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Recommendation for a

COUNCIL RECOMMENDATION TO LITHUANIA

with a view to bringing an end to the situation of an excessive government deficit

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the recommendation from the Commission;

Whereas:

- (1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.
- (2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.
- (3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.
- (4) The Council has decided on [7 July 2009], in accordance with Article 104(6), that an excessive deficit exists in Lithuania.
- (5) In accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure¹ (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances, and request the achievement of a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of 0.5% of GDP as a benchmark.. In deciding whether special

¹ OJ L 209, 2.8.1997, p. 6.

circumstances exist, “relevant factors” as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account.

- (6) Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of Lithuania, notably on account of the size of the required adjustment but especially the very weak economic situation and outlook. In particular, the large further widening of the deficit expected in 2009 and 2010 – despite the government's substantial consolidation efforts – is due to the severe downturn, as the domestic cyclical slowdown, following a lending and housing price boom, has been reinforced by the global economic and financial crisis.
- (7) The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework. Considering the Commission services' spring 2009 deficit forecast for 2009 and 2010 and the existence of special circumstances, Lithuania is recommended to correct the excessive deficit by 2011 at the latest. This would imply an annual average fiscal effort of at least 1½% of GDP over the period 2009-2011.
- (8) In the context of the currency board arrangement, the timing and composition of measures, including structural measures, necessary to correct the excessive deficit should also reflect the need to address macro-economic imbalances and to restore competitiveness. The rapid slowdown in Lithuania's economy in 2008 came after years of sustained growth, fuelled by booming domestic demand, and increasing internal and external imbalances. Fiscal policy was expansionary throughout the boom period, while monetary and credit conditions tightened in 2008 amid higher country risk perceptions and a continued appreciation of the real effective exchange rate.
- (9) From this point of departure, given the lack of room for manoeuvre, in line with the EERP agreed in December by the European Council, the authorities adopted a 2009 budget including substantial fiscal consolidation measures. A comprehensive tax reform and a wide range of expenditure saving measures, including reduction in public wages, have been taken. In view of a sharper than expected deterioration in the macroeconomic outlook at the beginning of 2009 and weaker than planned revenue collection, despite revenue increasing measures, a supplementary budget was approved by Parliament on 7 May 2009, with additional fiscal consolidation measures of around 3% of GDP, targeting a general government deficit of 2.9% of GDP. However, taking into account substantial downside risks to the macroeconomic outlook, adopted fiscal consolidation measures are likely to be insufficient to bring the deficit below the reference value in 2009 as planned. In light of its particular vulnerabilities linked to financial market conditions, Lithuania should implement the fiscal measures included in the 2009 budget and in the supplementary 2009 budget as planned, so as to limit the deterioration of public finances. Further measures should be considered to limit the deterioration of public finances in 2009. For 2010, new consolidation measures will need to be articulated and implemented to correct the excessive deficit in 2011.
- (10) In order to further enhance the credibility of the medium-term consolidation strategy, it will be crucial to address the fragilities of the Lithuanian budgetary framework. The current medium-term budgetary framework remains rather weak as regards medium-term planning and control of public finances. Therefore, as already mentioned in the March 2009 Council opinion on the convergence programme update, risks to the

adjustment should be limited by strengthening fiscal governance and transparency, by enhancing the medium-term budgetary framework and reinforcing expenditure discipline as well as improving the monitoring of the budget execution throughout the year.

- (11) Although general government debt remains well below the 60% of GDP reference value (15.6% of GDP in 2008), according to the Commission services' spring 2009 forecast it is projected to be on a rapidly growing trend rising to 22.6% of GDP in 2009 and 31.9% of GDP in 2010.
- (12) Enhanced surveillance under the EDP, which seems necessary in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in the updates of the Lithuania convergence programme which will be prepared in the period until the abrogation of the excessive deficit procedure could usefully be devoted to this issue.
- (13) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

HEREBY RECOMMENDS:

- (1) On the basis of the macroeconomic outlook of the Commission services' spring 2009 forecast, the Lithuanian authorities should put an end to the present excessive deficit situation by 2011.
- (2) The Lithuanian authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Lithuanian authorities should:
 - (a) implement the fiscal measures included in the 2009 budget and in the supplementary 2009 budget approved by Parliament in May 2009 as planned, so as to limit the deterioration of public finances; further measures should be considered to limit the deterioration of public finances in 2009.
 - (b) to this end, taking into account the economic developments in 2009 and subsequent years, ensure an average annual fiscal effort of at least 1½% of GDP over the period 2009-2011 in order to bring the deficit below 3% of GDP by 2011.
 - (c) devise the additional consolidation measures for 2010 that are necessary to achieve this consolidation path and implement them rigorously.
- (3) To limit risks to the adjustment, Lithuania should strengthen fiscal governance and transparency, by enhancing the medium-term budgetary framework and reinforcing expenditure discipline, as well as improve the monitoring of the budget execution throughout the year.
- (4) The Council establishes the deadline of [7 January 2010] for the Lithuanian government to take effective action to implement the adopted fiscal consolidation in

2009, to progress towards the correction of the excessive deficit and to specify the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' spring 2009 forecast.

- (5) Lithuania's authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programme which will be prepared in the period until the abrogation of the excessive deficit procedure.

In addition, the Council highlights the importance of achieving the medium-term objective (MTO) for appropriate budgetary management of economic downturns. It therefore invites the Lithuanian authorities to ensure that budgetary consolidation towards the medium-term objective for the budgetary position – a deficit of 1% of GDP in structural terms – is sustained after the excessive deficit will have been corrected.

This recommendation is addressed to the Republic of Lithuania.

Done at Brussels,

*For the Council
The President*