



**COUNCIL OF  
THE EUROPEAN UNION**

**Brussels, 14 March 2006**

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**NOTE**

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from : General Secretariat of the Council  
to : Delegations  
Subject: Council Opinion on the updated Convergence Programme of Lithuania

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Delegations will find attached the Council's opinion on the updated Convergence Programme presented by Lithuania, as adopted by the ECOFIN Council on 14 March 2006.

Attachment

**COUNCIL OPINION**  
**of 14 March 2006**  
**on the updated convergence programme of Lithuania, 2005-2008**

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<sup>1</sup>, 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 14 March 2006 the Council examined the updated convergence programme of Lithuania, which covers the period 2005 to 2008.

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<sup>1</sup> OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: [http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)

- (2) During the last decade, Lithuania successfully completed the transition to a functioning market economy and currently enjoys one of the highest growth rates in the EU. Structural reforms allowed to increase employment significantly since 2001. Real GDP growth averaged almost 8% in the period 2001-2004. GDP per capita in purchasing power standards was about 48% of the EU-25 average in 2004. There have not been significant macroeconomic imbalances, although it remains important to continue speedy reduction of the structural unemployment and manage risk of demand pressures related to lagged and ongoing effects of a rapid expansion of bank credit. A significant deterioration of the general government deficit occurred as a consequence of the external shock induced by the Russian crisis in 1998. Afterwards, a budgetary consolidation plan was implemented. Since 2001 the deficit has remained at 2% of GDP or below and the cyclically adjusted deficit was brought to 1% of GDP in 2002.
- (3) In its opinion of 8 March 2005 on the previous update of the convergence programme; covering the period 2004-2007, the Council invited Lithuania to make further progress towards a close to balance budgetary position, particularly in order to manage domestic demand pressures, to implement strictly the budget for 2005 in order to reduce the risk of breaching the 3% reference value and to use better-than-projected or additional revenues and unused expenditure items for deficit reduction.
- (4) As regards budgetary implementation in 2005, the general government deficit for 2005 was estimated at 2% of GDP in the Commission services' autumn 2005 forecast, against a target of 2.1% of GDP set in the previous update of the convergence programme<sup>1</sup>. The updated programme presents a deficit estimated at 1.5% of GDP. However, preliminary data for the whole of 2005 point to an even better deficit outcome, at around 1% of GDP. The better-than-targeted outcome stems from a good budgetary performance of all levels of general government, which are estimated to have recorded higher-than-planned revenues while expenditure plans were broadly achieved.

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<sup>1</sup> Following a decision by Eurostat in May 2005 on the classification of payments related to the compensation for lost rouble savings in the early years of transition and the restitution of real estate property confiscated in Soviet times, the deficit target set in the previous update (2.5% of GDP) has been adjusted to exclude payments related to these liabilities to allow for a meaningful comparison.

- (5) The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.<sup>1</sup>
- (6) The macroeconomic scenario presented in the programme expects real GDP growth to reach 7% in 2005 and to decelerate progressively to 5.3% in 2007, bouncing back to 6.8% in 2008. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions (and cautious assumptions for 2007). The programme's projections for inflation could be on the low side if demand pressures increase.
- (7) The main goal of the programme is to reduce the general government deficit in structural terms (i.e. in cyclically-adjusted terms and net of one-off and other temporary measures) to or below 1% of GDP, which is the country's medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact, by the end of the programme period. The update foresees the general government deficit to gradually decrease from 1.5% of GDP in 2005 to 1.0% in 2008. The time profile of the primary deficit is similar, with a decline from 0.6% of GDP in 2005 to 0.2% at the end of the programme period. Overall, the programme relies on a favourable economic outlook that would create good conditions for fiscal retrenchment. The consolidation foreseen in the programme is expenditure-driven, mostly due to a cut in collective consumption and social transfers as a percentage of GDP. A significant increase in government investment is planned, from 4.1% of GDP in 2005 to 5.2% in 2008, remaining well above the EU average (2.5% of GDP). Against a broadly unchanged macroeconomic scenario, taking into account the reclassification of savings and real estate restitutions, the budgetary adjustment is slower compared to the previous update. The slower adjustment is a result of personal income tax reduction.

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<sup>1</sup> The programme provides all compulsory and most optional data prescribed by the new code of conduct, although the presentation of compulsory data is in a few cases slightly different from that in the new code of conduct, for instance domestic demand is shown instead of final domestic demand, interest expenditure corresponding to FISIM is missing and the tax burden shows what should be total taxes, i.e. the sum of direct, indirect and capital taxes, therefore indirect taxes paid to the EU budget and social contributions are missing in the calculation of the tax burden.

- (8) Based on Commission services' calculations according to the commonly agreed methodology, the structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) would improve from about 2¼% of GDP in 2005 to 1¼% in 2008. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of 1% of GDP and aims at achieving this position by 2008. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of 1¾% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States and adequately reflects the debt ratio and average potential output growth in the long term.
- (9) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the general government deficit outcome in 2005 is very likely to be lower than estimated in the programme. A likely carry-over to 2006 and the authorities' track record of cautious revenue planning in the last few years indicate that outcomes could be better than targeted in 2006. On the other hand, the programme largely relies on a decrease in expenditure (as a percentage of GDP), particularly through public payroll moderation in the context of lower personal income tax rates. Nonetheless, the moderation could prove difficult to obtain and there are some uncertainties about the impact of the pension reform and tax reforms towards the end of the programme period.

- (10) In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the programme's MTO is achieved by 2008, as envisaged in the update. However, the budgetary stance in the programme seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations from 2007. The pace of the adjustment towards the programme's MTO implied by the programme is not fully in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times. In particular, the planned structural adjustment towards the MTO is on average 0.4% of GDP in the period 2006-2008, against the background of favourable cyclical conditions (indicated by a large positive output gap that gradually closes over the programme period) according to the agreed methodology. However, the data availability and structural\_breaks in Lithuania imply that estimates of output gaps and structural balances are subject to a margin of uncertainty.
- (11) According to the Stability and Growth Pact, "major structural reforms" with a verifiable impact on the long-term sustainability of the public finances should be taken into account when defining the adjustment path to the programme's MTO. The medium-term budgetary strategy outlined in the programme embodies a temporary deviation from the adjustment path towards the programme's MTO. While the programme lists several reforms to support the deviation, only the pension reform, consisting in the introduction of a funded pillar, is sufficiently detailed in the programme and can be considered as having a beneficial impact on the long-term sustainability of the public finances. The average annual structural adjustment towards the MTO over the period 2006-2008 is 0.5 percent of GDP if the net budgetary cost of the ongoing pension reform, which increases from 0.5% of GDP in 2005 to 0.8% in 2008, is taken into account. However, a safety margin against breaching the 3% of GDP deficit threshold would not be provided in 2006, when the structural deficit (calculated by Commission services) exceeds the minimum benchmark by ¼ percentage point of GDP. Thus, the temporary deviation would be admissible in the meaning of the revised Stability and Growth Pact and the new code of conduct, conditional on meeting the minimum benchmark in 2006, which is possible if a better-than-planned deficit outcome in 2005 is carried over to 2006 and subsequent years.

- (12) The debt ratio is estimated to have reached about 19% of GDP in 2005, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to remain at about 19-20% of GDP throughout the remainder of the programme horizon.
- (13) With regard to the sustainability of public finances, Lithuania appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The level of gross debt is currently very low and is projected to remain below the 60% of GDP reference value throughout most the projection period and a contained government deficit is planned over the programme period. Lithuania has enacted a pension reform which contributes significantly to contain the budgetary impact of ageing populations. Further changes to the pension system are envisaged by the Lithuanian authorities, aiming at increasing the replacement rates for pensioners and at the same time gradually raising the retirement age. The implementation of the latter measure would be key in ensuring the financial sustainability of the public pension system.
- (14) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, taking into account the temporary deviation linked to pension reform, Lithuania is making progress towards its MTO. Also, the government is taking several measures to improve the quality of public finances (e.g. tax reform) and has also progressed with the pension reform in order to improve the sustainability of public finances in the long-term.
- (15) The measures presented in the NRP in the area of public finances are consistent with those presented in the programme, and mostly relate to next steps to be taken with the pension, health care and tax reforms. Measures aiming at improving budgetary procedures (e.g. to complete programme-based budget at the different levels of the general government and a flexible use of funds for co-financing of EU projects) are also in line with those described in the update. The budgetary implications of the limited number of concrete reform measures specified in the NRP are reflected in the budgetary projections of the convergence programme.

In view of the above assessment, and in the context of strong growth prospects and to ensure sustainable convergence with the EU, the Council invites Lithuania to:

(i) strengthen the effort in the structural budgetary adjustment in order to speed up the attainment of the MTO, and

(ii) in particular, aim for a more demanding general government deficit target in 2006, making sure that a better-than-projected deficit outcome in 2005 is carried over to 2006 and subsequent years.

### Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	<b>CP Dec. 2005</b>	<b>7.0</b>	<b>7.0</b>	<b>6.0</b>	<b>5.3</b>	<b>6.8</b>
	COM Nov 2005	7.0	7.0	6.2	5.8	n.a.
	CP Jan 2005	6.5	6.5	6.2	6.0	n.a.
HICP inflation (%)	<b>CP Dec. 2005</b>	<b>1.1</b>	<b>2.7</b>	<b>2.7</b>	<b>2.7</b>	<b>2.5</b>
	COM Nov 2005	1.1	2.6	2.8	2.9	n.a.
	CP Jan. 2005	1.2	2.9	2.5	2.9	n.a.
Output gap (% of potential GDP)	<b>CP Dec. 2005<sup>3</sup></b>	<b>2.5</b>	<b>2.9</b>	<b>2.1</b>	<b>0.5</b>	<b>0.6</b>
	COM Nov 2005 <sup>6</sup>	2.1	2.2	1.4	0.2	n.a.
	CP Jan. 2005 <sup>3</sup>	1.6	1.3	0.5	-0.1	n.a.
General government balance <sup>1</sup> (% of GDP)	<b>CP Dec. 2005</b>	<b>-1.4</b>	<b>-1.5</b>	<b>-1.4</b>	<b>-1.3</b>	<b>-1.0</b>
	COM Nov 2005	-1.4	-2.0	-1.8	-1.6	n.a.
	CP Jan.2005 <sup>7</sup>	-2.5	-2.5	-1.8	-1.5	n.a.
Primary balance (% of GDP)	<b>CP Dec 2005</b>	<b>-0.4</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.2</b>
	COM Nov 2005	-0.4	-1.1	-1.0	-0.8	n.a.
	CP Jan 2005 <sup>7</sup>	-1.5	-1.4	-0.8	-0.5	n.a.
Cyclically-adjusted balance (% of GDP)	<b>CP Dec. 2005<sup>3</sup></b>	<b>-2.1</b>	<b>-2.3</b>	<b>-2.0</b>	<b>-1.4</b>	<b>-1.2</b>
	COM Nov 2005	-2.0	-2.6	-2.2	-1.7	n.a.
	CP Jan 2005 <sup>3</sup>	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance <sup>2</sup> (% of GDP)	<b>CP Dec. 2005<sup>4</sup></b>	<b>-2.1</b>	<b>-2.3</b>	<b>-2.0</b>	<b>-1.4</b>	<b>-1.2</b>
	COM Nov 2005 <sup>5</sup>	-2.0	-2.6	-2.2	-1.7	n.a.
	CP Jan 2005	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	<b>CP Dec 2005</b>	<b>19.5</b>	<b>19.2</b>	<b>19.9</b>	<b>19.8</b>	<b>18.9</b>
	COM Nov 2005	19.6	20.7	20.2	19.6	n.a.
	CP Jan 2005	20.1	20.9	20.3	20.1	n.a.

**Notes:**

<sup>1</sup>The costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.3% in 2004, 0.5% of GDP in 2005, 0.7% in 2006, 0.8% in 2007 and 0.8% in 2008.

<sup>2</sup>Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures. The adjustment taking out the pension reform costs according to the updated programme would be 0.5% of GDP in 2006, 0.7% in 2007 and 0.2% in 2008, or 0.5% on average in the period 2006-2008.

<sup>3</sup>Commission services calculations on the basis of the information in the programme.

<sup>4</sup>There are no one-off and other temporary measures in the programme.

<sup>5</sup>There are no one-off and other temporary measures in the Commission services' forecast.

<sup>6</sup>Based on estimated potential growth of 7.0%, 6.9%, 7.0% and 7.0% respectively in the period 2004-2007.

<sup>7</sup>It included payments related to savings compensations and real estate restitutions amounting to 0.4% of GDP in 2005, 0.8% in 2006 and 1.2% in 2007.

**Source:**

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations