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LITHUANIA: MACRO FISCAL ASSESSMENT

**AN ANALYSIS OF THE JANUARY 2009 UPDATE OF THE CONVERGENCE
PROGRAMME**

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not.

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 25 February 2009. Comments should be sent to Agne Geniusaite (Agne.Geniusaite@ec.europa.eu) and Julda Kielyte (Julda.Kielyte@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’ January 2009 interim 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 25 February 2009. The ECOFIN Council is expected to adopt its opinion on the programme on 10 March 2009.

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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

1. INTRODUCTION

This document assesses the January 2009 update of Lithuania's convergence programme. It takes into account all currently available information, notably the Commission services' January 2009 Interim Forecast and the measures adopted by the Lithuanian authorities in response to the economic downturn. The programme was submitted on 23 January 2009¹, seven weeks after the deadline of 1 December specified in the code of conduct, reflecting delay following the parliamentary elections in October 2008 that led to the formation of a new government only in December 2008. The programme covers the period 2008-2011 and builds on the new government's programme approved by parliament on 9 December 2008 and the 2009 budget adopted by parliament on 22 December. The convergence programme was approved by the government on 21 January 2009 and presented to the parliament's European Affairs Committee, where it was debated on 6 February 2009 without being voted upon; there is thus no formal parliamentary approval of the programme.

2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

In 2008 Lithuanian GDP decelerated to an estimated growth of 3.2% y-o-y from 8.9% in 2007, signifying the end of the exceptionally high economic growth experienced since the beginning of the decade. Estimates of the output gap² indicate that the adjustment will be large, with the gap moving from being strongly positive in 2007 and 2008 (respectively around 8% and 6½% of potential output) to turning negative in 2009 and 2010 (by around ½% and 5% respectively). The downturn has led to rapidly deteriorating labour market conditions over the last months of 2008. As evidenced by a marked slowdown in retail spending, falling housing prices and decreasing investment, as well as downbeat economic sentiment indicators, the economy is expected to decelerate further in 2009. In the context of the currency board framework, monetary and credit conditions tightened in 2008 amid higher country risk perceptions and a continued appreciation of the real effective exchange rate. Several external factors – notably the deepening global financial crisis and weakening external demand – are contributing to speeding up the contraction of the economy. Moreover, the weakness of the economic environment will be more protracted in Lithuania due to the closure of the Ignalina nuclear power plant at the end of 2009, expected to significantly increase inflation. Accordingly, the economy is assessed to have entered economic 'bad times' in late 2008 and to remain in bad times over the forecast horizon.

In view of sharply slowing economic growth, which turned negative in the fourth quarter of 2008, and wide macro-economic imbalances, the immediate economic policy challenge for Lithuania is to manage the economic slowdown so as to preserve macroeconomic stability. In particular, this relates to containing inflationary pressures and reducing the large external deficit. The recovery and rebalancing of the economy will crucially depend on a better export performance and thus in particular on public and private sector wages adjusting to restore the cost competitiveness of the economy. In the short run, achieving an export-led recovery will be very challenging given the deep economic malaise in the main Lithuanian export markets.

¹ The English language version was submitted on 3 February 2009.

² Output gap figures in general must be interpreted with special caution in the case of an economy such as Lithuania's, as potential growth is difficult to determine for an economy subject to rapid structural change.

Reflecting the rapid economic downturn, budget revenue has fallen sharply. In 2008, instead of the planned general government deficit of 0.5% of GDP, the deficit is estimated to have reached 2.9%, from 1.2% in 2007. This sharp deterioration also reflects an expansionary fiscal policy in 2008 when fiscal consolidation was limited and no reserves were accumulated to prepare for changing cyclical conditions.

Despite its low public debt ratio, Lithuania does not appear to have any available 'fiscal space'³, given the need for macroeconomic adjustment stemming from the country's high imbalances. External financing of the government seems to be one of the major challenges, as borrowing needs are substantial at a time when access to international capital markets is limited. In line with the European Economic Recovery Plan (EERP) agreed in December by the European Council, Lithuania has thus adopted a budgetary policy aimed at correcting its imbalances. Taking into account this objective and the difficulty in securing new financing on acceptable conditions due to market risk aversion, the planned fiscal stance from 2009 until 2011 is restrictive. Mainly motivated by the need to reduce the general government and external borrowing requirement, the newly elected government approved on 9 December 2008 an anti-crisis plan aiming for significant fiscal consolidation. A new budget for 2009 was adopted by parliament on 22 December including a number of significant measures on both the expenditure and the revenue side. The new budget included a comprehensive tax reform, which came into force on 1 January 2009. Moreover, significant cuts in the public wage bill, other current expenditure as well as in investment are planned. A number of professions that formerly did not pay social contributions have been brought within the scope of the social security system. The government contribution to private pension funds is temporarily reduced from 5.5% to 3%. Subsequently, the Lithuanian authorities are planning to adopt a comprehensive package of measures aimed at business support by reducing administrative burdens, improving access to finance and facilitating exports and investment. One of the priorities is modernisation of Soviet-era buildings so as to improve energy efficiency. In this context, Lithuania aims to accelerate (and simplify) the absorption of EU structural funds, where the possibilities of financing such investments would be considerably enlarged under the Commission's EERP proposals. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

3. MACROECONOMIC SCENARIO

According to the programme update, Lithuania will face a recession in 2009 and stagnate in 2010, with a recovery expected in 2011 (Table I). Domestic demand is set to fall sharply in 2009, but the negative impact on growth will be partly absorbed by net exports. Net exports are expected to make a strong positive contribution to GDP growth in 2009, which reflects falling imports and a relatively strong performance of exports, despite the deteriorating global demand. In 2009, the macroeconomic scenario in the programme expects a much sharper correction in domestic demand, especially in investment (-20%), than the Commission services' interim forecast. On the other hand, it foresees export growth to remain positive, whereas Commission services expect less optimistic developments on export markets.

Compared to the Commission services' interim forecast, the programme's macroeconomic outlook appears to be based on plausible growth assumptions in 2009 but markedly

³ The 'fiscal space' indicates a country's capacity to finance desired budgetary programmes as well as service its debt without compromising macroeconomic stability and fiscal sustainability.

favourable growth assumptions thereafter, considering that worsening domestic demand in Lithuania due to constrained credit and more subdued export market growth are likely to be more pronounced and protracted than envisaged in the programme. The estimated potential growth in 2011 is rather on the high side.

Table I: Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	3.4	3.5	-4.0	-4.8	-2.6	-0.2	4.5
Private consumption (% change)	6.0	7.3	-5.4	-7.8	-1.9	1.2	5.1
Gross fixed capital formation (% change)	-3.2	-4.5	-12.0	-20.2	-2.6	7.1	9.5
Exports of goods and services (% change)	13.1	13.2	-1.2	4.3	2.9	0.2	4.5
Imports of goods and services (% change)	11.6	13.0	-6.4	-6.4	3.6	2.2	5.3
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	3.9	5.1	-7.4	-12.0	-2.1	1.2	5.5
- Change in inventories	0.2	1.2	-0.3	0.0	0.0	0.0	0.0
- Net exports	-0.8	-1.6	3.7	7.2	-0.6	-1.4	-0.9
Output gap ¹	6.6	5.4	-0.5	-2.8	-4.8	-5.7	-4.0
Employment (% change)	-1.7	-0.8	-3.9	-1.9	-1.6	-0.5	-0.5
Unemployment rate (%)	5.4	5.6	8.8	7.8	10.2	8.5	8.6
Labour productivity (% change)	5.1	4.4	-0.2	-3.0	-1.0	0.4	5.1
HICP inflation (%)	11.1	11.2	5.6	5.4	4.8	3.6	-0.1
GDP deflator (% change)	12.1	12.0	5.1	6.0	2.9	0.5	-0.2
Comp. of employees (per head, % change)	18.0	20.1	3.8	4.3	1.7	2.3	4.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-10.7	-10.2	-4.8	-1.8	-4.7	-4.7	-5.7
<p><u>Note:</u></p> <p>¹In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.</p> <p><u>Source:</u></p> <p>Commission services' January 2009 interim forecasts (COM); Convergence programme (CP)</p>							

Cyclical conditions are expected to deteriorate considerably, with the output gap⁴ as recalculated by Commission services based on the information in the programme, following the commonly agreed methodology⁵, turning markedly negative in 2009 and 2010. This is accompanied by declining inflation and wages, a deteriorating labour market and a narrowing external deficit. Compared to the Commission services' interim forecast, the programme projects a much faster unwinding of external imbalances in 2009, due to a more severe contraction in domestic demand and more favourable developments in export markets.

⁴ It should be noted, however, that calculation of potential output growth and hence the output gap should be interpreted with particular caution for countries undergoing structural adjustment. In addition, the sharp turn in the cycle has added further uncertainty to the output gap estimations.

⁵ Significant differences between the output gap calculations according to Commission services' calculations on the basis of the information in the programme according to the commonly agreed methodology and the output gap calculations presented in the programme are due to different methodologies used, as the programme uses the Hodrick-Prescott filter. This results in a significantly lower positive output gap turning more negative in 2009 and a somewhat better structural balance on average in the Commission services' recalculations than reported in the programme.

The programme's projection for inflation appears realistic for 2009 but could be on the low side for 2010, notably because of the impact on energy prices in Lithuania after the closure of the Ignalina nuclear power plant scheduled by the end of 2009 could alone contribute around 2p.p. to inflation based on the programme estimate. At the same time the programme assumes a strong disinflationary process in other parts of the economy. Furthermore, against more recent information, the projected rise in unemployment seems to be rather on the low side.

Further downside risks to the macroeconomic scenario relate to a possible stronger deterioration of the global economic environment and in particular in the main trading partners of Lithuania, such as Russia, Latvia, Estonia, Germany and Poland,, a very sharp correction in the real estate market or insufficient flexibility of the labour market entailing an even deeper and/or prolonged recession than currently foreseen, posing risks to the expected return to potential growth by the end of the programme period.

4. BUDGETARY STRATEGY

4.1. Budgetary implementation in 2008

According to both the Commission services' interim forecast and the January 2009 convergence programme update, the general government deficit is expected to have reached 2.9% of GDP in 2008, compared to a planned deficit of 0.5% of GDP in the previous update. This significantly worse-than-expected outturn reflects mainly considerable expenditure overruns on public sector wages and social transfers for families and pensioners following policy decisions adopted during the year (and thus not included in the 2008 budget) and to a lesser extent a tax shortfall due to over-optimistic revenue assumptions and sharply slowing economic activity towards the end of the year. Investment expenditure and EU funds absorption were lower than planned.

Budget revenue is estimated to have increased somewhat less than planned: 15.9% year-on-year according to the January interim forecast compared to a planned increase of 18.3% in the previous convergence programme update. A tax revenue shortfall reflects very optimistic revenue planning but also lower-than-expected economic activity in general, especially in the second half of the year. The shortfall in tax revenue was mainly related to the underperformance of taxes on production and imports (-1.1% of GDP). On the other hand, receipts of taxes on income and wealth was as budgeted, as lower than expected personal income tax receipts (mirroring a tax cut by 3p.p. at the beginning of 2008) were compensated by higher than assumed corporate income tax (due to very high corporate profits in 2007). Positive revenue surprises came from social contributions (0.5% of GDP) due to continuingly rapid wage growth.

Expenditure is expected to have increased by around 21.3% rather than the planned rise of 16.9% in the previous programme update, with a negative effect of around 1.2% of GDP. This was a result of the raising of public sector wages and social transfers to families and pensioners before the parliamentary elections in October 2008 (when adoption of a supplementary budget was not required). The social security sub-sector finished the year with a large deficit, despite higher-than-budgeted receipts from social contributions. Most of the accumulated reserves from previous year's surpluses were used for financing of these additional expenditures (1.3% of GDP). These expenditure slippages seem particularly high considering that expenditure on investment fell short of target due to considerably lower than initially planned absorption of EU structural funds.

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 2.6% of GDP in 2007 to a 4.9% of GDP deficit in 2008.

4.2. Near-term budgetary strategy

On 14 October 2008 the Lithuanian government adopted an initial draft budget for 2009 including state and local governments. However, the new government that took office on 9 December 2008 revised the budget substantially, including a significant fiscal retrenchment plan. In line with this, the revised 2009 budget, which takes into account a fiscal consolidation package, aimed at restoring market confidence and limiting government's financing needs, was adopted by Parliament on 22 December 2008. Fiscal consolidation is based on a comprehensive tax reform, overall revenue-raising, and substantial cuts in budgetary expenditure, expected to contribute in roughly equal measure to fiscal consolidation. The budget targets a general government deficit of 2.1% of GDP, which in the absence of the consolidation measures would have been substantially higher.

The main revenue measures include a 1 percentage point VAT and excise duties increases, a 3 percentage points cut in the rate of personal income tax and a 5 percentage points increase in the rate of corporate income tax as well as removal of most VAT and personal income tax exemptions and broadening the tax base, particularly by including more payers into the social security system and corporate taxation. The estimated net effect of these changes according to the programme is around 1.8% of GDP. Tax changes aim to shift the taxation burden from direct to indirect taxes and from labour to capital, to increase tax progressivity and to broaden the tax base by removing exemptions. The budget also plans significant expenditure cuts, estimated at around 1.7% of GDP, including public sector wages, other current expenditure and planned investment. However, some measures underpinning the budget have been rejected by the parliament either in full (e.g. a tax on corporate cars, estimated revenue of 0.3% of GDP) or in part (recently some laws related to personal and corporate income taxation as well as social security contributions have been partly revised by the parliament) and therefore need to be substituted by new measures. The government also plans to sell the remaining state shares in the refinery "Mazeikiu nafta" (+0.5% GDP), with the proceeds to be added to the reserve (stabilisation) fund.

The programme expects a general government deficit of 2.1% of GDP in 2009; however, whereas the central government is expected to have a deficit of 2.2% of GDP, the local governments are expected to register a balance and the social security funds to record a small surplus of 0.1% of GDP. The social security fund is set to be in balance, because of the planned subsidy from the central government budget (0.5% of GDP) and additional revenue planned to be received after the rate of contributions to the private pension funds (second pillar) has been lowered from 5.5% to 3% in 2009-2010 (additional revenue estimated at around 0.5% of GDP per year). The general government deficit is expected to narrow to 1.0% of GDP in 2010 and to be in balance in 2011. There is no reliance on one-off and temporary measures from 2008 onwards⁶.

⁶ The Commission services do not currently consider that the recording of additional VAT receipts in 2008 as a one-off revenue measure. Moreover, Commission services did not take into account deficit-reducing one-offs related to the additional revenue expected to the social security funds in 2009 and 2010 as a consequence of a lower contribution rate to the private pension funds (as described above) to be of temporary nature.

Table II. Main budgetary measures for 2009

Revenue measures ¹	Expenditure measures ²
<ul style="list-style-type: none"> • Increase standard VAT rate from 18% to 19%; increase reduced VAT rates from 5% and 9% to 19% (except for heating, medicine and book publication) (+0.9% of GDP); • Increases of excise taxes on fuel, alcohol and tobacco (+0.65% of GDP); • Increase corporate income tax and taxes on dividends from 15% to 20% (+0.4% of GDP); • Reduce personal income tax rate from 24% to 15% and levy a 6% tax to the health insurance fund (-0.45% of GDP). • Enlarge the scope of the social security system by including professions that formerly did not pay social contributions (such as athletes, farmers and artists) within the scope of the social security system (+0.17% of GDP). • Reducing the rate of social contribution transferred to the second pillar private pension funds from 5.5% to 3% in 2009 and 2010 (+0.55% of GDP). 	<ul style="list-style-type: none"> • Reduction in compensation of public wages by 12% on average (-0.7% of GDP) • Salary increases for teachers, social workers, culture, art and science workers and lecturers (+0.8% of GDP). • Cut in assignments for government investment spending (-0.55% of GDP) • Cut in subsidies for agriculture and spending on land reform (-0.5% of GDP) • Cut in current government expenditure (-0.3% of GDP) • Cuts in social expenditure on childcare (-0.13% of GDP) • Reduction in transfers to the municipalities (-0.3% of GDP).
<p><u>Note:</u></p> <p>¹ Estimated impact on general government revenue</p> <p>² Estimated impact on general government expenditure</p> <p><u>Source:</u> Commission services and the latest convergence programme update.</p>	

The overall fiscal stance in 2009, as measured by the change in the structural balance, is expected to be strongly restrictive. According to the programme, the structural balance as recalculated by Commission services is expected to improve by around 3 percentage points of GDP in 2009, reflecting fiscal consolidation measures adopted by the government. It occurs against less favourable cyclical conditions as measured by a large negative output gap from 2009 until 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 rapid structural changes.

Table III: Composition of the budgetary adjustment

(% of GDP)	2007	2008		2009		2010		2011	Change: 2008-2011
	COM	COM	CP	COM	CP	COM ¹	CP	CP	CP
Revenue	33.9	33.9	33.8	34.8	35.8	36.0	37.3	36.4	2.6
<i>of which:</i>									
- Taxes on production and imports	11.6	11.5	11.8	12.0	12.6	12.1	12.9	12.8	1.0
- Current taxes on income, wealth, etc.	9.3	9.0	9.2	8.5	8.3	8.5	8.2	8.2	-1.0
- Social contributions	8.9	9.3	9.2	9.5	9.7	9.6	9.9	9.3	0.1
- Other (residual)	4.1	4.1	3.7	4.8	5.1	5.7	6.3	6.1	2.5
Expenditure	35.2	36.8	36.7	37.8	37.8	39.4	38.3	36.4	-0.4
<i>of which:</i>									
- Primary expenditure	34.5	36.1	36.1	36.8	36.9	38.3	37.2	35.3	-0.8
<i>of which:</i>									
Compensation of employees	10.0	10.2	10.3	10.1	10.2	10.1	9.7	8.7	-1.5
Intermediate consumption	5.4	5.2	5.3	4.9	5.4	5.1	5.1	4.6	-0.7
Social payments	10.9	13.3	13.3	14.0	13.9	14.4	13.9	13.7	0.4
Subsidies	0.9	0.9	0.9	1.0	0.5	1.0	0.5	0.5	-0.5
Gross fixed capital formation	5.2	4.4	4.4	4.6	5.1	5.3	5.6	5.4	1.0
Other (residual)	2.1	2.1	1.9	2.3	2.0	2.5	2.4	2.4	0.5
- Interest expenditure	0.7	0.7	0.7	0.9	0.9	1.1	1.0	1.1	0.4
General government balance (GGB)	-1.2	-2.9	-2.9	-3.0	-2.1	-3.4	-1.0	0.0	2.9
Primary balance	-0.5	-2.2	-2.3	-2.0	-1.2	-2.3	0.0	1.1	3.3
One-off and other temporary measures	-0.6	0.0	0.5	0.0	0.5	0.0	0.5	0.0	-0.5
GGB excl. one-offs	-0.7	-2.9	-3.4	-3.0	-2.5	-3.4	-1.4	0.0	3.4
Output gap ²	7.7	6.6	5.4	-0.5	-2.8	-4.8	-5.7	-4.0	-9.4
Cyclically-adjusted balance ²	-3.3	-4.6	-4.4	-2.9	-1.3	-2.1	0.5	1.1	5.5
Structural balance³	-2.7	-4.6	-4.9	-2.9	-1.8	-2.1	0.1	1.1	6.0
<i>Change in structural balance</i>		-1.9	-2.2	1.8	3.1	0.7	1.8	1.0	
Structural primary balance ³	-2.0	-3.9	-4.2	-1.9	-0.9	-1.1	1.1	2.1	6.3
<i>Change in structural primary balance</i>		-1.9	-2.2	2.0	3.4	0.9	1.9	1.0	
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' January 2009 interim forecasts (COM); Commission services' calculations									

4.3. Medium-term budgetary strategy

The medium-term budgetary strategy of the programme is to achieve the MTO of a general government structural deficit of 1% of GDP by 2010, and to reach a balanced headline budget in later years. There has been no change in the medium-term objective compared to the previous programme update.

On the basis of recalculated output gaps and structural balance, the fiscal position was below the MTO in 2008 and is expected to remain below the MTO in 2009. According to the programme, the MTO is expected to be achieved in 2010, supported by the restrictive fiscal policy throughout 2009-2011. The programme expects a positive change in the structural balance of 1¾ percentage points of GDP in 2010 and 1 percentage point of GDP in 2011. The

adjustment is intended to be achieved by a substantial increase in the revenue-to-GDP ratio (by around 2½ percentage points) and a modest reduction in the expenditure ratio (by around ½ percentage points). Higher revenue growth can mainly be explained by the tax changes introduced in the 2009 budget. The government has begun a more detailed review of current expenditure, including public sector employment, which could lead to further expenditure savings to be proposed in later years. However, the programme explicitly acknowledges that achievement of the budgetary targets presented in the programme require additional measures of around ½% of GDP in 2010 and around 1½% of GDP in 2011.

Broad measures intended to support the achievement of budgetary targets beyond 2009 are spelled out to some extent in the programme. On the revenue side, indirect taxes are projected to increase by 1% of GDP over 2008-2011, mainly reflecting tax changes introduced in the 2009 budget, including an increase in standard VAT rate from 18% to 19%, removal of most VAT exempted rates and higher excise duties on energy products, alcohol and tobacco. On the other hand, lower revenue from current taxes on income and wealth (-1 pp.) is expected due to the reduction of the single personal income tax rate from 24% to 21% as of January 2009 and worsening corporate income tax collection due to slowing economic activity and diminishing profits. The increase in other expenditure (by 2.5 pp.) seems to be partly related to higher inflows of EU funds, assuming an acceleration of absorption. On the expenditure side, substantial savings are planned in general government wage bill (-1.5 pp.), which reflect government's intentions to streamline public administration by cutting public sector wages and eliminating vacant positions, however, but the biggest cut is foreseen in 2011 and is not specified in the programme. Furthermore, intermediate consumption (-0.7 pp.) and subsidies (-0.5 pp.) are set to decline, whereas other expenditure positions are set to increase over 2008-2011: investment, which depends on the absorption of EU structural funds (+1 pp.), social payments (+0.4 pp.), other (+0.5 pp.) and interest expenditure (+0.4 pp.).

Compared with the previous programme, the new update backloads the structural adjustment in the context of a significantly weaker macroeconomic scenario. In light of the significantly worse-than-planned budgetary outturn in 2008 and expected further worsening of economic situation, the budgetary targets for 2009 and 2010 need to be backed by additional measures.

The fiscal stance, as measured by the change in the structural balance, as recalculated by the Commission services, is planned to be restrictive from 2009 on.

4.4. Risks to the budgetary targets

As regards the macroeconomic outlook discussed in Section 3, the programme's growth projections are plausible until 2009 but markedly favourable thereafter. The programme acknowledges possible downside risks to macroeconomic prospects related to the adjustment path in the real estate market, flexibility of the labour market and economic developments in Lithuania's main export markets.

The budgetary measures for 2009 are spelled out sufficiently in the programme for revenue; however, they are less detailed on the expenditure side. The overall level of revenue in the programme is considerably higher than those in the Commission services' forecast, with differences arising mainly from more optimistic projections in the programme of revenue from all types of taxes as well as higher assumed inflows of EU funds. Considering the severe downturn in the economy, the outlook for tax receipts is very uncertain and revenue could be significantly lower than projected in the programme, mainly related to the risk that discretionary revenue-increasing measures adopted in December 2008 together with the 2009 budget, particularly the indirect tax increases, will not lead to higher tax revenue to the extent

planned in the programme. Furthermore, some measures underpinning the budget have been rejected by the parliament either in full or in part and have to be substituted by new measures. There is also a risk that the implementation of some of the measures may prove to be difficult, especially on subsidies (national direct payments to agriculture) and public sector employee compensation. Uncertainties relate to the implementation of the proposed cuts to public sector employee compensation (12% on average). The basic salary, which is used for the calculation of the public servants salaries, was reduced by 3% from 1 January 2009. However, a large part of the public sector remuneration is in form of premiums and bonuses, paid on top of the "normal" salary and which are more difficult to control. The measures related to budgetary adjustment in 2010 and 2011, which includes both revenue-increasing and expenditure-decreasing measures, are broadly specified in the programme, however, there are some uncertainties particularly related to a sharp drop in intermediate consumption and compensation of employees foreseen for 2011. The programme itself explicitly acknowledges that additional measures will be needed to achieve budgetary targets in 2010 and 2011. Furthermore, the projected fiscal consolidation in 2010 and 2011 seems to be based on markedly favourable growth assumptions.

While overall fiscal targets have often been outperformed in years before 2007 (see Figure 2 in Annex 2), it was largely helped by strong growth and constant revenue overshoots. However, extra revenue has been mainly spent by approving additional expenditure in the form of supplementary budgets. The situation worsened significantly in 2008, when the general government deficit target of 0.5% of GDP, was clearly breached. On the other hand, the new government appointed in December 2008 boosted its credibility by adopting a substantial fiscal stabilisation package. Furthermore, the government signalled recently that if revenue collection will be behind the schedule in the first quarter of 2009, a supplementary negative budget might be adopted including further cuts in current expenditure and investment programmes.

Overall, there is a risk that the budgetary outcomes could be worse than targeted in the January 2009 programme update. This concerns all programme years: in 2009 the main risk is that revenue could be significantly lower than projected in the programme, mainly related to the risk that discretionary revenue-increasing measures, particularly the indirect tax increases, will not lead to higher tax revenue to the extent planned in the programme, and that all proposed expenditure cuts, especially on subsidies and public sector employee compensation, may not be implemented; in 2010 and 2011 risk arises from the projected fiscal consolidation being based on markedly favourable growth assumptions and requiring additional measures to underpin the budgetary targets.

With a view to stabilising the financial sector, the Lithuanian authorities have increased the guarantee for deposit insurance from €2 000 to €100 000 in October 2008 and the deposit guarantee ratio has been extended to 100%. The programme acknowledges a possible risk related to deposit guarantees, where the total amount guaranteed at the end of 2008 was around 30% of GDP.

5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

5.1. Debt developments

The programme estimates Lithuania's government debt ratio to have decreased from 17% of GDP in 2007 to 15.3% in 2008. This is notably below the Commission services' forecasts and the target presented in the previous programme update. The difference mainly stems from the different estimation of the stock-flow adjustment in 2008. According to the programme, part

of the 2008 deficit was financed by using previously accumulated reserves in the cash balance of the central government and social security funds (1.3 billion LTL). To a lesser extent it also reflects accrued liabilities to private sector, which accumulated at the end of 2008 as the government delayed payments for goods and services, though these are accounted for in the 2008 general government budget deficit. In 2009, the stock-flow adjustment indicated in the programme refers to the allocation of 0.6 billion LTL from the stabilisation reserve fund to the social security funds for financing of the pension reform.

According to the Commission services' January 2009 forecast, the government debt ratio is expected to raise and to reach 23.3% in 2010. Because of the different starting position in 2008 and the risk stemming from higher-than-targeted deficits in later years, there are significant differences in the expected debt figures compared to the programme. The programme expects the debt ratio to reach around 18% of GDP in 2010 and to decline to 17.1% in 2011.

The largest part of the general government debt is in long-term liabilities, denominated in LTL or euro, although the percentage by currency denomination is not specified in the programme. However, since autumn 2008 the government was not able to issue long-term debt and has to borrow short-term. This involves also higher debt servicing costs which reflect increased spreads.

Table IV: Debt dynamics

(% of GDP)	average 2002-06	2007	2008		2009		2010		2011
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio¹	19.9	17.0	17.1	15.3	20.0	16.9	23.3	18.1	17.1
Change in the ratio	-1.0	-1.0	0.1	-1.7	2.8	1.6	3.4	1.2	-1.0
<i>Contributions²:</i>									
1. Primary balance	0.1	0.5	2.2	2.3	2.0	1.2	2.3	0.0	-1.1
2. "Snow-ball" effect	-1.0	-2.0	-1.6	-1.6	0.8	0.7	1.0	0.9	0.3
<i>Of which:</i>									
Interest expenditure	1.0	0.7	0.7	0.7	0.9	0.9	1.1	1.0	1.1
Growth effect	-1.5	-1.4	-0.5	-0.5	0.7	0.7	0.5	0.0	-0.8
Inflation effect	-0.5	-1.3	-1.8	-1.8	-0.9	-0.9	-0.6	-0.1	0.0
3. Stock-flow adjustment	-0.1	0.6	-0.4	-2.3	0.0	-0.3	0.0	0.3	-0.3
<i>Of which:</i>									
Cash/accruals diff.	0.6	0.7	-0.5	n.a.	0.0	n.a.	0.0	n.a.	n.a.
Acc. financial assets	-0.4	-0.2		0.0		0.7		0.0	n.a.
Privatisation	-1.2	-0.1		n.a.		n.a.		n.a.	n.a.
Val. effect & residual	-0.3	0.0		n.a.		n.a.		n.a.	n.a.

Notes:

¹End of period.

²The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). 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' January 2009 interim forecasts (COM); Commission services' calculations

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

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to an agreed methodology.⁷

Table 4 in the Annex shows that the age-related spending is projected to rise by 2.1 percentage points of GDP between 2010 and 2050, which is below the EU average. Sustainability indicators for two scenarios are presented in Table 5 in the Annex. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2008 level, the sustainability gap (S2)⁸ would amount to 4.9% of GDP; about 3 percentage points more than in last year's assessment, which is due to a lower estimated structural primary balance in the starting year. The starting budgetary position is not sufficient to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing.

In contrast to the "2008 scenario", which reflects the weakening of the budgetary position on account of the current economic crisis, the "programme scenario", which is based on the projected end-of-programme structural primary balance, would eliminate the gap. If the budgetary consolidation planned in the programme was achieved, risks to long-term sustainability of public finances would be mitigated.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 4 in the Annex displays the projected debt/GDP ratio over the long-term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account. They are summarized in Annex Table 6. The programme presents projections updated by national authorities, taking into account recent changes to the pension system, which tend to increase the long-term cost of ageing.

The long-term budgetary impact of ageing is lower than the EU average, as a result of the pension reform already enacted. However, the budgetary position in 2008, as estimated in the programme, has worsened considerably compared with the starting position of the previous programme and compounds the budgetary impact of population ageing on the sustainability gap. Achieving primary surpluses over the medium term, as foreseen in the programme, would contribute to reducing the medium risks to the sustainability of public finances.

6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

Lithuania's medium-term budgetary framework has not succeeded in preventing expenditure overruns in recent years. Buoyant revenue growth has facilitated repeated upward revisions of expenditure targets and the weaknesses of the budgetary framework have been even more

⁷ Economic Policy Committee and the European Commission (2006), 'The impact of aging on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', *European Economy – Special Report* No. 1/2006. European Commission (2006), 'The long-term sustainability of public finances in the European Union', *European Economy* No. 4/2006. European Commission (2008), *Public finances in EMU – 2008*, *European Economy* No. 4/2008.

⁸ The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

evidenced by the recent deterioration of the headline deficit due to electoral cycle. With a view to strengthening the framework, a Law on Fiscal Discipline was adopted in November 2007, including notably an expenditure rule. However, the law focused on preparation and execution of the annual budget and did not as such introduce a more of the necessary forward-looking medium-term elements.

Hence, the current framework is still rather weak as regards medium-term planning and control of public finances. There is scope for enhancing planning and for reinforcing the binding character of the medium-term expenditure ceilings, which would contribute to restraining expenditure growth. Moreover, the framework would need to ensure fiscal consolidation in good economic times, by preventing that additional revenue entail higher spending. Better targeting, quantified evaluation criteria and improved cost-benefit analysis as well as better integration of strategic expenditure planning and budgeting would enhance the medium-term spending framework.

Transparency of the whole budgetary process including appropriate reporting of revenue and expenditure executions also remains weak, including as regards the comparability of the budgetary indicators on cash and accrual bases. The public sector wage system, particularly as regards payments of premiums and bonuses seems to be insufficiently transparent and would benefit from monitoring at the central level.

7. ASSESSMENT

This section assesses the budgetary strategy, taking into account risks, in the light of (i) the adequacy of the fiscal stimulus package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as agreed by the European Council conclusions on the European Economic Recovery Plan (EERP) on 16 December 2008 and the overall fiscal stance (ii) the criteria for short-term action laid down the above mentioned Commission Communication, and (iii) the objectives of the Stability and Growth Pact.

Lithuania, which is facing significant external and internal imbalances, adopted a fiscal consolidation package, which aims at correcting such imbalances and restoring confidence in Lithuania's public finances. A comprehensive tax reform and a wide range of expenditure saving measures, including reductions in public wages, have been taken. Furthermore, the Lithuanian authorities are planning to adopt a comprehensive package of measures aiming at business support by reducing administrative burden, improving access to finance and facilitating export and investment in spring 2009. One of the priorities includes modernisation of Soviet-era buildings so as to improve energy efficiency. For this purpose, Lithuania aims to accelerate (and simplify) the absorption of EU structural funds.

Fiscal policy was pro-cyclical and expansionary in 2008, with change in the structural balance of 2.3 percentage points of GDP according to the most recent update of the convergence programme and around 2% of GDP according to the Commission services' interim forecast. The fiscal stance is planned to turn restrictive from 2009 onwards as authorities adopted serious measures aiming to limit the deterioration of the budgetary deficits. The programme targets a deficit of 2.1% of GDP in 2009 and a gradual decline in the headline deficit thereafter to a balanced position in 2011. Taking into account the risks related to the macroeconomic scenario and the lack of information on measures needed to underpin fiscal consolidation after 2009, the budgetary outcomes in the programme are subject to significant downside risks, with the headline deficit possibly exceeding the 3% of GDP threshold in 2009

and 2010. The planned restrictive fiscal stance from 2009 until 2011 is an appropriate response in the light of existing imbalances.

The MTO, defined as a structural balance, is projected to be reached in 2010 according to the programme. However, budgetary outcomes could be worse than projected in the programme. This concerns all programme years: in 2009 the main risk is that revenue could be significantly lower than projected in the programme and not all proposed expenditure cuts implemented; the projected fiscal consolidation in later years (2010-2011) in the programme is based on more favourable macroeconomic scenario than the Commission services' forecast and is insufficiently backed by measures. Although the safety margin against normal cyclical fluctuations appears to be respected in the programme in all years starting in 2009, this may become insufficient, taking into account the risks including the severe recession that the country faces, to prevent breaching the 3% threshold in 2009 and 2010.

ANNEX 1. SPECIAL TOPIC: EXTERNAL IMBALANCES AND POLICY ADJUSTMENT

Lithuania's large external imbalances have increased its vulnerability in view of the tightening credit conditions and lower growth in export markets. Economic growth will depend on both fiscal policy adjustment and on the ability to maintain competitiveness.

The Commission services' macro-fiscal assessment of Lithuania's 2007 convergence programme already identified preserving macroeconomic stability as the main challenge in the area of public finances⁹. This section analyses in more detail the factors behind the external imbalances and the potential role of structural policies and fiscal policy, in addressing the associated challenges. The analysis will first concentrate on the structural changes in the economy, the developments of competitiveness indicators, as well as trade and external balance developments. Secondly, the role of and challenges for fiscal policy and structural policies will be discussed.

1. INTRODUCTION: OVERVIEW OF RECENT MACRO-ECONOMIC DEVELOPMENTS

Lithuania has enjoyed several years of very high growth (7.6% on average over 2001-2007), mainly driven by domestic demand and characterised by growing macroeconomic imbalances. The convergence process has been impressive, with real GDP per capita (in purchasing power standards) increasing from 42% of the EU-27 average in 2001 to 60% in 2007.

However, GDP decelerated from growth of 8.9% in 2007 to an estimated 3.2% y-o-y in 2008. As evidenced by a marked slowdown in retail spending, falling housing prices and decreasing investment, the economy is expected to decelerate further. The accumulated macro-economic imbalances weigh heavily: consumer price inflation has reached double digit highs in 2008 and the external imbalance is still very high.

Short-term prospects are for a marked downturn, with output contracting, but there are significant risks of an even weaker and more extended downturn. First, elevated risks stem from the global credit shock. Despite a narrowing trade deficit, the external debt ratio is rising (see below) and will require financing at a time when it is international capital markets on which Lithuania is heavily dependent are under intense pressure. Secondly, an export led recovery is threatened by to the worsening economic outlook of Lithuania's main trading partners. Thirdly, as compared to the other Baltic States, the weakness of the economic environment in Lithuania will be more protracted due to the closure of the Ignalina nuclear power plant by the end of 2009. The closure, agreed in the EU Accession Treaty, will bring a slowdown in economic growth by a few percentage points and a direct increase in inflation by around 2 percentage points in 2010; indirect effects on producer prices and competitiveness are estimated to be also significant.

In view of slowing economic growth and wide macro-economic imbalances, the immediate economic policy challenge for Lithuania is to manage the economic slowdown so as to preserve macroeconomic stability. In particular, this relates to containing inflationary pressures and reducing the large external deficit. Therefore, fiscal discipline and wage-setting in line with productivity will be vital in not exacerbating existing imbalances. Stepping up fiscal consolidation would support more sustainable external deficits and at least partly

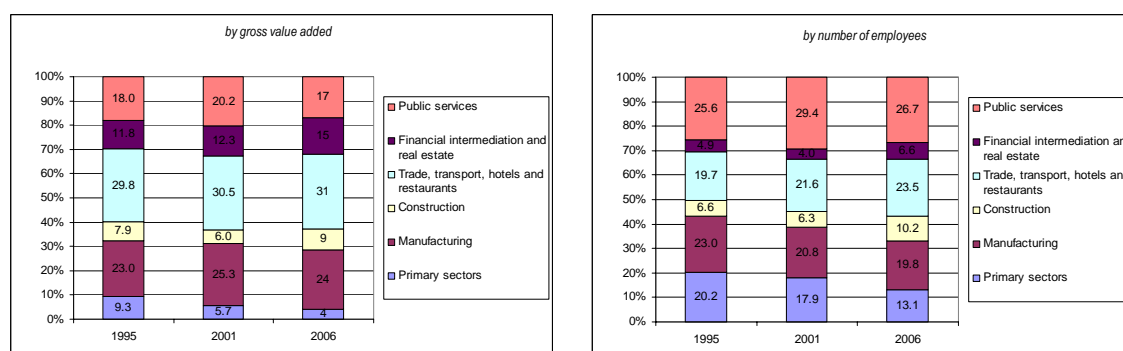
⁹ European Commission (2008): Economic assessment of the Convergence Programme of Lithuania (Mach 2008). Available at: http://ec.europa.eu/economy_finance/publications/publication12215_en.pdf

counterbalance the high private sector deficit. With domestic demand slowing considerably, the recovery of the economy and improvement of the macro-economic imbalances will depend strongly on export performance and Lithuania's ability to restore competitiveness.

1.1. Structural changes in the economy

Since 1995 significant changes in the structure of the economy have occurred. The shift from tradable to non-tradable sectors has been large, though less pronounced than in the neighbouring Baltic economies. This shift is most evident in the increase in the construction and financial sectors and the decrease in the share of primary sectors (i.e. mainly agriculture and forestry) both as a share in value added and as a percentage of the workforce. Nevertheless, the weight of the primary sectors in employment remains relatively large (around 13% in 2006). Nevertheless, it is clear that in the long run promotion of higher value-added exports would create higher growth. The share of gross value added (GVA) of manufacturing has even somewhat increased (from 23% in 1995 to 26% in 2007), although employment in this sector fell slightly (from 23% in 1995 to around 20% in 2006). This is indicative of a shift to higher value-added production. Besides oil refining activities, the chemicals and plastics sector has increased in importance, nearly quadrupling since 2000. In general, all manufacturing sectors have been growing, the growth being less pronounced in the textile sector.

Figure 1 : Structure of the economy



Source: Statistic of Lithuania

Non-tradable sectors¹⁰ nevertheless have gained even more importance than the tradable sectors: output in transport has nearly doubled as compared to 2000, output of hotels and restaurants increased by a third. Due to the real estate boom, output in construction grew by more than 250% in 2007 compared to 2000. The relative magnitude of the construction sector substantially increased: GVA in this sector jumped from around 6% in 2001 to around 9% in 2006, employment - from slightly above 6% to 10%. Accordingly, financial intermediation grew in importance (from around 12% to around 15% of GVA and from 4% to 7% of employment). The rapid growth in the construction and financial intermediation sectors is indicative of the corresponding domestic credit growth and the vulnerability to a sudden sharp

¹⁰ A non-tradable good or service cannot be sold in another location distant from where it was produced. Non-tradable sectors include construction, financial intermediation, real estate, internal trade, transport, hotels and restaurants, etc.

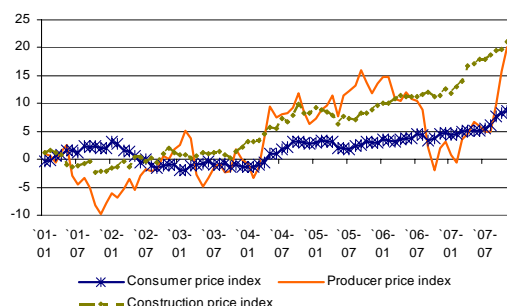
drop in lending, of which the first signs are visible. Since mid-2008 construction has been shedding jobs. To assure inter-sectoral adjustment, wage flexibility could play an important role.

1.2. Competitiveness indicators

Overall competitiveness is determined by productivity, quality of the final products, as well as efficiency and cost of inputs in the production process. The development of competitiveness indicators shows a marked increase in various measures of relative prices and costs, especially since 2006. These trends mirror the pick-up in domestic inflation and, in particular, the rapid acceleration in wage growth which has outpaced labour productivity growth, thus eroding external cost competitiveness. Moreover, due to recent devaluations in the neighbouring countries with flexible exchange rates (i.e. Russia, Poland, Belorussia) the Lithuanian litas has further appreciated vis-à-vis the currencies of these countries.

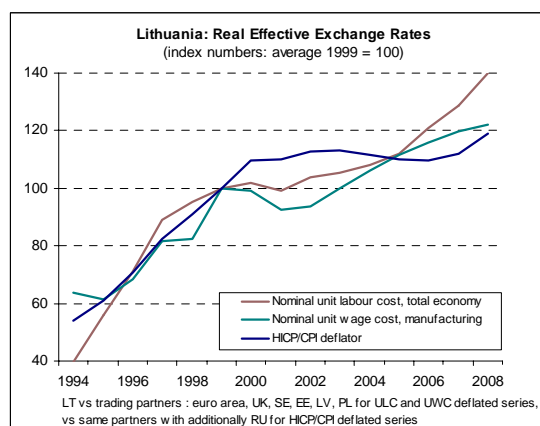
Rising inflation has resulted in the real effective exchange rate (REER) based on the HICP to appreciate by 13% vis-à-vis the EU-27 between 2005 and 2008. HICP inflation in Lithuania is estimated to have increased from 5.8% in 2007 to just over 11% in 2008, strongly driven by external developments such as higher food and energy prices and domestic price pressures. Wage growth has been very high, approaching 20% in the last few years. Rising inflation might be seen as part of the process of convergence to EU price levels. Furthermore, recently there might be some evidence of relative price adjustment, as implied by the Balassa-Samuelson effect¹¹.

Figure 2: Price developments, annual % change



Source: Statistic of Lithuania

Figure 3: Competitiveness indicators compared to the main trading partners



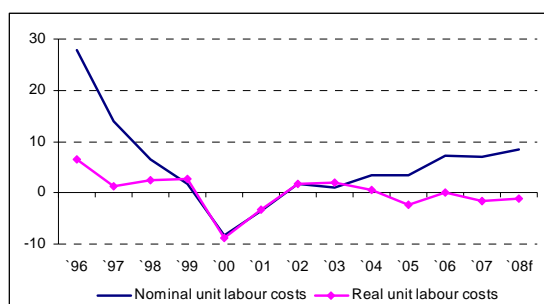
Source: Commission services

Excessive wage growth, well above productivity growth, has led to rapidly rising unit labour costs. The REER based on unit labour costs has appreciated by 16% between end-2005 and 2008 (see Figure 3). Nominal unit labour costs have increased over the last few years (see figure 4). This reflects the very high wage growth over the last few years, averaging 14% in

¹¹ The Balassa-Samuelson (BS) 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. Research is rather inconclusive on the existence of this effect in the new member states as some, for example Egert (2007), suggests that the effect is minor, while others, for example Mihaljek and Klau (2008) suggest a very large BS effect for Lithuania

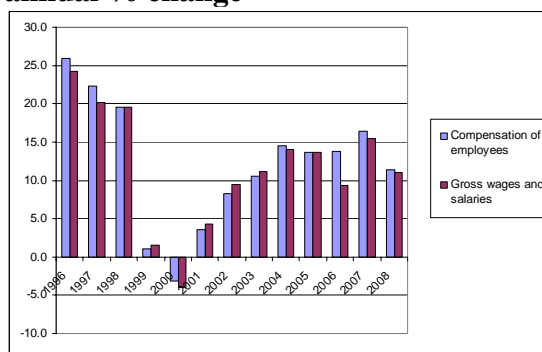
2004-2007 and peaking at 22.5% in the first half of 2008. Productivity has been rising by an average of 7% in 2000-2007. This increasing gap between wage and productivity growth stemmed from tight labour market conditions in Lithuania. The labour market tightened rapidly in the 2004-2007 period as employment growth hit against a declining labour force, partly reflecting high emigration flows. Shortages of qualified workers in several sectors created significant upward pressures on labour costs. The unemployment rate declined markedly from 17.4% in 2001 to 4.3% in 2007. Despite robust growth in economic activity, employment growth was relatively moderate at about 1% p.a. over the period 2001-2006. With the slowing economy wage growth is expected to moderate; however, the size the adjustment will be will depend on a few factors. On the one hand, substantial increase in unemployment (unemployment has already reached 8% in December 2008) is exerting a strong downward pressure on wages, on the other hand, this pressure might be restrained by open EU labour markets that lead to potentially high reservation wages. Wage flexibility should play a positive role in the adjustment process.

Figure 4: ULC, annual % change



Source: Eurostat

Figure 5: Labour costs developments, annual % change



Source: Eurostat

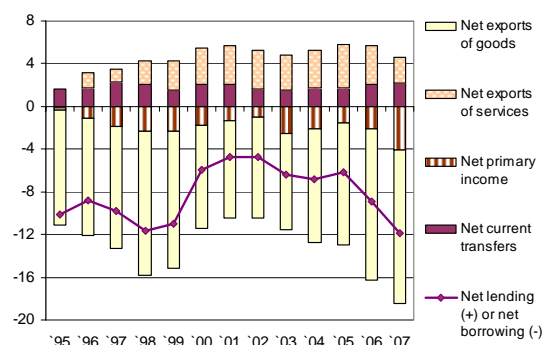
Export performance (as measured by export market shares or export growth) has remained relatively robust in recent years, which could be at least to a certain extent related to EU accession (according to preliminary data, in 2008 exports still showed a strong growth of 28.4% y-o-y). On the other hand, 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 due to higher domestic salaries and increasing energy costs. As a result, the current account deficit widened until mid-2008. Policy should focus on productivity increasing and export-enhancing measures. In this respect the use of EU structural funds should support competitiveness and stimulate total factor productivity (TFP) growth and thereby improve export enhancing sectors.

1.3. External balance

Over the past few years robust private consumption and investment drove the external deficit to record high levels. According to preliminary data, the external deficit reached 11.2% of GDP in the 2008 (down from 12.8% in 2007). At the same time the current account deficit accounted for 13% of GDP (in 2007 the current account deficit stood at 14.5% of GDP, up from 10.8% of GDP in 2006, while in 2005 it was still less than 6%). The external deficit and the current account peaked in the first half of 2008 (at 15% and 17.7% respectively). These developments were driven by increases in trade and income deficits and a diminishing surplus

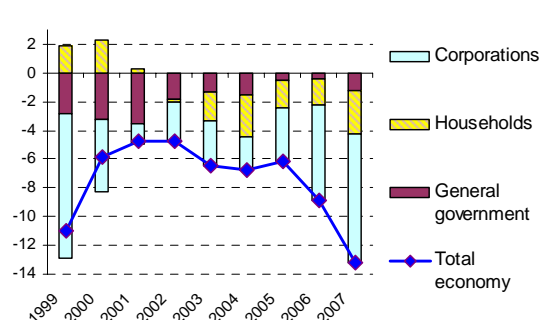
on services. Most recently, however, a narrowing in the trade deficit was observed due to falling import growth. A continued narrowing of the trade deficit can be expected as the economic slowdown progresses and imports respond. However, this in itself is unlikely to ensure a sustainable narrowing of the external deficit as export demand will be hit by recession in most of Lithuania's principal trade partners. Furthermore, Lithuania is losing competitiveness against many of these partners due to recent devaluations in Poland, Belorussia, Russia and other new Member States with flexible exchange rates.

Figure 6: External balance, in % of GDP



Source: Eurostat

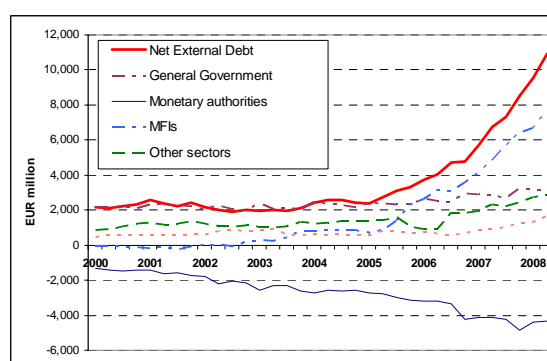
Figure 7: Net lending (+) / borrowing (-) by sector, in % of GDP



Source: Ameco database

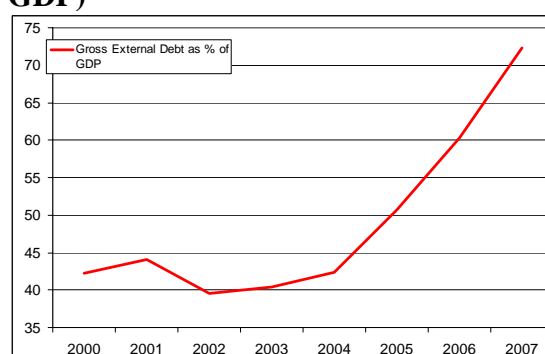
Concerning the net borrowing needs of the country, low domestic savings, still high private investments and the real estate boom in 2003 - 2007 have led to a growing financial deficit of the private sector. The steepest deterioration has been observed since 2005, witnessing the fact that the real estate boom started later in Lithuania than in the other Baltics. In this period, the external deficit widened sharply, mainly due to continuing rapid consumption and investment of the private sector (especially households) and the relatively small, but increasing government deficit. In 2008 private sector consumption and investment have slowed, while the government deficit has increased further. At the same time, the gross external debt has increased significantly (from 40% in 2003 to over 70% of GDP in 2008) (see fig 9).

Figure 8: Net external debt



Source: Bank of Lithuania

Figure 9: Gross external debt (as % of GDP)



Source: Bank of Lithuania, Statistics Lithuania

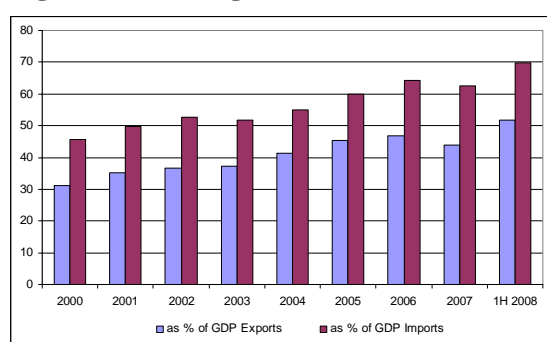
The widening external deficit was mainly financed through the banking sector, typically through loans from the parent banks or syndicated loans and by FDI. Today the large refinancing needs are a sign of major vulnerability as global de-leveraging has negative

consequences for access to credit. Lithuania is exposed to the seizing up of the credit markets because of the large ratio of debt to gross domestic product that needs to be refinanced. So as to cover the rising budgetary deficits of 2008 and 2009, the public sector borrowing should augment as well. Increasing interest rate spreads will have significant negative implications for the current account deficit.

1.4. Foreign trade characteristics

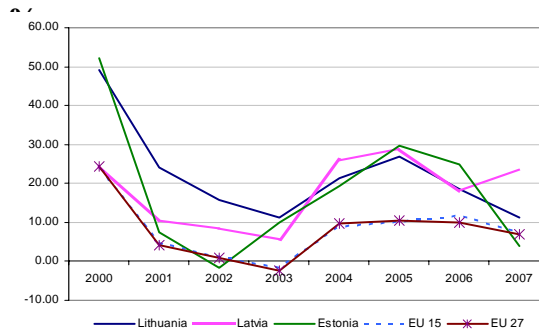
Lithuania is a small open economy which has seen an impressive growth in export of goods and services averaging over 22% in the 2000-2007 period, a performance usually explained by Lithuania's relatively diversified export structure. As a result, Lithuania's exports of goods and services in 2007 comprised around 50% of GDP. Over 2000-2007 Lithuanian exports grew nearly three times faster than the EU-27 average (around 8%) in the same period, and somewhat higher growth than in the two other Baltic States (Latvian and Estonian exports grew by an average 18% in the same period).

Figure 10: Foreign trade, as % of GDP



Source: Statistics Lithuania

Figure 11: Export growth, year on year



Source: Eurostat

However, Lithuanian exports are still dominated by low-to-medium tech and labour intensive traditional industries such as oil refining, chemicals, food and textiles, for which retaining price and cost competitiveness is crucial. Oil products on average account for 30% of exports and are often excluded from analysis of export developments as being strongly reliant on interrupted functioning of a single very large oil refinery (Mazeikiai). Furthermore, the chemical sector is highly energy-dependent and hence, export revenues are exposed to volatile global commodity price developments. Due to globalisation, Lithuania's low value added sectors face competition from Asian markets and are losing market share (textile and wood exports decreased by close to 7% in 2008). The food, chemicals, paper and metals sectors are still showing strong performance. However, unfavourable real exchange rate developments and the negative effect they might be having on external competitiveness, particularly in the labour-intensive sectors, increase the urgency in shifting to higher valued added sectors. The economic recession in Latvia and Estonia is already reflected in the slowing exports of machinery and transport vehicles to these countries. Company profits have showed signs of weakening as costs have been rising significantly, pointing to a possible deterioration in competitiveness, but also to energy inefficiency and slowing external demand.

Maintaining good trade performance will be essential to determining the unwinding of macro-economic imbalances. The economic slowdown will have negative consequences for domestic demand and thereby import growth. It also represents a threat to continued export growth.

This is why due to slowing import growth, external balance and inflation will only partially improve. Fundamental restructuring of the economy, in particular, reforms aimed at tackling labour market bottlenecks, remains vital and this requires a strong political will to proceed with structural reforms.

2. THE ROLE OF FISCAL POLICY AND STRUCTURAL REFORMS IN CONTAINING EXTERNAL IMBALANCES

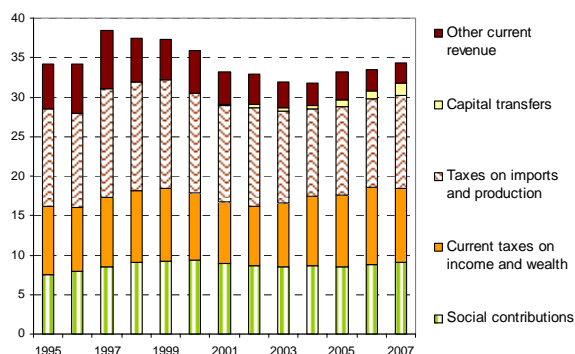
Since 1990s after regaining Lithuania's independence a broad range of structural reforms have been taken, leading to a transformation from a command to a market-driven economy. The very rapid economic developments in recent years have nevertheless resulted in major macro-economic imbalances that require a re-assessment of the current economic and regulatory framework conditions. The major challenges relate to the worsening labour market conditions, aggravated by skill mismatches. So as to sustain the pace of the catching-up process policy should focus on increasing productivity and investment. As regards fiscal policy, it is clear that an expansive stance tends to drive up prices and, without wage moderation, undermines competitiveness. As the direct saving/investment balance role is less relevant in a small open economy and considering that the major imbalances in Lithuania stem from the developments in the private sector, focussing on structural reforms enhancing productivity will be essential to sustained growth.

This chapter will look at the role of fiscal policy and structural measures in containing external imbalances. The focal point of the analysis mostly relates to the quality of public finances and its effects on growth and competitiveness. First, the characteristics of the public sector as regards size and composition of revenue and expenditure will be examined and output and efficiency questions related to public expenditure will be raised. Then, the focus will shift to the evaluation of investment in the exporting sectors increasing policies.

The size of the government sector relative to the whole economy in 2007 remained the lowest in the EU as Lithuania had both the lowest share of revenue and expenditure in EU-27. However, the trend is increasing for both expenditure and revenue as compared to GDP. A small size of the public sector is considered to be supportive to growth since it decreases the tax burden and the related disincentives to capital accumulation.

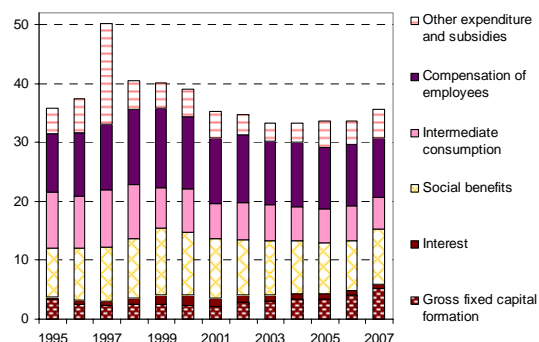
Due to recent high economic growth, general government revenue boomed but expenditure followed suit, with the general government deficit having increased from 0.5% of GDP in 2005 to 1.2% in 2007 and, according to preliminary data, to 2.9% in 2008. Nevertheless, government debt has remained below 20% of GDP in the period between 2004 and 2007 and the ratio has been on a declining trend due to high economic growth. Expansionary fiscal stance in itself has been adding to inflationary pressures and macro-economic imbalances.

Figure 12: Government revenue, in % of GDP



Source: Eurostat

Figure 13: Government expenditure, in % of GDP



Source: Eurostat

Current challenges relate to declining potential growth and slowing fiscal revenue that could potentially lead to a substantial budgetary deterioration. As fiscal receipts falter, in order to avoid further build-up of imbalances, there is a need to reset priorities in public spending. The newly elected government adopted a significant fiscal austerity package. Due to the steep deterioration of economic growth in the end of 2008 (-1.5% q-o-q in 4Q 2008) and the very negative forecasts for 2009, these measures will refrain from a further deterioration in the budgetary situation.

According to a recent assessment carried out by DG ECFIN the composition of public expenditure in Lithuania is well balanced and supportive to growth.¹² Productive expenditure such as public investment and expenditure on education and healthcare is relatively high. However, outcome performance in these areas is estimated to be rather poor. In particular, expenditure on R&D, public infrastructure, public order and safety and administration, widely accepted as important for economic growth, are estimated to perform poorly, while education is evaluated to perform close to the EU average. Hence, important challenges of Lithuanian public finance relate to efficiency, improving which could lead to better outcomes in the performance of the public services.

¹² European Commission (2008), 'Developing indicators on quality of public finance', Note to the EPC Working Group on Quality and Public Finances'

Table 1. Structure of public spending in % of GDP

Expenditure by COFOG function	Lithuania		EU-25
	2002	2006	2005
General public services	4.7	4.2	6.6
Defense	1.5	1.6	1.6
Public order and safety	1.9	1.8	1.8
Economic affairs	3.7	4.0	0.7
Environment protection	0.1	0.8	1.0
Housing and community amenities	0.1	1.0	6.5
Health	4.5	4.7	1
Recreation, culture and religion	1.0	1.0	5.2
Education	6.2	5.5	5.2
Social protection	10.7	10	18.6
Total	34.8	34	46.8
o.w. compensation of employees	11.4	10.5	10.8
o.w.gross fixed capital	2.9	4.2	2.2
o.w. R&D activities		0.3	0.3
<i>Source: Eurostat</i>			

Reallocation of resources towards tradable and higher value-added in current circumstances is hampered by the tightening credit conditions and the deceleration of external demand. However, structural measures aimed at making the economy more responsive to economic downturns and economic shocks are vital. As the cost advantage of the Lithuanian manufacturing sector is decreasing (as evidenced by deteriorating market shares in the textile and wood industries), among the most urgent priorities should be facilitating the switch of production and investment from non-tradable sectors to tradable sectors by improving the business environment for export-oriented sectors. This includes promoting product market flexibility and the functioning of the energy market. The technological content of its tradable sector will be one of the important factors determining Lithuania's further economic growth in the long term.

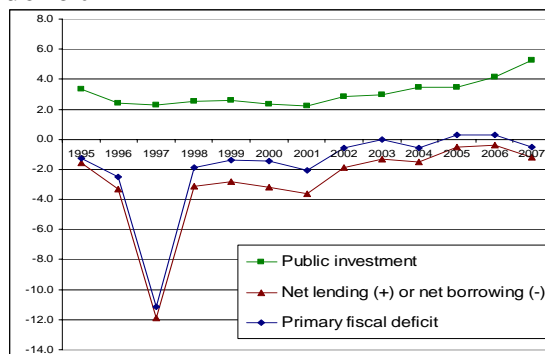
In the past few years the government has been preparing measures aiming at increasing the competitiveness of Lithuanian enterprises by adopting legislation to increase innovation and improve quality standards. In April 2008 a law on profit tax exemptions for scientific research and experimental expansion was enacted. These measures are quite timely as the business sector investment is still very low, even though R&D intensity increased in 2006 (still remaining lower than in 2001) to 0.21% of GDP from 0.16% in 2005. Analysis of the economic sectors and factors behind this increase could help to better target future measures. However, there are no signs of progress on the public side with the intensity of R&D government funding decreasing in 2006 (down to 0.43% of GDP, from 0.48% in 2005). Further initiatives taken by the Lithuanian authorities in order to enhance export performance include is the adoption of the Investment Promotion Programme. Adopted in December 2007,

the programme aims at increasing investment levels and has a particular focus on increasing FDI. More specifically, it deals with infrastructure issues such as territorial planning and handling of construction documents and developing a network of industry parks. The programme is co-financed by EU Structural Funds. Furthermore, there is some evidence of stricter enforcement of competition law with a quantity fixing agreement in the milk sector having led to fines imposed in February 2008.

On 30 January 2009, the government announced the preparation of a business support package, presented as worth up to 4% of GDP. Main financing sources foreseen are EU structural funds with co-financing from the EIB (and other smaller international donors) and domestic commercial banks. The draft plan includes measures to revive country's credit market, to accelerate and simplify the acquisition of EU structural funds and to secure jobs in the construction sector. Furthermore, the draft plan aims at substantially improving business environment and facilitating export and investment. To support the ailing construction sector, the plan foresees massive investment in renovation and insulation of the private and public Soviet-type buildings. Around LTL 1.8 billion is planned to be allocated in 2009-2010. The government will also seek to accelerate EU funds absorption so that all of the 2007-2009 allocations of EU structural funds are used by end-2009. The government's plan also foresees allowing companies in temporary financial difficulties to defer loan repayments. A personal bankruptcy law is also to be prepared.

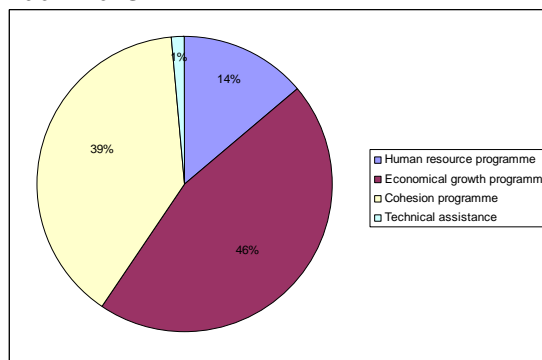
Inflow of EU funds is an opportunity to increase productivity and strengthen competition, but the effectiveness of these resources will depend heavily on administrative absorption capacity, human resources and institutions dealing with management, programming and implementation of EU grants in the recipient countries. For the 2007-2013 period Lithuania should receive over LTL 23bln (roughly 23% of GDP), about 46% of which is devoted to the programme promoting economic growth (see fig.15) which mainly includes productivity and competitiveness enhancing measures as well as infrastructure; about 13% of these funds are devoted to developing human resources. However, apart from the above mentioned loan from the EIB, the financial absorption capacity is dependent on funds from the Lithuanian budget, which is under pressure (see Section [4]); this concerns the ability to co-finance EU-supported programmes and projects, to plan and guarantee these national contributions in multi-annual budgets and to collect these contributions from several partners (public and private), interested in a programme or project.

Figure 14: Public Investment and fiscal deficit



Source: Ameco

Figure 15: Structural funds allocations. 2007-2013



Source: Lithuanian Ministry of Finance.

Businesses face difficulties due to slowing global demand and diminishing cost advantages and the productivity challenge remains huge. Furthermore, high structural unemployment, bottlenecks in the labour market, linked to shortages of skilled labour and the inflexible working arrangements, as well as the uncertain prospects of re-emigration characteristic to Lithuania call for prioritising labour productivity increases and human capital investment enhancement. In the labour market, the short term challenge is wage realignment to productivity. As regards increasing the long-term capacity of the economy, tertiary education reform seems to be vital so as to assure human capital improvement. The goals of reform are to intensify competition in the higher education sector; reform governance of higher education institutions (with greater involvement of social partners); increase transparency in the funding of research projects and studies; reduce government regulation and raise quality standards. In 2007 political parties signed an agreement on the principles of research and higher education reform. Different draft laws have been prepared. In 2009, the president of Lithuania has supported a resolution to start a higher education reform as of the school year 2009/2010.

The above mentioned challenges are relatively well reflected in the updated National Reform Programme (part of the Lisbon process), which in the macro area contains three major objectives: to follow a restrictive fiscal policy, to reform tertiary education, to continue healthcare and pension reforms. Whether the priorities will result in effective policy action remains to be seen.

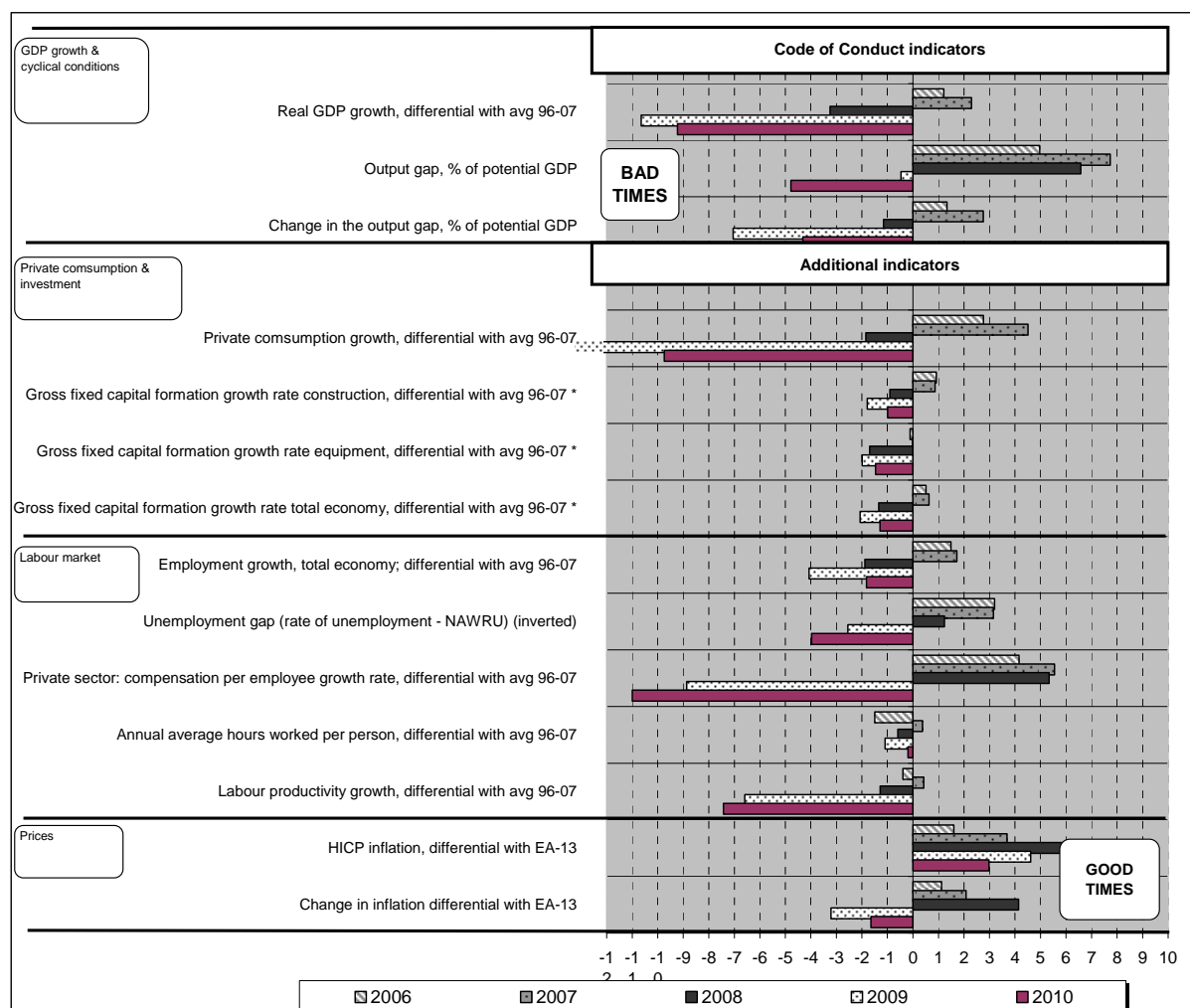
3. CONCLUSIONS

After a period of above-potential growth, several years of low domestic demand are in prospect. Sectors that have seen exceptionally high recent growth, including construction and financial intermediation face difficulties in the light of slowing economic growth, the burst of the real estate bubble and the weakened financial sector. The shift of the main growth drivers to tradables requires policy focus on the supply side measures. The main challenges here relate to the diminished cost and price competitiveness of the Lithuanian economy. A shift to higher value-added sectors requires maintaining high investment levels. Labour market flexibility would facilitate the adjustment throughout the economic malaise. The productivity challenge should be treated with high priority.

As public finances are coming under pressure, the newly elected Lithuanian government is implementing cost cutting measures as well as broadening the tax base. Prioritising public expenditure underpinning structural restructuring will be a significant challenge, which if met successfully will contribute to the necessary reorientation of the economy.

ANNEX 2. ADDITIONAL TABLES AND FIGURES

Figure 1: Good and bad economic times



Source: Commission services' January 2009 forecast (COM) and successive convergence programmes

Table 1: Budgetary implementation in 2008

	2007		2008	
	Planned	Outcome	Planned	Outcome
	CP Dec 2007	COM	CP Dec 2007	COM
Government balance (% of GDP)	-0.9	-1.2	-0.5	-2.9
Difference compared to target	-0.3		-2.4	
<u>Of which</u> : due to a different starting position end 2007			-0.4	
due to different revenue / expenditure growth in 2008			-1.8	
p.m. Denominator effect and residual ^{2,3}			-0.2	
<i>p.m. Nominal GDP growth (planned and outcome)</i>			12.3	15.9
Revenue (% of GDP)	35.5	33.9	37.4	33.9
Revenue surprise compared to target¹	-1.6		-3.5	
<u>Of which</u> : due to a different starting position end 2007			-1.7	
due to different revenue growth in 2008			-0.6	
p.m. Denominator effect ²			-0.9	
p.m. Residual ³			-0.2	
<i>p.m. Revenue growth rate (planned and outcome)</i>			18.3	15.9
Expenditure (% of GDP)	36.4	35.2	37.9	36.8
Expenditure surprise compared to target¹	1.2		1.1	
<u>Of which</u> : due to different starting position end 2007			1.3	
due to different expenditure growth rate in 2008			-1.2	
p.m. Denominator effect ²			1.0	
p.m. Residual ³			0.0	
<i>p.m. Expenditure growth rate (planned and outcome)</i>			16.9	21.3
Notes:				
¹ A positive number implies that the outcome was better (in terms of government balance) than planned.				
² The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue				
³ The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.				
Source: Commission services				

Table 2: Evolution of budgetary targets in successive programmes

		2007	2008	2009	2010	2011
General government balance (% of GDP)	CP Jan 2009	-1.2	-2.9	-2.1	-1.0	0.0
	<i>CP Dec 2007</i>	<i>-0.9</i>	<i>-0.5</i>	<i>0.2</i>	<i>0.8</i>	<i>n.a.</i>
	COM Jan 2009	-1.2	-2.9	-3.0	-3.4	n.a.
General government expenditure (% of GDP)	CP Jan 2009	35.2	36.7	37.8	38.3	36.4
	<i>CP Dec 2007</i>	<i>36.4</i>	<i>37.9</i>	<i>38.5</i>	<i>38.6</i>	<i>n.a.</i>
	COM Jan 2009	35.2	36.8	37.8	39.4	n.a.
General government revenue (% of GDP)	CP Jan 2009	33.9	33.8	35.8	37.3	36.4
	<i>CP Dec 2007</i>	<i>35.5</i>	<i>37.4</i>	<i>38.6</i>	<i>39.4</i>	<i>n.a.</i>
	COM Jan 2009	33.9	33.9	34.8	36.0	n.a.
Structural balance ¹ (% of GDP)	CP Jan 2009	-2.6	-4.9	-1.8	0.1	1.1
	<i>CP Dec 2007</i>	<i>-1.2</i>	<i>-0.9</i>	<i>0.3</i>	<i>1.1</i>	<i>n.a.</i>
	COM Jan 2009	-2.7	-4.6	-2.9	-2.1	n.a.
Real GDP (% change)	CP Jan 2009	8.9	3.5	-4.8	-0.2	4.5
	<i>CP Dec 2007</i>	<i>9.8</i>	<i>5.3</i>	<i>4.5</i>	<i>5.2</i>	<i>n.a.</i>
	COM Jan 2009	8.9	3.4	-4.0	-2.6	n.a.

Note:

¹Cyclically-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, 0.5% in 2008, 0.5% in 2009 and 0.5% in 2010; all deficit-reducing according to the most recent programme and 0.6% of GDP in 2007; deficit-increasing according to the Commission services' January interim forecast.

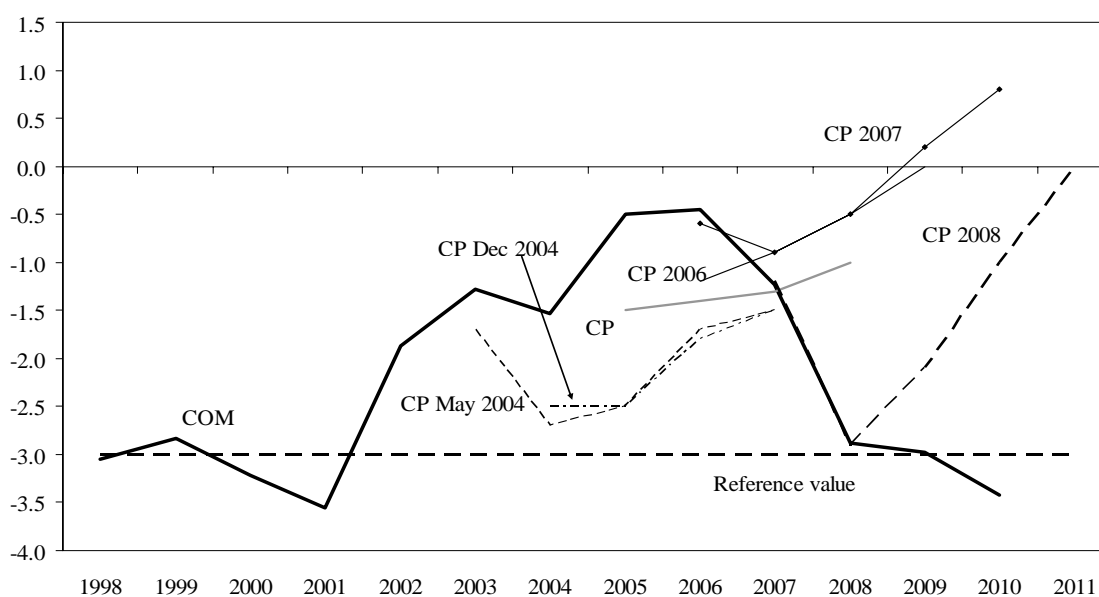
Source :

Convergence programmes (CP); Commission services' January 2009 interim forecasts (COM)

Table 3: Assessment of tax projections

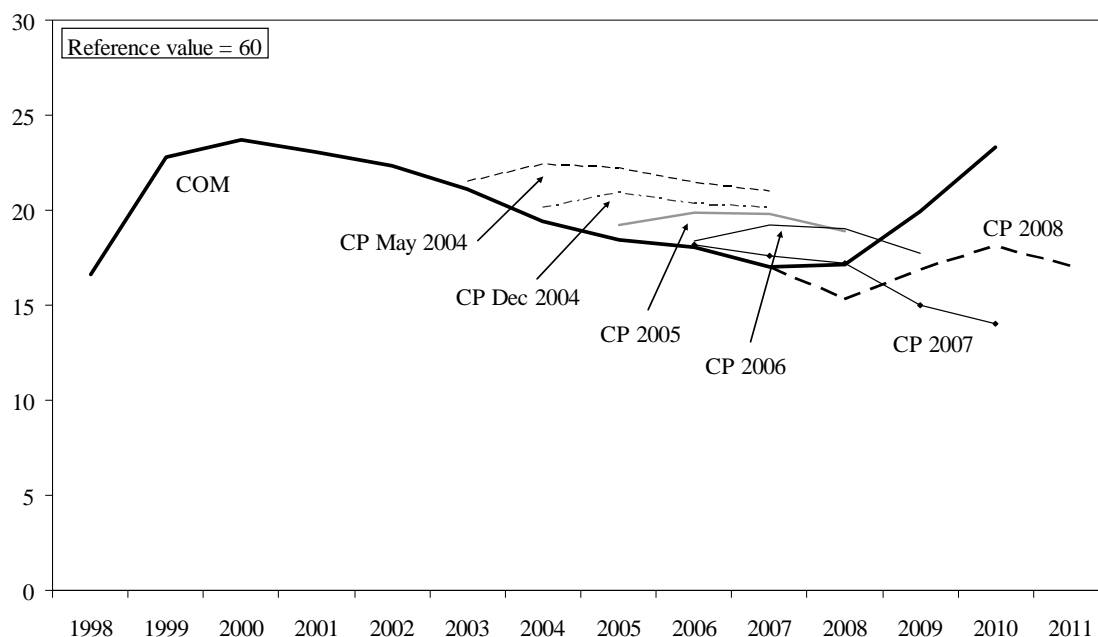
	2009			2010			2011
	CP	COM	OECD ³	CP	COM ¹	OECD ³	CP
Change in tax-to-GDP ratio (total taxes)	0.5	0.2	0.0	0.3	0.3	0.0	-0.8
Difference (CP – COM)	0.4		/	0.4		/	/
of which ² :							
- discretionary and elasticity component	0.3		/	0.3		/	/
- composition component	0.5		/	6.9		/	/
Difference (COM - OECD)	/	0.2		/	0.3		/
of which ² :							
- discretionary and elasticity component	/	0.9		/	0.1		/
- composition component	/	-0.4		/	0.2		/
p.m.: Elasticity to GDP	3.0	1.7	0.9	3.7	5.8	0.9	0.4
<p>Notes:</p> <p>¹On a no-policy change basis.</p> <p>²The 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.</p> <p>³OECD ex-ante elasticity relative to GDP.</p> <p>Source:</p> <p>Commission services' January 2009 interim 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).</p>							

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive convergence programmes

Figure 3: Debt projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive convergence programmes

Table 4: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2010- 50
Total age-related spending	16.0	15.3	15.1	16.3	16.8	17.4	2.1
- Pensions	6.7	6.6	7.0	7.9	8.2	8.6	2.0
- Healthcare	3.7	4.0	4.3	4.4	4.5	4.6	0.6
- Long-term care	0.5	0.6	0.6	0.6	0.7	0.9	0.3
- Education	5.0	4.2	3.2	3.3	3.3	3.3	-1.0
- Unemployment benefits	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Property income received	0.7	0.6	0.5	0.5	0.5	0.5	-0.1

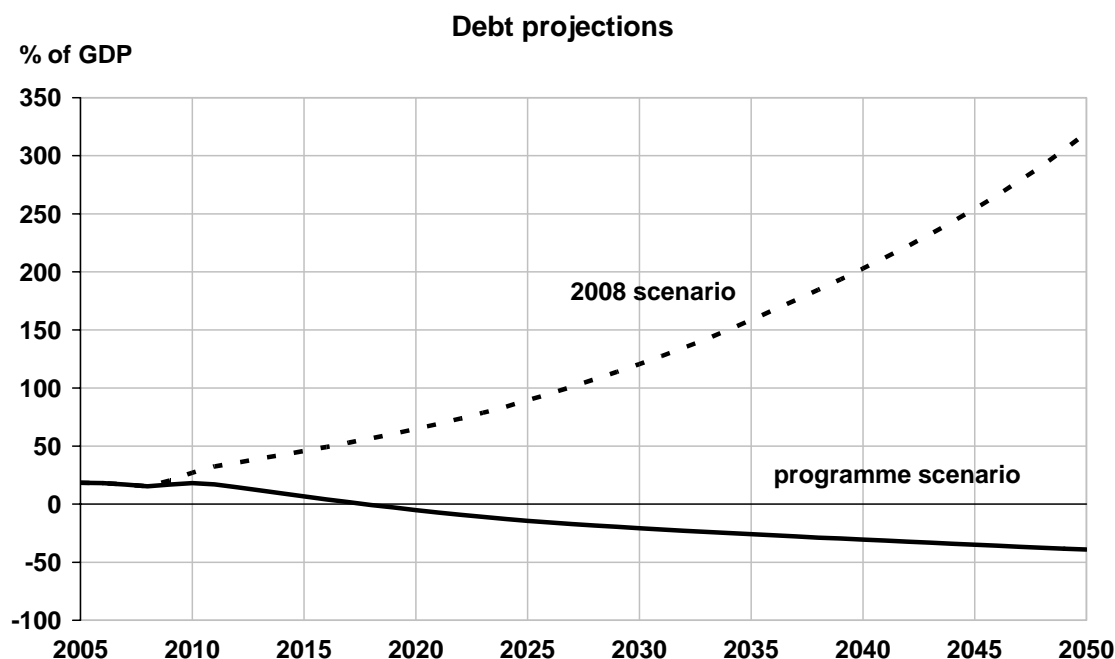
Source: Economic Policy Committee and Commission services.

Table 5: Sustainability indicators and the required primary balance

Value	2008 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	4.9	6.3	2.3	-1.9	-0.3	2.1
<i>of which:</i>						
Initial budgetary position (IBP)	4.5	4.8	-	-1.9	1.8	-
Debt requirement in 2050 (DR)	-0.5	-	-	-0.8	-	-
Long-term change in the primary balance (LTC)	0.9	1.5	-	0.9	1.5	-

Source: Commission services.

Figure 4: Long-term projections for the government debt ratio



Note: 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.

Source: Commission services.

Table 6: Additional factors

	Impact on risk
Debt and pension assets	+
Decline in structural balance until 2010 in COM January forecast 2009	+
Significant revenue from pension taxation	na
Alternative projection of cost of ageing	-
Strong decline in benefit ratio	na
High tax burden	na
Non-age related budgetary measures with intertemporal effect	na

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability.
'na': not applicable.
Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".
An explanation on these factors can be found in chapter IV of: European Commission (2006), *The long-term sustainability of public finances in the European Union*, European Economy No. 4/2006.
Source: Commission services.

ANNEX 3. COMPLIANCE WITH THE CODE OF CONDUCT AND TABLES FROM THE PROGRAMME

The tables on the following pages show the data presented in the January 2009 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.

The programme broadly follows the model structure outlined in the code of conduct, covering all principal sections. The programme also broadly adheres to the code of conduct as far as data requirements are concerned, although there are some gaps in the provision of optional data. Regarding optional data, in Table 1c (Labour market developments) line (employment, hours worked) and line 5 (labour productivity, hours worked) are missing for 2008-2011; in Table 3 (General government expenditure by function) no data on sub-indicators has been provided for 2011, 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 2008-2011; in Table 5 (Cyclical developments) breakdown for line 5 (potential GDP growth) has not been provided; in Table 7 (Long-term sustainability of public finances) data on pension reserve fund assets are missing for 2010-2050.

Table 1a. Macroeconomic prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	78186.0	8.9	3.5	-4.8	-0.2	4.5
2. Nominal GDP	B1*g	98138.7	18.5	15.9	0.9	0.4	4.3
Components of real GDP							
3. Private consumption expenditure	P.3	56212.3	12.4	7.3	-7.8	1.2	5.1
4. Government consumption expenditure	P.3	13481.7	3.3	1.3	-9.7	-6.6	0.0
5. Gross fixed capital formation	P.51	22662.4	20.8	-4.5	-20.2	7.1	9.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	11.5	2.9	4.7	0.8	0.0	-0.7
7. Exports of goods and services	P.6	45493.6	4.3	13.2	4.3	0.2	4.5
8. Imports of goods and services	P.7	60489.6	11.6	13.0	-6.4	2.2	5.3
Contributions to real GDP growth							
9. Final domestic demand		-	14.4	5.1	-12.0	1.2	5.5
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.5	1.2	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	-5.5	-1.6	7.2	-1.4	-0.9

Table 1b. Price developments

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		125.5	8.8	12.0	6.0	0.5	-0.2
2. Private consumption deflator		112.9	5.7	9.2	5.4	3.7	0.1
3. HICP¹		105.8	5.8	11.2	5.4	3.6	-0.1
4. Public consumption deflator		132.7	8.4	14.8	12.8	3.3	-0.8
5. Investment deflator		121.1	9.1	6.0	-0.1	1.0	2.0
6. Export price deflator (goods and services)		117.3	4.6	12.5	4.5	2.6	2.2
7. Import price deflator (goods and services)		110.0	4.0	7.8	3.6	6.0	2.6

¹ Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons¹		1534.2	2.3	-0.8	-1.9	-0.5	-0.5
2. Employment, hours worked ²		2868390	4.0	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)³		4.3	4.3	5.6	7.8	8.5	8.6
4. Labour productivity, persons⁴		57.5	5.9	4.4	-3.0	0.4	5.1
5. Labour productivity, hours worked ⁵		30.6	4.7	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees	D.1	43707.2	23.2	19.2	2.3	1.7	3.5
7. Compensation per employee		28488.6	20.3	20.1	4.3	2.3	4.1

¹Occupied population, domestic concept national accounts definition.

²National accounts definition.

³Harmonised definition, Eurostat; levels.

⁴Real GDP per person employed.

⁵Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-12.7	-10.2	-1.8	-4.7	-5.7
<i>of which :</i>						
- Balance on goods and services		-13.4	-11.5	-3.8	-7.7	-8.7
- Balance of primary incomes and transfers		-1.2	-1.1	-0.2	-0.4	-0.4
- Capital account		1.8	2.4	2.2	3.4	3.4
2. Net lending/borrowing of the private sector	B.9	-11.5	-7.2	0.2	-3.7	-5.7
3. Net lending/borrowing of general government	EDP B.9	-1.2	-2.9	-2.1	-1.0	0.0
4. Statistical discrepancy		0	0	0	0	0

Table 2. General government budgetary prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-1209.9	-1.23	-2.94	-2.07	-0.98	0.00
2. Central government	S.1311	-1482.2	-1.51	-1.71	-2.19	-1.15	-0.16
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	-288.5	-0.29	-0.25	0.00	0.00	0.00
5. Social security funds	S.1314	560.8	0.57	-0.99	0.13	0.16	0.16
General government (S13)							
6. Total revenue	TR	33294.8	33.93	33.79	35.76	37.26	36.35
7. Total expenditure	TE ¹	34504.7	35.16	36.73	37.83	38.25	36.35
8. Net lending/borrowing	EDP B.9	-1209.9	-1.23	-2.94	-2.07	-0.98	0.00
9. Interest expenditure	EDP D.41	689.7	0.70	0.67	0.91	1.01	1.06
10. Primary balance ²		-520.2	-0.53	-2.27	-1.15	0.02	1.06
11. One-off and other temporary measures ³		n.a.	-0.57	0.50	0.45	0.46	0.00
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		20517.8	20.91	20.95	20.94	21.12	20.96
12a. Taxes on production and imports	D.2	11418	11.63	11.77	12.60	12.92	12.75
12b. Current taxes on income, wealth, etc	D.5	9093.6	9.27	9.18	8.34	8.20	8.21
12c. Capital taxes	D.91	6.3	0.01	0.00	0.00	0.00	0.00
13. Social contributions	D.61	8775.4	8.94	9.17	9.72	9.87	9.26
14. Property income	D.4	560.5	0.57	0.60	0.60	0.60	0.60
15. Other ⁴		3441.1	3.51	3.06	4.50	5.67	5.53
16=6. Total revenue	TR	33294.8	33.9	33.8	35.8	37.3	36.3
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ⁵			29.82	30.12	30.66	30.99	30.22
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	15096.6	15.38	15.55	15.60	14.85	13.29
17a. Compensation of employees	D.1	9775.5	9.96	10.25	10.22	9.73	8.71
17b. Intermediate consumption	P.2	5321.1	5.42	5.30	5.38	5.12	4.58
18. Social payments (18=18a+18b)		10654.0	10.86	13.33	13.86	13.93	13.72
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	1579.2	1.61	1.98	2.05	2.07	2.03
18b. Social transfers other than in kind	D.62	9074.8	9.25	11.36	11.80	11.87	11.68
19=9. Interest expenditure	EDP D.41	689.7	0.70	0.67	0.91	1.01	1.06
20. Subsidies	D.3	887.1	0.90	0.90	0.45	0.45	0.45
21. Gross fixed capital formation	P.51	5115.1	5.20	4.38	5.05	5.63	5.41
22. Other ⁶		2062.2	2.10	1.90	1.96	2.38	2.42
23=7. Total expenditure	TE ¹	34504.7	35.16	36.73	37.83	38.25	36.35
p.m.: Government consumption (nominal)	P.3	17884.7	18.22	18.28	18.46	17.74	16.04

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

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

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

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

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

⁶D.29+D.4 (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	2007*	2011
1. General public services	1	4.0	n.a.
2. Defence	2	1.9	n.a.
3. Public order and safety	3	1.7	n.a.
4. Economic affairs	4	4.4	n.a.
5. Environmental protection	5	0.9	n.a.
6. Housing and community amenities	6	0.3	n.a.
7. Health	7	4.6	n.a.
8. Recreation, culture and religion	8	1.0	n.a.
9. Education	9	5.2	n.a.
10. Social protection	10	11.1	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE ¹	35.2	36.35

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

* instead of data for 2006 (as foreseen in the CoC), national authorities presented data for 2007.

Table 4. General government debt developments

% of GDP	ESA Code	2007	2008	2009	2010	2011
1. Gross debt¹		17.00	15.30	16.90	18.10	17.10
2. Change in gross debt ratio		-1.00	-1.79	1.40	1.20	-1.0
Contributions to changes in gross debt						
3. Primary balance²		-0.51	-2.27	-0.63	-0.01	1.03
4. Interest expenditure³	EDP D.41	0.70	0.67	0.91	0.99	1.03
5. Stock-flow adjustment		-0.5	0.6	2.0	1.3	-2.0
<i>of which:</i>						
- Differences between cash and accruals ⁴		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets ⁵		0.06	0.02	0.70	0.01	n.a.
<i>of which:</i>						
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other ⁶		n.a.	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt⁷		5.2	4.6	6.1	6.0	6.1
Other relevant variables						
6. Liquid financial assets ⁸		13.1	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		3.9	n.a.	n.a.	n.a.	n.a.

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

²Cf. item 10 in Table 2.

³Cf. item 9 in Table 2.

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

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

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

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

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

Table 5. Cyclical developments

% of GDP	ESA Code	2007	2008	2009	2010	2011
1. Real GDP growth (%)		8.9	3.5	-4.8	-0.2	4.5
2. Net lending of general government	EDP B.9	-1.2	-2.9	-2.1	-1.0	0.0
3. Interest expenditure	EDP D.41	0.7	0.7	0.9	1.0	1.1
4. One-off and other temporary measures¹		-0.57	0.50	0.45	0.46	0.00
5. Potential GDP growth (%)		5.0	4.4	3.9	3.6	3.4
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		9.6	8.7	-0.4	-4.0	-2.9
7. Cyclical budgetary component		3.0	2.8	-0.12	-1.3	-0.9
8. Cyclically-adjusted balance (2 - 7)		-4.2	-5.8	-1.94	0.3	0.9
9. Cyclically-adjusted primary balance (8 + 3)		-3.5	-5.1	-1.0	1.3	2.0
10. Structural balance (8 - 4)		-3.6	-6.3	-2.4	-0.2	0.9

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

Table 6. Divergence from previous update

	ESA Code	2007	2008	2009	2010	2011
Real GDP growth (%)						
Previous update		9.8	5.3	4.5	5.2	n.a.
Current update		8.9	3.5	-4.8	-0.2	4.5
Difference		-0.9	-1.8	-9.3	-5.4	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		-0.9	-0.5	0.2	0.8	n.a.
Current update		-1.2	-2.9	-2.1	-1.0	0.0
Difference		-0.3	-2.4	-2.3	-1.8	n.a.
General government gross debt (% of GDP)						
Previous update		17.6	17.2	15.0	14.0	n.a.
Current update		17.0	15.3	16.9	18.1	17.1
Difference		-0.6	-1.9	1.9	4.1	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	39.1	33.3	38.3	35.7	37.0	38.7
Of which: age-related expenditures	13.7	16.6	18.5	18.0	19.2	20.9
Pension expenditure	7.8	6.6	6.8	6.9	7.8	9.3
Social security pension	7.8	6.6	6.8	6.9	7.8	9.3
Old-age and early pensions	6.8	5.5	5.6	5.7	6.7	8.4
Other pensions (disability, survivors)	1.0	1.1	1.2	1.2	1.1	0.9
Occupational pensions (if in general government)	–	–	–	–	–	–
Health care	4.1	4.9	5.2	5.5	5.7	6.1
Long-term care (<i>this was earlier included in the health care</i>)	-	0.5	0.5	0.6	0.6	0.9
Education expenditure	5.7	5.2	5.8	5.0	5.0	4.6
Other age-related expenditures	0.2	0.1	0.2	0.1	0.1	0.1
Interest expenditure	1.7	0.8	0.6	1.5	2.7	6.2
Total revenue	35.8	32.8	37.3	36.3	36.3	36.3
Of which: property income	1.2	0.8	0.6	0.6	0.6	0.6
<i>Of which</i> : from pensions contributions (or social contributions if appropriate)	7.1	6.2	6.7	6.8	6.7	6.1
Pension reserve fund assets	0	0	n.a.	n.a.	n.a.	n.a.
<i>Of which</i> : consolidated public pension fund assets (assets other than government liabilities)	0	0.5	3.9	13.8	26.0	53.1
Assumptions						
Labour productivity growth	-	1.7	0.4	3.6	2.7	1.7
Real GDP growth	-	7.8	-0.2	3.0	1.9	0.4
Participation rate males (aged 20-64)	82.1	81.5	79.5	87.6	88.0	86.3
Participation rates females (aged 20-64)	74.2	72.7	73.7	81.4	82.2	79.7
Total participation rates (aged 20-64)	77.9	76.9	76.5	84.4	85.0	83.0
Unemployment rate	16.4	8.3	8.5	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

	2007	2008	2009	2010	2011
Short-term interest rate¹ (annual average)	3.7	6.8	7.7	5.9	5.6
Long-term interest rate (annual average)	4.1	8.8	9.6	7.5	6.8
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.37	1.48	1.36	1.36	1.36
Nominal effective exchange rate	1.1	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	5.0	4.5	3.5	4.3	4.3
EU GDP growth	2.9	1.4	0.2	1.1	1.1
Growth of relevant foreign markets	2.9	1.4	0.2	1.1	1.1
World import volumes, excluding EU	6.7	6.4	4.8	5.9	5.9
Oil prices (Brent, USD/barrel)	72.5	104.0	50	50	50

¹If necessary, purely technical assumptions.

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