COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Lithuania, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Lithuania was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Lithuania, submitted on 28 December 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

(1) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme)

(2) the country's commitments undertaken at the time of entry into ERM II, the exchange rate mechanism

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2009, as follows. "The Council concludes that, in a context of strong growth prospects, the programme envisages progress towards the MTO, which is targeted to be reached by 2008. However, there are risks to the achievement of the budgetary targets from 2008 onwards. A strong budgetary position is particularly important in view of pressures on inflation and the current account". In view of its assessment, the Council 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 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" and "continue to improve the medium-term framework for the planning and control of public finances".

2.2. ERM II commitments of Lithuania

On 28 June 2004, the Lithuanian litas joined ERM II[2] and Lithuania undertook the following commitments to ensure its smooth participation in the mechanism[3].

“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.”

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[4]. In the area of budgetary policies, Lithuania was encouraged to “improve macroeconomic stability and contain inflation".

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[2] ERM II is the exchange rate mechanism established by the Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union of 16 June 1997 (OJ C 236, 2.8.1997, p. 5).

[3] Available at: http://ec.europa.eu/economy_finance/publications/eurorelated_en.htm.

[4] OJ L 92, 3.4.2007, p. 23.

2.4. 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[5]. This can be 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 and the evidence on progress made, the Commission recommended that Lithuania is recommended to give highest priority to the challenges in the areas of: R&D and innovation; and the supply of skilled labour.

In addition, Lithuania should 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.

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[5] 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)" - COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[6];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[7], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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

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

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On the updated convergence programme of Lithuania, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[8], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the updated convergence programme of Lithuania, which covers the period 2007 to 2010[9].

(2) Over the past several years, Lithuania has been experiencing a period of strong growth 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

8 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

9 The update was submitted 4 weeks beyond the 1 December deadline set in the code of conduct.

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.

(3) 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[10], 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 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. However, recent price and wage developments pointing to the danger of deteriorating competitiveness could themselves result in a worsening external position.

(4) 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[11]. 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. 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[12] 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.

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10 The assessment takes notably into account the Commission services' autumn 2007 forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

11 The one-off measure relates to compensation of partly unpaid pensions in 1995-2002 that follows a Constitutional Court decision and was adopted by the government in November 2007. This operation was decided after the cut-off date of the Commission services' autumn 2007 forecasts, hence the estimated outturn for 2007 cannot be compared with that in the programme.

12 OJ C 71, 28.3.2007, p. 19.

(5) 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, does not as such introduce a binding medium-term budgetary framework.

(6) 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 strong 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.

(7) 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.

(8) 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.

(9) 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.

(10) 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. However, the projected fiscal stance does not contribute adequately to improving macroeconomic stability and containing inflationary pressures.

(11) 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. Measures have been undertaken to curb credit growth, such as raising the reserve requirements and expanding the compulsory reserve base, but their direct impact has been limited. 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.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most optional data[13].

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

[13] In particular, the data on the subcomponents of the stock-flow adjustment, estimates of the contributions to potential growth and some data on long-term sustainability are not provided.

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.

In view of the above assessment and also given the need to ensure sustainable convergence and a smooth participation in ERM II, Lithuania is invited to contribute to reducing overheating pressures by:

(i) aiming for significantly better budgetary outturns in 2008 and thereafter than foreseen in the programme, notably by restraining expenditure growth, saving windfall revenues and reinforcing the binding character of the medium-term expenditure ceilings;

(ii) tackling inflationary pressures by promoting wage setting in line with overall productivity gains and adopting structural measures to remove labour market bottlenecks.

Lithuania is also invited to improve compliance with the submission deadline for stability and convergence programmes specified in the code of conduct[14].

[14] Late submissions affect the effectiveness and consistency of the multilateral surveillance process.

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 services' autumn forecast.

Source:

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