

Lithuanian monetary policy: from post-soviet to the eurozone

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When Lithuania gained its independence from the Soviet Union; its first agenda was to break away from the Soviet Union's economy and its common currency; the ruble. Before the union collapsed, the Soviet ruble has a significant advantage as a common currency because it linked the Soviet republics into a common trade area where goods move quite freely, and this enabled the Soviet Union to achieve its economic greatness. However, in its collapse the former republics are now imposing quotas and tariffs to one another's product. Lithuania realized that as it remains in the hands of the monetary authorities in Moscow, it cannot have and pursue its own monetary policy.

Lithuania was affected by the Soviet authorities' decision to print more rubles than what it originally planned causing hyperinflation. The Baltic state decided to introduce the talonas on August 1991 which is a coupon used together with the ruble. The talonas became Lithuania's temporary currency until it was ready to introduce the Litas and in October 1992 it was made the only legal tender.

The coupon (talonas) scheme grants Lithuanian citizens coupons which are equal to 20% of their currency in rubles and if their income is 80 rubles or less, they will receive coupons more than 20% of their income. However, the coupon system cannot curb a hyperinflation and citizens who wish to purchase expensive consumer goods (e. g. appliances) will have to save up large amounts of coupons as well as rubles. Former Soviet republics who also implemented the couponing systems have felt similar failures.

The Bank of Lithuania was re-established on February 1990 as a branch of USSR Central Bank; the Lithuanian central bank's goal was to issue an independent currency, however, during its Post-Soviet state it did not have a definite plan to establish and maintain the proposed currency, the Litas. During 1992-1993, the Bank of Lithuania applied these monetary instruments to curb the inflation rate: minimum reserve requirements, credit ceilings, and deposit and credit auctions. The BoL also developed its domestic foreign exchange market for its proposed national currency and the Litas was introduced on January 25, 1993. However, the BoL is lacking the credibility and transparency needed in order to decrease the inflation and interest rates further.

In its introduction the Litas faced uncertainties on its external stabilities due to economic recession, high degree of dollarization of Lithuania's economy and a weak fiscal policy. In order to stabilize the Litas, the BoL adopted a currency board agreement on April 1, 1994. The agreement was covered by the Law on the Credibility of the Litas which was passed on March 1994; it guaranteed that Lithuania's currency will have 100% coverage by gold and foreign exchange reserves of the Bank of Lithuania; it also anchored the Litas to the US Dollar with a fixed exchange rate of 4 LTL to 1 USD. When the BoL implemented the CBA the domestic inflation decreased rapidly and remained at single digit level. A currency board agreement is a form of monetary transmission mechanisms which are macroeconomic models that explains the channels in how monetary policy decisions are related to the economy and achieve policy objectives.

The Lithuanian government was planning to dismantle the CBA; the authorities has seen the dismantlement as a way to give the Bank of Lithuania to fine-tune the domestic economy by pursuing a more independent monetary policy and allowing it to use a variety of policy instruments. On January 16, 1997, a three stage program for 1997-1999 was enacted and its aim was the gradual dissolution of the CBA and the BoL began to make an active monetary policy. An Open Market Operation were also applied in this period as a minor fine-tuning tools aimed to level off the temporary fluctuations in the banking system liquidity and helps Lithuania's domestic banking system to adjust to the international market.

However, Lithuania totally scrapped its idea to dismantle the CBA when it was affected by the Southeast Asian Crisis in 1997 and the Russian Ruble Crisis in 1998/99. The default on the Russian government debt spread throughout the Baltic States; it affected their GDP growth negatively as exports to Russia decreased. There was a negative outlook on Lithuania's economy as there were fears on defaulting on government obligations and the expectations of devaluing the Litas. In order to cope up with this challenge, Lithuania retained its CBA, tighten its monetary policy and went back to the terms of the IMF memorandum.

When it shifted its trade to West during the Russian Ruble Crisis, the economic relations between Lithuania and the EU increased. The BoL's objective was to develop the domestic financial market and accelerate Lithuania's EU integration by harmonizing their monetary policy with the ECB requirements. After the consultations with the Lithuanian Government and

the IMF, on February 2, 2002 the BoL replaced US dollar with Euros as the Litas' anchor currency with a fixed exchange rate of 3.4528 LTL to 1 €. The BoL went back to its passive monetary policy as they hinted that the CBA would remain until Lithuania gained full membership to the EMU.

Since 2002, the Euros eventually became a de jure currency in Lithuania even though it was not yet a formal member of the European Union.

However, as Lithuania negotiates its membership to the EU it has brought positive shocks to their economy as there was a huge increase of net capital inflows but it manifested as an enormous and increasing current account deficit. However, this boom was accompanied by signs of economic overheating, thus, making Lithuania susceptible to adverse economic shocks.

Lithuania joined the European Union during the Eastern Enlargement on May 1, 2004 as a way to lessen its economic dependence on Russia and to cement that it is fully embracing its European identity. Aside from that, Lithuania wished to accede to the Eurozone on January 1, 2007 but it has to join the ERM2 which it did on June 2004, which is a waiting club for the Eurozone membership which in the exchange rate is tied to the Euro. However, Lithuania has fulfilled this requirement when they anchored the Litas to the Euro.

The Lithuanian government has asked the European Commission and the European Central Bank to assess if they were ready to adopt the Euro by January 1, 2007. However, their hopes to join the Eurozone by 2007 were shot down by the convergence report published by the ECB and EU in May

2006. Lithuania only met 4 out of 5 of the Maastricht Convergence Criteria failing in the price stability criterion. Lithuania's HICP inflation was a . 1% (2. 7%) higher than the required reference point of the ECB which is 2. 6%. Even though it was such a small difference, Lithuania was refused entry into the Eurozone because it was forecasted that Lithuania's low HICP inflation will not be maintained.

The decision of the European Commission was seen as a double standard by some observers because the Eurozone has not yet experienced a period which in all of its member states adhered to the Maastricht Criteria. A . 1% excessive inflation should not stop Lithuania in adopting the Euro in 2007 and that the Maastricht Criteria should be amended to fully capture the convergence experience of countries joining the EMU.

Lithuania was one of the badly hit countries during the global financial crisis and it caused its GDP to drop by 11. 8% due to overheating; the CBA even though it served Lithuania well in its development cannot function as a shock absorber from external situations affecting its economy. In order to curb the effects of the crisis, the International Monetary Fund (IMF) has suggested that Lithuania and other countries who are in the ERM2 should partially adopt the Euro. Lithuania has agreed to such arrangement as they see it as a way to speed up their process to join the European Monetary Union by not seeking a seat in the European Central Bank until they have met the Maastricht Criteria.

Also, at this time period Lithuania has been slowly removing its national currency from the cash market. However, the double circulation of the Litas and the Euro caused a lot of organizational difficulties as it consumes a lot of human, material and immaterial resources. Aside from that, the BoL is not responsible for the smooth circulation, sorting, checking and disposal of foreign cash. The increase of deposits in euro also affects the costs of covering market risks which will come from the banking sector and from the changeability of monetary aggregates.

On a 2013 ECB convergence report, Lithuania has yet again met 4 out of 5 of the Maastricht Criteria, this time failing to meet the 3% standard of the European Monetary Union on government deficit; Lithuania's government deficit was 2.1%.

Lithuania has finally fulfilled the Maastricht Criteria on 2014 and the European Parliament has voted to allow the Baltic state to join the Eurozone on January 1, 2015.

When it acceded into the European Monetary Union; it was the last Baltic and the 19th state to be admitted into the monetary union. As Lithuania joined the Eurozone, the BoL was admitted into the Eurosystem and the Single Supervisory Mechanisms that placed its three biggest banks (SEB Bankas, Swedbank and DNB Bankas) under the ECB. BoL is committed to maintain the price stability in their country under 2% as mandated by the ECB.