



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.2.2007  
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Recommendation for a

**COUNCIL OPINION**

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

**On the updated convergence programme of Lithuania, 2006-2009**

(presented by the Commission)

## **EXPLANATORY MEMORANDUM**

### **1. GENERAL BACKGROUND**

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies<sup>1</sup>, which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Lithuania was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

### **2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME**

The Commission has examined the most recent update of the convergence programme of Lithuania, submitted on 13 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

- (1) the economic and budgetary performance over the last ten years
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme) and
- (3) the Commission's assessment of the October 2006 national reform programme.

#### **2.1. Recent economic and budgetary performance**

Lithuania has successfully completed the transition to a functioning market economy and now enjoys one of the highest output growth rates among the EU Member States. GDP per capita was just above 50% of the EU average in 2005. Domestic demand has accelerated rapidly in

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<sup>1</sup> OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)

the last years partly reflecting buoyant credit growth, becoming the main driver of economic growth and leading to higher external deficits. After a period of non-inflationary growth, inflation picked up since mid-2004 reflecting a combination of factors including increases in unprocessed food and energy prices and significant wage increases against the background of a tightening labour market. The government has shown a good track record in meeting its fiscal targets in the last years, while better advantage could have been taken from the good times enjoyed by Lithuania.

## **2.2. The assessment in the Council opinion on the previous programme**

On 14 March 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2008. "In the context of strong growth prospects and to ensure sustainable convergence with the EU", the Council invited Lithuania "(i) to strengthen the effort in the structural budgetary adjustment in order to speed up the attainment of the MTO, and (ii) in particular, aim for a more demanding general government deficit target in 2006, making sure that a better-than-projected deficit outcome in 2005 is carried over to 2006 and subsequent years".

## **2.3. The Commission assessment of the October 2006 national reform programme**

The implementation report of the national reform programme of Lithuania, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 13 October 2006. Lithuania's national reform programme identifies as key challenges/priorities: to sustain fast economic growth and a stable macroeconomic environment; to promote the competitiveness of Lithuanian companies; and to promote employment and investment in human capital.

The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report<sup>2</sup>) showed that Lithuania is making good progress in the implementation of the National Reform Programme, in most of the main policy areas across the macro, micro and employment sectors. However, with many important measures at the conceptual stage, there remains much to do in terms of implementation.

Against the background of strengths and weaknesses identified, Lithuania was recommended to take action in the areas of R&D and supply of skilled labour.

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<sup>2</sup> Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

### **Box: Main points covered by the assessment**

As required by Article 5(1) (for stability programmes) Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability<sup>3</sup>;
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct<sup>4</sup>, which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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<sup>3</sup> Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

<sup>4</sup> "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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

**On the updated convergence programme of Lithuania, 2006-2009**

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<sup>5</sup>, 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 [27 February 2007] the Council examined the updated convergence programme of Lithuania, which covers the period 2006 to 2009. The update was submitted almost two weeks beyond the 1 December deadline set in the code of conduct in view of a change in the approval procedure for the programme which now involves the Parliament.
- (2) The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate progressively from 7.8% in 2006 to 4.5% in 2009. Assessed against currently available information, this scenario appears to be based on cautious growth assumptions from 2007. The programme's projections for inflation appear to be on the low side in the light of recent developments.
- (3) For 2006, the general government deficit is estimated at 1% of GDP in the Commission services' autumn 2006 forecast against a target of 1.4% of GDP set in the previous update of the convergence programme. The updated programme presents a deficit estimated at 1.2%. However, preliminary data for the whole of 2006 point to an even better deficit outcome close to balance. This is due to much higher-than-foreseen economic activity and employment, faster wage growth and improvements in tax

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<sup>5</sup> OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)

collection and was achieved in spite of a budget amendment in July 2006 which increased expenditures by around 0.5% of GDP.

- (4) The main goal of the programme is to gradually reduce the general government deficit throughout the programme period so as to achieve the medium-term objective (MTO, see below) by 2008 and a balanced budget in 2009. The primary deficit is expected to be in balance by 2007 and to record a surplus of 0.8% of GDP at the end of the programme period. Compared with the previous update, the planned adjustment is more ambitious, but backloaded against a less favourable macroeconomic scenario towards the end of the programme period. The envisaged fiscal consolidation relies on an increase in the revenue-to-GDP ratio that is higher than the increase in the expenditure-to-GDP ratio (2.6 percentage points compared to 1.4 percentage point). On the revenue side, only 0.5 percentage point is explained by an increase in the tax ratio, which is mainly due to an expected improvement in tax collection. The rest of the increase is not specified in the programme, but seems to be linked to the inflow of EU funds. On the expenditure side, the changes stem from a rise in public investment, social transfers and "other" primary expenditures, which is less than fully offset by a significant cut in government consumption as a percentage of GDP (by more than 2 percentage points).
- (5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to gradually improve from a deficit of 1¾% of GDP in 2006 to a surplus of ½% of GDP in 2009. As in the previous update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 1% of GDP, which the programme aims to achieve by 2008. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 2% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.
- (6) The risks to the budgetary projections in the programme appear broadly balanced until 2007, but budgetary outcomes could be worse than projected in the programme from 2008 onwards. The budgetary strategy relies on a significant increase in the revenues-to-GDP ratio and the substantial cut in public consumption-to-GDP ratio, which could have been better substantiated, taking into account the medium-term framework for the planning and control of public finances which is not sufficiently binding. While the likely carry-over from a lower-than-estimated deficit outcome in 2006 implies that the target for 2007 could be achieved, the lack of detailed information on the envisaged measures introduces considerable uncertainty for the achievement of the budgetary targets from 2008 onwards.
- (7) In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2008, as envisaged in the programme. However, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. According to the programme, the pace of the adjustment towards the MTO is in line with the Stability and Growth Pact which specifies that the adjustment should be higher in good economic times and could be lower in bad

economic times. Nevertheless, in view of the risks identified above, the planned structural adjustment should be strengthened by backing it up with measures so that the annual improvement in the structural balance is 0.5% of GDP as a benchmark, as required for euro-area and ERM II Member States.

- (8) Government gross debt is estimated to have reached 18½% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to remain at around 19% of GDP in 2007-2008 before decreasing to 17¾% in 2009.
- (9) The long-term budgetary impact of ageing in Lithuania is lower than the EU average, with a limited increase in pension expenditure over the coming decades, influenced by the pension reforms enacted. The current level of gross debt is very low in Lithuania and improving the budgetary position as planned in the convergence programme update would contribute to containing the risks to the long-term sustainability of public finances. Overall, Lithuania appears to be at low risk with regard to the sustainability of public finances.
- (10) The convergence programme does not contain a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. However, it provides systematic information on the direct budgetary costs of the main reforms envisaged in the national reform programme and its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, both programmes highlight the ongoing pensions, health care and tax reforms. Nevertheless, the general government deficit targets presented in the convergence programme are significantly lower than those presented in the national reform programme.
- (11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.
- (12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data<sup>6</sup>.

The overall conclusion is that, in a context of strong growth prospects, the programme envisages progress towards the MTO, which is targeted to be reached by 2008. However, there are risks to the achievement of the budgetary targets from 2008 onwards.

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<sup>6</sup> In particular the data on the subcomponents of the stock-flow adjustment and the contributions to potential GDP growth by labour, capital and TFP are missing.

In view of the above assessment, Lithuania is invited to

- (i) exploit the good times by aiming for a more demanding deficit target in 2007 in view of the likely better deficit outcome in 2006 and back-up the pace of adjustment towards the MTO with measures which would ensure that the annual improvement in the structural balance is 0.5% of GDP as a benchmark, as required for euro-area and ERM II Member States;
- (ii) improve the medium-term framework for the planning and control of public finances.



### Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	<b>CP Dec 2006</b>	<b>7.6</b>	<b>7.8</b>	<b>6.3</b>	<b>5.3</b>	<b>4.5</b>
	COM Nov 2006	7.6	7.8	7.0	6.5	n.a.
	CP Dec 2005	7.0	6.0	5.3	6.8	n.a.
HICP inflation (%)	<b>CP Dec 2006</b>	<b>2.7</b>	<b>3.9</b>	<b>4.7</b>	<b>3.4</b>	<b>3.1</b>
	COM Nov 2006	2.7	3.8	4.6	3.3	n.a.
	CP Dec 2005	2.7	2.7	2.7	2.5	n.a.
Output gap (% of potential GDP)	<b>CP Dec 2006<sup>1</sup></b>	<b>1.9</b>	<b>2.4</b>	<b>1.6</b>	<b>0.1</b>	<b>-1.9</b>
	COM Nov 2006 <sup>5</sup>	1.2	1.4	0.7	-0.6	n.a.
	CP Dec 2005 <sup>1</sup>	2.9	2.1	0.5	0.6	n.a.
General government balance (% of GDP)	<b>CP Dec 2006</b>	<b>-0.5</b>	<b>-1.2</b>	<b>-0.9</b>	<b>-0.5</b>	<b>0.0</b>
	COM Nov 2006	-0.5	-1.0	-1.2	-1.3	n.a.
	CP Dec 2005	-1.5	-1.4	-1.3	-1.0	n.a.
Primary balance (% of GDP)	<b>CP Dec 2006</b>	<b>0.3</b>	<b>-0.4</b>	<b>0.0</b>	<b>0.4</b>	<b>0.8</b>
	COM Nov 2006	0.3	-0.2	-0.4	-0.5	n.a.
	CP Dec 2005	-0.9	-0.8	-0.7	-0.4	n.a.
Cyclically-adjusted balance (% of GDP)	<b>CP Dec 2006<sup>1</sup></b>	<b>-1.0</b>	<b>-1.8</b>	<b>-1.3</b>	<b>-0.5</b>	<b>0.5</b>
	COM Nov 2006	-0.8	-1.4	-1.4	-1.2	n.a.
	CP Dec 2005 <sup>1</sup>	-2.3	-2.0	-1.4	-1.2	n.a.
Structural balance <sup>2</sup> (% of GDP)	<b>CP Dec 2006<sup>3</sup></b>	<b>-1.0</b>	<b>-1.8</b>	<b>-1.3</b>	<b>-0.5</b>	<b>0.5</b>
	COM Nov 2006 <sup>4</sup>	-0.8	-1.4	-1.4	-1.2	n.a.
	CP Dec 2005	-2.3	-2.0	-1.4	-1.2	n.a.
Government gross debt (% of GDP)	<b>CP Dec 2006</b>	<b>18.7</b>	<b>18.4</b>	<b>19.2</b>	<b>19.0</b>	<b>17.7</b>
	COM Nov 2006	18.7	18.9	19.6	19.8	n.a.
	CP Dec 2005	19.2	19.9	19.8	18.9	n.a.

**Notes:**

<sup>1</sup> Commission services calculations on the basis of the information in the programme.

<sup>2</sup> Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

<sup>3</sup> There are no one-off and other temporary and other temporary measures in the programme..

<sup>4</sup> There are no one-off and other temporary measures taken from the Commission services' autumn 2006 forecast.

<sup>5</sup> Based on estimated potential growth of 7.9%, 7.7%, 7.8% and 7.9% respectively in the period 2005-2008.

**Source:**

*Convergence programme;* *Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations.*