been positive

[49] *Ibid.*

without a violation of legal requirements. Yet, analysing the reasons behind the negative decision it would be unfair to consider solely the formal non-fulfilment of the price stability criterion. One should take many reasons into account. The decision did not include adequate assessment of the specifics of the countries with the currency board system. Such treatment of the price stability criterion contradicts the objective principle of taking decisions based on economic logic and its fair application. Besides, this suggests that the decision is made not quite transparently, and without considering the assessments of the competent independent international institutions could have resulted from the attempts of the old member states to reduce the competitiveness of the dynamically developing CEE countries and their attractiveness for foreign investors. The European Commission appeared more passive then as expected.

A clear application of the criterion of inflation sustainability while assessing the convergence progress means a new future-orientated component of price stability, which was not used for the euro area pioneers. Such an attitude towards the enlargement is very likely to postpone the expectations over the euro adoption in the countries with the currency board system for indefinite time.

In the short-term perspective, the euro adoption would not cause any major problems, but, in the long-term run, it would definitely have a negative impact on the image of Lithuania as an attractive state for business and significantly reduce its competitive advantages and lead to great loss of the economic growth potential and stagnation tendencies. It is vital, therefore, to seek more transparency in the decision-drafting and making process upon assessing the convergence progress, so that all states would be treated equally and taking into account the economic realities of the new EU member states and interpretation of the criteria fulfilment based on the economic logic. Furthermore, it is important to retain the role of the IMF as an expert attaching more significance to the consultations on controversial issues of the exchange rate policy. One should not disregard the possibility that potential external or internal shocks may cause the reaction of the market players, which could adversely influence an extremely open and small Lithuanian economy. Under such conditions, the wisest step would be to patiently and slowly seek to reduce the asymmetry appeared, first and foremost, by supporting the efforts in the institutional structure of the euro area enlargement to adopt the Constitution for Europe, thus, contributing to more effective governance of the European Union.

Bibliography

1. AFP-BNS, Lietuva ir Estija nevykdo Mastrichto kriterijų, perspėja ES komisaras, 2006 01 20.
2. Ahearne A., Pisani-Ferry J., „The Euro: Only for the Agile“, Bruegel policy brief, 2006 02 01.

3. Alesina A., Barro R., Tenreyro S., „Optimal Currency Areas“, NBER Working Paper 9702, 2002.
4. Atkins R., Schieritz M., „Estonia and Lithuania Ready for the Eurozone“, Financial Times, 2006 03 05.
5. Babetski J., Boon L., Maurel M., „Exchange Rate Regimes and Supply Shock Asymmetry: the Case of the Accession Countries“, CERGE-EI Working paper 206, 2003.
6. Balasz E., „Assessing Equilibrium Exchange Rates in CEE Acceding Countries: Can We Have DEER with BEER without FEER? A Critical Survey of the Literature“, Focus on Transition 2, 2003.
7. Baldwin R., Wyplosz C., The Economics of European Integration, London: McGraw-Hill, 2006.
8. Baltaduonis R., Jurgilas M., „Lithuania and the Euro“, Presentation, Department of Economics. University of Connecticut, 2006 05 02, http://www.sp.uconn.edu/~rib01002/LTeuro.pdf, 2007 04 30.
9. Beres P., „The Euro-zone hasn’t the Capacity to Absorb New Member States“, Europolitics, April 2006.
10. BNS, Vokietijos centrinis bankas ragina neskubėti plėsti euro zonos, 2006 01 24.
11. Buiter W. H., Grete C., „Anchor, Float or Abandon Ship: Exchange Rate Regimes for Accession Countries“, Presentation at the Eighth Dubrovnik Economic Conference Monetary Policy and Currency Substitution in the Emerging Markets, Dubrovnik, June 27–29, 2002.
12. Buiter W. H., Sibert A., „Europe Must Relax its Inflation Test for Euro Entrants“, Financial Times, 2006 05 04.
13. Cavaco Silva A., „The Portuguese Experience in the Integration Process“, Special Address at the Millennium Bankers Seminar for the new EU Member States and Candidate Countries, Lisbon, February, 2004.
14. „Dėl Lietuvos banko pinigų politikos priemonių taikymo krypčių“, 1999 m. liepos 1 d. Lietuvos banko valdybos nutarimas Nr. 101, Vilnius, Valstybės žinios 10–197, 1997.
15. Duisenberg W., Noyer C., „Introductory Statement“, Press Conference, Frankfurt am Main, ECB, 2000 04 13.
16. ECB, „Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries“, 2003 12 18.
17. European Commission, Business and Consumer Survey Results, Directorate-general for Economic and Financial Affairs, April, Brussels, 2007, http://ec.europa.eu/economy_finance/indicators/businessandconsumersurveys_en.htm, 2007 05 07.
18. Europos Bendrijos steigimo sutartis , 121 str.
19. Europos Komisija, „2006 m. gruodžio mėn. konvergencijos ataskaita (KOM 762)“, EUR-Lex, http://eur-lex.europa.eu/lt/prep/index.htm, 2007 05 03.
20. Europos Komisija, Komunikatas, Briuselis, 2004 07 27.
21. Fidrmuc J., Korhonen I., „A Meta-Analysis of Business Cycle Correlations between the Euro Area“, CEECs and SEECs – What do we now?, Focus on European Economic Integration 2, 2004, p. 76–94.

22. Frankel J. A., Rose A. K. „Is EMU More Justifiable ex post than ex ante?", European Economic Review 41 , 1998, p. 753–760.
23. Frankel J. A., Rose A. K., „The Endogeneity of the Optimum Currency Area Criteria", Economic Journal 49/449, 1998.
24. Frenkel M., Nickel C., „How Symmetric are the Shocks and the Shock Adjustment Dynamics between the Euro Area and Central and Eastern European Countries?", Washington, D. C.: IMF Working Paper 222, December, 2002.
25. International Monetary Fund, World Economic Outlook. Spillovers and Cycles in the Global Economy, Washington, D. C.: IMF, April 2007, p. 71.
26. Iskrov I., „Bulgarian Economy on the Road to EU and EMU Membership", Lecture by Governor of the BNB before the Greek economic and financial elite, Central Bank of Greece, Athens, 2006 07 14.
27. Kenen P., „The Optimum Currency Area: an Eclectic View" in Mundell R. A., Swoboda A., eds., Monetary Problems of the International Economy, Chicago, 1969.
28. „Komisaras J. Almunia: „Lietuva neatitinka infliacijos kriterijų"Respublika, 2006 02 23 (Remiantis 2006 m. vasario 22 d. spaudos konferencija).
29. Krikščiūnas R., „Enlargement of the Euro Zone – Why and When for Lithuania?", Brussels: Center for European policy studies, 2006 05 10.
30. Krugman P., „Lessons of Massachusetts for EMU" in Torres F., Giavazzi F., eds., Adjustment and Growth in the European Monetary Union, Cambridge: University Press, 1993, p. 241–269.
31. Kuodis R. „Dėl narystės ekonominėje ir pinigų sąjungoje siekiančių šalių valiutos kurso pasirinkimo strategijų", Pinigų studijos 1, 2003, p. 5–22 .
32. Lewis J., „Hitting and Hoping? Meeting the Exchange Rate and Inflation Criteria During a Period of Nominal Convergence", CESifo Working Paper 1902, January 2007.
33. „Lithuania Set to Become Victim of Tough EU Single Currency Stance", Financial Times, 2006 03 13.
34. „Lithuania's EMU Bid Encounters Resistance", KBC Market Research Desk, http://www.csob.sk/data/ft/flash/2006-05-17.pdf, 2007 01 27.
35. Lynn M., „Europe's Currency won't Work as Rich Man's Club" http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFNSgWNw_Djw, 2006 06 12.
36. Maurel M., „On the Way to EMU Enlargement Towards CEEC's: What is the Appropriate Exchange Rate Regime?", CEPR Discussion Paper 3409, 2002.
37. Mody A., Rosenberg C., „Why Lithuania and Estonia could Fare Well in Eurozone?", Financial Times, 2006 02 08.
38. Munchau W., „Monetary Union is not for Poor", Financial Times, 2006 01 29.
39. Mundell R. A., „A Theory of Optimum Currency Areas", American Economic Review 51, 1961, p. 657–665.
40. Mundell R. A., „Exchange Rate Arrangements in Central and Eastern Europe" in Arndt S., Handler H., Salvatore D., Eastern Enlargement: the Sooner, the Better?, Vienna: Austrian Federal Ministry of Economic Affairs and Labour, 2002, p. 168–165.

41. Mundell R. A., „Uncommon Arguments for Common Currencies“ in Johnson H., Swoboda A., eds., The Economics of Common Currencies, London: Allen and Unwin, 1973.

42. „Parliament Sets Out its Hopes for the Eurozone“, Europolitics 3187, November 2006.

43. „R. Šarkinas eurokomisaro vertinimą vadina neetišku“, Lietuvos aidas, 2006 02 25 .

44. Reuters-ELTA, K. H. Graseris: Estijos ir Lietuvos infliacija greičiausiai bus per didelė įsivesti eurą, 2006 01 24.

45. Schadler S., „Anchoring Policies in Uncertain Times. Regional Outlook: New EU Members from Central and Eastern Europe“, Presentation in Vilnius, 2006, http://www.lb.lt/lt/apie/presentation101106.pps, 2006 11 12.

46. Schadler S., Drummond P., Kuijs L., Murgasova Z., Elkan R., „Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration“, IMF Occasional Paper 234, 2005.

47. Stark J., „Economic and Monetary Policy Challenges of Euro Area Enlargement“, Diner speech at Conference the changing landscape of FDI in Europe, Oesterreische Nationalbank, Vienna, 2006 11 20.

48. Trichet J. C., „Looking at EU and Euro Area Enlargement from a Central Banker's Angle: The Views of the ECB“, Speech by President of the European Central Bank, Diplomatic Institute Sofia, 2006 02 27.

18 June, 2007

-