EUROPEAN COMMISSION
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# LITHUANIA: MACRO FISCAL ASSESSMENT

## AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Lithuania's convergence programme was submitted on 28 December 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 29 February 2008. Comments should be sent to Julda KIELYTE (julda.kielyte@ec.europa.eu); Agne GENIUSAITE (agne.geniusaite@ec.europa.eu)). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' autumn 2007 forecast, (ii) the code of conduct ("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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 19 February 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

**http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm**

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## SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Lithuania, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2007-2010, was submitted on 28 December 2007.

Lithuania is on the path of a rapid catching-up process converging towards the European average income levels. Real GDP growth in Lithuania has ranked among the fastest in the EU averaging to around 7.3% in 2000-2006. However, growth has been primarily driven by domestic demand. Monetary conditions have been accommodative, given a high degree of euroisation in the framework of a currency board arrangement within ERM II. In the absence of measures to curb excessive domestic lending, rapid credit expansion facilitated by financial deepening has boosted private consumption and real estate investment. However, capacity constraints have emerged as emigration and high economic growth have led to labour shortages, aggravated by skill mismatches and low participation rates, and increasing costs. A wage-price spiral with increasingly rapid wage growth outstripping productivity is leading to rapid inflation and declining price competitiveness. Even though export performance remains robust, the external deficit has widened rapidly as strong domestic demand has led to high import growth and external vulnerability has increased. In this context fiscal policy has not responded to the rising macroeconomic imbalances: the general government balance has remained in deficit and, in the absence of binding medium-term expenditure ceilings, better-than expected revenues have been systematically spent. Tax incentives and exemptions help underpin the ongoing real estate boom and thus add to overheating. A tighter fiscal stance and structural reforms in the labour market and educational system will be major contributors to addressing internal and external imbalances and attracting inward investment, thus ensuring a sustainable catching-up process. This is particularly important given the limited number of policy instruments available to Lithuania in the context of the constraints implied by its monetary policy regime.

The macroeconomic scenario underlying the programme envisages real GDP growth reaching 9.8% in 2007 and declining relatively sharply thereafter to 5.3% in 2008 and to 4.8% per annum on average over the rest of the programme period. Domestic demand is expected to slow but to remain the main driver for growth. Assessed against currently available information, this scenario appears cautious. This is particularly so in 2008 given recent momentum, and inconsistent including in terms of showing a widening external imbalance despite a projected strong slowdown of domestic demand. The programme projects inflation to increase from 5.8% in 2007 to 6.5% in 2008 before falling to 5.1% in 2009 and 3.6% in 2010 showing very little progress towards convergence. Moreover, in view of food price trends, planned gas price increases (explicitly recognised in the programme and estimated at 1.5% in 2008 but not incorporated into its 2008 inflation projection) and wage increases far above productivity growth, underlining the danger of exacerbating the wage-price spiral, serious upside risks to these projections are evident. Widening external imbalances, if materialising as foreseen by the programme, would increase the economy's external vulnerability. Moreover, recent price and wage developments pointing to the danger of deteriorating competitiveness could themselves result in a worsening external position.

For 2007, the general government deficit is estimated at 0.9% of GDP in the most recent update of the convergence programme, identical to the target set in the previous update in spite of a much better-than-expected performance in 2006. The favourable base effect of some 0.6% of GDP was offset by a one-off measure of similar magnitude. Similarly to the practice of previous years, additional revenues on the back of higher-than-anticipated economic growth were spent, exceeding the previously planned expenditure ceilings. Budgetary implementation in 2007 was not in line with the invitation in the Council opinion of 27 February 2007 on the previous update of the convergence programme as the economic good times and lower-than-targeted deficit in 2006 did not lead to a more demanding deficit target for the year. Further, even though the medium-term objective (MTO) of a structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) of 1% of GDP was just reached in 2006, there was a small slippage from the MTO in 2007, by about ¼% of GDP.

The main goal of the medium-term budgetary strategy is to foster macroeconomic stability via a tighter fiscal policy. Compared to the previous update, the target year for achieving the MTO has been postponed by one year from 2008 to 2009 despite a broadly unchanged macroeconomic scenario. However, applying the common methodology to the information in the programme suggest the MTO could be reached from 2008. The programme targets a gradual improvement of the headline general government balance from a deficit of 0.9% of GDP in 2007 to a surplus of 0.8% in 2010. The structural balance calculated according to the commonly agreed methodology is projected to improve from a deficit of 1¼% of GDP in 2007 to a surplus of 1% in 2010, with the main adjustment effort back-loaded to after 2008. On the back of relatively strong economic growth, the adjustment is planned to be achieved through a greater increase in the revenue-to-GDP ratio than in the expenditure-to-GDP ratio (3.9 percentage points compared to 2.2 percentage points respectively). Despite further direct tax cuts, revenues are expected to increase on the basis of higher EU funds inflows, increases in excise duties and a further considerable improvement in tax collection. On the expenditure side, the increase stems from significantly higher social payments and rising public investment, the latter mainly supported by EU funds. The adoption in November 2007 of the Law on Fiscal Discipline aimed at strengthening the multi-annual expenditure framework and providing a firm commitment to fiscal restraint. However, the law, effective from the beginning of 2008, is focused on annual budgetary preparation and execution and does not as such introduce a forward-looking medium-term budgetary framework, which needs to be enhanced.

The budgetary outcomes could be worse than projected in the programme. Despite the programme's particularly cautious projection of real and nominal output growth from 2008 onwards, the projected revenue increase seems substantial: even with a more favourable macroeconomic growth scenario, the revenue projection appears on the high side, especially taking into account the impact of further direct tax reductions and its reliance on improved tax collection. The large increase in the ratio of non-tax revenues to GDP and the expected results from improved tax collection are insufficiently substantiated in the programme. Moreover, the numerous expenditure-increasing measures together with the absence of a sufficiently binding medium-term framework for the planning and control of public finances imply a risk that expenditure will continue to exceed previously set ceilings. If the economic slowdown proves to be severe or protracted, producing a rapid fall in revenue growth, this would exert greater pressure on the budget.

In view of this risk assessment, the budgetary stance in the programme seems insufficient to ensure that the MTO is achieved by 2009, as envisaged in the programme. In particular, there could be deterioration in the structural balance in 2008, because of the planned revenue-decreasing and expenditure-increasing measures, whereas Lithuania, which currently enjoys strong growth, should pursue an effort above the 0.5% of GDP benchmark for the annual structural improvement. The pace of adjustment towards the MTO implied by the programme should thus be strengthened, especially in 2008, to be in line with the Stability and Growth Pact. After the projected achievement of the MTO, the fiscal policy stance implied by the programme is in line with the Stability and Growth Pact. However, given persisting external and domestic pressures, a tighter fiscal policy than currently planned would be appropriate.

Lithuania appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, with a limited increase in pension expenditure over the coming decades, influenced by the pension reforms already enacted. The current level of gross debt is very low and the initial budgetary position in 2007 as estimated in the programme, which is better than the starting position of the previous programme, would contribute to containing the risks to the long-term sustainability of public finances.

Lithuania's National Reform Programme (NRP) identifies as key challenges/priorities: sustaining rapid economic growth, a stable macroeconomic environment and seeking full-fledged membership in the EMU; promoting the competitiveness of Lithuanian enterprises; promoting employment and investment in human capital. On 11 December 2007 the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which included an assessment of the October 2007 implementation report of Lithuania's NRP[1]. The Commission's assessment is that Lithuania has made good progress in implementing its national reform programme over 2005-2007. The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem to be in line with those foreseen in the national reform programme. In particular, both programmes cover the ongoing pension, healthcare and tax reforms. Information provided in both programmes on the direct budgetary costs associated with the healthcare and education reforms are insufficient, while the convergence programme provides more detailed information on other reform areas. However, a qualitative assessment of the overall impact of the national reform programme within the medium-term fiscal strategy is lacking. The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines in the area of budgetary policies issued in the context of the Lisbon strategy.

Upon entry into the ERM II mechanism, Lithuania undertook commitments related to fiscal policy, the financial sector and structural policies. Concerning progress in implementing these commitments, the authorities have insufficiently strengthened the fiscal stance and measures to restrain credit growth have been limited. Despite the rapid economic growth of recent years, the government has not achieved a balanced budget, budgetary targets have been unambitious and windfall revenues mainly spent. The medium-term budgetary strategy remains insufficiently binding and needs to be strengthened. Measures have been undertaken to curb credit growth, such as raising the reserve requirements and expanding the compulsory reserve base, but their direct impact

[1] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

has been limited. A The anti-inflation initiatives announced by the government in March and December 2007 have not so far led to concrete measures. A number of structural reforms are ongoing, but further efforts are needed in the fields of education, labour market and to attract inward investment.

The overall conclusion is that the programme aims at tackling Lithuania's macroeconomic imbalances by tightening fiscal policy. However, the budgetary targets seem modest in the light of the current high economic growth. The programme envisages only a back-loaded adjustment effort so that the MTO is reached only in 2009. There are risks to the achievement of the budgetary targets as the consolidation is insufficiently backed by announced measures or a binding medium-term framework. The revenue projections are optimistic given the further planned direct tax cuts and a reliance on improved tax collection and inconsistent with the cautious macroeconomic scenario. A significantly tighter fiscal policy than foreseen in the programme and further structural policy measures are needed to address mounting inflationary pressures, maintain competitiveness and tackle remaining bottlenecks in the labour market, crucial also for sustaining catching-up. As regards the long-term sustainability of public finances Lithuania remains at low risk.

## Comparison of key macroeconomic and budgetary projections

| | | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| Real GDP (% change) | **CP Dec 2007** | **7.7** | **9.8** | **5.3** | **4.5** | **5.2** |
| | COM Nov 2007 | 7.7 | 8.5 | 7.5 | 6.3 | n.a. |
| | *CP Dec 2006* | *7.8* | *6.3* | *5.3* | *4.5* | *n.a.* |
| HICP inflation (%) | **CP Dec 2007** | **3.8** | **5.8** | **6.5** | **5.1** | **3.6** |
| | COM Nov 2007 | 3.8 | 5.6 | 6.5 | 5.2 | n.a. |
| | *CP Dec 2006* | *3.9* | *4.7* | *3.4* | *3.1* | *n.a.* |
| Output gap[1] (% of potential GDP) | **CP Dec 2007** | **1.7** | **3.3** | **1.5** | **-0.4** | **-1.3** |
| | COM Nov 2007[2] | 1.0 | 1.0 | 0.4 | -0.6 | n.a. |
| | *CP Dec 2006* | *2.4* | *1.6* | *0.1* | *-1.9* | *n.a.* |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | **CP Dec 2007** | **-9.5** | **-12.5** | **-12.7** | **-14.5** | **-15.4** |
| | COM Nov 2007 | -8.9 | -12.5 | -12.9 | -13.0 | n.a. |
| | *CP Dec 2006* | *-6.6* | *-7.5* | *-7.0* | *n.a.* | *n.a.* |
| General government balance (% of GDP) | **CP Dec 2007** | **-0.6** | **-0.9** | **-0.5** | **0.2** | **0.8** |
| | COM Nov 2007 | -0.6 | -0.9 | -1.4 | -0.8 | n.a. |
| | *CP Dec 2006* | *-1.2* | *-0.9* | *-0.5* | *0.0* | *n.a.* |
| Primary balance (% of GDP) | **CP Dec 2007** | **0.2** | **-0.1** | **0.3** | **0.9** | **1.4** |
| | COM Nov 2007 | 0.2 | 0.0 | -0.5 | 0.2 | n.a. |
| | *CP Dec 2006* | *-0.4* | *0.0* | *0.4* | *0.8* | *n.a.* |
| Cyclically-adjusted balance[1] (% of GDP) | **CP Dec 2007** | **-1.0** | **-1.8** | **-0.9** | **0.3** | **1.1** |
| | COM Nov 2007 | -0.8 | -1.2 | -1.5 | -0.6 | n.a. |
| | *CP Dec 2006* | *-1.8* | *-1.3* | *-0.5* | *0.5* | *n.a.* |
| Structural balance[3] (% of GDP) | **CP Dec 2007** | **-1.0** | **-1.2** | **-0.9** | **0.3** | **1.1** |
| | COM Nov 2007 | -0.8 | -1.2 | -1.5 | -0.6 | n.a. |
| | *CP Dec 2006* | *-1.8* | *-1.3* | *-0.5* | *0.5* | *n.a.* |
| Government gross debt (% of GDP) | **CP Dec 2007** | **18.2** | **17.6** | **17.2** | **15.0** | **14.0** |
| | COM Nov 2007 | 18.2 | 17.7 | 17.2 | 16.1 | n.a. |
| | *CP Dec 2006* | *18.4* | *19.2* | *19.0* | *17.7* | *n.a.* |

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 7.9%, 8.4%, 8.2% and 7.4% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.6% of GDP in 2007 (deficit-increasing), according to the most recent programme. As this transaction was decided after the cut-off date of the autumn 2007 forecast, it is not reflected in the Commission

Source :

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

## 1. INTRODUCTION

The Lithuanian convergence programme, covering the period 2007-2010, was submitted on 28 December 2007[2]. It was submitted four weeks after the deadline of 1 December specified in the code of conduct. The Lithuanian government approved the convergence programme on 17 December 2007 and it was sent to the European Affairs committee of the Lithuanian Parliament. There is no formal parliamentary approval of the convergence programme in Lithuania. The budgetary projections for 2008 are based on the national budget for 2008 which was adopted by the Parliament on 6 December 2007. Economic projections presented in the programme reflect the authorities' autumn forecast as published in September 2007 and updated with more recent information in November 2007.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Lithuania, with a particular focus on catching-up and overheating – challenges for fiscal policy. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. Section 8 reviews progress in implementing Lithuania's ERM II commitments. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

## 2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON CATCHING-UP AND OVERHEATING – CHALLENGES FOR FISCAL POLICY

### 2.1. Introduction: rapid economic growth but growing concerns

Lithuania is on the path of a rapid catching-up process converging towards the European average income levels. Real GDP growth in Lithuania has ranked among the fastest in the EU averaging to around 7.3% in 2000-2006. Economic convergence was rapid: real GDP per capita (in purchasing power standards) increased from 42% of EU-27 average in 2001 to an estimated 62% in 2007.

The growth accounting exercise in the Commission services' assessment of the previous programme update attributed GDP growth in Lithuania largely to total factor productivity (TFP) growth and to a lesser extend capital deepening; labour input was not a driver of growth and made both positive and negative contributions depending on its individual determinants. Therefore major challenges include a greater labour use, improved labour market performance as well as increasing investment. Furthermore, financing of

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[2] The English translation of the programme was submitted on 23 January 2008.

investment, substantially from abroad will remain a critical endeavour as domestic saving remains low.

However, the rapid economic growth is characterised by mounting imbalances and is showing clear signs of overheating. Rapid credit expansion facilitated by financial deepening and a real estate boom is fuelling domestic demand, though more recently the ongoing tightening of credit conditions is supportive of the necessary adjustment. The country faces capacity constraints as emigration and high economic growth is leading to labour shortages and increasing costs. Excessive wage growth outpaces productivity growth. Even though export performance remains robust, it is outpaced by import growth. The internal pressures are stimulating inflation and further widening the current account deficit. In the light of these developments, and given that other policy instruments are limited within a currency board arrangement, fiscal policy has a crucial role to play in maintaining macroeconomic stability. Stepping up fiscal consolidation would support more sustainable external deficits and help prevent overheating of the economy and at least partly counterbalance the steady widening of the private sector deficit.

The assessment of Lithuania's 2006 convergence programme already identified preserving macroeconomic stability as a main challenge in the area of public finances[3]. Over the last year, concerns have grown regarding the overheating of the economy as reflected in the macro-economic imbalances. This section analyses in more detail the factors behind the growing imbalances and the potential role of fiscal policy, including its limitations in addressing the associated challenges. The analysis will first concentrate on the supply side and more in particular on the labour market and investment and their contribution to economic development in the medium-term. Secondly, the current challenges on the demand side reflected in growing imbalances, suggesting overheating, will be analysed. Finally, the role of and challenges for fiscal policy will be discussed.

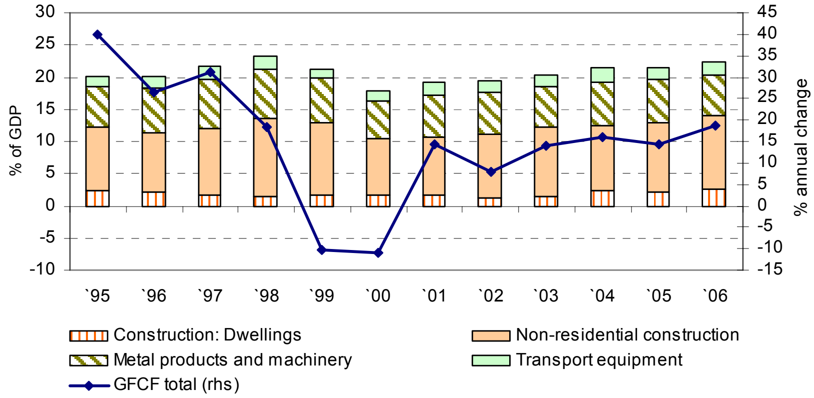
## 2.2. Supply-side effects on growth potential

### *2.2.1. Investment*

Investment is crucial in sustaining economic growth given a fairly low quality and quantity of infrastructure in Lithuania. Starting from a relatively low capital stock, gross fixed capital formation (GFCF) has been growing at double digit rates since 2001. The share of total GFCF in GDP reached about 23% in 2006, somewhat above the EU-15 average, but much lower than in Estonia and Latvia (both around 34%). Public investment (by general government) was above 4% of GDP in 2006 and thus higher than in the EU-15. However, as shown in the Figure 1, investment has been increasingly directed to construction activities and to a lesser extent towards productive assets such as machinery and transport equipment.

[3] European Commission (2007): Economic assessment of the Convergence Programme of Lithuania (February 2007). Available at: http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/lt/com_lt20062007.pdf

**Figure 1: Total gross fixed capital formation by asset type**




*Source: Eurostat*

Investment into construction, real estate and domestic trade activities outpaced by far the investment growth in tradable sectors, especially in the most recent years. The breakdown of the investment by sector show large investment concentration in non-tradable sectors (about 25% in real estate and construction sectors). However, over the period of 2003-2006 about a third of all investment has been directed to sectors such as manufacturing, transport vehicles and agriculture.

Furthermore, EU funds provide an important source of capital and speed up the upgrading of infrastructure, increase investment in human capital and help to achieve a more balanced regional development. Although the positive effect from EU funds will get stronger in the coming years, it is important to attract additional sources of investment.

The role of foreign direct investment (FDI) is crucial in this respect. In general, despite the positive business environment and relatively low taxes, Lithuania is struggling to attract higher FDI flows, with FDI per capita roughly four times smaller than in Estonia. Furthermore, a large part of foreign capital is coming in the form of banking loans or reinvested earnings, not in the form of green field investment. The most frequently cited causes for this failure to attract FDI relate to red tape, corruption and the uncompleted land reform[4]. To a large extent the FDI that has taken place has flowed to domestically oriented sectors such as transport and communications, retailing and electricity, gas and water supply and financial intermediation. Upgrading of infrastructure in these sectors is essential in the catching-up process. Furthermore, a high share of the FDI stock (around 40% in 2006) is located in the manufacturing sector, mainly in manufacturing of petroleum products[5].

### *2.2.2. Labour market*

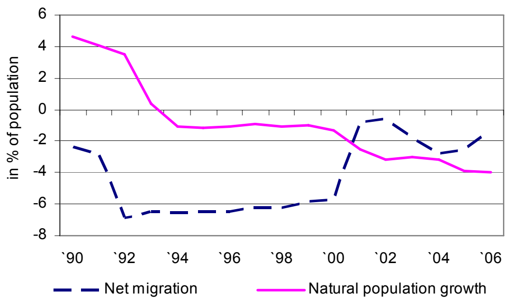
The labour market has tightened rapidly over the last few years as employment growth has hit against a declining labour force, partly reflecting high emigration flows.

[4] Main goals of the current government programme include fighting corruption, reducing red tape and completing land reform.

[5] However, this is mainly a result of the sale of the state-owned stake in Mazeikiu Nafta oil refinery in 2006 to Poland's PKN Orlen.

Shortages in several sectors are creating upward pressures on labour costs. The unemployment rate declined markedly from 17.4% in 2001 to below 3.9% in 3Q 2007[6]. Despite robust growth in economic activity, employment growth was relatively moderate at about 1% p.a. over the period 2001-2006. However, increased participation rates, particularly of people close to retirement age (+11.6% y-o-y), were observed in the first half of 2007.

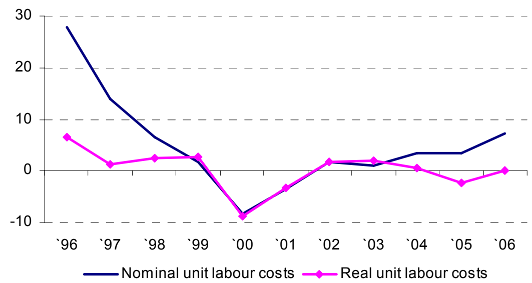
**Figure 2: Natural population change and net migration, 1990-2006**




*Note: 1990–2000 net migration was recalculated taking into account undocumented outflows.*

*Source: Statistics Lithuania*

**Figure 3: Unit labour costs, annual % change (total economy)**




*Source: Eurostat*

As mentioned earlier, emigration poses an important economic and social challenge for Lithuania. It has contributed significantly to a decline of population (7% over the period 1990-2006) and to an even larger decline in the labour force[7]. The most recent wave of emigration, which is largely related to the labour market liberalisation following the EU accession[8] and is mainly economically motivated, has placed an additional constraint on the labour market. Because of the selectivity of migrants, most emigrants are young (about 40% in the age group of 20-34) and economically active. This leads to a decline of economically active population and a tightening of the labour market while economic activity and demand for labour is surging[9].

[6] The rate of unemployment in Lithuania has fallen below the NAIRU (non-accelerating inflation rate of unemployment). In the short-term this increases inflation risks but in the long term it could put a constraint to economic growth. Rising wages could erode international competitiveness and put further constrain to growth sustainability.

[7] In the beginning of 1990s emigration increased dramatically and remained high until the end of decade, including mostly the so-called "Russian speaking population" which returned to their countries of origin. The main destination of the majority of emigrants was the Russian Federation, Belarus and the Ukraine.

[8] The United Kingdom, Ireland and Sweden opened their labour markets immediately after the EU enlargement in May 2004. However, most other EU-15 countries introduced transitory periods implying restrictions to labour mobility from the new EU member states (European Commission 2004).

[9] According to a study by the Bank of Lithuania (2006) migration flows amounting to 1% of the labour force could lead to a 0.5% p.a. lower GDP in the initial years compared to no-change scenario. Due to emigration, unemployment is estimated to fall below the trend; wages of skilled workers are estimated to be lower by 2%, mainly because of assumed increased in share of skilled workers in the total workforce, and these of unskilled higher by 4% compared to hypothetic trend.

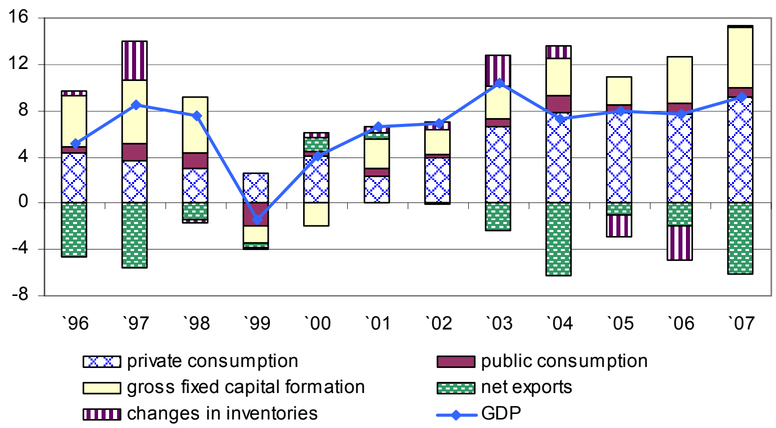
Following these developments, registered vacancies, especially for specialists in fast growing sectors (construction, financial intermediation, and retailing), but also in public administration are on the rise. The supply side is struggling to match demand and labour market constraints have become more evident (low regional mobility, skill mismatch, relatively low activity rates).

Increasing labour shortages are resulting in upward pressures on wages. Wages increased rapidly in 2006 (15.2% in 2006), by far outpacing labour productivity growth and accelerated further in 2007. Wage growth in the private sector somewhat outpaced wage growth in the public sector. There is some evidence that Lithuanian enterprises are increasingly considering hiring foreign workers from non-EU countries to overcome labour shortages.

### 2.3. Demand pressures leading to overheating

High domestic demand is the main force driving the Lithuanian economy: growth is determined by increasing private and government consumption and investment while the contribution from net exports is negative. In 2006, real household consumption expenditure increased by 13.5%, due to, higher employment, rising incomes (compensation of employees went up by 17.1% in nominal terms), growing borrowing and transfers from emigrants. Real investment increased by 11.9%, positively influenced by low interest rates, high profitability of enterprises and EU support.

**Figure 4: Contributions to real GDP growth by expenditure approach, annual % change**

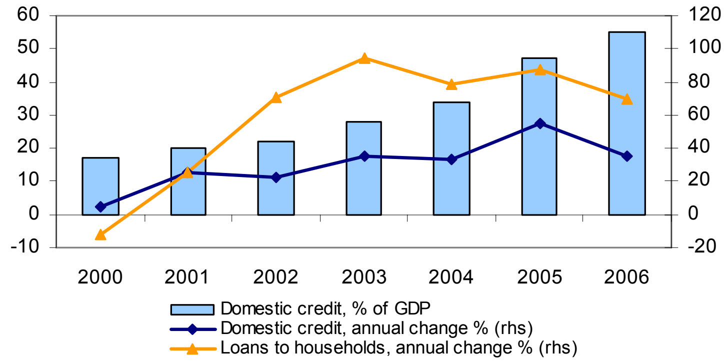



*Source: Eurostat and Statistics of Lithuania.*

#### *2.3.1. Credit growth and real estate boom*

Domestic demand, the main driver of GDP growth, was largely fuelled by active borrowing by households and enterprises. Credit costs decreased substantially and liquidity constraints weakened since 2002, leading to low or negative real interest rates. The availability of accessible borrowing boosted domestic demand; and as wages started to increase so did optimistic expectations about future income growth. Loan growth to households reached annual rates of 70-80% over the period 2002-2006 (60% y-o-y in November 2007), whereas annual credit growth to non-financial corporations was close to 30-40% (36% y-o-y in November 2007). Total credit to private sector reached 47% of GDP by the end of 2006, while the annual flow of credit to private sector accounted for 16% of GDP.

**Figure 5: Domestic credit and loans to households**




*<u>Source</u>: Bank of Lithuania*

At the end of 2006, 45% of outstanding loans were attributable to the household sector, with residential mortgages dominating household borrowing (66% of the total claims) while consumer loans were growing rapidly. Measured against gross disposable household income, outstanding debt reached 25% in 2006. Credit growth to enterprises has expanded most rapidly to non-tradable sectors, particularly to real estate and construction.

The credit to GDP ratio of Lithuania is not very high relative to the EU-average level, but it is higher than for most recently acceded Member States in transition, having risen rapidly in just a few years. The currency denomination represents a significant balance sheet risk for the corporations and households. In 2006, about half (53%) of total outstanding loans to non-financial corporations and households were foreign currency denominated (95% in euros) down from 68% in 2000. Increasing external borrowing of the private sector entails a further increase in gross external debt, up from 40% of GDP in 1999 to 55% by the end of 2006; nearly half short-term external debt. The general government external debt also increased, albeit at a slower rate than the growth of the economy.

**Box 1. The macroeconomic effects of rapid financial convergence**

**EU membership and strong presence of foreign banks accelerated financial convergence in most RAMS.** This has improved availability of credit to domestic borrowers, including households. As a result, many RAMS are going through periods of rapid private credit growth, in many cases financed through external borrowing by their commercial banks. Private credit growth has been particularly strong in the Baltic countries and Bulgaria in recent years, ranging from 37.4 to 61.3 percent in the twelve months to November 2007. Financial convergence offers major benefits, most importantly it tends to improve the efficiency of capital allocation and, thus, enhance the growth potential.

**Recent research in the European Commission points to a mechanism through which financial convergence may also influence real exchange rate and current account trends in RAMS**. Results of stochastic dynamic general equilibrium model-based simulations show that improved access to credit, while leaving TFP growth unchanged, leads to a persistent real appreciation and a widening of the current account deficit in the short to medium run — just like in the case of the Balassa-Samuelson (B-S) effect (Székely and Watson, 2007). The longer-run implications are, however, markedly different from those of the B-S effect, where the real appreciation is due to a productivity shock in the tradable sector. The appreciation of the real exchange rate is not permanent. In the longer run, when the impact of the improved access to credit is over, the real exchange rate returns to a level that is slightly more depreciated than in the baseline. The current account balance also starts to improve and in the long run returns to the same level as in the baseline. The faster the financial convergence the larger the swings in the real exchange rate and the current account balance are likely to be.

**These results also indicate the vulnerabilities rapid financial development and integration can create in RAMS.** When prices are sticky the exchange rate regime matters in the short run: a fixed exchange rate regime generates a larger current account deficit than a flexible exchange rate regime. That is, the dynamics will depend on several factors, and trade-offs between these. These factors include the stickiness of prices, the extent of unhedged balance sheet exposures, and the degree of nominal flexibility afforded by the exchange rate regime.

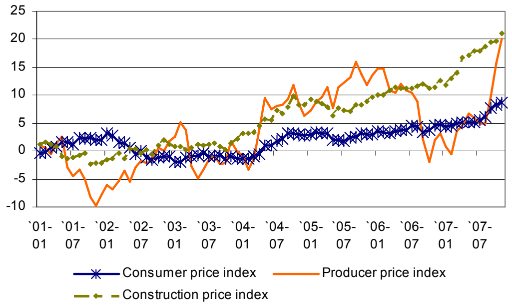
Székely, István P. and Maxwell Watson (2007), Growth and Economic Policy: Are There Speed Limits to Real Convergence?, Economic Papers, European Commission DGECFIN, forthcoming.

### *2.3.2. Inflationary pressures and the competitiveness of the economy*

HICP inflation in Lithuania increased from 3.8% by the end of 2006 to around 5.8% by the end of 2007, strongly driven by external developments such as higher food and energy prices, EU accession related indirect tax harmonisation and increases in administered prices. More recently domestic demand pressures have been more evident. Rising inflation might be seen as part of the process of convergence to EU price levels. Furthermore, very recently there might be some evidence of relative price adjustment, as implied by the Balassa-Samuelson effect[10].

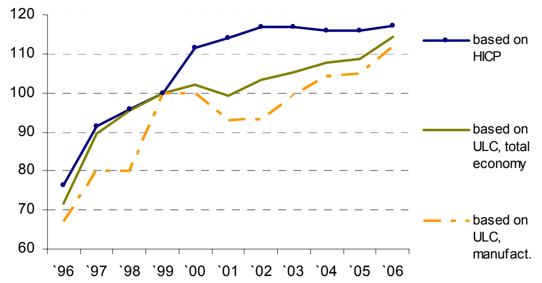
[10] The Balassa-Samuelson effect suggests that in a catching-up economy higher productivity growth in the tradables sector than in the non-tradables sector leads to relatively higher inflation in the latter.

**Figure 6: Price developments, annual % change**




*Source: Statistic of Lithuania*

**Figure 7: Price and cost competitiveness indicators compared to EU-27 (1999=100)**




*Source: Commission services*

Rising inflation has resulted in the REER based on the HICP to appreciate by 17% vis-à-vis the EU-27 since 1999. Excessive wage growth, well above productivity gains in recent years, leading to rapidly rising unit labour costs, are reflected in the REER based on unit labour costs appreciating by 14% since 1999 (see Figure 8)[11].

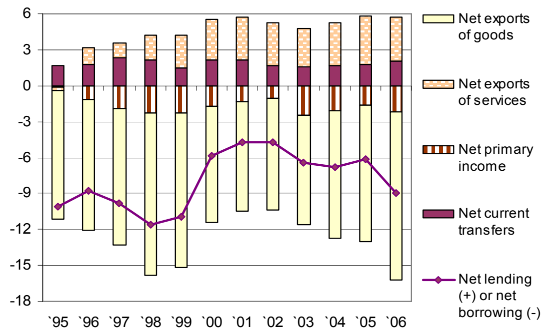
However, given the increasing gap between domestic saving and investment as domestic demand has accelerated, it seems unlikely that deteriorating price and cost competitiveness has played the primary role in explaining the growing external deficit. Export performance (as measured by export market shares or export growth) has remained relatively robust in recent years, which could be at least to a certain extent related to EU accession. Although most recent figures suggest some slowing of export growth, they partly reflect one-off effects related to the capacity constraints in the oil refining industry (excluding oil products, exports showed a strong growth of 27% y-o-y in January-September 2007). On the other hand, buoyant domestic demand has sustained a strong growth in imports, even though some increase in import penetration can also probably be attributed to reduced price competitiveness of domestic producers. As a result, the current account deficit has further widened.

### *2.3.3. Growing external imbalances*

The trade deficit, which has been the main driver of the external deficit, widened further, as strong domestic demand supported by household spending stimulated imports. Lithuania's current account deficit increased to 10.8% of GDP by the end of 2006 compared to just below 6% in 2005 and deteriorated further in the first three quarters of 2007 to 12.7% of GDP. The deteriorating external balance was mainly financed through the banking sector, typically through loans from the parent banks or syndicated loans and by FDI. FDI in Lithuania made up 50% of the current account deficit in 2006.

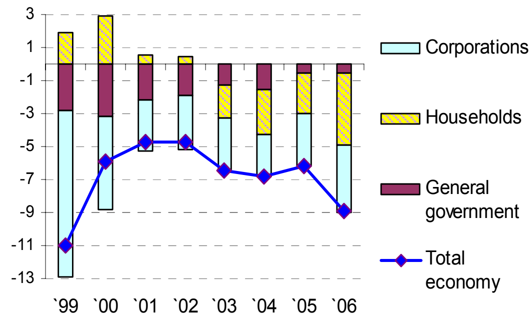
[11] On the other hand, the Bank of Lithuania points to depreciation vis-à-vis the currencies of the Commonwealth of Independent States (CIS), thus indicating a better competitive position of Lithuania vis-à-vis these countries.

**Figure 8: External balance, in % of GDP**




*Source: Eurostat*

**Figure 9: Net lending (+) / borrowing (-) by sector, in % of GDP**




*Source: Ameco database*

Concerning the net borrowing needs of the country, insufficient domestic savings, increasing private investments and the real estate boom (which started in 2003) have led to a growing deficit of the private sector. In 2006, the external balance deteriorated sharply, mainly due to continuing rapid consumption and investment of the private sector (especially households), while the government deficit worsened only slightly.

### 2.4. Role of fiscal policy

In view of the currency board arrangement which limits the room of manoeuvre for monetary policy, restrictive fiscal policy is the main available tool the government has to address in the short term the growing imbalances. Even though the direct effect of fiscal policy on the Lithuanian economy is relatively limited given that government expenditure and revenue to GDP ratios are among the lowest in the EU (close to 33% in 2006) and the economy is small and open, fiscal policy can play an important role in addressing demand-side pressures. Fiscal tightening could mitigate the risks arising from exuberant demand concentrated in the non-tradable sector and signal that the government is taking measures in tackling inflationary pressures and scaling back on tax incentives, particularly those for real estate. Public saving could help to at least partly compensate the widening private savings-investment gap. Furthermore, public finances could also play an important role in alleviating labour market pressures through wage moderation and through measures aiming to increase the relatively low participation rates.

However, fiscal policy in Lithuania seems to have added to overheating pressures as the fiscal stance has been slightly pro-cyclical. Considering the rapid economic growth, better advantage could have been taken from good times. Faced by the different challenges of the economy, the government has been taking measures by adopting recently a Law on Fiscal Discipline. The Law is based on provisions of the Stability and Growth Pact: having as objectives a balanced budget in the medium term and long-term sustainability. It requires the government to respect the fiscal discipline needed for the long-term sustainability of public finances taking account of growth conditions. However, the Law has been criticised as being too lax and unclear. Furthermore, it does not as such introduce a binding medium-term budgetary framework as had been recommended by international institutions. Although Lithuania's economy is showing strong signs of overheating, the Law still allows the government to run a budget deficit of 0.5 percent of GDP in 2008 and aims at balancing the budget only in 2009[12]. Considering the strong economic growth in the recent years and the current overheating, the commitment to fiscal restraint seems insufficient and fiscal policy remains expansionary. Moreover, the Law does not ensure greater budget transparency and scrutiny of the budgetary process. Therefore, a more ambitious medium-term expenditure framework is needed. In order to increase the efficiency and effectiveness of spending, it would be key to improve annual expenditure evaluation and to introduce binding expenditure ceilings.

### *2.4.1. Evolution in government revenue*

Total government revenues declined from a peak of 38% in 1997 to 33% of GDP in 2006 though since 2003 a slight recovery in the revenue ratio has taken place. A significant restructuring of public revenues has taken place. The biggest decline was observed in other current revenues. While the share of indirect taxes decreased slightly, the proportion of direct taxes increased.

Lithuania has one of the lowest implicit tax rates[13] on consumption (16.5% in 2005) and on capital (11.4% in 2005). Lithuania introduced a flat corporate income tax (CIT) of 33% in 1994 and reduced it substantially to 15%[14] in 2002; since then revenues from the CIT have been growing robustly. However, its implicit tax rate on labour (35.9% in 2005) was relatively high which prompted the government to propose a gradual reduction of the personal income tax (PIT) from 33% to 27% in July 2006 and to reduce it further to 24% in January 2008. The main purpose of tax rate reduction is to balance labour and capital taxation and to lower the tax burden on individuals.

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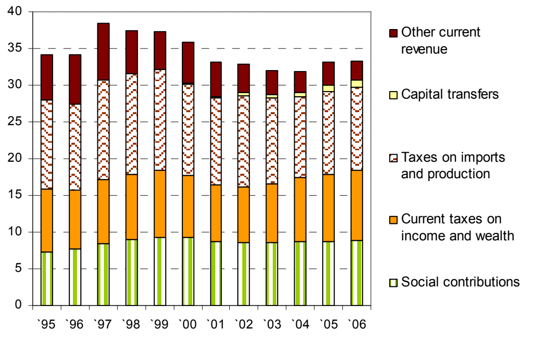
[12] However, downside risks to achieving the 2008 target exist in the light of planned tax and pension reforms and higher expenditures on social transfers and public wages (see section 4.3 for further analysis).

[13] Implicit tax rates (ITR) measure the effective average tax burden on labour, consumption and capital. ITR express aggregate tax revenues as a percentage of the potential tax base for each field.

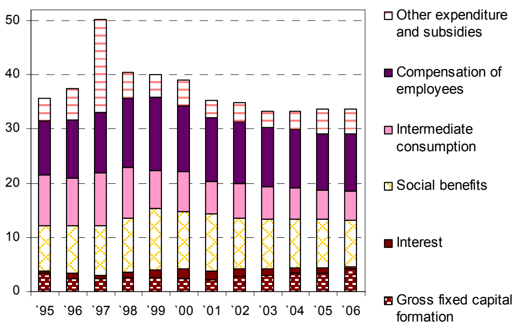
[14] A temporary "social tax" was introduced in 2006 for two years (4% in 2006 and 3% in 2007). The tax base is the taxable profit as assessed for corporate income tax.

**Figure 10: Government revenue, in% of GDP**




*Source: Eurostat*

**Figure 11: Government expenditure, in% of GDP**




*Source: Eurostat*

The government has some room to respond to the demand boom and to the threats of overheating. Some policies, such as tax incentives for borrowing[15], are adding to overheating and to the real estate boom. Furthermore, elimination of the existing tax exemptions[16] would broaden the tax base and make the system more transparent.

### *2.4.2. Evolution in government expenditure*

After peaking in 1997, government expenditures decreased gradually and stood at around 33% of GDP over the period 2003-2006. A certain restructuring of public expenditure has also taken place. Investment expenditures have increased slightly both as a share of total expenditure (12% in 2006) and as a share of GDP (reaching around 4.2% in 2006). At the same time, social expenditures have been gradually reduced and the government wage bill remained relatively stable in recent years. Nevertheless, windfall revenues have been mainly spent instead of achieving more ambitious fiscal consolidation. Considering the rapid annual GDP growth, government expenditures have increased at a similar pace as GDP. Thus, the budgetary improvement was not achieved by expenditure restraint but mainly revenue-driven on the back of higher-than-anticipated growth.

In the light of the ongoing catching-up process, the need for public spending to improve public administration capacity, the social situation and to increase (efficient) investment in R&D and human capital, as well as in larger infrastructure projects remains high. More could be done to improve efficiency and transparency of government spending: a much more targeted fiscal policy which aims at streamlining of expenditures and does not rely only on over-performing revenues is important. So as to increase efficiency, prioritising public investment and holding back projects which have a lower contribution to a real catching-up would be a prudent way of managing expenditure in this situation. Furthermore, as the budget is formed based on institutional rather than programming principles, it lacks evaluation of the efficiency of expenditure. A more conservative expenditure planning and growth would help to avoid overheating of the economy and to preserve more flexibility which would be needed with a turn in the economic cycle.

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[15] Tax incentives exist for mortgage borrowing, notably with regard to the deduction of mortgage interest payments from personal taxable income on house acquisition or construction loans.

[16] Several exemptions from VAT are applied to real estate and construction (e.g. a reduced VAT rate of 9% is applied to the construction, renovation and heat insulation of residential premises). A reduced VAT rate of 5% is also applied for some food products, pharmaceutical products, public transport, hotel and accommodation services etc.

### 2.5. Conclusions: challenges for fiscal policy

The government has to respond to mounting demand and external pressures and through budgetary means avoid adding further stimulus to the economy. High inflows of EU funds, undoubtedly being important for the catching-up process, are further stimulating demand. Also the government's decision to resume cash compensation payments to individuals for earlier rouble saving losses (1.3% of GDP) in March 2007 added further stimulus to the economy and demand pressures. Also the adopted budget law for 2008 contains several tax cuts, significantly higher social transfers and increases in public wages, which will strongly increase disposable income and add to demand pressures.

Responsible fiscal policy aiming at containing inflation and sending an important signal about less optimistic expectations, would contribute to reducing the risks of a hard landing. Substantial fiscal consolidation would require using all revenue over-performance for deficit reduction and restraining from expenditure increases by improving multi-annual planning and control of government expenditure and introducing binding expenditure ceilings. Further consolidation of employee positions in the public sector and especially moderation of further wage increases in the public sector would allow for savings on the general government wage bill[17].

Given the limited range of policy instruments to curb domestic demand, improving supply-side conditions will be central to achieve high and sustained economic growth while at the same time reducing economic imbalances. Public finances should play an important role in this, by re-directing public spending to growth-enhancing areas, easing labour market pressures and by improving the efficiency of public spending in key sectors.

[17] The regular Commission on the Improvement of the Public Administration System established by the Lithuanian government, recently concluded that Lithuania lacked a human resources management model for the civil service and that further measures controlling growth of the number of civil servants should be taken.

## 3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes how the macroeconomic vulnerabilities identified in the preceding section are expected to develop according to the programme.

### 3.1. Economic activity

The macroeconomic scenario presented in the programme projects real GDP growth to reach 9.8% in 2007 and to ease relatively sharply thereafter to 5.3% in 2008 and 4.5% in 2009 (Table 1). The projected economic slowdown is based on the key assumption of a drop in credit growth due to a potential correction of real estate prices and to a tightening of monetary conditions. As a result, domestic demand is expected to slow but to remain the main driver for growth. Counter-intuitively, weaker demand growth is not shown as affecting the demand for imports until 2009[18]. The contribution of external trade to growth, although remaining negative throughout the programme period, is forecast to improve sharply from 2008. This forecast improvement in exports can be mainly attributed to the restoration of full capacity in the oil refining industry. Furthermore, the slower credit growth scenario leading to a sharp slowdown of domestic demand is based on an assumed tightening of monetary policy by the ECB. However, this seems to be inconsistent with the interest rate assumptions presented in the programme, where short-term interest rates are set to decline from 2007 to 2009 while long-term interest rates are to remain stable. Overall, the programme forecasts a worsening of the macro-economic imbalances as reflected in the inflation and external position figures.

The real growth estimate for 2007 is higher in the programme than in the Commission services' autumn forecasts but much more cautious for 2008 and 2009 at 2.2 percentage points and 1.8 percentage points below the Commission services' autumn forecasts. The growth projections beyond 2009 are much below the Commission services' estimates of potential growth. The assumed very abrupt deceleration of economic growth in 2008 seems inconsistent with the strong carryover from high growth in 2007 and lack of unequivocal signs so far of economic slowdown. The most recent data do not indicate a reversal in economic activity. From November 2007 onwards, credit growth data shows some signs of slowing down, especially in terms of the net increase in the level of the loans stock, but the moderation so far appears limited. However, a scenario of a significantly stronger slowdown is not to be excluded, linked to the unsustainability of current macroeconomic trends and negative changes in the global environment. In this respect, the tightening of global liquidity conditions could become one of the factors instrumental in triggering a possible upcoming slowdown, rather than the assumed monetary tightening in the euro area.

Private consumption growth as projected in the programme remains relatively robust, supported by tax cuts and rapid wage growth; however, while the figure in 2007 is

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[18] The main external assumptions underlying the programme's macroeconomic scenario are in line with those underlying the Commission services' 2007 autumn forecast (until 2009), except for interest rates. Short-term interest rates are set to decrease in 2008 and 2009 in the programme in contrast to relatively stable rates assumed in the Commission services' forecast. Long-term interest rates are forecast to increase somewhat less than in the Commission services' forecast.

comparable to that of the Commission services' autumn 2007 forecast, it is lower for 2008 and 2009. The foreseen moderation of private consumption seems to be on the low side given real wage growth in 2008 projected at over 10%. The programme foresees an extremely sharp slowdown in investment growth in 2008 (from 26.5% of GDP to 3.4%), reflecting the expectations of a deeper adjustment after several years of very strong investment performance, which compares to a relatively gradual slowdown foreseen in the autumn forecast. For 2008, in a certain contradiction with the assumed steep deceleration of domestic demand, in particular of investment, the updated convergence programme projects a similar rate of import growth to that of the autumn forecast. The programme does not articulate this scenario nor the significant slowdown of both export and import growth foreseen in 2009. The programme notes that the REER has appreciated in respect to the EU as a whole and CIS countries and depreciated somewhat with respect to the new EU member states. However, this cannot be clearly attributed to a possible deteriorating price and cost competitiveness as trade is again forecast to pick up in 2010. According to the programme, the external deficit is forecast to widen further, in particular from 2009, mainly because of a further widening in the goods and services deficit. This leads to an even less sustainable external position over the programme period than that depicted by the autumn forecast.

In general, there are several apparent inconsistencies in the macroeconomic scenario: while in 2008 wage growth remains very robust and measures resulting in higher disposable income are adopted (see Section 2.5), private domestic consumption growth is forecast to decline relatively sharply and the current account deficit to stabilise before widening further from 2009. A rise in the savings ratio in response to tighter financial conditions or worsened expectations could provide part of the explanation for the domestic demand slowdown, but such a mechanism is not specified (and would not explain the relative buoyancy of imports). Furthermore, excessive wage growth does not seem to translate into higher inflation.

### Table 1: Comparison of macroeconomic developments and forecasts

| | 2007 | | 2008 | | 2009 | | 2010 |
|---|---|---|---|---|---|---|---|
| | COM | CP | COM | CP | COM | CP | CP |
| Real GDP (% change) | 8.5 | 9.8 | 7.5 | 5.3 | 6.3 | 4.5 | 5.2 |
| Private consumption (% change) | 12.9 | 12.4 | 9.3 | 6.7 | 7.2 | 6.2 | 5.4 |
| Gross fixed capital formation (% change) | 19.8 | 26.5 | 11.9 | 3.4 | 8.2 | 5.2 | 7.9 |
| Exports of goods and services (% change) | 8.7 | 8.6 | 11.3 | 12.2 | 9.1 | 2.4 | 8.0 |
| Imports of goods and services (% change) | 15.0 | 16.0 | 12.4 | 12.3 | 9.6 | 4.1 | 8.4 |
| *Contributions to real GDP growth:* | | | | | | | |
| - Final domestic demand | 15.2 | 15.8 | 11.0 | 7.0 | 8.6 | 6.1 | 6.8 |
| - Change in inventories | 0.1 | 0.0 | -0.4 | 0.0 | 0.1 | 0.0 | 0.0 |
| - Net exports | -6.1 | -6.0 | -3.1 | -1.7 | -2.3 | -1.6 | -1.6 |
| Output gap[1] | 1.0 | 3.3 | 0.4 | 1.5 | -0.6 | -0.4 | -1.3 |
| Employment (% change) | 2.2 | 2.3 | 0.2 | 0.3 | -0.1 | 0.1 | 0.0 |
| Unemployment rate (%) | 4.2 | 4.5 | 4.2 | 5.2 | 4.4 | 6.0 | 5.9 |
| Labour productivity (% change) | 6.2 | 7.3 | 7.3 | 5.0 | 6.4 | 4.4 | 5.2 |
| HICP inflation (%) | 5.6 | 5.8 | 6.5 | 6.5 | 5.2 | 5.1 | 3.6 |
| GDP deflator (% change) | 7.8 | 6.1 | 7.1 | 6.7 | 6.0 | 3.2 | 2.3 |
| Comp. of employees (per head, % change) | 14.6 | 20.4 | 15.4 | 18.7 | 8.3 | 7.6 | 7.2 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -12.5 | -12.5 | -12.9 | -12.7 | -13.0 | -14.5 | -15.4 |

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

*Source*:

*Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)*

Cyclical conditions implied by the programme (as measured by the output gap recalculated by Commission services with the commonly agreed methodology) are favourable although the significant positive gap is closing towards the end of the programme period and becomes negative in 2009. They are more favourable for 2007 and 2008 than in the Commission services' autumn forecasts, and are comparable for 2009 (the programme itself presents even higher output gap calculations which indicate even more optimistic conditions)[19]. In general, the assessment of cyclical conditions in successive convergence programmes has become more positive over time for 2007 and 2008. The macroeconomic outlook assumes a marked deceleration over the period 2008-2009 which is much lower than the average growth performance of the past five years (7.3%).

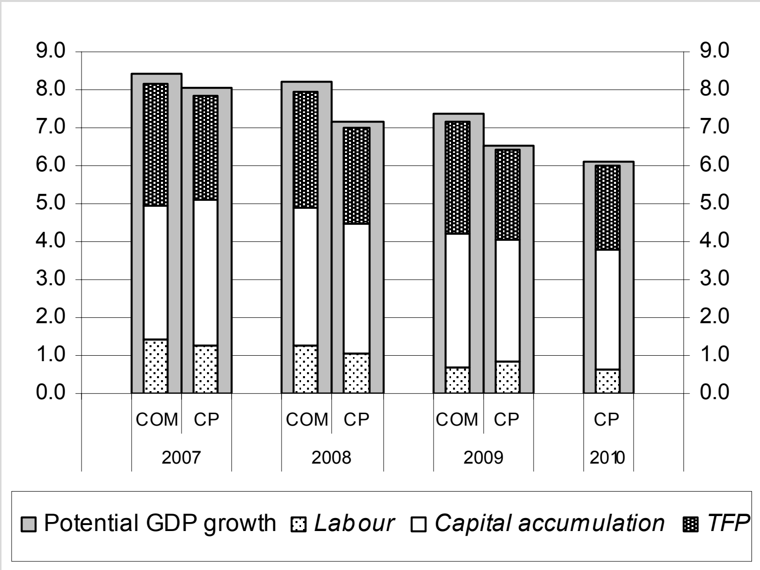
It should be noted that the calculation of the potential output growth (and hence the output gap) needs to be interpreted with caution for countries catching-up rapidly and undergoing fast structural changes: estimates of cyclical conditions have varied quite significantly in successive convergence programmes and Commission services' forecasts.

[19] The programme states that there are many uncertainties related to the precision of the output gap calculations, especially as regards structural shock estimations, using the HP filter. Furthermore, the tax elasticity is not precisely estimated due to the numerous recent changes in tax law. This could lead to a different estimation of the output gap from that recalculated by the Commission services using the commonly agreed methodology.

**Box 2: Potential growth and its determinants**

The graph below compares the potential growth estimates of the Commission services autumn 2007 forecast with the Commission services' recalculations using the commonly agreed methodology based on the information provided in the programme. These potential growth figures are somewhat below the potential growth estimates derived from the Commission services' autumn 2007 forecast due to more cautious growth scenario presented in the programme. The programme implies a somewhat lower contribution from TFP and a slightly higher contribution from capital than in the autumn forecast. Compared with the last five years when growth was led predominantly by TFP growth due to structural reforms, both the programme and the forecast expect capital accumulation to become the main driver of growth as a result of continuingly high investment, partly related to EU funds.

**Potential growth and its determinants**




### 3.2. Labour market and cost and price developments

Continuing the trend seen in the past five years and against the background of strong economic growth, employment is expected to increase by 2.3% in 2007, reaching the highest rate since 2002. Employment should continue to grow until 2009 but at much lower rates than in 2006-2007, in line with the Commission services' autumn forecasts, mainly due to a shrinking labour force driven by continuing net emigration. According to the programme, structural changes in the labour market continue as labour moves from less productive sectors to currently very buoyant but more cyclically exposed sectors such as construction, real estate and distribution. According to the programme, favourable cyclical conditions, in terms of a positive (though declining) output gap, are expected to contribute the most to the decline in the rate of unemployment, which is estimated to have fallen by 1.1 percentage points to 4.5% in 2007. However, under the influence of a reversal of continuing net emigration and higher activity rates, the unemployment rate is expected to increase again to 6.0% over the rest of the programme period[20]. Whereas the programme foresees an increase in the unemployment rate, the

[20] The unemployment projections of 4.8% in 2008 and 4.9% in 2009-2010 are based on the assumption that rapidly increasing wages lead to much higher activity rates and a continuing reversal in net outward migration.

Commission services' forecasts projects unemployment to remain at a relatively low level (4.2%) until 2009.

The programme projects growth of employee compensation to remain strong and higher than projected in the autumn forecast for 2007-2008, well above productivity growth. Growth of average monthly wages is expected to continue at rates of almost 20% in 2007 and 2008 before slowing down to above 7% in 2009. Real wage growth is estimated to remain considerably above labour productivity gains until 2009. However, the programme posits that current wage increases are reacting with a lag to past productivity growth exceeding wage growth.

The inflation forecast has been revised substantially upwards compared to the previous update because of very marked rises in food and energy prices. According to the programme, HICP inflation is expected to increase from 5.8% in 2007 to 6.5% in 2008 before easing to 5.1% in 2009. Although much in line with the Commission services' autumn forecast, in view of the recent price developments there are now clear upside risks to the programme's inflation projections due to possible higher food and gas prices[21], ongoing wage increases and higher inflation expectations.

Continued high wage growth and inflation could reduce the competitiveness of the economy which in turn could undermine growth potential. Risks for macroeconomic stability, most notably relating to persistently high inflation and high external imbalances, are on the rise. If external imbalances enlarge at a rate foreseen by the programme, the economy's external vulnerability would increase.

### 3.3. Macroeconomic challenges

Lithuania has been experiencing a period of strong growth, primarily driven by domestic demand, with little evidence so far of slowdown. However, it shows clear signs of overheating and imbalances are mounting. As described in more detail in Section 2, it is characterised by a very large and increasing external deficit, continuing rapid credit growth, rising inflationary and wage pressures and a tight labour market.

Monetary conditions have been accommodative given a high degree of euroisation in the context of a narrowly pegged exchange rate within ERM II[22]. In the absence of measures to curb excessive domestic lending, rapid credit expansion facilitated by financial deepening has boosted private consumption and real estate investment. However, capacity constraints have been emerging as emigration and high economic growth have led to labour shortages and increasing costs. Prominent labour market challenges are skill mismatches and low participation rates. As a consequence, very high wage growth has far outpaced productivity growth, adding to inflationary pressures and reducing price competitiveness. Even though export performance remains robust, the external deficit has widened rapidly as strong domestic demand has led to high import growth and external vulnerability has increased.

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[21] Gas prices for private households were increased by 62-67% (depending on categories) from 1 January 2008. This mainly reflects the higher natural gas price to Lithuania from the sole gas supplier Gazprom. According to press reports Lithuania will pay around USD350 per 1000 cubic meters of natural gas from January 2008, up 35% from the USD 260 average price in 2007 (and 78% more than in January 2007).

[22] See Section 8 for a detailed assessment of progress in implementing the ERM II commitments.

The programme foresees a soft landing scenario, triggered by sharply decreasing credit growth from 2008. However, it also foresees a further worsening of macroeconomic imbalances: inflation is to increase and remain high (with risks still being on the upside), while the already wide external deficit is set to deteriorate. The programme mentions new measures to be adopted during 2008 to address inflationary pressures and to contain credit growth, but is not specific regarding their substance[23]. It indicates that the purposefulness of tax exemptions will be reviewed and possible "quasi-monetary" measures will be considered. However, while a plausibly gradual slowdown of the economy and structural adjustment from booming sectors requires labour market flexibility, including wage moderation, the programme projects a large shortfall remaining between productivity and wage growth. Given the scale of the excess of wage growth over productivity growth, the projected rise in inflation seems likely to be exceeded.

Even though some signs of stabilisation in the real estate market are apparent and there are signs of credit growth having peaked, recent data still indicate ongoing strong credit growth. The balance sheet positions of the household and corporate sectors are already greatly exposed to foreign currency, interest rate and refinancing risks. A tightening of monetary conditions and a receding real estate boom should lead to a moderation of borrowing but present balance sheet risks are so substantial that they need some time to unwind. In this context, it may be noted that tightening financing conditions and a moderation of optimistic expectations might lead to a quite rapid increase in household savings and in lower investment on the part of both households and the corporate sector. In terms of risks to the outlook for economic activity, this might lead to a rather sharp deceleration in growth in the near term to which policies might have to react swiftly. Under any likely scenario, strong inflationary pressures remain, posing a further challenge to households and putting pressure on corporate sector costs. Even though it seems that worsening competitiveness indicators have not yet translated into weaker export performance, imports remain high on the back of strong domestic demand. Uncertainty is high as to the timing of receding demand pressures, while widening external imbalances increase the economy's external vulnerability.

In this context the lack of an appropriate fiscal policy response to the macroeconomic imbalances has induced vulnerabilities: the general government balance has remained in deficit and, in the absence of binding medium-term expenditure ceilings, better-than expected revenues have been systematically spent instead of achieving a more ambitious fiscal consolidation. Tax incentives and exemptions help underpin the ongoing real estate boom and thus add to overheating. The fiscal position has thus become vulnerable to a change in the cycle. An adequate fiscal stance and removal of structural bottlenecks will be key to address internal and external imbalances. Structural reforms in the labour market and educational system could play a stronger role in the catching-up process.

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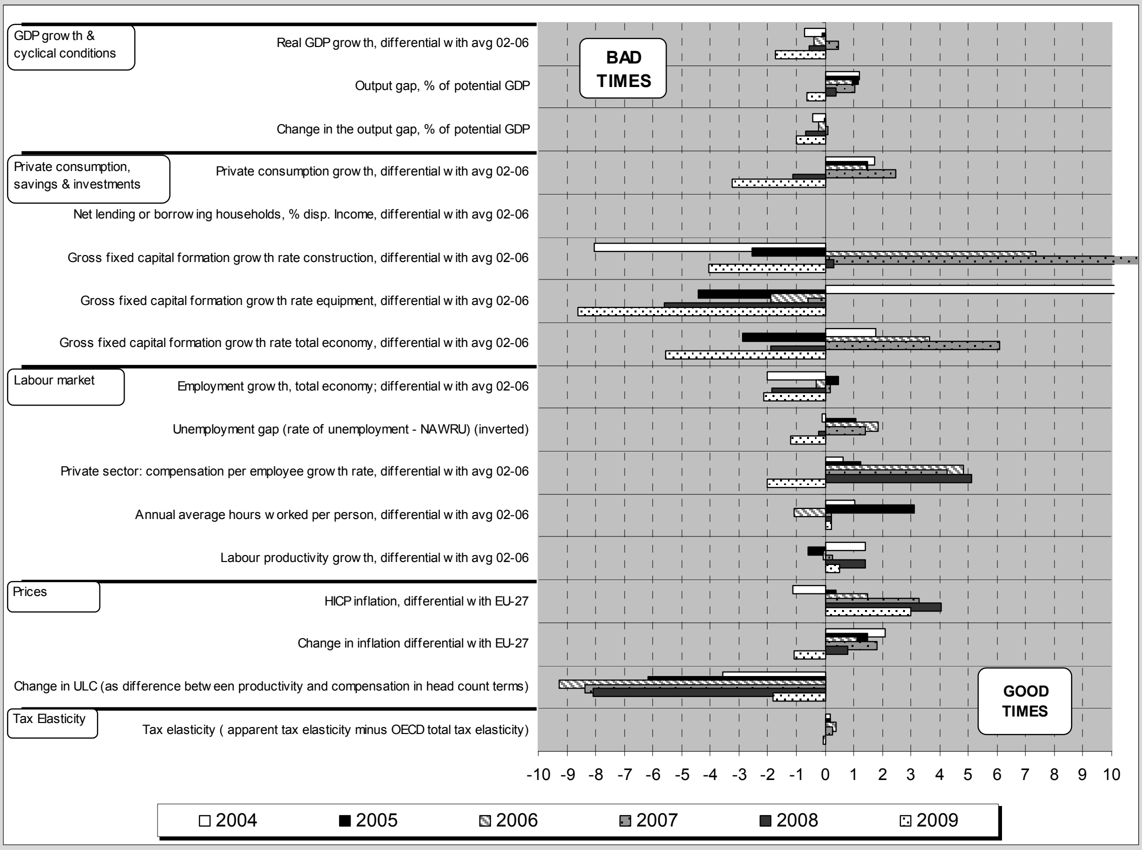
[23] An "Inflation Management Action Plan" adopted by the government in December 2007 envisages certain measures such as increasing the scope of application of the tax on real estate (to properties sold less than five years after purchase rather than to properties sold less than three years after purchase, as is currently the case) and restricting the deduction of mortgage interest payments from personal income tax to lower income households only. However, these measures, envisaged for 2008, have not yet been implemented.

**Box 3: Good or bad economic times?**

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times in 2007-2008 and "neutral" economic times in 2009 taking into account tax elasticities.

Although the positive output gap, as implied by the Commission services autumn 2007 forecast, is closing towards the end of the programme period and becomes negative in 2009 (-0.6% of GDP), the overall macroeconomic situation remains favourable. Growth remains robust but is projected to moderate starting from 2008, while private consumption and investment stay strong over the whole period. Employment is expected to rise only slightly and the unemployment rate is forecast to increase somewhat over the period 2008-2009. Price pressures will remain considerable. The apparent tax elasticity also indicates good times until 2008 turning slightly negative in 2009.

**Good versus bad times**




## 4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

### 4.1. Budgetary implementation in 2007

Table 2 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the new update. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[24]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

The estimated budgetary outturn for 2007 in the new update of the convergence programme confirms the target set in the previous update of a general government deficit of 0.9% of GDP, in spite of a much better than expected performance in 2006. This favourable base effect, mainly due to unspent expenditure in 2006, was entirely offset by an unscheduled one-off expenditure-increasing measure announced in November 2007 (0.6% of GDP: see below)[25]. Similarly to the practice of previous years, additional revenues on the back of higher-than-anticipated economic growth were spent, in breach of previously set expenditure ceilings.

[24] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

[25] This measure was announced after the cut-off date of the Commission services' autumn 2007 forecasts. Had the measure been taken into account in the autumn forecasts, the forecast headline deficit for 2007 would have been 1.5% of GDP and the cyclically-adjusted deficit 1.8% of GDP; the structural deficit (1.2% of GDP) would not have been affected. Considering the most recent budgetary information, the outturn for 2007, taking into account the one-off measure, is likely to be closer to the new update's projections than to the "adjusted" Commission services' forecast.

**Table 2: Budgetary implementation in 2007**

| | 2006 | | 2007 | |
|---|---|---|---|---|
| | Planned<br>CP Dec 2006 | Outcome<br>CP Dec 2007 | Planned<br>CP Dec 2006 | Outcome<br>CP Dec 2007 |
| Revenue (% of GDP) | 33.3 | 33.4 | 33.9 | 35.5 |
| Expenditure (% of GDP) | 34.5 | 34.0 | 34.8 | 36.4 |
| Government balance (% of GDP) | -1.2 | -0.6 | -0.9 | -0.9 |
| Nominal GDP growth (%) | | | 10.0 | 16.4 |
| Nominal revenue growth (%) | | | 12.0 | 23.7 |
| Nominal expenditure growth (%) | | | 11.0 | 24.6 |
| **Revenue surprise compared to target (% of GDP)** | | | **1.6** | |
| *Of which* [1] *:* 1. Base effect | | | 0.1 | |
| 2. GDP growth effect on the denominator | | | -1.7 | |
| 3. Revenue growth effect | | | 3.1 | |
| *Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1* [2] | | | *1.4* | |
| **Expenditure surprise compared to target (% of GDP)** | | | **1.6** | |
| *Of which* [1] *:* 1. Base effect | | | -0.5 | |
| 2. GDP growth effect on the denominator | | | -1.7 | |
| 3. Expenditure growth effect | | | 3.6 | |
| **Government balance surprise compared to target (% of GDP)** | | | **0.0** | |
| *Of which:* 1. Base effect | | | 0.6 | |
| 2. GDP growth effect on the denominator | | | 0.0 | |
| 3. Revenue / expenditure growth effect | | | -0.6 | |

Notes:

[1] A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive denominator effect indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:
*Commission services*

Compared with the previous update, positive revenue surprises in 2007 are estimated to have been particularly strong with regards to taxes on income and wealth (by an extra 1.1% of GDP) and social contributions (1.0% of GDP), mainly because of the positive base effect from 2006 and higher-than-projected nominal GDP growth. The marginal elasticity of total revenue with respect to GDP also largely exceeded 1, which can be explained by wage developments outpacing nominal GDP growth. Receipts of taxes on production and imports were slightly lower than projected in the previous update. "Other revenue", which includes revenue from EU funds, was lower than projected by 0.4% of GDP, mainly due to lower-than-anticipated revenue growth in 2006. This underperformance of "other revenue" is mainly linked to delays in absorbing EU funds under the 2004-2006 budgetary framework; however it seems that the absorption capacity is improving and Lithuania will not need to recommit "unused" funds[26].

On the side of primary expenditure, the outturn ratio estimated in the programme exceeds that targeted in the previous update by 1.7%, mainly because of a positive carry-over effect from 2006 and substantially higher-than-planned expenditure growth. In

[26] During 2007, Lithuania signed a "National general strategy: the Lithuanian Strategy for the use of European Union Structural Assistance for 2007-2013", according to which the EU structural funds will be allocated, and the operational programmes approved. The commitment of the funds within this new framework started end-2007.

comparison with 2006, general government expenditure ratios increased, in particular for social payments (by 0.8% of GDP), public wages (0.3% of GDP) and investment (0.3% of GDP). Also "other" expenditure, not explained in the programme, increased by 1.1% of GDP. This figure probably encompasses the one-off expenditure measure amounting to 0.6% of GDP. This measure, announced in November 2007, relates to a 2002 Constitutional Court decision ruling unconstitutional the practice of not paying part of the mandatory pension to working pensioners in respect of earnings exceeding an identified limit. The government's decision to compensate for the share of pensions unpaid during the 1995-2002 period will be implemented over 2008-2010 but will accrue exclusively in 2007.

Considering the continuing strong economic growth, the current stance of fiscal policy has remained slightly expansionary. Additional revenues received in 2006 and in 2007 because of higher-than-anticipated GDP growth, higher wage growth and inflation have been mainly spent and not used for a stronger fiscal consolidation. Adding to the expansion, cash compensation paid by the government to individuals for earlier rouble saving losses (1.2% of GDP) in March 2007 added further stimulus to the economy[27].

According to the programme, the structural balance (recalculated by Commission services' on the basis of the information in the programme according to the commonly agreed methodology) is estimated to have worsened from a deficit of 1% of GDP in 2006 to a 1¼% of GDP deficit in 2007.

The Council opinion of 27 February 2007 on the previous update of the convergence programme invited Lithuania to "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 adjustment towards the medium term objective (MTO) with measures which would ensure an annual improvement in the structural balance of 0.5% of GDP as a benchmark as required for euro-area and ERM II Member States, and the intended improvement beyond the MTO".

After reaching a lower than targeted deficit in 2006, the recommendation to achieve a more demanding deficit target for 2007 than had been foreseen has clearly not been followed. Considering the continuing strong economic growth, the current stance of fiscal policy has remained expansionary. A more restrictive fiscal policy is urgently needed to address mounting economic imbalances and high inflation. Even though the MTO (a structural deficit of 1% of GDP) was reached in 2006, there was a small slippage from it in 2007.

## 4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

### *4.2.1. The main goal of the programme's budgetary strategy*

The main goal of the programme's budgetary strategy is to foster macroeconomic stability via a tighter fiscal policy and ensuring long-term sustainability of public

[27] Following a decision by Eurostat in May 2005 on the classification of payments related to the compensation for lost rouble savings in the early years of transition and the restitution of real estate property confiscated in Soviet times this measure is accrued to 1999.

finances. It aims to reduce the general government structural deficit (i.e. the deficit in cyclically-adjusted terms net of one-off and other temporary measures) to 1% of GDP (which is the country's medium-term objective) or below by 2009, and to reach a balanced or surplus budget in later years.

Compared to the previous update, this would appear to imply a departure from the MTO in 2007 and 2008, after it was achieved in 2006 due to strong revenue growth. However, Commission services' recalculations of the structural balance on the basis of the information in the programme show that the MTO would be achieved again in 2008.

**Table 3: Evolution of budgetary targets in successive programmes**

| | | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| General government balance (% of GDP) | **CP Dec 2007** | **-0.6** | **-0.9** | **-0.5** | **0.2** | **0.8** |
| | *CP Dec 2006* | *-1.2* | *-0.9* | *-0.5* | *0.0* | *n.a.* |
| | COM Nov 2007 | -0.6 | -0.9 | -1.4 | -0.8 | n.a. |
| General government expenditure (% of GDP) | **CP Dec 2007** | **34.0** | **36.4** | **37.9** | **38.5** | **38.6** |
| | *CP Dec 2006* | *34.5* | *34.8* | *35.0* | *35.9* | *n.a.* |
| | COM Nov 2007 | 34.0 | 35.2 | 35.6 | 34.6 | n.a. |
| General government revenue (% of GDP) | **CP Dec 2007** | **33.4** | **35.5** | **37.4** | **38.6** | **39.4** |
| | *CP Dec 2006* | *33.3* | *33.9* | *34.5* | *35.9* | *n.a.* |
| | COM Nov 2007 | 33.4 | 34.3 | 34.1 | 33.8 | n.a. |
| Structural balance[1] (% of GDP) | **CP Dec 2007** | **-1.0** | **-1.2** | **-0.9** | **0.3** | **1.1** |
| | *CP Dec 2006* | *-1.8* | *-1.3* | *-0.5* | *0.5* | *n.a.* |
| | COM Nov 2007 | -0.8 | -1.2 | -1.5 | -0.6 | n.a. |
| Real GDP (% change) | **CP Dec 2007** | **7.7** | **9.8** | **5.3** | **4.5** | **5.2** |
| | *CP Dec 2006* | *7.8* | *6.3* | *5.3* | *4.5* | *n.a.* |
| | COM Nov 2007 | 7.7 | 8.5 | 7.5 | 6.3 | n.a. |

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.6% of GDP in 2007 (deficit-increasing), according to the most recent programme. As this transaction was decided after the cut-off date of the autumn 2007 forecast, it is not reflected in the Commission services' autumn forecast.

*Source*:
*Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)*

The programme targets a gradual improvement of the general government balance from a deficit of 0.9% of GDP in 2007 to a surplus of 0.8% of GDP in 2010. The adjustment is achieved through an increase in the revenue-to-GDP ratio higher than the increase in the expenditure-to-GDP ratio (3.9 percentage points compared to 2.2 percentage points). On the revenue side, the increase reflects higher EU funds inflows, increases in excise duties and a further considerable improvement in tax collection. On the expenditure side, the increase stems from significantly higher social transfers other than in kind and rising public investment, mainly supported by EU funds. In contrast to previous years, the main consolidation effort stems from the central and local governments, while the social security funds' surplus ratio declines. The most significant general government deficit reduction is planned to occur after 2008.

The primary balance is expected to be in a slight surplus by 2008 and to record a surplus of 1½% of GDP at the end of the programme period. The structural balance as recalculated by the Commission services will improve from a deficit of 1¼% of GDP in 2007 to around a 1% surplus in 2010. The structural improvement between 2007 and 2010, by about 2¼ percentage points of GDP, occurs against the background of favourable cyclical conditions as measured by a large positive output gap, which are, however, turning neutral by the end of the programme period. However, when analysing the structural balance, it should be recalled that the calculation of potential output growth (and hence the structural balance) needs to be interpreted with caution for countries going through a catching-up process, accompanied by strong and rapid structural changes (see section 3.1)[28].

The fiscal stance as measured by the change in the structural balance (as recalculated by Commission services on the basis of the information in the programme) is broadly neutral in 2008 and restrictive from 2009 in view of fiscal retrenchment on the side of the structural primary balance.

Compared with the previous programme, the new update backloads the structural adjustment, against a broadly unchanged macroeconomic scenario in terms of GDP. However, wage growth is projected to be higher than in the previous update. In light of the better than expected budgetary outcomes in 2006 and 2007 (and also taking into account the one-off nature of some of the expenditure increasing measures), the target for 2008 is clearly unambitious.

[28] Significant differences between the output gap recalculations reported in the update and in the Commission services' calculations are due to different methodologies used, as the programme uses the Hodrick-Prescott filter. This results in a significantly lower positive output gap turning negative by the end of the programme period and a better structural balance on average in the Commission services' recalculations than reported in the programme.

**Table 4: Composition of the budgetary adjustment**

| (% of GDP) | 2006 | 2007 | 2008 | 2009 | 2010 | Change: 2010-2007 |
|---|---|---|---|---|---|---|
| **Revenue** | **33.4** | **35.5** | **37.4** | **38.6** | **39.4** | **3.9** |
| *of which:* | | | | | | |
| - Taxes on production and imports | 11.2 | 12.0 | 13.6 | 13.5 | 13.5 | **1.5** |
| - Current taxes on income, wealth, etc. | 9.7 | 9.7 | 9.8 | 10.2 | 10.2 | **0.5** |
| - Social contributions | 8.8 | 9.3 | 9.3 | 9.3 | 9.2 | **-0.1** |
| - Other (residual) | 3.7 | 4.5 | 4.7 | 5.6 | 6.5 | **2.0** |
| **Expenditure** | **34.0** | **36.4** | **37.9** | **38.5** | **38.6** | **2.2** |
| *of which:* | | | | | | |
| - Primary expenditure | 33.3 | 35.6 | 37.1 | 37.8 | 38.0 | **2.4** |
| *of which:* | | | | | | |
| Compensation of employees | 10.5 | 10.8 | 11.1 | 11.1 | 11.2 | **0.4** |
| Intermediate consumption | 6.0 | 5.7 | 5.7 | 5.8 | 5.9 | **0.2** |
| Social payments | 10.0 | 10.8 | 11.9 | 12.4 | 12.3 | **1.5** |
| Subsidies | 0.7 | 0.8 | 0.8 | 0.7 | 0.7 | **-0.1** |
| Gross fixed capital formation | 4.2 | 4.5 | 5.1 | 5.3 | 5.3 | **0.8** |
| Other (residual) | 2.7 | 3.8 | 3.1 | 3.2 | 3.3 | **-0.5** |
| - Interest expenditure | 0.7 | 0.8 | 0.8 | 0.7 | 0.6 | **-0.2** |
| **General government balance (GGB)** | **-0.6** | **-0.9** | **-0.5** | **0.2** | **0.8** | **1.7** |
| **Primary balance** | **0.2** | **-0.1** | **0.3** | **0.9** | **1.4** | **1.5** |
| One-off and other temporary measures | 0.0 | -0.6 | 0.0 | 0.0 | 0.0 | **0.6** |
| **GGB excl. one-offs** | **-0.6** | **-0.3** | **-0.5** | **0.2** | **0.8** | **1.1** |
| Output gap[1] | 1.7 | 3.3 | 1.5 | -0.4 | -1.3 | **-4.6** |
| Cyclically-adjusted balance[1] | -1.0 | -1.8 | -0.9 | 0.3 | 1.1 | **2.9** |
| **Structural balance**[2] | **-1.0** | **-1.2** | **-0.9** | **0.3** | **1.1** | **2.3** |
| *Change in structural balance* | | *-0.2* | *0.3* | *1.2* | *0.8* | |
| Structural primary balance[2] | -0.3 | -0.4 | -0.1 | 1.0 | 1.7 | **2.1** |
| *Change in structural primary balance* | | *-0.1* | *0.3* | *1.1* | *0.7* | |

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

*Source:*

*Convergence programme; Commission services' calculations*

### *4.2.2. The composition of the budgetary adjustment*

On the revenue side, the revenues-to-GDP ratio is expected to increase from 35.5% of GDP in 2007 to 39.4% in 2010. The increases are explained by higher EU funds' inflows, increases in excise duties and a further considerable improvement in tax collection. 1.5 percentage point of the change is explained by increases in taxes on production and imports, and 0.5 percentage point by increases in taxes on income and wealth. The rest (2 pp.) is due to "other revenues" which are not concretely specified in the programme. The increase in this category may reflect the expected higher inflow of the EU funds, mentioned (but not quantified) in the programme as a reason for the overall increase of the revenue-to-GDP share. The programme plans a shift of the tax burden from direct to indirect taxation. The reduction of the single personal income tax rate from 27% to 24% as of January 2008 (following the cut from 33% to 27% as of July 2006) is forecast to result in a decrease of 0.5% of GDP in direct taxes in 2008. A temporary "social tax" (a *de facto* increase of the corporate income tax), introduced to mitigate the loss of revenues from the tax reform in 2006 and 2007, will be abolished in 2008, reducing revenue in 2008 by 0.3% of GDP. Indirect taxes are projected to increase by 1.5 percent of GDP over 2007-2010, notably thanks to improved tax administration and higher excise duties on energy products, alcohol and tobacco. The programme announces increases in excise duties on energy products and alcohol as of January 2008 and on cigarettes as of March 2008, with an expected combined impact on the budgetary revenues is 0.3% of GDP in 2008. A further two increases in excise duties on tobacco are foreseen over the period 2008-2009 to meet minimum EU requirements by 2010. Direct taxes are expected to increase by 0.5 percent of GDP over the whole programme period, mainly due to an expected improvement in tax collection and wage growth exceeding nominal GDP growth, even with the foreseen tax cuts described above.

On the expenditure side, the rise of the expenditure-to-GDP ratio from 36.4% in 2007 to 38.6% in 2010 stems from an increase in primary expenditure, while the interest expenditure ratio decreases slightly. A significant part of the increase is due to a rise in social transfers other than in kind (due to increasing pensions and family allowances). A rise in the public investment ratio from 4.5% of GDP in 2007 to 5.3% in 2010 also drives the increase in the expenditure-to-GDP ratio. The planned increase in investment is subject to some uncertainty as it assumes an acceleration of absorption of EU structural funds. Some factors moderating the expenditure increase are expected to come from subsidies, interest expenditure and "other" expenditures. A decrease in “other" expenditure over the programme period by 0.5 percentage point is not explained in the programme. According to the programme, the major offsetting factor moderating the expenditure increase is expected to come from a significant cut in collective government consumption from 7.7% of GDP in 2006 to 7% of GDP in 2010, but there is a lack of information on measures to achieve the planned decrease and against the background of rapid inflation, this decrease will be particularly difficult to attain. There is no decrease foreseen in the programme in the ratio of individual government consumption.

According to the programme, the main consolidation effort is expected to stem from the central and local governments, which have been running budgetary deficits. While central government is forecast to achieve budgetary surpluses from 2009, the local government sub-sector is projected to present balanced budgets from 2008, as prescribed in the budgetary law. The surplus of the social security funds is expected to decrease and the funds to be in balance from 2008, mainly due to a planned increases in social transfers and lower receipts of social contributions because of the ongoing pension reform.

**Box 4: The budget for 2008**

Lithuania’s 2008 national budget (state and local governments) was adopted by the Government on 16 October 2007. After two readings it was approved by the Parliament on 6 December 2007 (with some changes) and signed by the President on 12 December 2007. The law targets a national government budget deficit of 1% of GDP (in domestic accounting terms, on a cash basis) and a general government budget deficit of 0.5% of GDP (in ESA 95 terms). A separate law on the social security fund was approved, where the fund is planned to be in balance.

Total revenue, including EU funds, is planned to increase by 33% in nominal terms compared to the 2007 budget and total expenditure, including EU funds, by 29%. It is foreseen that Lithuania will receive LTL 5.1 billion (4.8% of GDP) from EU funds and will pay 1.1 billion (1.0% of GDP) to the EU budget.

On the revenue side, the personal income tax rate will be reduced from 27% to 24% and the temporary social tax on corporate income (+3pp.) will be abolished from 1 January 2008. The costs of the ongoing pension reform are included in the budget. Excises duties for fuel will be increased by 12% and by 20% for alcohol (beer by 10%) from 1 January 2008, and by 17% for tobacco from 1 March 2008. Against the background of strong consumption and improved tax collection, the VAT revenue is set to increase strongly (by 43% compared to 2007 budget). Taxes on income and wealth are budgeted to increase by some 13% (despite the foreseen tax cuts). On the expenditure side the increase reflects higher social transfers and public wages as well as higher capital investment. The main measures are presented below.

**Main measures in the budget for 2008**

| **Revenue measures*** | **Expenditure measures**** |
|---|---|
| o Personal income tax cut from 27% to 24% (-0.5% of GDP) | o Increases in public sector wages (1.1% of GDP) |
| o Abolition of the temporary social tax (-0.3% of GDP) | o Higher social transfers other than in kind (0.8% of GDP) |
| o Ongoing pension reform (2nd pillar) (-0.8% of GDP) | |
| o Increase in excise taxes (0.3% of GDP) | |

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
*Sources*: Commission services and Lithuanian Ministry of Finance.

### 4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

**Table 5: Comparison of budgetary developments and projections**

| (% of GDP) | 2006 | 2007 | | 2008 | | 2009 | | 2010 |
|---|---|---|---|---|---|---|---|---|
| | COM | COM | CP | COM | CP | COM[1] | CP | CP |
| **Revenue** | **33.4** | **34.3** | **35.5** | **34.1** | **37.4** | **33.8** | **38.6** | **39.4** |
| *of which:* | | | | | | | | |
| - Taxes on production and imports | 11.2 | 12.2 | 12.0 | 12.3 | 13.6 | 12.3 | 13.5 | 13.5 |
| - Current taxes on income, wealth, etc. | 9.7 | 9.4 | 9.7 | 9.0 | 9.8 | 8.8 | 10.2 | 10.2 |
| - Social contributions | 8.8 | 8.8 | 9.3 | 8.7 | 9.3 | 8.4 | 9.3 | 9.2 |
| - Other (residual) | 3.7 | 3.9 | 4.5 | 4.1 | 4.7 | 4.3 | 5.6 | 6.5 |
| **Expenditure** | **34.0** | **35.2** | **36.4** | **35.6** | **37.9** | **34.6** | **38.5** | **38.6** |
| *of which:* | | | | | | | | |
| - Primary expenditure | 33.3 | 34.4 | 35.6 | 34.6 | 37.1 | 33.6 | 37.8 | 38.0 |
| *of which:* | | | | | | | | |
| Compensation of employees | 10.5 | 10.4 | 10.8 | 10.2 | 11.1 | 10.0 | 11.1 | 11.2 |
| Intermediate consumption | 6.0 | 5.5 | 5.7 | 5.4 | 5.7 | 5.1 | 5.8 | 5.9 |
| Social payments | 10.0 | 10.8 | 10.8 | 11.2 | 11.9 | 10.6 | 12.4 | 12.3 |
| Subsidies | 0.7 | 0.8 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 |
| Gross fixed capital formation | 4.2 | 4.7 | 4.5 | 4.9 | 5.1 | 5.0 | 5.3 | 5.3 |
| Other (residual) | 1.9 | 2.2 | 3.8 | 2.1 | 3.1 | 2.2 | 3.2 | 3.3 |
| - Interest expenditure | 0.7 | 0.9 | 0.8 | 0.9 | 0.8 | 1.0 | 0.7 | 0.6 |
| **General government balance (GGB)** | **-0.6** | **-0.9** | **-0.9** | **-1.4** | **-0.5** | **-0.8** | **0.2** | **0.8** |
| **Primary balance** | **0.2** | **0.0** | **-0.1** | **-0.5** | **0.3** | **0.2** | **0.9** | **1.4** |
| One-off and other temporary measures | 0.0 | 0.0 | -0.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **GGB excl. one-offs** | **-0.6** | **-0.9** | **-0.3** | **-1.4** | **-0.5** | **-0.8** | **0.2** | **0.8** |
| Output gap[2] | 1.0 | 1.0 | 3.3 | 0.4 | 1.5 | -0.6 | -0.4 | -1.3 |
| Cyclically-adjusted balance[2] | -0.8 | -1.2 | -1.8 | -1.5 | -0.9 | -0.6 | 0.3 | 1.1 |
| **Structural balance**[3] | **-0.8** | **-1.2** | **-1.2** | **-1.5** | **-0.9** | **-0.6** | **0.3** | **1.1** |
| *Change in structural balance* | | *-0.4* | *-0.2* | *-0.4* | *0.3* | *0.9* | *1.2* | *0.8* |
| Structural primary balance[3] | -0.1 | -0.3 | -0.4 | -0.6 | -0.1 | 0.4 | 1.0 | 1.7 |
| *Change in structural primary balance* | | *-0.2* | *-0.1* | *-0.3* | *0.3* | *1.0* | *1.1* | *0.7* |

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

As regards the macroeconomic outlook, the programme's growth projections are plausible until 2007 but inconsistently cautious from 2008 (see Section 3 above). However, the programme also projects a more favourable composition of growth with respect to tax revenue than the Commission services' autumn 2006 forecast (in particular for personal income tax and social contributions), because of higher wage growth for 2007 and 2008. The programme also acknowledges that macroeconomic prospects significantly depend on the development of the credit growth. Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 1 percentage point higher real GDP growth projections in the programme over the 2008-2010 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), indicate that, by 2010, the cyclically-adjusted balance is 1.1 percentage point of GDP above the central scenario.

Nevertheless, the programme does not provide sufficient information regarding the measures envisaged in order to achieve its fiscal projections, especially as regards the significant drop in the collective consumption-to-GDP ratio. With inflation increasing rapidly, these savings in collective consumption will be particularly difficult to achieve. It is possible that the programme's projections with respect to tax revenue (in particular for personal income tax and social contributions) are somewhat high for 2008 and to a lesser extend in the years thereafter. Indeed, the programme acknowledges that additional (but unspecified) measures are needed. The considerable improvement in tax revenue collection due to better tax collection (1.8% of GDP over the programme period) as well as the significant increase in the non-tax revenue-to-GDP ratio (by 2% of GDP) are also insufficiently substantiated in the programme. This can be considered as a downside risk. At the same time, numerous revenue-decreasing (tax cuts) and expenditure-increasing measures are already adopted (social transfers) and clearly spelled out in the programme.

The overall level of revenue and expenditure in the programme is considerably higher that those in the Commission services' forecast, with the differences on the revenue side arising mainly from more optimistic projections in the authorities' programme of revenue from all types of taxes as well as assumed higher inflows of EU funds. Despite more cautious GDP growth assumptions, the programme's tax projections are significantly higher than the Commission services' forecast for 2008 and 2009. They can be mainly explained by a much higher increase in social payments and compensation of employees than foreseen by the Commission services as well as "other" expenditures. In 2008, the difference in tax revenues can be attributed mainly to the discretionary and elasticity component and to a lesser extent to a more favourable growth composition, whereas for 2009, the difference is mainly due to the discretionary and elasticity component. Overall, taking into account the tax reform, the programme's assumptions with respect to the tax intensity of the economic activity seem optimistic. Furthermore, expenditures are also much higher than forecast by the Commission services.

**Table 6: Assessment of tax projections**

| | 2008 | | | 2009 | | | 2010 |
|---|---|---|---|---|---|---|---|
| | **CP** | **COM** | **OECD[3]** | **CP** | **COM[1]** | **OECD[3]** | **CP** |
| Change in tax-to-GDP ratio (total taxes) | 1.9 | -0.4 | -0.4 | 0.3 | -0.6 | -0.2 | -0.1 |
| Difference (CP – COM) | 2.4 | | / | 0.9 | | / | / |
| *of which[2]:* | | | | | | | |
| *- discretionary and elasticity component* | *2.3* | | */* | *0.1* | | */* | */* |
| *- composition component* | *0.9* | | */* | *0.9* | | */* | */* |
| Difference (COM - OECD) | / | -0.1 | | / | -0.3 | | / |
| *of which[2]:* | | | | | | | |
| *- discretionary and elasticity component* | */* | *-0.9* | | */* | *-0.2* | | */* |
| *- composition component* | */* | *1.2* | | */* | *-0.1* | | */* |
| p.m.: Elasticity to GDP | 1.5 | 0.9 | 0.9 | 1.1 | 0.8 | 0.9 | 1.0 |

Notes:

[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

*Source*:

*Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).*

As regards the credibility and political backing of the targets, the Law on Fiscal Discipline which gained parliamentary approval in November 2007 has as its main objectives (i) a balanced budget in the medium term and (ii) long-term sustainability. It requires the government to respect the fiscal discipline needed for the long-term sustainability of public finances taking account of growth conditions. It also introduces a formula for the maximum growth of budgetary expenditure depending on an average of previous years' growth and deficit indicators. Even though the law has been criticised as being too lax and unclear and does not as such introduce a binding medium-term budgetary framework, it could give more credibility to the budgetary targets.

**Box 5: The Law on Fiscal Discipline**

This Law was adopted by the Parliament on 8 November 2007, and entered into force on 1 January 2008 (it will be applied as of the 2009 budget). The Law is based on provisions of the Stability and Growth Pact: having as objectives a balanced budget in the medium term and long-term sustainability.

The aim is to achieve a balanced or surplus budget in "good times" (defined as nominal GDP growth compared to the EU average + 2 percentage points), reducing the risk of the deficit rising above 3% of GDP (Treaty reference value) in "unfavourable times".

However, the law is focused on annual budgetary preparation and execution and does not as such introduce a forward-looking medium-term budgetary framework. According to the Law, the projected national budgetary indicators should "take into consideration the last valid recommendations and opinion of the Council of the EU on Lithuania's Medium-Term Economic Programme". In more detailed operational terms: (i) As a rule, general government finances shall be managed in order to have a surplus or close to balance. (ii) If the average general government balance for the last five calendar years is a deficit (net borrowing), then the annual growth percentage of the State budget appropriations may not exceed ½ of the average growth percentage of the State budget revenue (EU financial assistance excluded) of the last five expired budget years. According to the Ministry of Finance, the remaining revenue part would be used to reduce the government debt.

However there are several exemptions when the second rule shall not be applied: (i) If the nominal GDP growth is less than the average EU nominal growth increased by 2 percentage points of the last five years. (ii) If there is to be an expected improvement of at least 1.0 percentage point of GDP at current prices of the general government balance stemming from the planned State budget appropriations and revenue. (iii) If the arithmetic average of the general government balances of the last four calendar years and for the current calendar year projected by the Ministry of Finance is a surplus (net lending), of at least 0.1 per cent of nominal GDP.

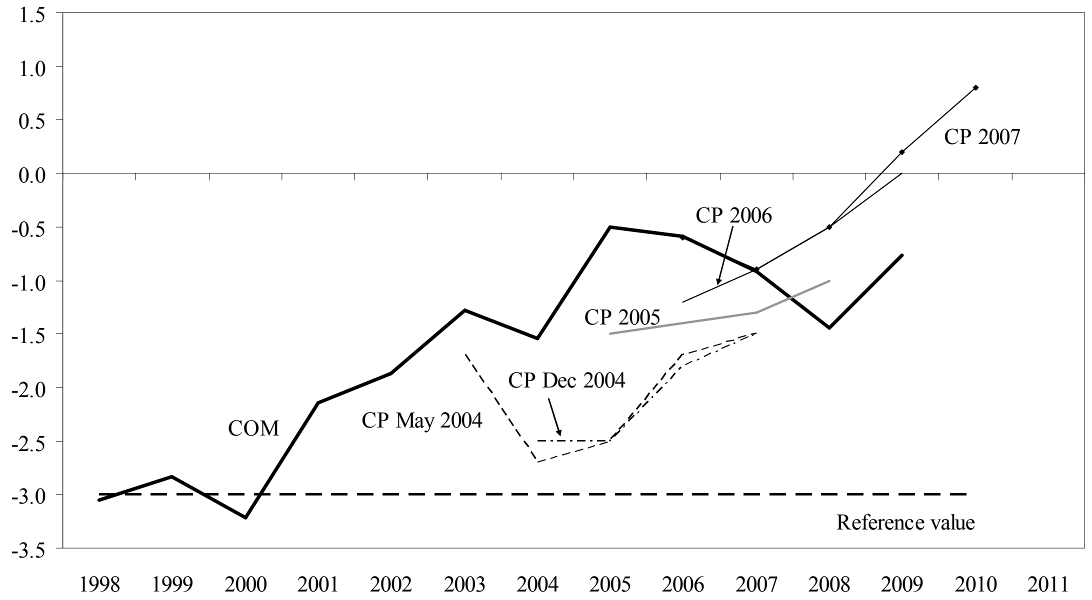
The practice of the previous years has been that the targeted expenditure ceilings presented in the medium-term framework with the annual budget have been revised upwards every year on the back of high economic growth and cannot by themselves be considered a sufficient instrument to restrain additional spending pressures. It seems that they are relatively easy to revise and there is no penalising mechanism in place which would force respect of the previously set expenditure ceilings. The new Law on Fiscal Discipline also fails to introduce a sufficient enforcement mechanism to ensure respect of expenditure limits. Hence, the current medium-term framework for the planning and control of public finances should be strengthened. There is a need for more cautious planning, restraining expenditure growth by reinforcing the binding character of the forward-looking medium-term expenditure ceilings and by saving additional revenues.

While overall fiscal targets have often been outperformed in recent years (see Figure 12 below), facilitated by strong growth and steady revenue overshoots, there has also been a practice of adopting supplementary budgets in the second half of the year to acknowledge higher-than-expected collection of revenues and to attribute these between expenditures. Thus, the 2006 supplementary budget increased expenditures by 0.5% of GDP. Positively, no supplementary budget has been adopted in 2007, following a multi-party agreement from December 2006, calling for fiscal consolidation. Nevertheless, both revenue and expenditure have increased by 1.6% of GDP compared with the previous update, even without a revision of the 2007 budget during the year. Therefore, there is a risk that planned expenditure levels will again be revised upwards for the programme period in the next updates, should economic growth and revenue collection continue to be stronger than foreseen in the programme.

The programme mentions further medium-term risks to the budgetary strategy stemming from deposit insurance, restitution of real estate ownership rights, debt of state-owned enterprises, decommissioning of the Ignalina Nuclear Power Plant and financial commitments in regard to the housing renovation programme. The achievement of the budgetary targets will also largely depend on the ability of the local governments to keep balanced budgets as prescribed by budgetary law. Previous experience shows that this was not the case. Particularly, commitments in regard to the increased costs of EU co-financed projects pose a risk to local government finances.

Overall, although growth could be higher than estimated in the programme and Lithuania has a good track record with meeting its fiscal targets on the back of high GDP growth, the lack of detailed information on envisaged measures introduces considerable uncertainty, while tax projections also seem to be on the optimistic side and expenditure envelopes may continue to be exceeded in the absence of a binding medium-term framework. This risk is particularly high considering the upcoming parliamentary elections in October 2008. In view of this risk assessment, outcomes could be worse than targeted over the programme period.

**Figure 12: Government balance projections in successive programmes (% of GDP)**




*Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes*

### 4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

**Table 7: Overview of compliance with the Stability and Growth Pact**

| | **Based on programme**[4] (with the targets taken at face value) | **Assessment** (taking into account risks to the targets) |
|---|---|---|
| a. Safety margin against breaching 3% of GDP deficit limit[1] | throughout programme period | throughout programme period |
| b. Achievement of the MTO | from 2008 onwards | possibly only from 2009 |
| c. Adjustment towards MTO in line with the Pact[2]? | Broadly in line | should be strengthened |
| d. Fiscal stance in line with Pact[3]? | in line (after being pro-cyclical in 2007) | in line (after being pro-cyclical in 2007) |

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 2% of GDP for Lithuania). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[4]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
*Commission services*

Given the risk assessment above, a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations would be provided throughout the programme period. However, the budgetary stance in the programme may be insufficient to ensure that the MTO is achieved by 2009, as envisaged in the programme.

The planned adjustment path towards the MTO is about 0.3% of GDP in 2008, but most of the effort is planned to be made from 2009. In particular, taking account of risks, a deterioration in the structural balance is expected in 2008, because of the numerous revenue-decreasing and expenditure-increasing measures that are planned. Furthermore, since the programme does not contain sufficient measures which would support such an adjustment effort after 2008, the structural adjustment could be slower than expected by the programme. Given the favourable cyclical conditions ("good times", see Section 3.1 above) in the near term, as broadly confirmed by the assessment of tax elasticities[29], the adjustment towards the MTO should be strengthened to be in line with the Pact, which requires an adjustment effort above 0.5% of GDP per year in good times.

After the projected achievement of the MTO, the fiscal policy stance implied by the programme is in line with the Stability and Growth Pact. Considering the continuing strong growth of the economy and persisting external and domestic pressures, a tighter fiscal policy than currently planned would be appropriate. This is particularly important given the limited number of policy instruments available to Lithuania in the context of the currency board. The fiscal stance should be tightened given the size of the economic

[29] The prevailing effect in 2008 comes from the composition component and not from the discretionary and elasticity one.

imbalances and commitments made under ERM II entry (see Section 8). Considering that the commonly agreed methodology tends to overestimate the potential growth rates for an economy such as Lithuania's with high real estate investment[30], the structural balance[31] appropriate for the current situation should be significantly larger. This rationale calls for a much stronger fiscal effort in 2008 and thereafter than the one envisaged by the programme..

## 5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

### 5.1. Recent debt developments and medium-term prospects

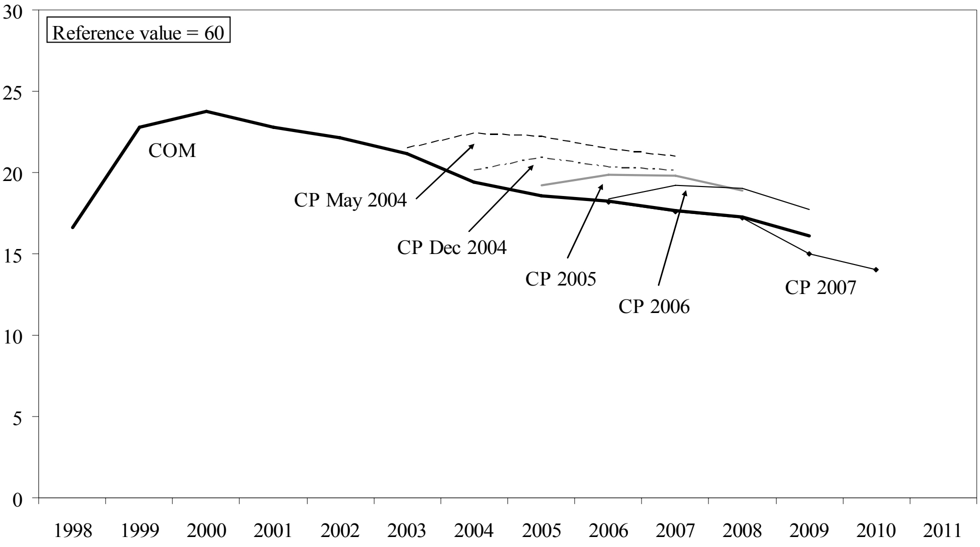
#### *5.1.1. Debt projections in the programme*

The programme estimates Lithuania's government debt ratio to have decreased from 18.2% of GDP in 2006 to 17.6% in 2007. This is only slightly below the Commission services' autumn 2007 forecasts. It is also notably below the target presented in the previous programme update (see Figure 13). The debt ratio is expected to remain at around 17% of GDP in 2008 before decreasing significantly to 14.0% in 2010. The general government debt mainly consists of central government debt (about 95%), whereas the municipal and social insurance funds' debts account for about 5%. The largest part of general government debt (85%) is in long-term liabilities, denominated in LTL and euro, although the percentage by currency denomination is not specified in the programme.

[30] See Section 2-3.

[31] Applying the output gap figures derived with the commonly agreed methodology.

## Figure 13: Debt projections in successive programmes (% of GDP)




*Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes*

## Table 8: Debt dynamics

| (% of GDP) | average 2002-05 | 2006 | 2007 | | 2008 | | 2009 | | 2010 |
|---|---|---|---|---|---|---|---|---|---|
| | | | COM | CP | COM | CP | COM | CP | CP |
| **Gross debt ratio**[1] | **20.3** | **18.2** | **17.7** | **17.6** | **17.2** | **17.2** | **16.1** | **15.0** | **14.0** |
| Change in the ratio | -1.1 | -0.4 | -0.6 | -0.6 | -0.4 | -0.4 | -1.2 | -2.2 | -1.0 |
| *Contributions* [2] *:* | | | | | | | | | |
| **Primary balance** | **0.2** | **-0.2** | **0.0** | **0.1** | **0.5** | **-0.3** | **-0.2** | **-0.9** | **-1.4** |
| **"Snow-ball" effect** | **-0.8** | **-1.6** | **-1.6** | **-1.7** | **-1.3** | **-1.1** | **-0.9** | **-0.5** | **-0.5** |
| *Of which:* | | | | | | | | | |
| Interest expenditure | 1.1 | 0.7 | 0.9 | 0.8 | 0.9 | 0.8 | 1.0 | 0.7 | 0.6 |
| Growth effect | -1.6 | -1.2 | -1.3 | -1.5 | -1.2 | -0.8 | -1.0 | -0.7 | -0.7 |
| Inflation effect | -0.3 | -1.1 | -1.2 | -0.9 | -1.1 | -1.0 | -0.9 | -0.5 | -0.3 |
| **Stock-flow adjustment** | **-0.4** | **1.4** | **1.1** | **1.0** | **0.5** | **1.0** | **0.0** | **-0.7** | **0.9** |
| *Of which:* | | | | | | | | | |
| Cash/accruals diff. | 0.3 | 1.4 | | n.a. | | n.a. | | n.a. | n.a. |
| Acc. financial assets | -0.3 | 0.1 | | n.a. | | n.a. | | n.a. | n.a. |
| *Privatisation* | *-0.8* | *-2.8* | | *0.1* | | *0.1* | | *0.0* | *0.0* |
| Val. effect & residual | -0.3 | 0.0 | | n.a. | | n.a. | | n.a. | n.a. |

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where $t$ is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and $i$ and $y$ represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

*Source:*

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

### 5.1.2. *Assessment*

Government debt ratio is expected to decrease more rapidly from 2009 than foreseen in the Commission services' autumn 2007 forecast, however, the latter is on a no-policy change basis for 2009. The primary balance is expected to be a debt-increasing factor only until 2007 before starting turning into a surplus and contributing to increase the debt level. The "snow-ball" effect, that is the combined effect of implicit interest rates and GDP growth, will help reduce the debt ratio over the programme's horizon. The debt-increasing contribution of stock-flow adjustments is expected to remain at a similar level (around 1% of GDP), except in 2009, but this development is not explained in the programme.

Given the relatively low level of general government debt and considering its decreasing trend as well as negligible state guarantees, public debt is not a major concern for Lithuania.

## 5.2. Long-term debt projections and the sustainability of public finances

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

### 5.2.1. *Sustainability indicators and long-term debt projections*

Table 9 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology. [32] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

**Table 9: Long-term age-related expenditure: main projections**

| (% of GDP) | 2004 | 2010 | 2020 | 2030 | 2040 | 2050 | Change up to 50 |
|---|---|---|---|---|---|---|---|
| **Total age-related spending** | 16.0 | 15.3 | 15.1 | 16.3 | 16.8 | 17.4 | 1.4 |
| - Pensions | 6.7 | 6.6 | 7.0 | 7.9 | 8.2 | 8.6 | 1.8 |
| - Healthcare | 3.7 | 4.0 | 4.3 | 4.4 | 4.5 | 4.6 | 0.9 |
| - Long-term care | 0.5 | 0.6 | 0.6 | 0.6 | 0.7 | 0.9 | 0.4 |
| - Education | 5.0 | 4.2 | 3.2 | 3.3 | 3.3 | 3.3 | -1.6 |
| - Unemployment benefits | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | -0.1 |
| **Property income received** | 0.7 | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 | -0.3 |

<u>Source:</u> *Economic Policy Committee and Commission services.*

The projected dynamics in age-related spending in Lithuania are below the EU average; increasing by 1.4% points of GDP between 2004 and 2050. This is mainly due to the projected moderate increase in pension expenditure of 1.8 percentage points of GDP over the projection period, due to the large pension reform enacted a few years ago. The increase in health-care expenditure is projected to be 0.9 percentage points of GDP, below the EU average. For long-term care spending, the projected increase of 0.4

32 See the accompanying "methodological paper" for a description of the property income projections.

percentage points of GDP up to 2050 is below the EU average, while the expected drop in education expenditure is higher than the EU average.

**Table 10: Sustainability indicators and the required primary balance**

| | 2007 scenario | | | Programme scenario | | |
|---|---|---|---|---|---|---|
| | **S1** | **S2** | **RPB** | **S1** | **S2** | **RPB** |
| Value | 0.5 | 2.0 | 2.0 | -1.7 | -0.1 | 1.9 |
| *of which:* | | | | | | |
| Initial budgetary position (IBP) | 0.6 | 0.7 | - | -1.5 | -1.4 | - |
| Debt requirement in 2050 (DR) | -0.8 | - | - | -0.8 | - | - |
| Long-term change in the primary balance (LTC) | 0.7 | 1.3 | - | 0.7 | 1.3 | - |

*Source: Commission services.*

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 10 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained. In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 2% of GDP.[33] Compared with the assessment of the previous update of the stability programme, the sustainability gap is smaller in the present assessment, by about ½% of GDP. This is mainly due to a lower estimated structural primary deficit in 2007 (at 0.4% of GDP) compared with the structural primary deficit in 2006 as estimated in the previous update (at 1.0% of GDP).

The initial budgetary position is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. According to both sustainability gaps, the long-term budgetary impact of ageing is limited, in particular thanks to the pension reform measures enacted in recent years. The programme plans a structural primary budgetary consolidation of 2.1% of GDP between 2007 and 2010. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by eliminating the S2 sustainability gap ("programme scenario"). The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the convergence programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is almost 2% of GDP, somewhat higher than the structural primary balance of about 1.7% of GDP in the last year of the programme's period.

The sustainability gap indicators would increase by up to 0.2% of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt-to-GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 14[34]. The gross debt ratio is currently

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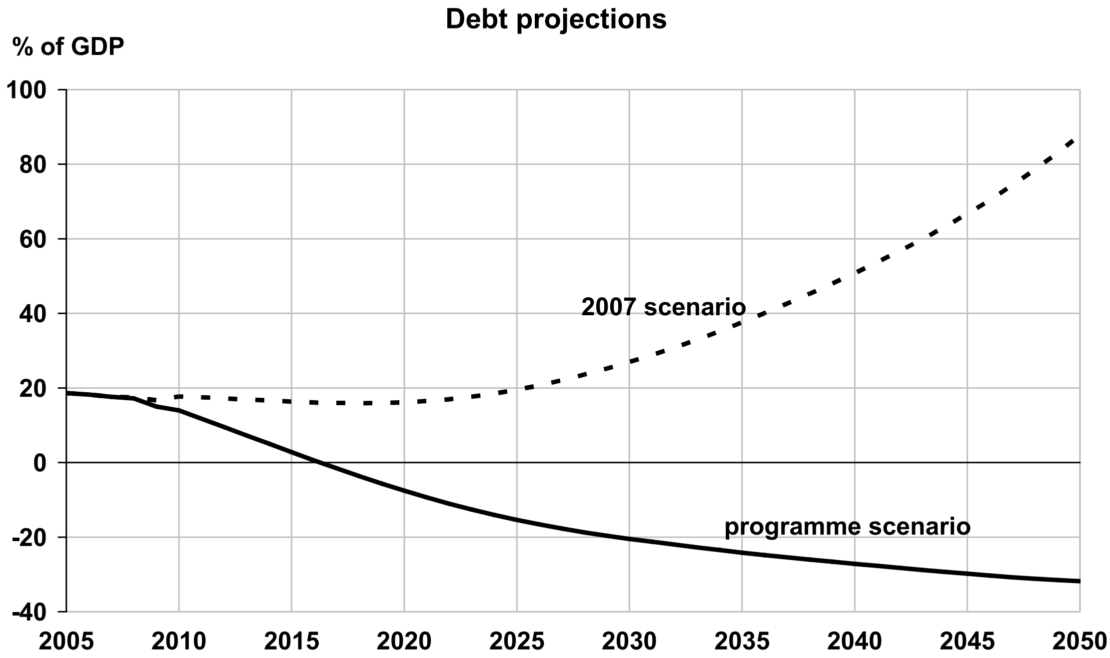
[33] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 0.5% of GDP.

[34] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

significantly below the 60% of GDP reference value, estimated in the programme at 17.6% of GDP in 2007. In the "2007 scenario", the debt ratio is projected to remain about constant until 2020 and to increase thereafter, exceeding 60% of GDP in the mid-2040s and reaching almost 90% of GDP by 2050. In the "programme scenario", the debt ratio is projected to decrease over the projection period.

**Figure 14: Long-term projections for the government debt ratio**




_Source_: *Commission services*

### *5.2.2. Additional factors*

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, as mentioned above, Lithuania has a very low stock of debt, below 20% of GDP in 2007, which would decline further if the implementation of the budgetary strategy as presented in the convergence programme update was implemented. This contributes to contain the sustainability risks of Lithuania's public finances.

Second, further changes to the pension systems are envisaged on the basis of the National Strategy Report on Adequate and Sustainable Pensions. This would entail an increase in the replacement rate until 2015, but also a stepwise increase in the statutory retirement age from 2012 until 2026, by 4 months per year for women and 2 months per year for men, until the retirement age reaches 65 years for both men and women in 2026. The programme update states that the implementation would contribute to the long-term sustainability of public finances but does not provide estimates of the fiscal impact.

### *5.2.3. Assessment*

Lithuania appears to be at low risk with regard to the sustainability of public finances. 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 budgetary position in 2007 as estimated in the programme, which is more favourable than the starting position of the previous programme, constitutes a risk to sustainable public finances even before considering the long-term budgetary impact of an ageing population. Nevertheless, 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.

## 6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The programme reviews the main ongoing structural reforms including tax, pension, healthcare and education reforms.

Lithuania started reforming its pension system in 2004 by introducing a funded pension pillar. The programme presents the budgetary impact of this pension reform during the programme period. Costs are estimated to be around 0.8% of GDP per annum in 2007 and 2008 and around 0.9% per annum over 2009-2010[35]. The programme states that the reform should improve the quality of public finances in the long run through the expansion of the long-term saving and investment infrastructure and the higher liquidity on the financial markets as well as the sustainability of public finances by reducing the pension liabilities to be paid from the state budget in the long-term. However, as mentioned above (see Section 5), further changes to the pension systems, notably increasing the retirement age as discussed in the programme, would contribute to the long-term sustainability of public finances.

A tax reform is being implemented. The single personal income tax rate was lowered from 33% to 27% from July 2006 and was cut further to 24% as of 1 January 2008. The programme expects the reform to lead to a better balance between labour and capital taxation, to improve competitiveness due to reduced labour costs and to increase employment and potential GDP, but the programme does not provide a quantitative estimations of these benefits. It does, however, estimate the revenue loss for 2007-2008: 1.3% of GDP in 2007 and 2.3% of GDP in 2008. A temporary "social tax" (a *de facto* increase in the corporate income tax), introduced to partly offset the revenue loss in 2006 and 2007, is abolished from 2008. This social tax covered around one third of the revenue loss in 2007. An expansion of the real estate tax base since 2006 is expected to also contribute to the financing of the tax reform; the programme quantifies the positive impact on budget revenues to be relatively small.

A healthcare reform is ongoing, with the main aim of modernising and guaranteeing the efficiency of the system. It is estimated that the budget of the Health Insurance Fund will be in balance over the programme period, and that healthcare-related expenditure increases gradually as a percentage of GDP up to 2050.

In 2007 several political parties signed an agreement on the principles of science and education system reform, the first stage of which is planned to start in 2008-2009. The budgetary impact of this reform during the programme period is not quantified.

A significant public investment programme is being implemented. The investment ratio is expected to increase from 4.5% of GDP in 2007 to 5.3% in 2010, assuming accelerating inflows from EU funds.

[35] However, in two different places in the programme somewhat different figures are presented.

## 7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The convergence programme seems to be in line with the 2005 national reform programme and the October 2007 implementation report. 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 pension, healthcare and tax reforms. The new update provides detailed information on the budgetary costs of the ongoing tax reform and estimates annual costs of the pension reform. However, information provided on the medium-term budgetary costs associated with the healthcare reform and the planned education reform is insufficient. Furthermore, the convergence programme does not contain a qualitative assessment of the overall impact of the national reform programme within the medium-term fiscal strategy, neither does it take into account public finance implications of the envisaged reforms. The two programmes seem to be consistent to some extent.

**Box 6: The Commission assessment of the October 2007 implementation report of the national reform programme**

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Lithuania's national reform programme[36] and is summarised as follows.

Lithuania's national reform programme identifies as key challenges/priorities: sustaining rapid economic growth, a stable macroeconomic environment and seeking full-fledged membership in the EMU; promoting the competitiveness of Lithuanian enterprises; promoting employment and investment in human capital.

The Commission's assessment is that Lithuania has made good progress in implementing its National Reform Programme over 2005-2007.

Against the background of strengths and weaknesses identified, the Commission recommends that Lithuania is recommended to take action in the areas of: R&D and innovation; supply of skilled labour.

Against the background of progress made, the Commission recommends that Lithuania is encouraged to (also) focus on the areas of: improving macro-economic stability and containing inflation; increasing foreign direct investment; improving the efficiency of regulatory environment with particular focus on legislative simplification; improving youth employability; expanding entrepreneurship education; increasing the availability of childcare; and strengthening occupational health and safety.

The tables below provide an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. Table 11makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. Table 12 makes the assessment against the point to watch adopted by the Council in March 2007. The budgetary strategy in the convergence programme is partly consistent with the point to watch issued in the context

[36] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

of the Lisbon strategy. However, the projected fiscal stance does not contribute adequately to improving macroeconomic stability and containing inflationary pressures.

**Table 11: Consistency with the broad economic policy guidelines (integrated guidelines)**

| Broad economic policy guidelines (integrated guidelines) | Yes | Steps in right direction | No | Not applicable |
|---|---|---|---|---|
| ***1. To secure economic stability*** | | | | |
| – Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1]. | | X | | |
| – Member States should avoid pro-cyclical fiscal policies[2]. | | | | X |
| – Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3]. | | | | X |
| – Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies. | | | X | |
| ***2. To safeguard economic and fiscal sustainability*** In view of the projected costs of ageing populations, | | | | |
| – Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances. | | | | X |
| – Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…) | X | | | |
| ***3. To promote a growth- and employment-orientated and efficient allocation of resources*** | | | | |
| Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages. | | X | | |

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

*Source:*
*Commission services*

**Table 12: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)**

| Broad economic policy guidelines (country-specific recommendations and points to watch) | Yes | Steps in right direction | No | Not applicable |
|---|---|---|---|---|
| ***1. Country-specific recommendations*** | | | | |
| – *none* | | | | X |
| ***2. Points to watch*** | | | | |
| – *improve macro-economic stability and contain inflation* | | X | | |
| *Source:*<br>*Commission services* | | | | |

## 8. PROGRESS IN IMPLEMENTING THE ERM II COMMITMENTS

On 28 June 2004, Lithuania joined ERM II. In order to ensure a smooth participation in ERM II, Lithuania undertook commitments covering a broad range of areas, including fiscal policy, financial supervision/credit growth and structural reforms (see box). Taking into account also the information provided in the most recent update of the convergence programme, this section assesses the implementation of these commitments.

**Box 7: ERM II commitments of Lithuania**

The agreement on participation of the litas in ERM II is based on a firm commitment by the Lithuanian authorities to pursue sound fiscal policies which are essential for preserving macroeconomic stability and ensuring the sustainability of the convergence process. The authorities, together with the responsible EU bodies, will closely monitor macroeconomic developments. The Lithuanian government's aim to secure a balanced budget over the medium term needs to be underpinned by a credible medium-term strategy with ambitious budgetary targets. Sound fiscal policy and a determination to contain domestic credit growth, assisted by effective financial supervision, will contribute to ensuring the sustainability of the current account position. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and to maintain the overall competitiveness of the economy.

- **Fiscal policy**

A main emphasis of the ERM II communiqué was to **secure a balanced budget over the medium term** underpinned by a **credible medium-term strategy** with **ambitious budgetary targets**. Lithuania has recorded decreasing fiscal deficits since 2004, reaching 0.5% of GDP in 2005 and 0.6% in 2006, outperforming the fiscal targets set in its convergence programmes[37]. The more favourable results stemmed from higher-than-expected revenues due to stronger economic activity and improved tax collection. However, the major part of the additional revenues was spent by adoption of supplementary budgets[38]. According to the December 2007 update, Lithuania aims at achieving the fiscal deficit target of 0.9% of GDP set in the previous programme. Windfall revenues have been spent even though the budget was not revised.

The Lithuanian authorities are committed to fiscal consolidation over the medium term. However, considering the rapid economic growth of recent years, the government's

[37] In the December 2006 convergence programme update, deficit targets were set at 1.2 percent of GDP for 2006, declining subsequently to 0.5% in 2008 and reaching a balanced budget in 2009.

[38] In 2007 the windfall revenues were spent without adopting a supplementary budget: see above Section 4.1.

budgetary targets seem unambitious. Calculations of the structural balance indicate a tightening in 2005 but a broadly neutral fiscal stance in 2006 and in 2007. However, in 2007, the cash compensation paid by the government to individuals for earlier saving losses added further stimulus to the economy[39]. An anti-inflation plan announced by the government in March 2007 aims to avoid additional expenditures and to strive for a balanced budget "as soon as possible". However concrete measures have not been implemented so far. An updated Inflation Management Action Plan was approved by the government on 12 November 2007. It notably reiterates the commitment to strict fiscal policy and envisages new measures to contain credit growth and inflationary pressures to be adopted during 2008. In addition, the plan also announces increases in government spending (such as increases in social transfers and public wages) as compensation for the negative consequences of inflation. These measures seem to go against the commitment to strict fiscal policy and could contribute to further inflationary pressures. The Law on Fiscal Discipline adopted on 8 November 2007 aims at ensuring the sustainability of public finances. It is a welcome step but does not explicitly address the need to reduce overheating pressures in the near term. The targeted budget deficit of 0.5% for 2008 seems insufficiently ambitious given the pace of economic growth; the law also lacks a binding medium-term expenditure framework.

- **Measures to contain credit growth and strengthen financial supervision**

The Bank of Lithuania acting as banking supervision authority applies a minimum **reserve requirement** for commercial banks of 6% – unchanged since ERM II entry – in comparison to 2% in the euro area. At the beginning of 2006 it imposed the inclusion of commercial bank profit for the current year into Tier II capital, in order to restrict the possibilities of commercial banks to expand their loan portfolios at the expense of current profits. Starting from 2007, the new capital directive introduced **new capital adequacy requirements** leading to a change in the supervisory approach to the calculation of capital charges of credit institutions for covering different risks; this should further improve the quality of financial supervision. The Bank of Lithuania has repeatedly alerted commercial banks to the need to be more conservative in evaluating the financial situation of their customers and alerted borrowers to the risks of taking credit. [40]

Tax incentives exist for mortgage borrowing, notably with regard to the deduction of mortgage interest payments from personal taxable income on house acquisition or construction loans. Several exemptions from VAT are applied to the real estate and construction sectors (e.g. a reduced VAT rate of 9% is applied to the construction, renovation and heat isolation of residential premises). A **tax on real estate** introduced in 2005 is levied on the value of immovable property. The "Inflation Management Action Plan" announced in December 2007 envisages increasing the scope of application for the tax on real estate (which would be applied to properties sold less than five years after purchase rather than to properties sold less than three years after purchase, as is currently the case) and restricting the deduction of mortgage interest payments from personal income tax lower income households only. However, no concrete measures have yet been implemented. Total credit growth to the private sector has slowed from a peak of around 70% in April 2006 to a rate of around 44% in November 2007, with the slowdown in housing growth less pronounced than for other types of credit.

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[39] See above, Section 4.1.

[40] Lending takes place mainly in foreign currency. About half of the outstanding stock of credit is denominated in foreign currency (mainly euro).

As regards **financial supervision**, in 2006 the Bank of Lithuania signed a memorandum of understanding on the management of financial crises in commercial banks with the central banks of the other Baltic countries and Sweden.

- **Structural reforms and other measures**

Lithuania is implementing a number of fundamental reforms, including comprehensive pension reform (started in 2004), healthcare reform (started in 2003), tax reform (started in 2006) and has announced educational reform will commence in 2008-2009. The most recent NRP identified the promotion of employment and investment in human capital, R&D and innovation policies and promotion of competitiveness as key priorities. Among the strengths of the Lithuanian NRP are approval of priority areas for R&D development and adoption of the Vocational Training Law as well as measures to unblock business potential. Lithuania has made some progress in responding to the recommendation issued by the Council on strengthening research and innovation; however, there has been a limited response to the recommendation on increasing the supply of skilled labour. Over the ERM II period the business environment has improved according to several indicators. In 2007, Lithuania was ranked $16^{th}$ in the IBRD Doing Business Index and $22^{nd}$ in the Heritage Foundation Index of Economic Freedom.

**Conclusion**

Upon entry into the ERM II mechanism, Lithuania undertook commitments related to fiscal, financial sector and structural policies. In the light of these the authorities have insufficiently strengthened the fiscal stance and measures to restrain credit growth have been limited. Despite the rapid economic growth of recent years, the government did not achieve a balanced budget; budgetary targets have been unambitious and windfall revenues mainly spent. The medium-term budgetary strategy remains insufficiently binding. Measures have been undertaken to curb credit growth, such as raising the reserve requirements and expanding the compulsory reserve base, but their direct impact on credit growth have been limited. In 2007 the government announced plans to contain inflation; however, no concrete measures have yet been implemented. Lithuania has implemented a number of structural reforms, but the promotion of labour mobility has so far been weak.

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## Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

### (i) Model structure

The programme broadly follows the model structure outlined in the code of conduct, covering all principal sections.

### (ii) Data requirements

The programme broadly adheres to the code of conduct as far as data requirements are concerned, but there are some gaps and deficiencies in the provision of optional data. Regarding optional data, in Table 1c (Labour market developments) line 2 (employment, hours worked) and line 5 (labour productivity, hours worked) are missing for 2007-2010; in Table 3 (General government expenditure by function) no data on sub-indicators has been provided for 2010, except total expenditure; in Table 4 (General government debt developments) breakdown for line 5 (stock-flow adjustment) has not been provided, except for privatisation proceeds, lines 6 (liquid financial assets) and 7 (net financial debt) are not filled for 2007-2010; in Table 5 (Cyclical components) breakdown for line 5 (potential GDP growth) has not been provided; in Table 7 (Long-term sustainability of public finances) data on health care and long-term care are missing for 2000; pension reserve fund assets are missing for 2010-2050.

The tables on the following pages show the data presented in the December 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

### (iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

| The SCP… | Yes | No | Comments |
|---|---|---|---|
| *a. Involvement of parliament* | | | |
| … mentions status vis-à-vis national parliament. | | X | |
| … indicates whether Council opinion on previous programme has been presented to national parliament. | | X | |
| *b. Economic outlook* | | | |
| … (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables. | X | | |
| … explains significant divergences with Commission services' forecasts[1]. | | X | |
| … bears out possible upside/downside risks to economic outlook. | X | | |
| … analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance. | X | | |
| *c. Monetary/exchange rate policy* | | | |
| … (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability. | X | | |
| *d. Budgetary strategy* | | | |
| … presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio. | X | | |
| … (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council. | | X | Not applicable |
| … (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them). | X | | |
| … backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance. | X | | partly |

| The SCP… | Yes | No | Comments |
|---|---|---|---|
| … specifies state of implementation of measures. | X | | partly |
| *e. "Major structural reforms"* | | | |
| … (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time. | X | | |
| … includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms. | | X | |
| *f. Sensitivity analysis* | | | |
| … includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of:<br>a) changes in main economic assumptions<br>b) different interest rate assumptions<br>c) (for CP only) different exchange rate assumptions<br>d) if common external assumptions are not used, changes in assumptions for main extra-EU variables. | | X | |
| … (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth. | | X | |
| *g. Broad economic policy guidelines* | | | |
| … provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them. | X | | Does not explicitly mention BEPGs |
| *h. Quality of public finances* | | | |
| … describes measures to improve quality of public finances, both revenue and expenditure sides. | X | | |
| *i. Long-term sustainability* | | | |
| … outlines strategies to ensure sustainability. | X | | |
| … includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information). | X | | |
| *j. Other information (optional)* | | | |
| … includes information on implementation of existing national budgetary rules and on other institutional features of public finances. | X | | |

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

*Source:*
*Commission services*

**Table 1a. Macroeconomic prospects**

| | ESA Code | 2006 Level | 2006 rate of change | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change |
|---|---|---|---|---|---|---|---|
| **1. Real GDP** | B1*g | *71649.1* | 7.7 | 9.8 | 5.3 | 4.5 | 5.2 |
| **2. Nominal GDP** | B1*g | *81905.2* | 14.7 | 16.4 | 12.3 | 7.9 | 7.7 |
| **Components of real GDP** | | | | | | | |
| **3. Private consumption expenditure** | P.3 | *50599.1* | 11.9 | 12.4 | 6.7 | 6.2 | 5.4 |
| **4. Government consumption expenditure** | P.3 | *12423.6* | 5.5 | 4.9 | 8.7 | 2.6 | 4.4 |
| **5. Gross fixed capital formation** | P.51 | *18499.4* | 17.4 | 26.5 | 3.4 | 5.2 | 7.9 |
| **6. Changes in inventories and net acquisition of valuables (% of GDP)** | P.52 + P.53 | *0.9* | 3.2 | -0.1 | 0.0 | 0.0 | 0.0 |
| **7. Exports of goods and services** | P.6 | *43669.8* | 12.2 | 8.6 | 12.2 | 2.4 | 8.0 |
| **8. Imports of goods and services** | P.7 | *54661.4* | 13.8 | 16.0 | 12.3 | 4.1 | 8.4 |
| **Contributions to real GDP growth** | | | | | | | |
| **9. Final domestic demand** | | - | 9.6 | 15.8 | 7.0 | 6.1 | 6.8 |
| **10. Changes in inventories and net acquisition of valuables** | P.52 + P.53 | - | -3.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **11. External balance of goods and services** | B.11 | - | -2.0 | -6.0 | -1.7 | -1.6 | -1.6 |

**Table 1b. Price developments**

| | ESA Code | 2006 Level | 2006 rate of change | 2007 rate of change | 2008 rate of change | 2009 rate of change | 2010 rate of change |
|---|---|---|---|---|---|---|---|
| **1. GDP deflator** | | *114.3* | 6.6 | 6.1 | 6.7 | 3.2 | 2.3 |
| **2. Private consumption deflator** | | *105.7* | 2.9 | 5.2 | 5.5 | 2.5 | 2.2 |
| **3. HICP**[1] | | *103.8* | 3.8 | 5.8 | 6.5 | 5.1 | 3.6 |
| 4. Public consumption deflator | | *119* | 14.5 | 9.3 | 9.4 | 4.9 | 3.9 |
| 5. Investment deflator | | *109.7* | 6.0 | 6.5 | 6.5 | 5.0 | 3.3 |
| **6. Export price deflator (goods and services)** | | *112* | 5.2 | 4.9 | 4.1 | 2.0 | 2.2 |
| **7. Import price deflator (goods and services)** | | *105* | 8.0 | 3.1 | 4.2 | 2.5 | 2.5 |

**Table 1c. Labour market developments**

| | ESA Code | 2006 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|
| | | Level | rate of change | rate of change | rate of change | rate of change | rate of change |
| **1. Employment, persons**[1] | | *1499.0* | 1.7 | 2.3 | 0.3 | 0.1 | 0.0 |
| 2. Employment, hours worked[2] | | *2757133.0* | 0.9 | n.a. | n.a. | n.a. | n.a. |
| **3. Unemployment rate (%)**[3] | | *n.a.* | 5.6 | 4.5 | 5.2 | 6.0 | 5.9 |
| **4. Labour productivity, persons**[4] | | *47798.0* | 5.9 | 7.3 | 5.0 | 4.4 | 5.2 |
| 5. Labour productivity, hours worked[5] | | *26.8* | 6.6 | n.a. | n.a. | n.a. | n.a. |
| **6. Compensation of employees** | D.1 | *34966.8* | 18.9 | 23.2 | 19.0 | 7.6 | 7.2 |
| **7. Compensation per employee** | | *23326.7* | 16.9 | 20.4 | 18.7 | 7.6 | 7.2 |

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

**Table 1d. Sectoral balances**

| % of GDP | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| **1. Net lending/borrowing vis-à-vis the rest of the world** | B.9 | -9.5 | -12.5 | -12.7 | -14.5 | -15.4 |
| *of which* :<br>- Balance on goods and services | | -10.4 | -13.5 | -14.2 | -15.4 | -16.3 |
| - Balance of primary incomes and transfers | | -0.3 | -0.5 | -0.1 | -0.6 | -0.6 |
| - Capital account | | 1.2 | 1.5 | 1.6 | 1.5 | 1.5 |
| 2. Net lending/borrowing of the private sector | B.9 | -8.9 | -11.6 | -12.2 | -14.7 | -16.2 |
| 3. Net lending/borrowing of general government | EDP B.9 | -0.6 | -0.9 | -0.5 | 0.2 | 0.8 |
| **4. Statistical discrepancy** | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

**Table 2. General government budgetary prospects**

| | ESA Code | 2006 Level | 2006 % of GDP | 2007 % of GDP | 2008 % of GDP | 2009 % of GDP | 2010 % of GDP |
|---|---|---|---|---|---|---|---|
| **Net lending (EDP B.9) by sub-sector** | | | | | | | |
| **1. General government** | S.13 | *-483* | -0.6 | -0.9 | -0.5 | 0.2 | 0.8 |
| **2. Central government** | S.1311 | *-755.3* | -0.9 | -0.9 | -0.5 | 0.2 | 0.8 |
| **3. State government** | S.1312 | *n.a.* | n.a. | n.a. | n.a. | n.a. | n.a. |
| **4. Local government** | S.1313 | *-288.5* | -0.4 | -0.1 | 0.0 | 0.0 | 0.0 |
| **5. Social security funds** | S.1314 | *560.8* | 0.7 | 0.1 | 0.0 | 0.0 | 0.0 |
| **General government (S13)** | | | | | | | |
| **6. Total revenue** | TR | *27396.9* | 33.4 | 35.5 | 37.4 | 38.6 | 39.4 |
| **7. Total expenditure** | TE[1] | *27879.9* | 34.0 | 36.4 | 37.9 | 38.5 | 38.6 |
| **8. Net lending/borrowing** | EDP B.9 | *-483* | -0.6 | -0.9 | -0.5 | 0.2 | 0.8 |
| **9. Interest expenditure** | EDP D.41 | *613.1* | 0.7 | 0.8 | 0.8 | 0.7 | 0.6 |
| **10. Primary balance[2]** | | *130.1* | 0.2 | -0.1 | 0.3 | 0.9 | 1.4 |
| **11. One-off and other temporary measures[3]** | | *n.a.* | 0.0 | -0.6 | 0.0 | 0.0 | 0.0 |
| **Selected components of revenue** | | | | | | | |
| **12. Total taxes** (12=12a+12b+12c) | | *17138.6* | 20.9 | 21.7 | 23.4 | 23.6 | 23.7 |
| **12a. Taxes on production and imports** | D.2 | *9194.8* | 11.2 | 12.0 | 13.6 | 13.5 | 13.5 |
| **12b. Current taxes on income, wealth, etc** | D.5 | *7939.6* | 9.7 | 9.7 | 9.8 | 10.2 | 10.2 |
| **12c. Capital taxes** | D.91 | *4.2* | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **13. Social contributions** | D.61 | *7226.3* | 8.8 | 9.3 | 9.3 | 9.3 | 9.2 |
| **14. Property income** | D.4 | *468.2* | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| **15. Other[4]** | | *2568* | 3.1 | 3.9 | 4.1 | 5.1 | 5.9 |
| **16=6. Total revenue** | TR | *27396.9* | 33.4 | 35.5 | 37.4 | 38.6 | 39.4 |
| **p.m.: Tax burden** (D.2+D.5+D.61+D.91-D.995)[5] | | | 29.7 | 31.1 | 32.7 | 33.0 | 32.9 |
| **Selected components of expenditure** | | | | | | | |
| **17. Compensation of employees + intermediate consumption** | D.1+P.2 | *13554.3* | 16.5 | 16.5 | 16.9 | 16.9 | 17.1 |
| 17a. Compensation of employees | D.1 | *8625.8* | 10.5 | 10.8 | 11.1 | 11.1 | 11.2 |
| 17b. Intermediate consumption | P.2 | *4928.6* | 6.0 | 5.7 | 5.7 | 5.8 | 5.9 |
| **18. Social payments** (18=18a+18b) | | *8158.2* | 10.0 | 10.8 | 11.9 | 12.4 | 12.3 |
| 18a. Social transfers in kind supplied via market producers | D.6311, D.63121, D.63131 | *1124.5* | 1.4 | 1.4 | 1.5 | 1.6 | 1.5 |
| 18b. Social transfers other than in kind | D.62 | *7033.7* | 8.6 | 9.4 | 10.4 | 10.8 | 10.7 |
| **19=9. Interest expenditure** | EDP D.41 | *613.1* | 0.7 | 0.8 | 0.8 | 0.7 | 0.6 |
| **20. Subsidies** | D.3 | *584.7* | 0.7 | 0.8 | 0.8 | 0.7 | 0.7 |
| **21. Gross fixed capital formation** | P.51 | *3408.5* | 4.2 | 4.5 | 5.1 | 5.3 | 5.3 |
| **22. Other[6]** | | *2174.2* | 2.7 | 3.8 | 3.1 | 3.2 | 3.3 |
| **23=7. Total expenditure** | TE[1] | *27879.9* | 34.0 | 36.4 | 37.9 | 38.5 | 38.6 |
| p.m.: Government consumption (nominal) | P.3 | *14779.5* | 18.0 | 17.9 | 18.3 | 18.3 | 18.4 |

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

**Table 3. General government expenditure by function**

| % of GDP | COFOG Code | 2005 | 2010 |
|---|---|---|---|
| 1. General public services | 1 | 4.4 | n.a. |
| 2. Defence | 2 | 1.4 | n.a. |
| 3. Public order and safety | 3 | 1.8 | n.a. |
| 4. Economic affairs | 4 | 3.6 | n.a. |
| 5. Environmental protection | 5 | 0.6 | n.a. |
| 6. Housing and community amenities | 6 | 0.3 | n.a. |
| 7. Health | 7 | 4.3 | n.a. |
| 8. Recreation, culture and religion | 8 | 1.0 | n.a. |
| 9. Education | 9 | 5.5 | n.a. |
| 10. Social protection | 10 | 10.5 | n.a. |
| 11. Total expenditure (=item 7=23 in Table 2) | TE[1] | 33.5 | 38.6 |

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 4. General government debt developments**

| % of GDP | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| **1. Gross debt[1]** | | 18.2 | 17.6 | 17.2 | 15.0 | 14.0 |
| **2. Change in gross debt ratio** | | -0.4 | -0.6 | -0.4 | -2.2 | -1.0 |
| **Contributions to changes in gross debt** | | | | | | |
| **3. Primary balance[2]** | | 0.2 | -0.1 | 0.3 | 0.9 | 1.4 |
| **4. Interest expenditure[3]** | EDP D.41 | 0.8 | 0.8 | 0.8 | 0.7 | 0.6 |
| **5. Stock-flow adjustment** | | -0.6 | -0.6 | -0.7 | -3.4 | -2.7 |
| *of which:* | | | | | | |
| - Differences between cash and accruals[4] | | n.a. | n.a. | n.a. | n.a. | n.a. |
| - Net accumulation of financial assets[5] | | n.a. | n.a. | n.a. | n.a. | n.a. |
| *of which:* | | | | | | |
| *- privatisation proceeds* | | 2.8 | 0.1 | 0.1 | 0.0 | 0.0 |
| - Valuation effects and other[6] | | n.a. | n.a. | n.a. | n.a. | n.a. |
| **p.m.: Implicit interest rate on debt[7]** | | 2.8 | 4.8 | 5.2 | 4.5 | 4.4 |
| **Other relevant variables** | | | | | | |
| 6. Liquid financial assets[8] | | 14.6 | n.a. | n.a. | n.a. | n.a. |
| 7. Net financial debt (7=1-6) | | 3.6 | n.a. | n.a. | n.a. | n.a. |

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5. Cyclical developments**

| % of GDP | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| **1. Real GDP growth (%)** | | 7.7 | 9.8 | 5.3 | 4.5 | 5.2 |
| **2. Net lending of general government** | EDP B.9 | -0.6 | -0.9 | -0.5 | 0.2 | 0.8 |
| **3. Interest expenditure** | EDP D.41 | 0.7 | 0.8 | 0.8 | 0.7 | 0.6 |
| **4. One-off and other temporary measures[1]** | | 0.0 | -0.6 | 0.0 | 0.0 | 0.0 |
| 5. Potential GDP growth (%) | | 7.2 | 7.0 | 6.6 | 6.3 | 5.9 |
| contributions: | | | | | | |
| - labour | | n.a. | n.a. | n.a. | n.a. | n.a. |
| - capital | | n.a. | n.a. | n.a. | n.a. | n.a. |
| - total factor productivity | | n.a. | n.a. | n.a. | n.a. | n.a. |
| 6. Output gap | | 1.1 | 3.8 | 2.4 | 0.7 | 0.0 |
| 7. Cyclical budgetary component | | 0.3 | 1.2 | 0.8 | 0.2 | 0.0 |
| 8. Cyclically-adjusted balance (2 - 7) | | -0.9 | -2.1 | -1.2 | 0.0 | 0.8 |
| 9. Cyclically-adjusted primary balance (8 + 3) | | -0.2 | -1.2 | -0.5 | 0.7 | 1.4 |
| 10. Structural balance (8 - 4) | | -0.9 | -1.5 | -1.2 | 0.0 | 0.8 |

[1]A plus sign means deficit-reducing one-off measures.

**Table 6. Divergence from previous update**

| | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| **Real GDP growth (%)** | | | | | | |
| **Previous update** | | 7.8 | 6.3 | 5.3 | 4.5 | n.a. |
| **Current update** | | 7.7 | 9.8 | 5.3 | 4.5 | 5.2 |
| **Difference** | | -0.1 | 3.5 | 0.0 | 0.0 | n.a. |
| **General government net lending (% of GDP)** | EDP B.9 | | | | | |
| **Previous update** | | -1.2 | -0.9 | -0.5 | 0.0 | n.a. |
| **Current update** | | -0.6 | -0.9 | -0.5 | 0.2 | 0.8 |
| **Difference** | | 0.6 | 0.0 | 0.0 | 0.2 | n.a. |
| **General government gross debt (% of GDP)** | | | | | | |
| **Previous update** | | 18.4 | 19.2 | 19.0 | 17.7 | n.a. |
| **Current update** | | 18.2 | 17.6 | 17.2 | 15.0 | 14.0 |
| **Difference** | | -0.2 | -1.6 | -1.8 | -2.7 | n.a. |

**Table 7. Long-term sustainability of public finances**

| % of GDP | 2000 | 2005 | 2010 | 2020 | 2030 | 2050 |
|---|---|---|---|---|---|---|
| Total expenditure | 39.1 | 33.6 | 38.6 | 38.2 | 39.6 | 41.7 |
| Of which: age-related expenditures | 13.7 | 16.8 | 16.0 | 15.6 | 17.0 | 19.0 |
| Pension expenditure | 7.8 | 6.7 | 6.0 | 6.4 | 7.2 | 8.7 |
| Social security pension | 7.8 | 6.7 | 6.0 | 6.4 | 7.2 | 8.7 |
| Old-age and early pensions | 6.9 | 5.7 | 5.0 | 5.4 | 6.3 | 7.7 |
| Other pensions (disability, survivors) | 0.9 | 1.0 | 1.0 | 1.0 | 0.9 | 1.0 |
| Occupational pensions (if in general government) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Health care | n.a. | 4.3 | 4.5 | 4.7 | 4.9 | 5.2 |
| Long-term care *(this was earlier included in the health care)* | n.a. | 0.5 | 0.6 | 0.6 | 0.6 | 0.9 |
| Education expenditure | 5.7 | 5.3 | 4.9 | 3.9 | 4.1 | 4.1 |
| Other age-related expenditures | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Interest expenditure | 1.7 | 0.8 | 0.5 | 0.3 | 0.4 | 1.8 |
| Total revenue | 35.6 | 33.1 | 39.4 | 39.4 | 39.4 | 39.4 |
| Of which: property income | 1.2 | 0.8 | 0.6 | 0.6 | 0.6 | 0.6 |
| *Of which* : from pensions contributions (or social contributions if appropriate) | 7.1 | 7.0 | 7.2 | 7.3 | 7.3 | 7.1 |
| Pension reserve fund assets | 0.2 | 1.7 | n.a. | n.a. | n.a. | n.a. |
| *Of which* : consolidated public pension fund assets (assets other than government liabilities) | 0.0 | 0.5 | 4.1 | 11.6 | 20.1 | 36.6 |
| **Assumptions** | | | | | | |
| Labour productivity growth | 9.7 | 7.1 | 5.2 | 3.6 | 2.7 | 1.7 |
| Real GDP growth | 4.1 | 7.9 | 5.3 | 3.0 | 1.9 | 0.4 |
| Participation rate males (aged 20-64) | 82.1 | 81.5 | 85.6 | 87.6 | 88.0 | 86.3 |
| Participation rates females (aged 20-64) | 73.4 | 72.7 | 77.8 | 81.4 | 82.2 | 79.7 |
| Total participation rates (aged 20-64) | 77.6 | 76.9 | 81.5 | 84.4 | 85.0 | 83.0 |
| Unemployment rate | 16.4 | 8.3 | 5.1 | 7.0 | 7.0 | 7.0 |
| Population aged 65+ over total population | 13.7 | 15.1 | 16.1 | 17.5 | 21.4 | 26.7 |

**Table 8. Basic assumptions**

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| **Short-term interest rate[1] (annual average)** | 3.7 | 5.0 | 4.6 | 4.0 | 4.9 |
| **Long-term interest rate (annual average)** | 4.1 | 4.7 | 4.7 | 4.8 | 5.0 |
| **USD/€ exchange rate (annual average) (euro area and ERM II countries)** | 1.25 | 1.35 | 1.40 | 1.40 | 1.40 |
| **Nominal effective exchange rate** | -1.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)** | n.a. | n.a. | n.a. | n.a. | n.a. |
| **World excluding EU, GDP growth** | 6.0 | 5.6 | 5.3 | 5.4 | 5.4 |
| **EU GDP growth** | 3.0 | 2.9 | 2.4 | 2.4 | 2.4 |
| **Growth of relevant foreign markets** | 3.0 | 2.9 | 2.4 | 2.4 | 2.4 |
| **World import volumes, excluding EU** | 8.0 | 7.8 | 7.1 | 7.7 | 7.7 |
| **Oil prices (Brent, USD/barrel)** | 66.2 | 70.6 | 78.8 | 75.5 | 76.0 |

[1]If necessary, purely technical assumptions.

## Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Lithuania. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

**Table: Key economic indicators**

| | Lithuania | | | | | | Recently acceded Member States | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Averages | | | 2005 | 2006 | 2007 | Averages | | | 2005 | 2006 | 2007 |
| | '96 - '05 | '96 - '00 | '01 - '05 | | | | '96 - '05 | '96 - '00 | '01 - '05 | | | |
| **Economic activity** | | | | | | | | | | | | |
| Real GDP (% change) | 6.3 | 4.7 | 7.8 | 7.9 | 7.7 | 8.5 | 3.8 | 3.6 | 4.1 | 4.8 | 6.3 | 6.0 |
| *Contributions to real GDP growth:* | | | | | | | | | | | | |
| *Domestic demand* | *8.3* | *6.9* | *9.7* | *8.9* | *9.6* | *15.3* | *4.4* | *4.6* | *4.1* | *4.1* | *7.3* | *7.8* |
| *Net exports* | *-2.0* | *-2.1* | *-1.8* | *-1.0* | *-2.0* | *-6.1* | *-0.5* | *-1.0* | *-0.1* | *0.8* | *-0.9* | *-1.8* |
| Real GDP per capita (PPS; EU27 = 100) | 44 | 39 | 48 | 55 | 58 | 61 | 47 | 45 | 49 | 52 | 54 | 56 |
| Real GDP per capita (% change) | 6.9 | 5.5 | 8.4 | 8.6 | 8.3 | 9.0 | 4.1 | 3.8 | 4.4 | 4.9 | 6.4 | 6.1 |
| **Prices, costs and labour market** | | | | | | | | | | | | |
| HICP inflation (%) | 4.8 | 8.6 | 0.9 | 2.7 | 3.8 | 5.6 | 7.8 | 12.9 | 5.7 | 3.8 | 3.4 | 4.0 |
| Labour productivity (% change) | 6.4 | 5.9 | 6.9 | 5.3 | 5.9 | 6.2 | 4.2 | 4.3 | 4.1 | 3.3 | 3.6 | 3.5 |
| Real unit labour costs (% change) | 0.5 | 0.8 | 0.2 | 0.2 | 2.0 | 0.1 | -1.3 | -1.4 | -1.3 | -0.6 | -1.5 | 0.4 |
| Employment (% change) | -0.1 | -1.1 | 0.9 | 2.5 | 1.7 | 2.2 | -0.3 | -0.6 | 0.0 | 1.4 | 2.6 | 2.4 |
| Unemployment rate (% of labour force) | 12.0 | 11.5 | 12.4 | 8.3 | 5.6 | 4.2 | 11.3 | 9.7 | 12.9 | 11.9 | 9.9 | 7.8 |
| **Competitiveness and external position** | | | | | | | | | | | | |
| Real effective exchange rate (% change) | 7.5 | 12.5 | 2.5 | 3.1 | 6.7 | 4.8 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Export performance (% change)[1] | 3.0 | -2.1 | 8.0 | 8.9 | 1.3 | 0.3 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -7.6 | -9.4 | -5.8 | -6.2 | -8.9 | -12.5 | -4.5 | -4.8 | -4.3 | -4.3 | -5.0 | -6.1 |
| **Public finances** | | | | | | | | | | | | |
| General government balance (% of GDP) | -3.2 | -4.9 | -1.5 | -0.5 | -0.6 | -0.9 | -4.2 | -3.8 | -4.4 | -3.5 | -3.3 | -2.7 |
| General government gross debt (% of GDP) | 19.7 | 18.6 | 20.8 | 18.6 | 18.2 | 17.7 | 37.7 | 35.4 | 39.0 | 39.6 | 38.8 | 37.9 |
| Structural balance (% of GDP)[2] | n.a. | n.a. | -1.5 | -0.8 | -0.8 | -1.2 | n.a. | n.a. | -3.8 | -3.3 | -3.6 | -3.0 |
| **Financial indicators** | | | | | | | | | | | | |
| Short-term real interest rate (%)[3] | 4.8 | 11.5 | 2.1 | -3.1 | -3.3 | -2.6 | 3.9 | 6.3 | 2.9 | 1.4 | 1.0 | 0.5 |
| Long-term real interest rate (%)[3] | 4.1 | n.a. | 4.1 | -1.9 | -2.3 | -2.8 | n.a. | n.a. | n.a. | n.a. | 1.6 | 1.1 |

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

*Source*:
*Commission services*