

Box 3

LITHUANIA ADOPTS THE EURO

On 1 January 2015 Lithuania adopted the euro and became the 19th member of the euro area. The conversion rate between the Lithuanian litas and the euro was irrevocably fixed at 3.45280 litas to the euro. This was the central rate of the Lithuanian litas throughout the country's membership of the Exchange Rate Mechanism II.

Lithuania is a very small economy compared with the rest of the euro area. As such, the country's adoption of the euro will have no significant impact on the euro area's aggregate macroeconomic data (see the table). Lithuania's population is around 3 million and its GDP accounts for about 0.4% of euro area GDP. In terms of purchasing power parity, GDP per capita was slightly below 70% of the euro area average in 2013.

Key economic characteristics of Lithuania and the euro area

	Reporting period	Unit	Euro area excluding Lithuania	Euro area including Lithuania	Lithuania
Population and economic activity					
Total population ¹⁾	2013	millions	335.8	338.8	3.0
GDP	2013	EUR billions	9,904.4	9,939.4	35.0
GDP per capita	2013	EUR thousands	29.5	29.3	11.8
GDP per capita (PPP)	2013	Euro 18=100	100.0	99.7	67.5
GDP (share of world GDP) ²⁾	2013	percentages	12.3	12.4	0.1
Value added by economic activity³⁾					
Agriculture, fishing, forestry	2013	percentage of total	1.7	1.7	3.8
Industry (including construction)	2013	percentage of total	24.6	24.6	30.7
Services (including non-market services)	2013	percentage of total	73.6	73.6	65.5
Monetary and financial indicators					
Credit to the private sector ⁴⁾	2013	percentage of GDP	128.8	128.5	45.8
Stock market capitalisation ⁵⁾	2013	percentage of GDP	56.9	56.7	9.1
External trade					
Exports of goods and services ⁶⁾	2013	percentage of GDP	43.7	43.8	84.1
Imports of goods and services ⁶⁾	2013	percentage of GDP	40.2	40.4	82.8
Current account balance ⁶⁾	2013	percentage of GDP	2.2	2.2	1.6
Labour market⁷⁾					
Labour force participation rate ⁸⁾	2014Q3	percentages	72.4	72.4	74.1
Unemployment rate	2014Q3	percentages	11.1	11.1	9.3
Employment rate ⁸⁾	2014Q3	percentages	64.4	64.4	67.2
General government					
Surplus (+) or deficit (-)	2013	percentage of GDP	-2.9	-2.9	-2.6
Revenue	2013	percentage of GDP	46.5	46.5	32.8
Expenditure	2013	percentage of GDP	49.4	49.4	35.5
Gross debt outstanding	2013	percentage of GDP	93.3	93.1	39.0

Sources: Eurostat, IMF, European Commission, ECB and ECB calculations.

1) Estimated annual average.

2) GDP shares are based on a purchasing power parity (PPP) valuation of the countries' GDP.

3) Based on nominal gross value added at basic prices.

4) Comprises loans, holdings of securities other than shares, and holdings of shares and other equities.

5) Defined as the total outstanding amount of quoted shares excluding investment funds and money market fund shares issued by euro area/Lithuanian residents at market value.

6) Balance of payments data. Euro area data are compiled on the basis of transactions with residents of countries outside the euro area (i.e. excluding intra-euro area flows). Data for Lithuania include transactions with residents from the rest of the world (i.e. including transactions with the euro area).

7) Referring to the working age population (i.e. those aged between 15 and 64). Data from the Labour Force Survey.

8) Share of the working age population (i.e. those aged between 15 and 64).

The macroeconomic imbalances that built up in the years preceding the 2007-08 crisis have been corrected thanks to measures put in place by the Lithuanian government, without any external support. Prior to 2007 credit growth and capital inflows fuelled growth in domestic demand in Lithuania, which experienced one of the EU's fastest growth rates. At the same time macroeconomic imbalances built up as the country experienced sizeable capital inflows, mainly to the non-tradable sector. The government started to implement adjustment measures in 2008 by cutting nominal wages in the public and private sectors in order to restore competitiveness. A credible and frontloaded consolidation strategy together with structural reforms also helped Lithuania's adjustment. The budget deficit was reduced from 9.4% in 2009 to 2.6% in 2013. Liquidity was provided to the banking system, combined with measures to raise capital buffers and reforms to strengthen banking supervision. The economy started to recover in 2010, led by a strengthening in exports on account of strong foreign demand and gains in competitiveness, followed by a rebound in domestic demand. Although the ratio of public debt to GDP more than doubled during the economic crisis, it stood at 39% in 2013, which is significantly below the euro area average of 93% in the same year.

More recently, economic activity has remained dynamic, with real GDP growing by 2.6% year on year in the third quarter of 2014 and positive developments in the labour market. The unemployment rate stood at 9.3%, compared with its peak of 18.2% in the second quarter of 2010. However, there has been a decline in the labour force owing to the number of people emigrating in search of work in other EU countries. This fact combined with the skill mismatching that characterises the Lithuanian labour market may lead to skill shortages and wage increases, undermining Lithuania's ability to continue to gain market shares in global trade.

Lithuania's production structure is broadly similar to that of the euro area as a whole. In the Lithuanian economy, industry (including construction) contributes around 31% to total value added. The share of services is slightly lower, at around 66%, while the contribution of the agricultural sector, at 4%, is somewhat above that of the euro area as a whole. Furthermore, Lithuania is a very open economy and its key trading partner is the rest of the euro area, which accounts for around 38% of its total exports and 40% of its total imports. Other important trading partners include Poland and Russia.

The country's financial sector is bank-dominated. Bank credit to the private sector amounted to 46% of GDP in 2013. The banking system is highly concentrated and dominated by Nordic banks, and became 90% foreign-owned after the failure of the two largest domestic banks. Meanwhile, the country's non-banking financial sector is very small and undeveloped – its stock market capitalisation, at just below 10% of GDP in 2013, is among the lowest of the euro area countries. Capital markets are small and mainly consist of government bond markets.

In order to fully reap the benefits of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, Lithuania needs to continue its reform efforts after the euro has been adopted.¹ Economic policies should be geared towards maintaining price stability, ensuring the sustainability of the convergence process and sustainable growth in the long term. The Lithuanian authorities have committed to fully aligning their fiscal framework with the euro area fiscal requirements, strengthening it through the Fiscal Compact and increasing the flexibility of the economy in the face of adverse shocks. Lietuvos bankas is assuming

¹ For more details see ECB Convergence Report (2014).

macro-prudential policy powers, as the relevant law was approved by the Parliament, which will further strengthen cooperation under the European banking union and maintain financial stability. Lithuania needs to remain vigilant by implementing macro-prudential policies that avoid the emergence of any renewed financial imbalances arising after euro adoption. Despite the progress made so far in terms of structural reforms, the authorities are committed to do more in terms of further improving the business environment, investing in infrastructure needs and improving the quality of state-owned enterprises with a view to maintaining the competitiveness of the economy. Skill mismatches in the labour market need to be addressed in order to tackle the high structural unemployment by reforming the educational system and reducing the labour tax wedge. These reforms would lead to an improved labour market and contribute to potential growth. In the environment of the stability-oriented monetary policy conducted by the ECB, it is essential that Lithuania ensures an economic environment that is conducive to sustainable output and job creation in the medium to long term.