BRIEFING

Exchange of views with Lithuania on a possible euro adoption

Committee briefing for the attention of ECON on 17 March 2014

This note presents selected information on the current status of the EU economic governance procedures and related relevant information in view of an exchange of views with Rimantas Šadžius, Minister of Finance of Lithuania, and Vitas Vasiliauskas, Governor of the Bank of Lithuania, in particular regarding a possible euro adoption in January 2015.

1. Recent economic developments

- The COM winter forecast of February 2014 confirmed that the **GDP growth remained strong** at 3.2% in 2013. Inflation fell to 1.2% and is forecast to be 1.1% for 2014 by the COM. Domestic demand was the main engine for growth expansion in the second half of the year, with exports dominating the first half. Investment improved against the background of low inflation, increase in wages and employment growth. As for 2014 and 2015 GDP growth, the COM forecasts 3.5% and 3.9% respectively.

- The IMF evaluated in its March 2014 mission that Lithuania seems **well placed to fulfil the entry criteria for euro adoption**, and also due to two decades of currency board arrangements, which has enabled economy to function well without an independent monetary policy. It also stressed that euro adoption would be beneficial for the Lithuanian economy and its financial stability. It would bring a higher level of integration with the euro area, ensure access to ECB liquidity, result in reduced risk premiums as well as foster trade and FDI.

- The Lithuanian authorities expressed intention to adopt euro as of 1 January 2015. The COM as well as the ECB will publish a convergence report in June 2014, with the Eurogroup and the Ecofin Council deciding whether Lithuania will be allowed to join. In 2006 Lithuania unsuccessfully attempted to join the euro due to marginally higher inflation.

- The EP (ECON) will be discussing a **draft report** on "*Lithuania's possible euro adoption as of 1 January 2015*" (rapporteur: W. Langen) on 17 March 2014.

2. Public Finances

On 21 June 2013 the Council **abrogated its decision** placing Lithuania under Excessive Deficit Procedure (EDP). Although the general government deficit in Lithuania reached 3.2% of GDP in 2012, above but close to the 3% of GDP reference value, the Council considered the deficit criterion fulfilled. While the excess over the reference value could not have been qualified as exceptional, it was considered temporary. Since Lithuania´s debt-to-GDP ratio has been below the 60% of GDP reference value in a sustained manner, the country was deemed eligible for application of the SGP provisions (Regulation 1467/97), which enabled to deduct the estimated direct net cost of 0.2% of GDP in 2012 due to systemic pension reform.

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The **general government deficit** is set to fall to 2.7% of GDP in 2013, 2.3% of GDP in 2014 and 1.7% of GDP in 2015 (COM winter forecast 2014) based on expected limited increase of expenditure. However the quality and sustainability of such expenditure needs to be reviewed. Moreover, pension and public wage cuts have been put on hold by the constitutional court, thus the government will need to find other means to compensate if current projections are to remain. In particular high-quality revenue enhancing measures, such as wealth and capital taxation, could be a source of income. The 2013 Lithuanian convergence programme set a target of achieving a budgetary surplus in 2016.

The structural deficit is forecast to decrease from 3.0% of GDP in 2012 and 2.5% in 2013 to 1.8% of GDP in 2015, with **government debt** to remain fairly stable (39.5% of GDP in 2013, 42.2% in 2014 and 41.4% in 2015) (see Annex 1).

Despite its solid public finance performance, the IMF is calling for Lithuania to **strengthen its fiscal framework** through implementing the fiscal compact, including speedy establishment of the fiscal council. Although fiscal results of the government are good supported also by a solid increase in direct taxes, the local governments need to improve their performance, preferably through independent scrutiny of its spending.

Lithuania's fiscal framework has however already been underpinned by the "Law on Fiscal Discipline", effective since 2007. In 2013, it was complemented by amendments to the "Law on Budget Structure", which strengthens the monitoring of budgetary planning in line with the SGP requirements.

Lithuania is among the most vulnerable countries in the EU for **security of energy supply** as well as for trade balance for energy products (COM paper on energy dependence of MS, April 2013). Its position has sharply deteriorated following closure of the last nuclear plant reactor. Virtually all energy imports come from non-EEA countries: 100% for gas, 98% for oil and petroleum products and 97% for solid fuels. The share of gas, for which Lithuania is reliant on one single Russian supplier, has increased strongly to compensate for the absence of nuclear power. All this has together with the lack of interconnections with other EU countries further worsened the exposure of Lithuania to potential security of supply risks and price shocks. Government plan is to reduce reliance on Russian gas, oil and solid fuels from the current 80% to 55% by 2016 and to 35% by 2020. As part of this plan, Latvia, Lithuania and Estonia are in talks to build a nuclear power plant in Lithuania with the reactor supplied by an American-Japanese company (Hitachi GE).

3. Addressing macroeconomic imbalances

In its November Alert Mechanism Report for 2014, the COM **excluded** Lithuania for any further in-depth review in the context of the macroeconomic imbalance procedure (MIP). Lithuania was also not identified as experiencing any imbalances in previous rounds of the MIP. In the ARM 2014 scoreboard, only a few indicators were beyond their indicative thresholds, namely the net international investment position and unemployment. Both have been continuously improving and the latter is forecast to fall below 10% threshold in 2015. The current account is also expected to show a slight surplus in 2013, reverting to a slight deficit in 2014 and 2015 of 0.5% and 0.7% respectively. Private sector and government debt remain low, housing prices stable and total financial sector liabilities minimal (see Annex 2).

4. Financial stability

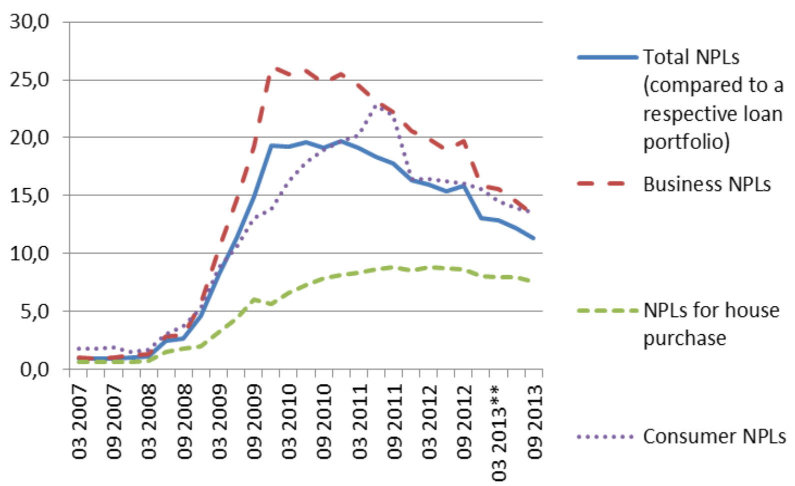
Scandinavian banks continue to dominate the financial sector in Lithuania and account for about 90% of the market. In its last mission, the IMF concluded for the Lithuanian banking sector to be **liquid and well capitalized**, but supervisors need to remain vigilant. Close cooperation between home and host country authorities of cross-border banks is strong and remains important.

The recent intervention of *Ukio Bankas* has strengthened **financial stability** as the market share of domestic banks in the banking system decreased to the minimum (less than 10%). Capital adequacy increased further in 2013 with CAR of 17½% and reliance on parent bank financing continued to edge down. Reduction of the non-performing loans is also encouraging, although progress across banks remains uneven. The Bank of Lithuania should continue to encourage smaller banks to increase capital buffers. Although the workout regimes for non-performing loans improved in 2013, they should be further strengthened over medium term with alternative financing avenues explored, such as more recourse to capital market financing.

The Bank of Lithuania stepped-up supervision of the **credit union sector;** market share of which has doubled over the past few years. Although representing only 2.6% of financial sector, the recent failure of several credit unions points to on-going fragilities. Therefore, the amendments to the Law on Credit Unions already submitted to parliament should be adopted as soon as possible followed by a much-needed broader reform of the sector, as proposed by the Bank of Lithuania.

Low credit growth could hamper growth-enhancing investment, despite robust GDP growth. Some banks are nearing the completion of the work-through of legacy assets, thus laying the foundation for reviving credit. The COM establishes in its 2014 winter forecast that while deposits continue to grow, credit to households stay flat with credit to enterprises contracting. According to the Lithuanian authorities these developments have been caused by breaks in credit data series due to recent restructuring of several domestic financial institutions. Their most recent information indicates that credit is resuming, as demand for credit recovers and lending standards ease. The COM, however, called in its 2013 CSRs staff evaluation for more attention to be given to ensuring sufficient credit supply to SMEs, supporting investment and growth going forward, since credit growth in 2012 was flat as a result of both supply and demand factors.

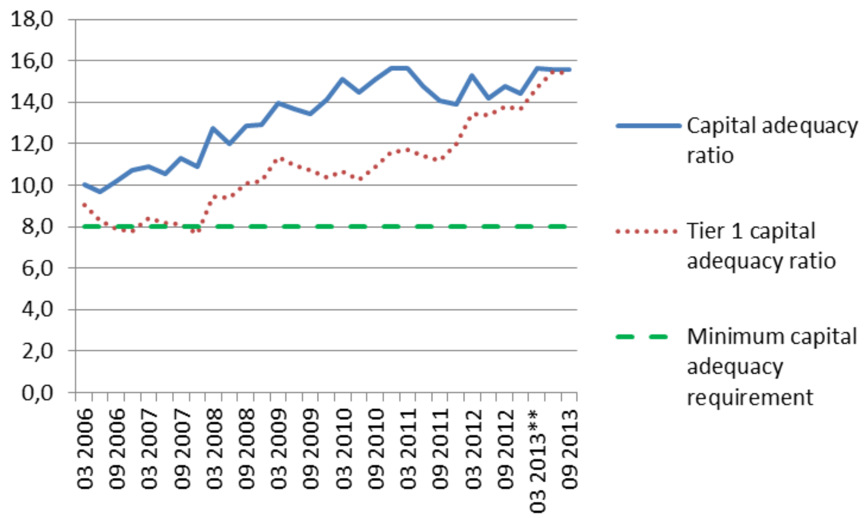
Non-Performing Loans of the Banking Sector



Source: Bank of Lithuania, March 2014

** Excluding data of AB Ūkio bankas

Capital Adequacy of the Banking Sector



Source: Bank of Lithuania, March 2014 ** Excluding data of AB Ūkio bankas

5. Europe 2020 Strategy and other Structural Reforms

In the COM latest communication of 5 March 2014 on Europe 2020 progress, Lithuania is standing as best performer in meeting its national target on early leaving from education and training in 2012 out of 9 Member States to do so. It also achieved high progress in tertiary educational attainment. It is also moving in the right direction as to reaching the target of poverty and social exclusion reduction. However, levels of primary energy consumption are below its indicative national target, as are the levels of reduction of greenhouse gas emissions in non-ETS sectors. Therefore Lithuania foresees significant investments in energy efficiency and renewable energy areas in the financial period for 2014–2020. In R&D, Lithuania has not set a very ambitious target (1.9% of GDP, while high set targets are 4% of GDP), but even this is far from being reached (see also Annex 3)

On structural reforms the IMF recognises that progress has been made and underlines upgrading of energy and transportation infrastructure a high priority, as well as the reform of public enterprises through better management and governance. On the latter, significant progress has been achieved through the reform of state owned enterprises (SoEs), which began in 2010. The reform has been based on the OECD Guidelines of Corporate Governance of SoEs and has improved their transparency as well as financial performance.

Lithuania also needs to tackle high structural unemployment, by bringing down high labour taxation and by education reform to reduce skills mismatch. However, the labour markets in Lithuania are relatively flexible, and should remain so, but need to be strengthened by reforming the labour code.

ANNEXES:

1. Key macro-economic indicators and outlook
2. MIP scoreboard
3. Lithuania's targets and progress in the context of Europe 2020 strategy
4. Country Specific Recommendations 2013 for Lithuania

Annex 1: Key macro-economic indicators and outlook

	2009	2010	2011	2012	2013	2014 (f)	2015(f)
GDP				*% change*			
Lithuania	-14.8	1.6	6.0	3.7	3.2	3.5	3.9
Euro Area	-4.5	1.9	1.6	-0.7	-0.4	1.2	1.8
Government balance				*% of GDP*			
Lithuania	-9.4	-7.2	-5.5	-3.2	-2.7	-2.3	-1.7
Euro Area	-6.4	-6.2	-4.2	-3.7	-3.1	-2.6	-2.5
Structural balance				*% of GDP*			
Lithuania	-6.6	-4.8	-4.5	-3.0	-2.5	-2.2	-1.8
Euro Area	-4.6	-4.4	-3.6	-2.1	-1.5	-1.3	-1.7
Government debt				*% of GDP*			
Lithuania	29.3	37.8	38.3	40.5	39.5	42.2	41.4
Euro Area	79.9	85.6	87.9	92.6	95.5	95.9	95.4
Inflation				*% Change*			
Lithuania	4.2	1.2	4.1	3.2	1.2	1.1	1.9
Euro Area	0.3	1.6	2.7	2.5	1.4	1.0	1.3
Unemployment				*% of labour force*			
Lithuania	13.6	17.8	15.4	13.4	11.8	10.4	9.6
Euro Area	9.6	10.2	10.2	11.4	12.1	12.0	11.7
Long term unemployment*	*% of labour force (Long term unemployed = unemployed for at least 12 months)*						
Lithuania	3.2	7.5	8.0	6.6	n.a.	n.a.	n.a.
Euro Area	3.4	4.3	4.6	5.3	n.a	n.a.	n.a.
Youth unemployment*	*% of youth labour force (youth defined as persons under the age of 25)*						
Lithuania	29.6	35.7	32.6	26.7	21.9	n.a.	n.a.
Euro Area	20.4	21.0	20.9	23.1	24.0	n.a.	n.a.
Inequality (Gini coefficient*)	*Scale from 0 to 100: 0 = total income equality; 100 = total income inequality*						
Lithuania	35.5	36.9	33.0	32.0	n.a.	n.a.	n.a.
Euro Area	30.2	30.3	30.6	30.5	n.a.	n.a.	n.a.
Current account balance				*% of GDP*			
Lithuania	2.1	-0.4	-3.9	-1.1	0.1	-0.5	-0.7
Euro Area (adjusted)	-0.2	0.0	0.1	1.4	2.2	2.3	2.3
Exports				*% change*			
Lithuania	-12.6	17.4	14.1	11.8	6.5	6.6	6.9
Euro Area	-12.4	11.6	6.5	2.5	1.3	4.2	5.7
Imports				*% change*			
Lithuania	-28.1	17.9	13.7	6.1	6.6	7.0	7.4
Euro Area	-11.0	10.0	4.5	-0.9	0.2	4.1	5.9
Domestic demand				*% change*			
Lithuania	-24.5	2.2	5.9	-0.5	3.3	3.9	4.3
Euro Area	-3.8	1.2	0.8	-2.2	-0.9	1.0	1.7
Investments				*% change*			
Lithuania	-39.5	1.9	20.7	-3.6	7.2	6.5	6.9
Euro Area	-12.8	-0.4	1.6	-4.0	-3.0	2.3	3.6
Unit labour cost				*% change (nominal values)*			
Lithuania	-1.5	-7.0	0.7	1.9	2.6	1.7	1.9
Euro Area	4.3	-0.6	0.7	1.8	1.0	0.7	0.8
Labour productivity				*% change*			
Lithuania	-8.6	15.3	5.5	1.9	1.7	2.1	2.6
Euro Area	-2.4	2.6	1.4	0.2	0.5	0.9	1.0

Sources: COM Winter Forecast, February 2014, and Eurostat for indicators with an * (Extraction date 11-03-2014)

Annex 2: Macroeconomic Imbalance Scoreboard for Lithuania

Indicators			Thresholds	2006	2007	2008	2009	2010	2011	2012
External imbalances and competitiveness	**Current account balance as % of GDP**	**3 year average**	**-4/+6%**	**-8.4**	**-10.7**	**-12.7**	**-7.9**	**-3.0**	**-0.0**	**-1.3**
		year value		*-10.6*	*-14.4*	*-12.9*	*3.7*	*0.1*	*-3.7*	*-0.2*
	Net international investment position as % of GDP		**-35%**	**-49**	**-55.8**	**-51.6**	**-57.3**	**-58.2**	**-52.3**	**-52.8**
	Real effective exchange rate - 42 trading partners	**% change (3 years)**	**± 5% €A**	**-2.6**	**0.9**	**9.0**	**16.7**	**7.3**	**1.7**	**-6.7**
		% change y-o-y		*-0.3*	*3.0*	*6.1*	*6.8*	*-5.3*	*0.5*	*-2.0*
	Share of world exports	**% change (5 years)**	**-6%**	**50.4**	**30.7**	**39.9**	**22.4**	**13.7**	**25.0**	**29.3**
		% change y-o-y		*3.2*	*2.2*	*17.1*	*-11.1*	*3.6*	*13.4*	*5.7*
	Nominal unit labour cost	**% change (3 years)**	**9%€A**	**20.7**	**24.5**	**29.6**	**15.9**	**1.1**	**-7.7**	**-4.6**
		% change y-o-y		*10.2*	*6.6*	*10.4*	*-1.5*	*-7.0*	*0.7*	*1.9*
Internal imbalances	% y-o-y change deflated **house prices**		**6%**	**n.a.**	**19.4**	**-1.7**	**-32.9**	**-8.6**	**2.3**	**-3.2**
	Private sector credit flow as % of GDP		**14%**	**18.7**	**23.1**	**10.7**	**-9.6**	**-5.4**	**-0.7**	**-0.3**
	Private sector debt as % of GDP		**133%**	**62**	**75.5**	**77.9**	**84.9**	**75.9**	**66.2**	**62.5**
	General government gross debt (EDP) as % of GDP		**60%**	**18**	**16.8**	**15.5**	**29.3**	**37.8**	**38.3**	**40.5**
	Unemployment rate	**3 year average**	**10%**	**8.2**	**6.2**	**5.3**	**8.0**	**12.5**	**15.7**	**15.6**
		year value		*5.2*	*4.3*	*5.8*	*13.8*	*17.8*	*15.4*	*13.4*
	% y-o-y change in **Total Financial Sector Liabilities,** non-consolidated		**16.5%**	**32.5**	**34.3**	**3.7**	**-3.7**	**0.0**	**8.9**	**-0.3**

Source: Eurostat MIP indicators, March 2014

Outside threshold

Annex 3: Lithuania's targets and progress in the context of Europe 2020 strategy

Indicator	Lithuania			EU28	
Employment rate (% of population aged 20-64)	**72.8**		**Target 2020**	**75**	
	68.5		2012	68.4	
	66.9		2011	68.5	
	64.3		2010	68.5	
	67.2		2009	68.9	
Expenditure on R&D (% of GDP)	**1.9**		**2020 target**	**3**	
	0.90		2012	2.06*	
	0.91		2011	2.04*	
	0.79		2010	2.00*	
	0.84		2009	2.01*	
Greenhouse gas emission (Index 1990=100)	**ncst**		**2020 target**	**80**	
	n.a.		2012	n.a.	
	44.31		2011	83.0	
	43.26		2010	85.7	
	41.77		2009	83.7	
Share of renewable energy (%)	**23**		**2020 target**	**20**	
	21.7		2012	14.1	
	20.2		2011	13.0	
	19.8		2010	12.5	
	20.0		2009	11.9	
Primary energy consumption (million tonnes of oil equivalent-TOE)	**n.a.**		**2020 target**	**1 483**	
	5.9		2012	1583	
	5.8		2011	1596	
	6.1		2010	1653	
	7.7		2009	1594	
Early school leaving (% of population aged 18-24)	**9**		**2020 target**	**10**	
	6.5		2012	12.7	
	7.4		2011	13.4	
	7.9		2010	13.9	
	8.7		2009	14.2	
Tertiary educational attainment (% of population aged 30-34)	**40**		**2020 target**	**40**	
	48.6		2012	35.7	
	45.7		2011	34.5	
	43.8		2010	33.4	
	40.6		2009	32.1	
Population at risk of poverty or social exclusion (thousand, *% of total population*)	**ncst**	**ncst**	**2020 target**	**Reduce by 20 millions**	**ncst**
	975	*32.5*	2012	124229*	*24.8**
	1011	*33.1*	2011	121 543	*24.3*
	1109	*33.4*	2010	118 126	*23.7*
	985	*29.5*	2009	n.a.	n.a

Source: Eurostat, - data extracted on 11 March 2014
* = Estimate; **ncst** = "no country specific target"

Annex 4: Lithuania - Country Specific Recommendations 2013

1. Ensure growth friendly fiscal consolidation and implement the budgetary strategy as planned, pursuing a **structural adjustment effort that will enable Lithuania to reach the medium-term objective**. Prioritise growth-enhancing expenditure. Continue to strengthen the fiscal framework, in particular by securing enforceable and binding expenditure ceilings in the medium-term budgetary framework. **Review the tax system** and consider increasing those taxes that are least detrimental to growth, such as recurrent property and environmental taxation, including introducing car taxation, while continuing to reinforce tax compliance.
2. Adopt and implement legislation on a comprehensive **pension system reform**. Align the statutory retirement age with life expectancy, restrict access to early retirement, establish clear rules for the indexation of pensions, and promote the use of complementary savings schemes while ensuring implementation of on-going reforms. Underpin pension reform with measures that promote the employability of older workers.
3. Tackle high unemployment amongst low-skilled and long-term by refocusing resources on active labour market policies while improving their coverage and efficiency. Improve the employability of young people, for example through a **Youth Guarantee**, enhance the implementation and effectiveness of apprenticeship schemes, and address persistent skill mismatches. Review the appropriateness of labour legislation with regard to flexible contract agreements, dismissal provisions and flexible working time arrangements, in consultation with social partners.
4. Implement concrete targeted measures to reduce **poverty and social exclusion**. Continue strengthening the links between the cash **social assistance reform and activation measures**.
5. Complete the implementation of the **reform of the State-Owned Enterprises**, in particular to ensure separation of ownership and regulatory functions, and closely monitor compliance with the requirements of the reform.
6. Step up measures to improve the **energy efficiency** of buildings, including through removing disincentives and rapid implementation of the holding fund. Promote **competition in energy networks** by improving interconnectivity with other Member States for both electricity and gas.