V. Vasiliauskas on the Potential of the Euro and the Eurozone

March 2016

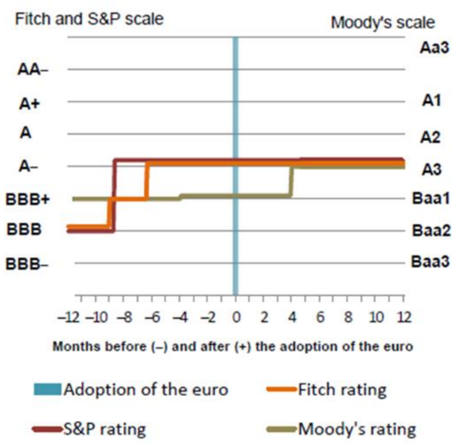
Mr. Vitas Vasiliauskas, the Chairman of the Board of the Bank of Lithuania and a Member of the Governing Council of the European Central Bank (ECB), shares his thoughts on Lithuania's first year of membership in the Eurozone as well *as on the EU's global economic environment and developments in its financial markets regulation. This is an edited version of the central banker's remarks to a recent gathering of executives at BMI.*

EURO BENEFITS FOR LITHUANIA

A year ago now, at the start of 2015, Lithuania introduced the euro. Why did we do that and what has been the outcome? To begin, I would note that before the euro introduction we had a currency board arrangement for more than 20 years, and for more than a decade our currency, the litas, was pegged to the euro. Those two commitments served as an anchor of financial stability and discipline for our small, open and export-orientated economy. And being already pegged to the euro, in my view the actual introduction of the euro was just a final formal step.

Economically it made sense for Lithuania to adopt the euro given our high degree of integration with the EU and the euro area in terms of exports, foreign direct investments and so on. Before the final decision to introduce the euro, the Bank of Lithuania conducted a detailed study and found the step would positively influence our economy via three main channels: improved borrowing conditions, reduced currency exchange and settlement costs, and stimulus for foreign trade and investment which directly impacts GDP. We forecasted the euro introduction would bring an increase in Lithuania's credit ratings from BBB, the lowest investment grade, to a higher rating of A.

Lithuania's ratings were upgraded



And that is precisely what happened. All three international agencies –S&P, Fitch and Moody's– in fact increased their ratings for Lithuania. They gave several reasons: reduced currency risk, sounder national debt due to improved access to financial markets and bank liquidity, and finally, more predictable economic policy with stronger capacity to manage crises. When you are part of such a club with rules, people know you will follow those rules since the Eurozone institutions will not allow you to ignore them. For our young democracy it is valuable to have such an outside watchdog.

Lower borrowing costs due to euro introduction saved Lithuanian households and companies about 35 million euros in loan payments already last year. For the private sector, loans in litas became loans in euros which have lower interest rates, and the margin on interest rates linked to Euribor decreased. Meanwhile, the government locked in savings of some 70 million euros for servicing the debt securities it issued in 2015. After the euro introduction last year the state borrowed at record-low interest rates, selling 10-year bonds at a rate below 1.5% and 20-year Eurobonds – Lithuania's longest maturity ever – with a rate of just 2.16%. So those 20-year bonds were cheaper than 10-year bonds the government issued in 2014 with a 2.18% interest rate!

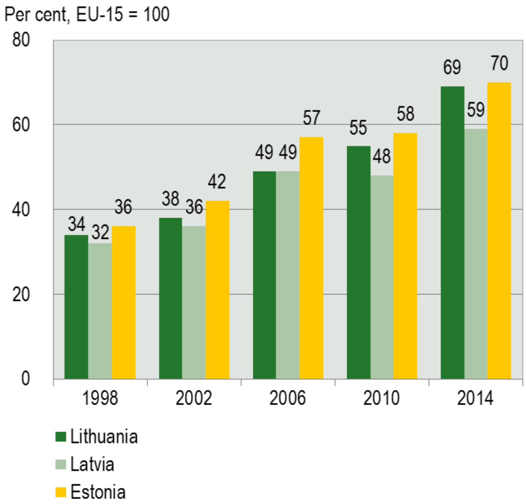
Another very tangible impact of the euro was the end of the need for litas-euro exchanges and currency risk insurance, saving people and institutions 40-50 million euros a year. (This change of course also had some negative impact on banking revenue, one of the costs of the euro introduction.)

As part of the Eurozone, Lithuania immediately benefited from the so-called "quantitative easing" (QE) programme of asset purchases that the Eurosystem has launched. QE has increased demand in the euro area for Lithuanian exports and lowered the euro exchange rate, which facilitates our exports to third countries. We calculate the positive impact of QE on our GDP was about 0.2 percentage points last year and will be about 0.1 percentage points in 2016 and 2017. This has helped compensate reduced trade with Russia. If exports to Russia and other eastern countries dropped by about 2.5 billion euros last year, exports to other countries rose by 1.7 billion euros. QE continues to improve the economic situation of our western partners, in this way also benefiting Lithuanian economy.

Before euro introduction, there was a lot of speculation that it would speed up inflation. In fact, due to low oil prices, we ended last year with a deflationary situation. Of course, core inflation, which excludes energy and food prices, was a bit higher, and prices of services rose much more than those in other areas. But overall, the average impact of euro introduction on the prices was only about 0.1 percent.

Looking ahead, Lithuania is positioned well to continue benefitting from being in the euro area. I like to stress that the euro is not a goal or a guarantee. It is an opportunity we have to make a better life, and now we are fully able to seize that opportunity. I dare to say the Baltic countries are an example of countries perfectly suited to working in a single currency area. Our economy is flexible, with a very responsive labour market – as proven after the crisis hit in 2008. Regarding prudent fiscal policy, currently we are in a good situation. We've come far with structural reforms to improve the business climate and global competitiveness, and we remain committed to further progress. And finally, within just over 15 years living standards have doubled in the Baltics and income has converged from one-third of the EU15 average to two-thirds. Not bad, I would say.

Income convergence (real GDP per capita in PPS)



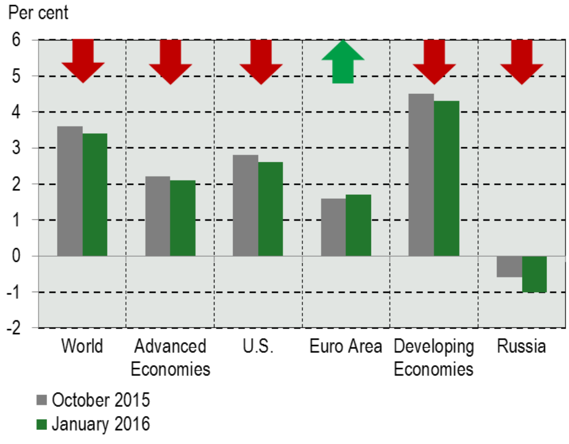
Source: Eurostat

GLOBAL ECONOMIC CONTEXT

In assessing the current and longer-term economic outlook, we should take into account several aspects of the international situation. Global growth estimates for 2016 have been downgraded as deceleration in major developing economies continues while the recovery in key advanced economies takes place at a slower pace than expected. The good news is that despite a challenging environment, the euro area is showing signs of improvement. GDP growth is positive in nearly all Eurozone economies. Short-term economic activity indicators, like the purchasing managers index (PMI), show signs of a recovering economy. A number of factors are supporting the positive outlook: low oil prices and substantial monetary policy easing are among the most important. These two factors are very much helping the recovery of the Eurozone economy.

I think in the medium-term perspective growth in the Eurozone will improve to close to 2 percent, which is not so bad for advanced economies. The outlook for prices is to a large extent determined by volatility of commodity prices. Core inflation, inflation minus energy products and food, could be about 1.6% in the medium term. As for Lithuania, our growth forecast for this year is 2.6%. In 2017 and 2018 we think it will be also around 3 percent.

Real GDP forecasts for 2016



Source: IMF.

Of course there are some risks, which are related to the situation outside the Eurozone and the advanced economies. In China, huge over-lending that lasted for years and the current rebalancing that is taking place makes it increasingly uncertain whether China's growth will stay in line with projections. Another factor is Russia's economy, which after declining by 3.7 percent in 2015, is expected to shrink this year by about 1 percent. Given lower commodity prices, economic growth in Russia and surrounding eastern countries will take time to re-emerge. The outlook for the US economy is broadly stable, though a strengthening dollar may weigh on exports and growth. News shows the Fed is now focused on analysis of the external environment – China and emerging markets. Main domestic figures for the US economy are quite stable.

ECB POLICY

The quantitative easing programme that the ECB first announced in 2014 involves measures designed to restore lending to the euro area economy, to push the banking system to inject money into the real economy rather than hoarding it in the central bank, and to support confidence in the private sector. And surveys conducted by the European Commission show economic sentiment in the euro area did increase already in 2015. We see a positive improvement, and in some periphery countries such as Italy and Spain the sentiment indicator has approached and even exceeded its pre-crisis level.

After three years of contraction, credit growth in the euro has returned to positive territory. Historically low interest rates along with rising confidence have increased private sector demand for credit, while better economic prospects have brought banks to soften their lending standards. There are differences between countries, but on average we can see positive movements in the credit policy of the banking sector. You can be more optimistic or less here, but clearly the situation has improved. So in terms of the credit channel stimulating the real economy, I think it works. We just need more time.

On 3 December 2015 the ECB announced it would extend the QE programme until March of 2017. The idea is to go deeper into QE, into more flexible monetary policy, and to give the banking system more possibilities to lend more to the real economy. In addition, on 10 March 2016 the Governing Council of the ECB introduced an extended package of tools to ease its monetary stance further, responding to weakened growth prospects and inflation development:

1) monthly purchases under the asset purchase programme will be expanded to €80 billion starting in April, and the scope of eligible assets under QE has been broadened by including investment-grade corporate bonds;
2) all key ECB interest rates were lowered: the base policy rate, marginal lending and deposit rates decreased to 0.00 percent, 0.25 percent and -0.40 percent, respectively;

3) a new series of four targeted longer-term refinancing operations (TLTRO II), each with a maturity of four years, will be conducted from June 2016 to March 2017, offering attractive long-term funding conditions to banks to stimulate credit creation.

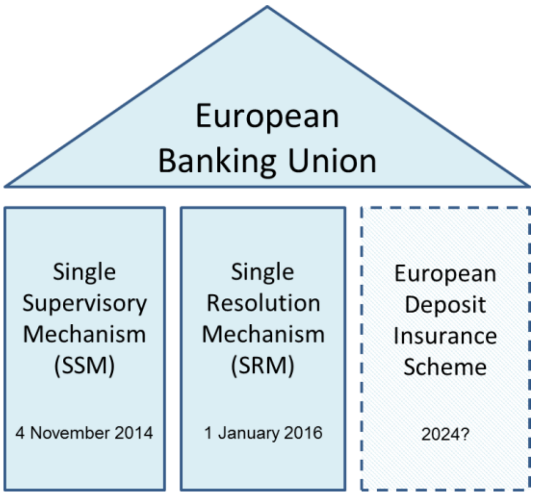
DEEPENING EUROPEAN INTEGRATION

In view of the recent economic challenges, the EU has proved its ability to take ambitious commitments and find solutions quickly in very difficult situations. But even if we have found some short-term solutions, it is important to admit that we still badly need long-term decisions and – I would like to particularly underline – not only decisions, but of course also actions. At this stage the most important thing is the ability to stick to what was agreed. Just to illustrate, according to the European Commission assessment of draft budget plans for 2016, only 5 of the 28 EU members fully complied with the provisions of the Stability and Growth Pact. Another sad example is that none of the EU states fully addressed any of the 157 country-specific recommendations for 2014-2015.

Why is the EU track record in complying with what is agreed so poor and, most importantly, how can we change that? The so-called Five Presidents' Report published last summer proposed the next steps toward completing the Economic and Monetary Union. Among other things, the report suggested to create new institutions including national competitiveness authorities and a European fiscal authority. In my understanding, the main problem today and what makes compliance weak is not the lack of institutions, but the complexity of the rules. I think we should spend less time creating new procedures and institutions, and should concentrate on implementing the agreed rules.

The core idea of the EU is the Single Market. Yet we tend to forget that the potential benefits of the Single Market are still not fully reaped. The capital market is a good example. Well-developed capital markets allocate capital more cost efficiently across industries and countries, offer financing to benefit long-term growth where banks are reluctant to take risks, and help to distribute risks more efficiently. In Europe we are used to seeing banks as the main source of capital. It is very important to create more opportunities to find alternatives to the banking finance.

While progress in capital markets may take some time, in banking sector supervision I see a quite positive outlook. The Single Supervisory Mechanism came into force at the end of 2014 and means all banks in the Eurozone are now supervised by one authority in Frankfurt. We also have the second pillar of the Banking Union in the Single Resolution Mechanism, which started from the first of January this year. And the European Commission has recently made a proposal for creating a supranational deposit insurance framework by 2024. That is also a very important pillar of the new banking framework and wider support for it is needed.



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