COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Lithuania, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Lithuania, submitted on 23 January 2009, and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");

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

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term, is made in the opinions of stability and convergence programmes.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2010, as follows: "The overall conclusion is that the programme aims at tackling Lithuania's macroeconomic imbalances by tightening fiscal policy. However, the budgetary targets seem modest in the light of the current high economic growth. The programme envisages only a back-loaded adjustment effort so that the MTO is reached only in 2009. There are risks to the achievement of the budgetary targets as the consolidation is insufficiently backed by announced measures while there is a need to strengthen the medium-term framework. The revenue projections seem optimistic given the further planned direct tax cuts and a reliance on improved tax collection and the cautious macroeconomic scenario counterbalances them only partly. A significantly tighter fiscal policy than foreseen in the programme and further structural policy measures are needed to address mounting inflationary pressures, maintain competitiveness and tackle remaining bottlenecks in the labour market, crucial also for sustaining catching-up. As regards the long-term sustainability of public finances Lithuania remains at low risk". In view of the above assessment Lithuania was invited to contribute to reducing overheating pressures by (i) "aiming for significantly better budgetary outturns in 2008 and thereafter than foreseen in the programme, notably by restraining expenditure growth, saving windfall revenues and reinforcing the binding character of the medium-term expenditure ceilings"; and (ii) "tackling inflationary pressures including by promoting wage setting in line with overall productivity gains and adopting structural measures to remove labour market bottlenecks".

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On the updated convergence programme of Lithuania, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [10 March 2009] the Council examined the updated convergence programme of Lithuania, which covers the period 2008 to 2011.

(2) Lithuania's economy started to slow rapidly in 2008 after a sustained boom centred on growth of domestic demand that started in 2003. 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. The period of high recent growth created overheating pressures: macro-economic imbalances increased, with both inflation and the external deficit peaking in the first half of 2008. Wage growth exceeded productivity growth by far, thus weakening the country's competitiveness. Fiscal policy was expansionary throughout the boom period and no reserves were accumulated to prepare for changing cyclical conditions. Lithuania's large external imbalances have amplified its vulnerability in view of the tightening global credit conditions and lower growth in export markets. The global financial crisis and weak external demand are expected to add to the ongoing fall in domestic demand and contribute to the contraction of the economy. The immediate economic policy challenge for Lithuania is to manage the economic slowdown so as to preserve macroeconomic stability. Given the need to correct the country's high imbalances the authorities adopted in December 2008 a fiscal austerity package to

3 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

facilitate the adjustment process and help maintain market confidence. This should also limit the worsening of the public deficits during the downturn.

(3) The macroeconomic scenario underlying the programme estimates real GDP to have grown by 3.5% in 2008. It projects a sharp contraction by 4.8% in 2009 and a further small decline by 0.2% in 2010, before a recovery to growth of 4.5% in 2011. Assessed against currently available information[4], this scenario is based on plausible growth assumptions until 2009 but markedly favourable ones thereafter. Growth assumptions appear optimistic from 2010 on, considering that worsening growth prospects in trading partner countries and domestic demand in Lithuania due to constrained credit are likely to be more pronounced and protracted than assumed in the programme. The estimated potential growth in 2011 is rather on the high side. The programme's projection for inflation is realistic for 2009 while it could be on the low side for 2010, notably because of the impact on energy prices from the closure of the Ignalina nuclear power plant scheduled by the end of 2009. Compared to the Commission services' January 2009 interim forecast, the programme projects a much faster unwinding of external imbalances in 2009 which is due to the more severe contraction of the domestic demand and the more favourable developments in export markets envisaged in the convergence programme.

(4) For 2008, the general government deficit is estimated in the Commission services' interim forecast at 2.9% of GDP, against a deficit target of 0.5% of GDP set in the previous update of the convergence programme. 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 lower tax revenues than initially projected by the authorities, in particular because of sharply slowing economic activity towards the end of the year. Investment expenditure and EU funds absorption were lower than planned.

(5) The new government that took office on 9 December 2008 adopted a programme of significant fiscal retrenchment. In line with this, the 2009 budget adopted by Parliament on 22 December 2008 includes a fiscal consolidation package aimed at restoring market confidence and limiting the government's financing needs. Fiscal consolidation is based on a comprehensive tax reform and substantial cuts in budgetary expenditure, both expected to contribute to a similar extent 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. Tax changes aim to shift the tax burden from direct to indirect taxes and from labour to capital and to broaden the tax base by removing exemptions. 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 with restricted eligibility to the initial tax-free threshold 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 persons into the social security system. The estimated net effect of these tax changes according to the programme is around 1.8% of GDP. The budget also plans significant expenditure cuts, estimated at around 2% of

[4] The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has since become available.

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 or in part and therefore need to be substituted by new measures. The overall fiscal stance in 2009, as measured by the change in the structural (cyclically-adjusted net of one-off and other temporary measures) balance, is estimated to be strongly restrictive.

(6) The main goal of the medium-term budgetary strategy in 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. The general government headline deficit is expected to narrow to 1.0% of GDP in 2010 and to be in balance in 2011. The adjustment is foreseen to be achieved by a substantial increase in the revenue-to-GDP ratio and a modest reduction in the expenditure ratio. The government has began a more detailed review of current expenditure, including public sector employment, which could lead to further expenditure savings to be proposed in later years. Higher revenue growth can mainly be explained by the tax changes introduced in the 2009 budget. 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.

(7) The budgetary outcomes are subject to significant downside risks. This concerns all programme years: in 2009 the main risk is that revenues 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 not all proposed expenditure cuts, especially on subsidies and public sector employee compensation, may 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.

(8) 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.

(9) 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 electoral cycle has put additional pressure on the framework as evidenced by the recent deterioration of the headline deficit. 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 the preparation and execution of the annual budget and did not as such introduce 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 needs to ensure fiscal consolidation in good economic times, by preventing that additional revenues entail

higher spending. 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.

(10) With a view to stabilising the financial sector, the Lithuanian authorities have increased the guarantee for deposit insurance from the equivalent of 22 000 EUR to 100 000 EUR 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.

(11) In line with the EERP agreed in December by the European Council, Lithuania, which is facing significant external and internal imbalances, adopted a budgetary policy which aims at correcting such imbalances. Taking into account the need to correct economic imbalances and the difficulty in securing new financing at acceptable conditions due to market risk aversion, the planned restrictive fiscal stance from 2009 until 2011 is an appropriate response to the macroeconomic and budgetary situation. A comprehensive tax reform and a wide range of expenditure-saving measures, including reductions in public wages in 2009, have been taken. Furthermore, the Lithuanian authorities are planning to adopt a comprehensive package of measures aiming at business support by reducing administrative burdens, improving access to finance and facilitating export and investment. One of the priorities includes modernisation of Soviet-type 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.

(12) Lithuania has adopted a consolidation programme, which is an adequate response to the need to correct macroeconomic imbalances. However, the budgetary outcomes are subject to significant downside risks. Moreover, the adjustment should be backed by additional measures, particularly in outer years. 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 economic downturn, to prevent breaching the 3% threshold in 2009 and 2010. The fiscal stance is expected to be restrictive from 2009 until 2011 as measured by the change in the structural (primary) balance. In the context of Lithuania's ERM II membership and the need to improve economy's cost competitiveness, correction of previously high wage growth is warranted.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most optional data[5].

The overall conclusion is that Lithuania is currently facing a severe contraction in domestic demand following years of above-potential economic growth. The deepening global financial crisis and weakening external demand contribute to aggravating the contraction of the

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

economy. For a sustained period wage growth has exceeded productivity growth by far, thus eroding the country's competitiveness hindering prospects of export-led economic recovery. The general government balance deteriorated considerably in 2008 mainly reflecting an expansionary fiscal policy. 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, while the debt ratio will remain very comfortably below the 60% of GDP reference level. The planned restrictive fiscal stance from 2009 until 2011 is an appropriate response in the light of existing imbalances. The current budgetary framework is rather weak as regards medium-term planning and control of public finances, especially in terms of expenditure.

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

(i) implement measures needed to achieve the budgetary target in 2009 by prioritising expenditures and continue targeted fiscal consolidation in the medium-term;

(ii) implement public sector wage restraint to facilitate the alignment of whole-economy wages with productivity and to strengthen cost competitiveness;

(iii) strengthen fiscal governance and transparency, by enhancing the medium-term budgetary framework and reinforcing expenditure discipline.

Comparison of key macro economic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	**CP Jan 2009**	**8.9**	**3.5**	**-4.8**	**-0.2**	**4.5**
	COM Jan 2009	8.9	3.4	-4.0	-2.6	n.a.
	CP Dec 2007	*9.8*	*5.3*	*4.5*	*5.2*	*n.a.*
HICP inflation (%)	**CP Jan 2009**	**5.8**	**11.2**	**5.4**	**3.6**	**-0.1**
	COM Jan 2009	5.8	11.1	5.6	4.8	n.a.
	CP Dec 2007	*5.8*	*6.5*	*5.1*	*3.6*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2009**	**7.1**	**5.4**	**-2.8**	**-5.7**	**-4.0**
	COM Jan 2009[2]	7.7	6.6	-0.5	-4.8	n.a.
	CP Dec 2007	*3.3*	*1.5*	*-0.4*	*-1.3*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2009**	**-12.7**	**-10.2**	**-1.8**	**-4.7**	**-5.7**
	COM Jan 2009	-13.2	-10.7	-4.8	-4.7	n.a.
	CP Dec 2007	*-12.5*	*-12.7*	*-14.5*	*-15.4*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2009**	**33.9**	**33.8**	**35.8**	**37.3**	**36.4**
	COM Jan 2009	33.9	33.9	34.8	36.0	n.a.
	CP Dec 2007	*35.5*	*37.4*	*38.6*	*39.4*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2009**	**35.2**	**36.7**	**37.8**	**38.3**	**36.4**
	COM Jan 2009	35.2	36.8	37.8	39.4	n.a.
	CP Dec 2007	*36.4*	*37.9*	*38.5*	*38.6*	*n.a.*
General government balance (% of GDP)	**CP Jan 2009**	**-1.2**	**-2.9**	**-2.1**	**-1.0**	**0.0**
	COM Jan 2009	-1.2	-2.9	-3.0	-3.4	n.a.
	CP Dec 2007	*-0.9*	*-0.5*	*0.2*	*0.8*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2009**	**-0.5**	**-2.3**	**-1.2**	**0.0**	**1.1**
	COM Jan 2009	-0.5	-2.2	-2.0	-2.3	n.a.
	CP Dec 2007	*-0.1*	*0.3*	*0.9*	*1.4*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2009**	**-3.1**	**-4.4**	**-1.3**	**0.5**	**1.1**
	COM Jan 2009	-3.3	-4.6	-2.9	-2.1	n.a.
	CP Dec 2007	*-1.8*	*-0.9*	*0.3*	*1.1*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2009**	**-2.6**	**-4.9**	**-1.8**	**0.1**	**1.1**
	COM Jan 2009	-2.7	-4.6	-2.9	-2.1	n.a.
	CP Dec 2007	*-1.2*	*-0.9*	*0.3*	*1.1*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2009**	**17.0**	**15.3**	**16.9**	**18.1**	**17.1**
	COM Jan 2009	17.0	17.1	20.0	23.3	n.a.
	CP Dec 2007	*17.6*	*17.2*	*15.0*	*14.0*	*n.a.*

Notes:

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

[2] Based on estimated potential growth of 6.1%, 4.5%, 2.8% and 1.8% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.6% of GDP in 2007; deficit-increasing, 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 programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.