EN

EUROPEAN COMMISSION

Brussels, 24.03.2010
SEC(2010) 343

Recommendation for a

COUNCIL OPINION

on the updated convergence programme of Lithuania, 2009-2012

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 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.

In accordance with the Regulation, the Council delivered an opinion on the first convergence programme of Lithuania on 3 March 20009 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Lithuania, submitted on 26 February 2010, 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 conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy";

(3) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure);

(4) 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).

[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/sgp/index_en.htm.

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

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed 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 challenges, continuing to implement structural reforms aimed at raising potential growth. The plan called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States 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.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions.

The Council agreed on the following principles of the fiscal exist strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) taking country-specific circumstances into account, timely withdrawal of fiscal stimulus was needed; provided that the Commission forecasts continued to indicate that the recovery was strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest;; (iii) in view of the challenges, the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) important flanking policies to the fiscal exit would include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term

[2] Communication from the Commission to the European Council of 26 November 2008.

fiscal sustainability; in addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The Council agreed that these elements should be reflected in the stability and convergence programmes, to be transmitted by Member States to the Commission by the end of January 2010.

2.3. The excessive deficit procedure for Lithuania

On 7 July 2009 the Council adopted a decision stating that Lithuania had an excessive deficit in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). At the same time, the Council addressed a recommendation under Article 104(7) TEC specifying that the excessive deficit had to be corrected by 2011.

On 16 February 2010 the Council, following a recommendation by the Commission, considered that action had been taken in accordance with the recommendations, but unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the recommendation. In accordance with Article 126(7) of the Treaty on the functioning of the European Union (TFEU), the Council issued new recommendations to correct the deficit by 2012. In particular, Lithuania was recommended to implement the measures planned in the 2010 budget and adopt additional measures if necessary to achieve the envisaged consolidation; to ensure an average annual fiscal effort of at least 2¼% of GDP over the period 2010-2012, notably by containing primary current expenditure; to specify and adopt additional measures necessary to achieve the correction of the excessive deficit by 2012 and to adopt and swiftly implement the planned structural reforms entailing significant budgetary savings. To limit risks to the adjustment, Lithuania should enhance the medium-term budgetary framework, including by strengthening fiscal governance and transparency and reinforcing expenditure discipline, through enforceable ceilings, as well as improve the monitoring of the budget execution throughout the year. The medium-term budgetary framework needs to be enhanced by introducing necessary forward-looking elements and mechanisms to avoid pro-cyclicality. The Council establishes the deadline of 16 August 2010 for the Lithuanian government to take effective action to implement the recommended fiscal consolidation in 2010 as planned in the budget for 2010 and to outline the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit.

The Lithuanian authorities should also report on the progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes which will be prepared between 2010 and 2012.

2.4. The assessment in the Council Opinion on the previous update

In its opinion of 10 March 2009, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2008-2011, as follows. The Council considers 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 economy. For a sustained period wage growth has exceeded productivity growth by far, thus weakening 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 macro-economic 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 this assessment, the Council invited Lithuania 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".

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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 [22 April 2010] the Council examined the updated convergence programme of Lithuania, which covers the period 2009 to 2012.

(2) Lithuania has experienced one of the strongest recessions in the EU, with output falling 15% year-on-year in 2009. Several years of rapid and increasingly unsustainable growth, mainly driven by domestic demand and a real estate boom, came to a halt in 2008 when the bursting of the domestic bubble was reinforced by the impact of the global financial crisis reducing external demand and sharply tightening access to credit. The sharp decline in domestic demand and the opening up of spare capacity helped narrow existing imbalances, reducing inflation and eliminating the external deficit, largely through a collapse in imports. The current account balance, substantially negative in the boom years and financed by capital imports associated with the banking sector, leading to a rapid increase in net external liabilities, in 2009 reached an estimated surplus of 3.1% of GDP. The sharp decline in government revenues resulting from the economic contraction, together with the consequences of an expansionary fiscal policy before the parliamentary elections in 2008, nevertheless left Lithuania facing significant fiscal challenges. A strong policy response was put in place by the government by pursuing fiscal consolidation to contain the deterioration in public finances and to limit debt accumulation, thereby inter alia supporting the credibility of the currency board arrangement. Given the wide internal and external imbalances accumulated during the boom years and the difficulty of securing new international financing once the global financial crisis set in, this was a prudent response in line with the European Economic Recovery Plan (EERP). Nevertheless, Lithuania was made subject to an EDP procedure, with the

[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/sgp/index_en.htm.

Council deciding on 7 July 2009 that an excessive deficit existed. Revised Council recommendations (Article 126(7), issued on 16 February 2010), called for correcting the excessive deficit by 2012. Ambitious fiscal consolidation is thus needed (an average fiscal effort of 2¼% of GDP per annum), underpinned by structural reforms. So as to provide some support to the ailing economy, Lithuania has increased and frontloaded the absorption of EU structural funds. Throughout the crisis the economy has proved a high degree of flexibility as a significant adjustment has occurred via decreases in prices and wages. Large increases in unemployment, which could become structural, nevertheless pose major risks to long-term convergence. With a view to restoring positive and sustainable growth and avoiding any relapse into unsustainable internal and external imbalances, the main economic challenges relate to ensuring that wage developments are in line with productivity, improving competitiveness and promoting sectoral transformation towards tradable sectors as well as encouraging further re-orientation towards medium- and high-tech products. A major adjustment of public finances to the expected lower growth in the coming years has already been initiated, but further progress remains to be secured in the medium term.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Lithuania it is important to improve administrative capacity, step up implementation of reforms in the areas of healthcare and the social security system as well as improving the quality of higher education and lifelong learning so as to improve skill levels and raise productivity.

(4) The macroeconomic scenario underlying the programme envisages that real GDP, after dropping by 15.0% in 2009, grows by 1.6% in 2010, accelerating to 3.2% in 2011, but slowing back to only 1.2% in 2012. The scenario projects domestic demand to contract further in 2010, as the labour market situation remains subdued, credit conditions tight and fiscal consolidation is set to continue. Growth in 2010 is thus dependent on a strong recovery in external demand, helped by market share gains, and recovery in fixed investment, mainly supported by accelerated absorption of EU structural funds. Continuing fiscal consolidation by the government is reflected in the macro-economic scenario. Domestic demand is expected to contribute positively to growth from 2011. Assessed against currently available information[4], this scenario appears to be based on favourable growth assumptions for 2010. While the 2.2% average growth rate envisaged for the final two programme years itself appears plausible, the profile and composition of growth between the two years is much less so. The programme's projections for inflation appear realistic. Current nominal declines in domestic prices and wages are expected to continue in 2010 according to both the programme and the Commission services' autumn 2009

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

forecast. Given the collapse of imports as a result of the recession, the previously high external deficit has turned into surplus, which is expected to be maintained also in 2011, before the balance would turn slightly negative on the back of recovering domestic demand. This is broadly plausible, although the size of the external surplus projected for 2010 is much higher than projected by the Commission services. Unemployment is projected to increase further in 2010 before starting to decline from 2011 onwards. Monetary and exchange rate assumptions of the programme are consistent with the rest of the macroeconomic scenario.

(5) The programme estimates the general government deficit in 2009 at 9.1% of GDP. The significant deterioration from a deficit of 3.2% of GDP in 2008 mainly reflects a substantial tax shortfall due to the considerably worse economic outcome (an estimated 16.9% contraction of nominal GDP against an expectation of 0.9% growth in the previous programme update) and despite sizeable budgetary consolidation measures of around 8% of GDP adopted in the course of the year. Revenue fell substantially, reflecting much lower-than-expected economic activity, although revenue fell even more than would be suggested by the standard elasticities. As a result of significant cuts in government consumption, including public sector wages, expenditure was also broadly down compared to the 2008 level. The restrictive expenditure stance was thus insufficient to offset the consequences of the economic crisis on the revenue side. The estimated deterioration in the structural balance in 2009 should be viewed with caution as the exceptionally volatile economic environment may lead to standard elasticities insufficiently capturing the impact of the extreme downturn. According to the programme, fiscal policy is planned to remain restrictive in 2010 and onwards. In view of Lithuania's relatively unfavourable budgetary and economic situation, the continued fiscal austerity in 2010 is appropriate and in keeping with the EERP. In line with the exit strategy advocated by the Council, and with a view to correcting the excessive deficit by 2012, it should contribute towards the achievement of a significantly more sustainable public finance position.

(6) The programme projects the headline deficit to decline to 8.1% of GDP in 2010; this compares with a deficit of 9.5% of GDP targeted in the budget adopted in December 2009, reflecting an improvement since then in the assumed macroeconomic outlook. The improvement compared to the estimated 2009 outturn is mainly attributable to further substantial cuts in expenditure of around 4% of GDP, particularly in government current spending, including the public sector wage bill, and social benefits. The expenditure-to-GDP ratio is nevertheless projected to increase by around 1 pp. in the programme, mainly due to a planned increase in investment and higher interest payments, while other expenditure categories are set to decline further. On the revenue side, changes are limited to a reduction in the corporate income tax rate and some increases in non-tax revenue. Furthermore, the 2010 budget also reflects the full-year impact of revenue and expenditure consolidation measures implemented in the second half of 2009. The share of non-tax revenue in the programme is projected to increase substantially, mainly relating to higher absorption of EU structural funds. While the ratio to GDP of taxes on production and imports is set to remain at a similar level to 2009, the ratio of current taxes on income and wealth is set to decline further, due to the ongoing decline in nominal wages and falling profits. Measures of a one-off and temporary nature in 2010 include the suspension of part of the transfers to the second-pillar pension funds. The overall fiscal stance in 2010, as measured by the change in the structural balance, is

expected to be restrictive, showing an improvement of ½ percentage point. However, this seems to significantly underestimate the government's consolidation efforts totalling 4.0% of GDP. The estimate of consolidation based on the structural balance should be treated with extreme caution, given its reliance on output gap estimates which are far from robust in current circumstances.

(7) The medium-term budgetary strategy of the programme is to reduce the deficit below the 3% threshold by 2012, in line with the recommendation by the Council on 16 February 2010. The structural balance calculated according to the commonly agreed methodology will improve according to the programme by 2¼% of GDP annually over the period 2011-2012 although the adjustment seems to be back-loaded. The improvement is mainly to be achieved by a further substantial reduction in the expenditure ratio (by around 4¾ pp.), with an expected nominal reduction in most primary expenditure categories, particularly compensation of employees and social payments, while the revenue-to-GDP ratio is set to increase (by around 1½ pp.). The programme explicitly acknowledges that achievement of its budgetary targets and correction of the excessive deficit by 2012 requires additional measures of around 4½% of GDP. Broad measures intended to support the achievement of budgetary targets beyond 2010 are spelled out to some extent in the programme. This adjustment takes place alongside gradually improving cyclical conditions, although the (recalculated) negative output gap will not close by the end of the programme period. The medium-term objective (MTO) has been substantially strengthened compared to the previous programme update, to a general government structural surplus of 0.5% of GDP, in order to reinforce confidence in the currency board arrangement, limit the increase of government debt and improve the long-term sustainability of public finances. The programme does not, however, mention a target year for achieving the MTO. In view of the new methodology[5] and given the most recent projections and debt level, the MTO more than adequately reflects the objectives of the Pact.

(8) The budgetary outcomes could turn out worse than projected in the programme over the whole programme period. In 2010, this is mainly because of a reliance on a more rapid recovery of economic activity than seems likely. The budgetary targets beyond 2010 are subject to risks given the limited extent of information provided in the programme regarding the measures underpinning the achievement of these targets and the need for additional measures to achieve these targets. Furthermore, reliance on a further substantial reduction in government expenditure and only to a limited extent on revenue-increasing measures in the outer years of the programme seems to be subject to implementation risks. Compensation of public employees is planned to decline by a further 3 pp. over 2011-2012, following already substantial wage cuts adopted in 2009 and 2010 and might be difficult to achieve. On the positive side, the relatively good track record of the Lithuanian authorities in meeting their targets, with a notable exception in 2008 mainly due to electoral cycle, and the decisive consolidation implemented during 2009 despite an unprecedented economic

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[5] The country-specific MTOs should take into account three components: i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

contraction, reduce these risks. Furthermore, the government has an ambitious reform agenda for 2010 and later years, which should also help to achieve the required ambitious fiscal targets. The apparently weak macroeconomic projection for 2012 also carries the possibility of somewhat stronger revenue growth in that year, if the programme is backed by concrete measures over the whole programme period.

(9) Government gross debt is estimated at 29.5% of GDP in 2009, substantially up from 15.6% in the year before. Apart from the increase in the deficit and the decline in nominal GDP growth, the increase in the ratio also results from a significant stock-flow adjustment that reflects financing of part of the 2008 deficit in 2009. The debt ratio is projected to increase by a further 11.5 pps. over the programme period to 41% of GDP in 2012, mainly driven by continued high government deficits. In view of the negative risks to the budgetary targets compounded by uncertainty about the stock-flow adjustment, the evolution of the debt ratio could also be less favourable than projected in the programme. Nevertheless, the debt level is projected to remain below the Treaty reference value throughout the programme period.

(10) The long-term budgetary impact of ageing is slightly above the EU average, mainly due to the projected increase in pension expenditure during the coming decades. The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap. Aiming at improving the primary balance over the medium term, as foreseen in the programme, and social security system reform, including pension reform, aimed at curbing the increase in age-related expenditures, would contribute to reducing the risks to the sustainability of public finances, which were assessed in the Commission 2009 Sustainability Report as high[6]. Medium-term debt projections until 2020 which assume that GDP growth rates will only gradually recover to the values projected before the crisis and tax ratios will return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value, is not enough to stabilise the debt ratio by 2020.

(11) In the years of high growth preceding the current downturn, Lithuania's medium-term budgetary framework failed to prevent expenditure overruns. Buoyant revenue growth facilitated repeated upward revisions of expenditure targets. With a view to strengthening the framework, a Law on Fiscal Discipline was adopted for the central government in November 2007. The law focuses on the preparation and execution of the annual budget and does not as such introduce more forward-looking medium-term elements. The enforcement mechanism is very weak and lacks sanctions. In general, significant weaknesses relate to the lack of transparency of the budgetary process, including appropriate reporting of revenue and expenditure executions, monitoring of fiscal target execution and the comparability of budgetary indicators on cash and accrual bases. The 2010 convergence programme proposes a number of measures to increase transparency, including data reporting and monitoring of budget

6 In the Council conclusion from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

execution improvements. If implemented, these proposals could substantially improve the institutional features of public finances.

(12) The composition of public expenditure in Lithuania is supportive to growth, as productive expenditure such as public investment and expenditure on education and healthcare is relatively high. However, medium to poor outcomes and performance indicators in the areas of education and health suggest significant scope for reaping efficiency gains. To this end important structural reforms in the education and healthcare systems have been launched. Moreover, the removal of tax exemptions and preferential rates implemented in 2009, and ongoing efforts in countering tax avoidance and further simplifying and streamlining the tax administration contribute to improving the quality of public finances, as well as to mitigating risks to the budgetary outlook.

(13) The strategy ensuring a smooth participation in ERM II is based on securing exchange rate stability by maintaining sufficient monetary buffers, financial and fiscal stability and preserving flexibility of labour and product markets. Since the end of 2008, the policy response to maintain macroeconomic stability in Lithuania has been strong; however, the situation remains challenging. Between the end of 2008 and the end of 2009, the government has undertaken strong fiscal consolidation by adopting several sizeable consolidation packages, totalling close to 12% of GDP. The high degree of wage and price flexibility is also contributing to recovering part of the deteriorated competitiveness of the economy. Despite the losses incurred through asset write-downs, the banking sector has remained well-capitalised. The government has also launched major structural reforms in the fields of education, healthcare and social security. Lithuania has revised labour legislation to enhance labour market flexibility, facilitating the adjustment of the economy. The challenge going ahead is to avoid any relapse to significant internal and external imbalances once the recovery becomes established.

(14) Overall, in 2010 the budgetary strategy set out in the programme is broadly consistent with the Council recommendations under Article 126(7) of 16 February 2010. From 2011 on, taking into account the risks, the budgetary strategy may not be consistent with the Council Recommendation. In particular, risks relate to a possibly optimistic macroeconomic outlook for 2010 and incomplete specification of measures to achieve the planned consolidation in the two later years, compounded by implementation uncertainties as regards planned expenditure reductions. The planned average fiscal effort of 1⅔% over the 2010-12 period also falls short of the Council Recommendation under Article 126(7) and will need to be strengthened by additional measures in case the relatively strong growth assumed for 2010 and 2011 does not materialise, in order to ensure a correction of the excessive deficit by 2012 as recommended by the Council.

(15) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the optional data. In its recommendations under Article 126(7) of 16 February 2010 with a view to bring the excessive deficit situation to an end, the Council also invited Lithuania to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the convergence programmes. With some gaps in the provision of optional data, Lithuania broadly complied with this recommendation.

The overall conclusion is that Lithuania implemented a decisive consolidation of public finances in 2009 against a significant deterioration of the economic situation, contributing to the ongoing adjustment in the economy and supporting smooth participation in ERM II and the correction of the excessive deficit. The economy is currently emerging from a severe recession, while average growth is projected to remain considerably lower over the medium term than in the peak years of the recent cycle. The consolidation implemented in 2009 already constitutes a major adjustment of public finances to the expected lower growth in the medium term. Stricter expenditure control and a strengthened medium-term budgetary framework would support the needed further consolidation. The programme targets a gradual decline in the general government headline deficit from 2010, aiming at the correction of the excessive deficit by 2012 as recommended by the Council, although these budgetary outcomes are subject to downside risks over the whole programme period.

In view of the above assessment and also in the light of the recommendation under Article 126 TFEU of 16 February 2010 and given the need to ensure sustainable convergence and a smooth participation in ERM II, Lithuania is invited to:

(i) consider additional corrective measures in 2010 if necessary to achieve the envisaged consolidation, in addition to implementing rigorously those planned in the budget;

(ii) specify the necessary measures to underpin fully the necessary adjustment over the programme period, and stand ready to adopt further consolidation measures in case risks related to the fact that the macroeconomic scenario of the programme is more favourable than the scenario underpinning the Article 126(7) Recommendation materialise;

(iii) implement planned social security system reforms, including pension reform, so as to reduce the high risks to long-term sustainability of public finances due to significant projected increases of pension expenditure during the coming decades;

(iv) strengthen fiscal governance and transparency, by enhancing the medium-term budgetary framework and improving reporting and monitoring of budgetary data, ensuring comparability of the budgetary indicators on cash and accrual bases.

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	**CP Jan 2010**	**2.8**	**-15.0**	**1.6**	**3.2**	**1.2**
	COM Nov 2009	2.8	-18.1	-3.9	2.5	n.a.
	CP Jan 2009	*3.5*	*-4.8*	*-0.2*	*4.5*	*n.a.*
HICP inflation (%)	**CP Jan 2010**	**11.1**	**4.2**	**-1**	**1**	**1.5**
	COM Nov 2009	11.1	3.9	-0.7	1.0	n.a.
	CP Jan 2009	*11.2*	*5.4*	*3.6*	*-0.1*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2010**	**8.8**	**-7.7**	**-5.9**	**-2.9**	**-1.7**
	COM Nov 2009[2]	11.8	-8.2	-10.8	-8.2	n.a.
	CP Jan 2009	*5.4*	*-2.8*	*-5.7*	*-4.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2010**	**-10.2**	**3.7**	**7.5**	**5.3**	**4.3**
	COM Nov 2009	-10.6	3.3	4.8	4.3	n.a.
	CP Jan 2009	*-10.2*	*-1.8*	*-4.7*	*-5.7*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2010**	**34.2**	**34.3**	**36.2**	**35.6**	**35.7**
	COM Nov 2009	34.2	36.1	36.8	36.3	n.a.
	CP Jan 2009	*33.8*	*35.8*	*37.3*	*36.4*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2010**	**37.4**	**43.4**	**44.3**	**41.4**	**38.7**
	COM Nov 2009	37.4	45.9	46.0	46.0	n.a.
	CP Jan 2009	*36.7*	*37.8*	*38.3*	*36.4*	*n.a.*
General government balance (% of GDP)	**CP Jan 2010**	**-3.2**	**-9.1**	**-8.1**	**-5.8**	**-3.0**
	COM Nov 2009	-3.2	-9.8	-9.2	-9.7	n.a.
	CP Jan 2009	*-2.9*	*-2.1*	*-1.0*	*0.0*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2010**	**-2.6**	**-7.8**	**-6.2**	**-3.6**	**-0.6**
	COM Nov 2009	-2.6	-8.4	-7.0	-7.1	n.a.
	CP Jan 2009	*-2.3*	*-1.2*	*0.0*	*1.1*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2010**	**-5.6**	**-7.0**	**-6.5**	**-5.0**	**-2.6**
	COM Nov 2009	-6.4	-7.6	-6.3	-7.5	n.a.
	CP Jan 2009	*-4.4*	*-1.3*	*0.5*	*1.1*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2010**	**-6.0**	**-7.2**	**-6.8**	**-4.8**	**-2.3**
	COM Nov 2009	-6.3	-8.0	-7.0	-7.5	n.a.
	CP Jan 2009	*-4.9*	*-1.8*	*0.1*	*1.1*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2010**	**15.6**	**29.5**	**36.6**	**39.8**	**41.0**
	COM Nov 2009	15.6	29.9	40.7	49.3	n.a.
	CP Jan 2009	*15.3*	*16.9*	*18.1*	*17.1*	*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 3.0%, -0.2%, -1.2% and -0.3% respectively in the period 2008-2011.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.5% of GDP in 2008, 0.2% of GDP in 2009 and 0.3% in 2010; all deficit-improving; and 0.3% of GDP in 2011 and 0.3% of GDP in 2012; all deficit-reducing according to the most recent programme and 0.1% of GDP in 2008, 0.6% in 2009 and 0.7% in 2010; all deficit-reducing in the Commission services' autumn 2009 forecast.

Source:

Convergence programme (CP); Commission services autumn 2009 forecasts (COM); Commission services' calculations