COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.2.2005
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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 updated 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. 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 do not participate 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.

The first convergence programme of Lithuania, covering the period 2004-2007, was submitted on 14 May 2004 and assessed by the Council on 5 July 2004. Lithuania submitted an update of its convergence programme on 14 January 2005. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 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 coordination of budgetary policies[3]. This evaluation warrants the following assessment:

– The macroeconomic scenario expects real GDP growth to reach 6.5% in 2004 and 2005 and to decelerate progressively thereafter to 6.0% in 2007. Compared to the May 2004 programme, growth has been revised downwards for the whole programme's period. Output growth in 2004 is estimated to have been lower than expected by the Commission services autumn 2004 forecast. The growth rates foreseen for 2005 and 2006 are somewhat higher than the Commission services autumn 2004 forecast. For the year 2007, the programme's estimate of potential output growth is below the Commission services estimate. On the basis of currently available information, the scenario in the programme can be considered as plausible.

– CPI inflation has been revised upwards throughout the programme horizon. It reached 1.2% in 2004 and is expected to be 2.9% in 2005, 2.5% in 2006 and 2.9% in 2007. The Lithuanian litas joined the ERM II in June 2004, with a unilateral commitment to maintaining the currency board regime. The litas has not deviated from its central rate vis-à-vis the euro. Medium-term interest rates have been trending down in 2004, fluctuating

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1 OJ L 209, 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 ECOFIN Council on 10.7.2001.

3 COM(2002) 668, 27.11.2002.

within 0.65 percentage points above the euro area level, including periods of significantly lower spreads. Lithuania intends to be ready for the introduction of the euro in early 2007.

– The key objective of the medium-term fiscal strategy defined in the programme is the approximation to a cyclically balanced general government budget. The programme foresees the general government deficit to remain at 2.5% of GDP in 2005 but to decline gradually thereafter, to 1.5% in 2007. The time profile of the primary deficit is very similar, improving gradually from 1.5% of GDP in 2004 to 0.5% in 2007. Consolidation is planned to be achieved mainly by an increase of revenues from a low base and, from 2005, also the expenditure side contributes. Revenues are expected to increase from 33% of GDP in 2004 to 34.5% in 2007, primarily due to higher EU financial transfers, the introduction of new taxes and better tax enforcement. Public expenditure is foreseen to increase by 0.5% of GDP over the same period, primarily owing to a significant increase in capital expenditure related to EU projects and "other" expenditures where the largest part corresponds to transfers to the EU budget and the costs of the pension reform[4]. Such increases will be partly compensated by a decrease in consumption and transfers and interest payments. A significant programme of public investment is being implemented, which lifts public investment from 3.4% of GDP in 2004 to 5% in 2007, resulting in an average public investment ratio over the programme period of about 4.6% of GDP. When compared to the May 2004 programme, the deficit outcome for 2004 is estimated to have been lower than budgeted, thanks to better-than-expected revenues. The targets for 2005-2007 are maintained, despite a considerable downward revision of GDP growth.

– The risks to the budgetary projections in the programme appear broadly balanced. The government has shown a good track in meeting the fiscal targets in recent years. The new growth assumptions are more cautious than those provided in the May programme and downside macro-economic risks seem more limited. The main risk to the fiscal projections stems from the uncertainty about the application of detailed measures envisaged in the programme. In particular, the tax revenue target for 2005 might be difficult to achieve if compensatory measures for the abolition of the road tax were not introduced. The execution of the foreseen use of better-than-projected revenues and unused co-financing funds for deficit reduction would be crucial to limit additional spending at the end of the year, which has been a frequent budgetary practice in the past that prevented a faster fiscal consolidation. Other risks stem from the relatively uncertain costs of the pension reform, the high outstanding contingent liabilities, budget arrears, liabilities related to the savings and real estate restitution obligations and spending related to the decommissioning of the Ignalina nuclear power plant.

– In view of this risk assessment, the budgetary stance in the programme may not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme's period, particularly in 2005, nor to achieve a budgetary position of close-to-balance in the medium term. Against the background of the strong economic performance and the large current account deficit, the

[4] A second-pillar pension system was introduced in 2004. Employees participating in the second pillar do not make direct contributions to the second pillar. The state collects all contributions from the employees to the first and second pillars and transfers thereafter to the second pillar the corresponding share (as a capital transfer). Therefore, the costs of the pension reform reflect in the expenditure side in the programme's government figures.

budgetary targets do not appear ambitious, also in view of preventing potential risks of overheating.

– The programme projects an initial increase of the debt to GDP ratio in 2004 by 0.8 percentage points, mostly due to the increase of the general government deficit in the same year. The ratio is expected to decrease throughout the remainder of the programme horizon and reach 20.1% in 2007. The government plans to decrease the stock of government-guaranteed loans from 2% of GDP to 1.2% over the medium-term. No guarantees on new loans have been issued since 2003.

– The programme reviews the government's structural reforms which focus on pension and healthcare, labour market, agriculture and product markets. The pension and healthcare reforms are expected to improve the efficiency of the system and the sustainability of public finances in the long run, but some uncertainty about their medium-term costs remains. Measures are proposed to strike a better balance between capital and labour taxes (decreasing the tax pressure on the latter) and to improve the control and efficiency of expenditure.

– Lithuania appears to be in a relatively favourable position with regard to long-term sustainability of public finances, of which the projected budgetary costs of an ageing population is an important element. The relatively low debt ratio, the pension reform measures enacted, including the introduction of the funded pillars will contribute to limit the budgetary impact of ageing. The strategy outlined in the programme is based on a contained budgetary deficit over the medium term and the long-term impact of the pension reform. Nevertheless, risks related to the costs of the pension reform and to the outstanding contingent liabilities should be monitored. In addition, reform measures in the field of health-care could involve higher expenditures. Lithuania has a relatively low tax ratio: the sustainability gap that arises in the long-run could be addressed by raising it.

– Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. There are measures to use better-than-projected revenues and savings in budgeted EU co-financing allocations for deficit reduction and limit expenditure overruns. The announced measures are not extended to savings made in items unrelated to EU co-financing.

In view of the above assessment it would be appropriate for Lithuania to:

i) make further progress towards a close-to-balance budgetary position, particularly in view of its current account deficit and domestic demand pressures, fuelled by strong credit growth,

ii) implement strictly the budget for 2005 in order to reduce the risk of breaching the 3% reference value,

iii) use better-than-projected or additional revenues and unused expenditure items for deficit reduction.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated 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 updated 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:

(1) On [8 March 2005] the Council examined the updated convergence programme of Lithuania, which covers the period 2004 to 2007. The programme broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". Some required data related to external assumptions are not available and also some optional data are not provided, although this does not make more difficult the programme's evaluation. Accordingly, Lithuania is invited to achieve compliance with the data requirements of the code of conduct.

(2) The macro-economic scenario underlying the programme envisages real GDP growth to decelerate from 6.5% in 2004 to 6.2% on average over the rest of the programme period. On the basis of currently available information, this scenario seems to reflect plausible growth assumptions. The programme's projections for inflation also appear realistic, although the projection for 2006 appears on the low side.

(3) The key objective of the medium-term fiscal strategy defined in the programme is the approximation to a cyclically balanced general government budget. The programme foresees the general government deficit to remain at 2.5% of GDP in 2005 and to decline gradually thereafter to 1.5% in 2007. The primary deficit is expected to improve marginally from 1.5% of GDP in 2004 to 1.4% in 2005, decreasing gradually

[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.

afterwards to 0.5% in 2007. Consolidation is planned to be mainly achieved by an increase in the revenue ratio from a low base, with the expenditure side also contributing from 2005. Revenues are expected to increase from 33% of GDP in 2004 to 34.5% in 2007, after peaking in 2006. Expenditure is foreseen to initially increase from 35.5% of GDP in 2004 to 36.9% in 2005, decreasing gradually to 36% in 2007. A significant programme of public investment is being implemented, which lifts public investment from 3.4% of GDP in 2004 to 5% in 2007, resulting in an average public investment ratio over the programme period of about 4.6% of GDP, against an EU-average of 2.4% of GDP in 2004. When compared to the May 2004 programme, the deficit outcome for 2004 is estimated to have been lower than budgeted. The targets for 2005-2007 are maintained, despite a considerable downward revision of GDP growth.

(4) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the government has shown a good track record in meeting the fiscal targets in recent years. The new growth assumptions are cautious and downside macro-economic risks seem limited. The main risk to the fiscal projections stems from the uncertainty about the application of budgetary measures announced in the programme. In particular, the tax revenue target for 2005 might be difficult to achieve if compensatory measures for the abolition of the road tax were not introduced. A failure to execute foreseen measures constraining expenditure overruns could threaten the budgetary targets over the programme's period. Other risks stem from the relatively uncertain costs of the pension reform, the high outstanding contingent liabilities, budget arrears, outstanding liabilities related to the savings and real estate restitution obligations and spending related to the decommissioning of the Ignalina nuclear power plant.

(5) In the light of this risk assessment, 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 throughout the programme period, particularly in 2005. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved.

(6) The debt ratio is estimated to have reached 20.1% of GDP in 2004, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to remain at the same level in 2007, after peaking at 20.9% in 2005.

(7) Lithuania appears to be in a relatively favourable position with regard to long-term sustainability of the public finances, of which the projected budgetary costs of an ageing population is an important element. The relatively low debt ratio, the pension reform measures enacted, including the introduction of the funded pillars will contribute to limit the budgetary impact of ageing. The strategy outlined in the programme is based on a contained budgetary deficit over the medium term and the long-term budgetary impact of the pension reform. Nevertheless, risks related to the costs of the pension reform should be monitored. In addition, reform measures in the field of health-care could involve higher expenditures. However, Lithuania has a relatively low tax ratio: the sustainability gap that arises in the long-run could be addressed by raising it.

(8) Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. There are measures to use better-than-projected revenues and savings in budgeted EU co-financing for deficit reduction and limit expenditure overruns. The announced measures are not extended to savings made in items unrelated to EU co-financing.

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In view of the above assessment, the Council is of the opinion that Lithuania should:

i) make further progress towards a close-to-balance budgetary position, particularly in view of its current account deficit and domestic demand pressures, fuelled by strong credit growth,

ii) implement strictly the budget for 2005 in order to reduce the risk of breaching the 3% reference value and,

iii) use better-than-projected or additional revenues and unused expenditure items for deficit reduction.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	**CP January 2005**	**6.5**	**6.5**	**6.2**	**6.0**
	COM October 2004	7.1	6.4	5.9	n.a.
	CP May 2004	*7.0*	*7.3*	*6.6*	*6.3*
HICP[1] inflation (%)	**CP January 2005**	**1.2**	**2.9**	**2.5**	**2.9**
	COM October 2004	1.2	2.9	2.8	n.a.
	CP May 2004	*0.9*	*2.0*	*2.1*	*2.5*
General government balance (% of GDP)	**CP January 2005**	**-2.5**	**-2.5**	**-1.8**	**-1.5**
	COM October 2004	-2.6	-2.5	-1.9	n.a.
	CP May 2004	*-2.7*	*-2.5*	*-1.8*	*-1.5*
Primary balance (% of GDP)	**CP January 2005**	**-1.5**	**-1.4**	**-0.8**	**-0.5**
	COM October 2004	-1.4	-1.4	-0.9	-0.5
	CP May 2004	*-1.3*	*-1.2*	*-0.6*	*-0.4*
Government gross debt (% of GDP)	**CP January 2005**	**20.1**	**20.9**	**20.3**	**20.1**
	COM October 2004	21.1	21.7	21.3	n.a.
	CP May 2004	*22.4*	*22.2*	*21.4*	*21.0*

Note:
[1] *CPI inflation for convergence programme data.*
Sources:
Convergence programme (CP); Commission services economic forecasts (COM).