COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
SEC(2004) 823 final

Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997**

On the convergence programme of Lithuania, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not participate yet in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

Lithuania's convergence programme covering the period 2004-2007 was submitted on 14 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the Code of Conduct[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> The Lithuanian first convergence programme, covering the period 2003-2007, was submitted on 14 May 2004. The programme does not make explicit references to the country's strategy on euro adoption and ERM II membership, although the authorities have indicated on several occasions that they intend to join the euro area soon after accession, which implies early ERM II entry, while keeping all the features of the current exchange rate system.
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> The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[4].

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[1] OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[2] Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECFIN Council on 10.7.2001

[3] COM(2002) 668 final, 27.11.2002

[4] The code-of-conduct tables annexed to the programme provide all the required data, with minor exceptions, and also some optional information indicated in the code. Table 4 of the programme on the general government budgetary projections gives an incomplete breakdown of expenditure. In addition, inflation is still reported on the basis on the consumer price index (CPI) although table 1 of Annex requires projections for the harmonised index of consumer prices (HICP). The accounting treatment of the compensations for loss of rouble savings and of the real estate restitutions merits further analysis.

The medium-term macroeconomic scenario depicted in the programme envisages GDP growth to remain robust over the programme horizon, particularly in 2004 and 2005, when it is projected at some 7%. Looking further ahead, growth is expected to slow down slightly to about 6.5% in 2006 and 2007, but stays above potential as estimated by the national authorities. Domestic demand is foreseen to continue as the main driver of growth, primarily led by high investment and private consumption growth. The programme's macro-economic projections and external assumptions until 2005 are broadly in line with the Commission Spring 2004 forecasts, with the partial exception of 2005, when GDP is foreseen to grow at 7.3%, against 6.6% projected by the Commission services. The risk of lower than expected growth over the programme's horizon cannot be ruled out and appears the main threat for the achievement of the envisaged fiscal consolidation plans.

Lithuania's inflation performance has been favourable in recent years. Average annual inflation has remained below 2% since 1999, strongly influenced by exchange rate developments in combination with favourable wage and productivity developments. Higher competition in the telecommunications sector added to these factors, contributing to a negative annual rate of HICP inflation of 1.1% in 2003. The deflationary trend initiated in 2002 is expected to reverse this year, to a large extent due to excise and VAT changes required by accession. Annual average inflation is expected to reach 0.9% in 2004 and progressively pick up to 2.5% in 2007. The litas has experienced a nominal effective appreciation of some 50% since 1999, initially under the peg against the dollar and, since February 2002, under the peg to the euro. Both short-term money market rates and long-term bond yields trended down in the course of 2002 and 2003. Money market rates stabilised last year, broadly in line with developments in the euro area money market, and the short-term interest rate spread to the euro area has remained stable at around 60 basis points since end-2003. The yield spread on long-term government bonds amounted to 55-65 basis points in early 2004.

The key objective of the medium-term fiscal strategy defined in the programme is *"the approximation to a cyclically balanced general government budget"*. However, while the targets for the actual general government deficit are set below the 3% of GDP reference value in each year, they are not consistent with a position of close-to-balance during the programme period. In particular, the general government deficit is expected to increase from 1.7% of GDP in 2003 to 2.7% in 2004, decreasing gradually thereafter to 1.5% in 2007. The deficit target for 2004 compares with a target of 2.9% projected in the 2003 pre-accession economic programme (PEP) and the budget for 2004 adopted in December 2003. The targets for 2005 and 2006 remain the same as in the PEP. The programme envisages a rise of the GDP-share of both revenues and expenditure in 2007 relative to 2003. The increase in the revenue ratio, by 2 percentage points, is mostly due to a significant expansion in non-tax revenues. The programme includes no major new policy measures to increase the tax ratio but projects this ratio to rise. The expenditure ratio is foreseen to increase by 1.8 percentage points over the same period, fully due to higher primary expenditure that is expected to be marginally compensated by a decrease in interest payments.

The budgetary outcomes could be worse than projected. In particular, the downside macroeconomic risks highlighted above and the experience with expenditure overruns in the past in response to better-than-planned budgetary outturns in the first half of the year, represent a risk to the envisaged budgetary targets in 2004 and 2005.

Therefore, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations, at least in the initial years of the programme.

The general government debt to GDP ratio has declined steadily from 23.8% in 2000 to 21.5% in 2003, following the fiscal consolidation path initiated in 2000, together with more favourable borrowing conditions. The programme projects an initial increase of the debt ratio in 2004 by nearly 1 percentage point, due to the projected increase of the general government deficit in the same year. The ratio is expected to decrease throughout the remainder of the programme period and stabilise at about 21% in 2007.

The programme reviews the government's structural reform programme which focuses on the labour market, pension and health-care. Overall, the presented reforms are ambitious and should improve the quality of the public finances. However, some of them, such as the health-care and pension reforms, may entail significant short-term costs, which are not sufficiently analysed in the programme.

Lithuania is placed relatively well to meet the budgetary costs of an ageing population although some risk may emerge in the long-run. A number of measures aimed at improving the age dependency ratio and at modernising the pension and health-care systems are being implemented to improve the long-term sustainability of public finances. Nevertheless, there are risks related to the short-term costs of the pension and health-care reforms and the outstanding contingent liabilities. Securing an adequate primary surplus is essential to ensure that the public finances remain on a sustainable footing.

Table: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	**CP**	**9.0**	**7.0**	**7.3**	**6.6**	**6.3**
	COM	8.9	6.9	6.6	n.a.	n.a.
	PEP	*6.8*	*6.2*	*6.5*	*6.0*	*n.a.*
HICP inflation* (%)	**CP**	**-1.2**	**0.9**	**2.0**	**2.1**	**2.5**
	COM	-1.1	1.0	2.2	n.a.	n.a.
	PEP	*0.1*	*2.8*	*2.5*	*2.6*	*n.a.*
General government balance (% of GDP)	**CP**	**-1.7**	**-2.7**	**-2.5**	**-1.8**	**-1.5**
	COM	-1.7	-2.8	-2.6	n.a.	n.a.
	PEP	*-2.4*	*-2.9*	*-2.5*	*-1.8*	*n.a.*
Primary balance (% of GDP)	**CP**	**-0.4**	**-1.3**	**-1.2**	**-0.6**	**-0.4**
	COM	-0.4	-1.4	-1.3	n.a.	n.a.
	PEP	*-1.1*	*-1.6*	*-1.2*	*-0.5*	*n.a.*
Government gross debt (% of GDP)	**CP**	**21.5**	**22.4**	**22.2**	**21.4**	**21.0**
	COM	21.9	22.8	23.2	n.a.	n.a.
	PEP	*22.9*	*22.7*	*23.2*	*23.3*	*n.a.*

**CP, PEP: CPI inflation*
Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Lithuania and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9
of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Lithuania, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July] 2004 the Council examined the convergence programme of Lithuania, which covers the period 2004 to 2007. The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

The budgetary strategy underlying the programme aims at "*approximating a cyclically balanced general government budget by ensuring a successful implementation of economic policy goals*", although the strategy is not well reflected in the programme's deficit targets. In particular, the programme envisages a deficit reduction of just 0.2 percentage points between 2003 and 2007, when the deficit is expected to be 1.5% of GDP. This results from an increase in the GDP-share of both revenues and expenditure. The rise in the revenue ratio over the programme period is expected to amount to 2 percentage points, primarily due to a significant increase in non-tax revenues related to EU financial assistance. Tax revenues are expected to increase by 0.4 percentage points of GDP, despite the planned elimination of the road tax in 2005, which is estimated to negatively affect revenues by 0.5% of GDP in the same year. Following a significant decrease of the expenditure ratio in the last five years, the ratio is foreseen to increase by 1.8 percentage points over the period under consideration, fully explained by an increase in primary expenditure, which is expected to be only marginally compensated by an anticipated decrease in interest payments. The increase in primary expenditure is foreseen to be mostly led by "other expenditures" which are expected to rise by

5 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

0.9% of GDP, mainly related to contributions to the EU budget, and by transfers and subsidies which are expected to increase by 0.7% of GDP, to a large extent related with increasing subsidies to farmers and the compensation for the loss of rouble savings and real estate restitution plans. Government gross fixed capital formation is expected to increase significantly by 1% of GDP in the programme's first two years, but is projected to fall back to 3.1% of GDP in 2007, remaining about 0.2 percentage points above the initial level of 2003.

The macro-economic scenario underlying the programme seems to reflect rather favourable growth assumptions. In particular, the projected growth rate in 2005, which has been revised upwards from 6.5% in the 2003 pre-accession economic programme to 7.3% in the convergence programme, appears on the high side. The evolution of growth in the medium term projected in the programme, while more cautious than in the initial years of the programme, still appears relatively optimistic. The projections for inflation appear realistic.

The programme's targets for the general government deficit are below the 3% of GDP reference value in each year. However, they are not consistent with a position of close-to-balance during the programme period. Moreover, the budgetary stance in the programme does not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations, at least in the initial years of the programme period. The budgetary outcome could be worse than projected. In particular, the downside macroeconomic risks highlighted above and past experience with expenditure overruns in response to better-than-planned revenue outturns represent a risk to the envisaged budgetary targets.

Lithuania is placed relatively well to meet the budgetary costs of an ageing population although some risk may emerge in the long-run. A number of measures aimed at improving the age dependency ratio and at modernising the pension and health-care systems are being implemented to improve the long-term sustainability of public finances. Nevertheless, there are risks related to the short-term costs of the pension and health-care reforms and the outstanding contingent liabilities. Securing an adequate primary surplus is essential to ensure that the public finances remain on a sustainable footing.

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In view of the above, if the growth rates envisaged in the programme materialise, Lithuania is recommended to make faster progress towards a close-to-balance budgetary position, particularly in view of its large current account deficit and domestic demand pressures. Furthermore, Lithuania is urged to implement strictly the budget in order to reduce the risk of breaching the 3% reference value in 2004. Finally, the Lithuanian authorities are encouraged to use better-than-projected revenues for deficit reduction.

Key projections from the convergence programme of Lithuania

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	9.0	7.0	7.3	6.6	6.3
Employment growth (%)	2.0	0.7	1.0	0.2	0.2
HICP inflation (%)	-1.2	0.9	2.0	2.1	2.5
General government balance (% of GDP)	-1.7	-2.7	-2.5	-1.8	-1.5
Government gross debt (% of GDP)	21.5	22.4	22.2	21.4	21.0