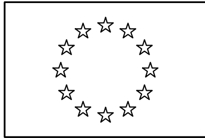

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Technical Annex to the

CONVERGENCE REPORT 2006 ON LITHUANIA

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European Economy

2006 Convergence Report on Lithuania – Technical annex

A Commission services working paper

http://europa.eu.int/comm/economy_finance/publications/european_economy/convergencereports2006_en.htm

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Abbreviations and symbols used

Member States

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EU-10 European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV,HU, MT, PL, SI, SK)

EU-12 European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)

EU-15 European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)

EU-25 European Union, 25 Member States

Currencies

EUR euro

ECU European currency unit

DEM German mark

LTL Lithuanian litas

USD US dollar

Other abbreviations

CPI consumer price index

ECB European Central Bank

EMI European Monetary Institute

EMU economic and monetary union

ERM II exchange rate mechanism II

ESCB European System of Central Banks

Eurostat Statistical Office of the European Communities

FDI foreign direct investment

GDP gross domestic product

GFCF gross fixed capital formation

HICP harmonised index of consumer prices

MTO medium-term objective

VAT value added tax

1. INTRODUCTION

1.1. Role of the report

The euro was introduced on 1 January 1999, following several years of successful adjustment efforts by the Member States to achieve a high degree of sustainable convergence. The decision[1] by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency (from the beginning) had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two convergence reports made by the Commission[2] and the European Monetary Institute (EMI).[3] These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation *(Box 1.1)*. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare convergence reports on such Member States.

Box 1.1: Article 122(2) of the Treaty

"At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned."

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty[4] and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision[5] that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of Heads of State or Government. The decision was based on two convergence reports made by the Commission[6] and the ECB[7], which covered both Greece and Sweden. Greece adopted the single currency with effect from 1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.
In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling the necessary conditions for the adoption of the single

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1. OJ L 139, 11.5.1998, pp. 30-35.
2. Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.
3. European Monetary Institute, Convergence Report, March 1998.
4. Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland
5. OJ L 167, 7.7.2000, pp. 19-21.
6. European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.
7. European Central Bank, Convergence Report 2000, May 2000.

currency and continued to be referred to as a "Member State with a derogation".[8]

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry "Member States with a derogation". Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.[9]

In 2006, two years will have elapsed since the last reports were made. The Commission and the ECB envisage to prepare a comprehensive report in October 2006, assessing progress with convergence for all Member States with a derogation. On 16 March, Lithuania submitted a request for an earlier convergence assessment. As a response to this request, the Commission and the ECB prepared convergence reports for Lithuania.

This Commission services working paper is a technical annex to the convergence report on Lithuania and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria and an overview of the main findings. Chapters 2 to 7 examine fulfilment of each of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in this convergence report was 28 April 2006.

1.2. Application of the criteria

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors *(Box 1.2)*. The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria). A more detailed explanation of how to interpret and apply the criteria was provided in the convergence reports issued up to present.

[8] European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence report 2002, May 2002.

[9] European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

Box 1.2: Article 121(1) of the Treaty

"1. The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

– *the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;*

– *the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);*

– *the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;*

– *the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long term interest rate levels.*

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices."

Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a National central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

Price stability

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: "*the achievement of a high degree of price stability […] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability"*.

Article 1 of the Protocol on the convergence criteria further stipulates that "the criterion on price stability […] shall mean that a Member State *has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions"*.

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation[10] setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005[11] provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

As has been the case in past convergence reports, a Member State's *average rate of inflation* is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The *reference value* is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points.

Over the 12 month period covering April 2005-March 2006, the three best-performing Member States in terms of price stability were Sweden (0.9 percent),

[10] Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4)

[11] Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

Finland (1.0 percent) and Poland (1.5 percent) yielding a reference value of 2.6 percent.[12] Over the period January 1999 to March 2006, the reference value – based on the EU-15 until April 2004 and the EU-25 afterwards – fell to a low of 1.8 percent in July 1999 and peaked between February and April 2002 at 3.3 percent. In September 2004, the reference value fell for the first time below the euro area average when Lithuania entered the basket of three best performers.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this Working Paper studies also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head. Also, developments in import prices are examined to assess whether and how external price developments have impacted on domestic inflation.

[12] The reference values used in the 1998, 2000, 2002 and 2004 Convergence Reports were 2.7, 2.4, 3.3 and 2.4 percent, respectively. The ordering of best performers is based on unrounded data.

Table 1.1.

Evolution of the inflation reference value [1)]

	Three best performers [2)]	Reference value [3)]	Euro area average inflation rate [2)]
January 04	DE, FI, AT	2.7	2.1
February 04	DE, FI, AT	2.6	2.0
March 04	FI, DE, AT	2.5	1.9
April 04	FI, DE, AT	2.5	1.9
May 04	FI, CZ, DE	2.5	2.0
June 04	FI, DK, CZ	2.5	2.0
July 04	FI, DK, UK	2.4	2.1
August 04	FI, DK, SE	2.4	2.1
September 04	LT, FI, DK	1.9	2.1
October 04	FI, LT, DK	2.1	2.1
November 04	FI, LT, DK	2.1	2.1
December 04	FI, DK, SE	2.2	2.1
January 05	FI, DK, SE	2.2	2.1
February 05	FI, DK, SE	2.1	2.2
March 05	FI, DK, SE	2.2	2.2
April 05	FI, SE, DK	2.3	2.2
May 05	FI, SE, DK	2.3	2.2
June 05	FI, SE, DK	2.3	2.2
July 05	FI, SE, DK	2.3	2.1
August 05	FI, SE, DK	2.4	2.1
September 05	FI, SE, NL	2.4	2.2
October 05	FI, SE, NL	2.4	2.2
November 05	FI, SE, NL	2.5	2.2
December 05	FI, SE, NL	2.5	2.2
January 06	SE, FI, NL	2.6	2.2
February 06	SE, FI, NL	2.6	2.2
March 06	SE, FI, PL	2.6	2.3

1) EU-15 until April 2004; EU-25 from May 2004 onwards.
2) Measured by the percentage change in the arthmetic average of the latest 12 monthly indices
relative to the arithmetic average of the 12 monthly indices of the previous period.
3) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 pecentage points.

Source: Commission services

Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as "*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)*". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that "*at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*".

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.[13] The existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion.[14]

Exchange rates

The Treaty refers to the exchange rate criterion in the third indent of Article 121 as *"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State"*.

Article 3 of the Protocol on the convergence criteria stipulates: *"The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period"*. Based on the Council Resolution on the establishment of the ERM II[15], the European Monetary System has been replaced by the exchange-rate mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Working Paper is May 2004 to April 2006.

Long-term interest rates

The fourth indent of Article 121(1) of the Treaty requires *"the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels"*. Article 4 of the Protocol on the convergence criteria further stipulates that *"the criterion on the convergence of interest rates (...) shall mean that,*

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13 Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp_en.htm.

14 The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

15 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March 2006, the reference value, derived from the average interest rate in Sweden (3.3 percent), Finland (3.3 percent), and Poland (5.0 percent), was 5.9 percent.

Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include the results of financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards *integration of financial markets*, focus is on compliance with the acquis communautaire in respect of the financial sector, on main characteristics, structures and trends of the financial sector and on progress in financial integration. *Integration of product markets* is assessed through trade, foreign direct investment and merger and acquisition activity and a smooth functioning of the internal market. Finally, the situation and development of *the current account of the balance of payments* is examined to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances leading to high vulnerability to shocks.

2. LEGAL COMPATIBILITY

2.1. Situation in the 2004 Convergence Report

In its 2004 Convergence Report, the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Lithuania, in particular the Law on the Bank of Lithuania and the Constitution of Lithuania, as well as the Law on Currency and the Law on the Credibility of the litas, was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular as regards the Bank's objectives.

With respect to the Law on the Bank of Lithuania, the incompatibilities in the area of integration into the ESCB were linked to the definition of monetary policy; the conduct of foreign exchange operations and the definition of foreign exchange policy; the holding and managing of foreign reserves; the right to authorise the issue of banknotes and the volume of coins; and the monetary functions, operations and instruments of the ESCB. In addition, the need for the ECB's prior approval for the participation of the Bank of Lithuania in international monetary organisations was not recognised, and the possibility for Lithuania's Parliament to dissolve the Bank of Lithuania was also considered incompatible.

Further incompatibilities were raised with respect to the Constitution of Lithuania, as Art 125 paragraph 2 attributed to the Bank of Lithuania an exclusive right to issue banknotes. The Law on Currency contained incompatibilities as regards the definition of the monetary unit, the right to authorise the issue of banknotes and coins, as well as in respect of the definition of the foreign exchange policy. The Law on the Credibility of the litas contained similar incompatibilities as regards the right to issue currency and the definition of the foreign exchange policy.

An imperfection subsisted as regards the Bank of Lithuania's objectives, since its secondary objective referred to the general economic policy of the State, without any reference to the general economic policies in the Community and without the latter taking precedence over the former.

2.2. Current legal situation

A first draft Law amending the Law on the Bank of Lithuania was prepared in summer 2005. Pursuant to Art 105(4) EC, it was submitted to the ECB for Opinion in autumn 2005. The ECB issued its Opinion (CON/2005/60) on 30 December 2005. Further amendments and improvements were incorporated in a revised draft Law, which was adopted by the Seimas on 25 April 2006.

The Law on Currency and the Law on the Credibility of the litas have been repealed by a special Law, which was adopted by the Seimas together with the Law on the amendments to the Law on the Bank of Lithuania.

A draft Law amending Article 125 of the Constitution of the Republic of Lithuania was submitted to the ECB for Opinion in autumn 2005. The ECB issued its Opinion (CON/2005/38) on 26 October 2005. The Seimas adopted a revised draft Law on 25 April 2006.

Integration into the ESCB

With respect to the Law on the Bank of Lithuania (LBoL), the incompatibilities raised in the 2004 Convergence Report have been removed. The Law on the amendments to the Law on the Bank of Lithuania repeals Articles 8(1)3, 11(1)1-3 and 5, 25-27, 29, 30 and 32 of the Law on the Bank of Lithuania. A series of articles have been amended so as to take account of the EC Treaty requirements and the respective roles and competences of the ECB, the ESCB and the EC Council. This concerns in particular articles 8(1)2 and 25 LBoL (on monetary policy); Article 31 LBoL (on

the conduct of foreign exchange operations and the definition of foreign exchange policy); Articles 11(1)4, 11(1)17 and 33 LBoL (on the holding and managing of foreign reserves); and Articles 6, 8(1)1 and 11(1)9 (on the issue of banknotes and coins). Article 11(1)8 LBoL now fully takes into account the need for the ECB's prior approval for the participation of the Bank of Lithuania in international monetary organisations. The possibility for the Parliament of dissolving the Bank of Lithuania is also removed.

The Law amending Art 125 of the Constitution of the Republic of Lithuania repeals paragraph 2 of Art 125. The special Law repealing certain other Laws not only repeals the Law on Currency and the Law on the Credibility of the litas, but also other legal acts and laws related to the litas, which also contained several incompatibilities.

Objectives

With respect to the Law on the Bank of Lithuania, a reference to the ESCB's secondary objective has been inserted. The latter takes precedence over the Bank of Lithuania's additional objective to support the economic policy carried out by the national authorities.

Independence

Article 125 of the Constitution has been amended in order to strengthen the Bank of Lithuania's "personal" independence.

Other issues

In Article 8(2)5 of the Law on the Bank of Lithuania, a safeguard clause has been inserted as regards the role of the Bank as lender of last resort, so as to strengthen compliance with Art 101 EC and to avoid that the Bank of Lithuania might eventually end up bearing financial costs which are in principle to be borne by the state.

Timing

The Law on the amendments to the Law on the Bank of Lithuania, the Law amending Art 125 of the Constitution of the Republic of Lithuania and the special Law repealing certain other Laws, are planned to enter into force on the day of the abrogation of the derogation of the Republic of Lithuania by the Council of the European Union pursuant to the procedure laid down in Article 122(2) of the Treaty. Articles 6 and 7 of the Law on the amendments to the Law on the Bank of Lithuania entered into force on 29 April 2006.

3. PRICE STABILITY

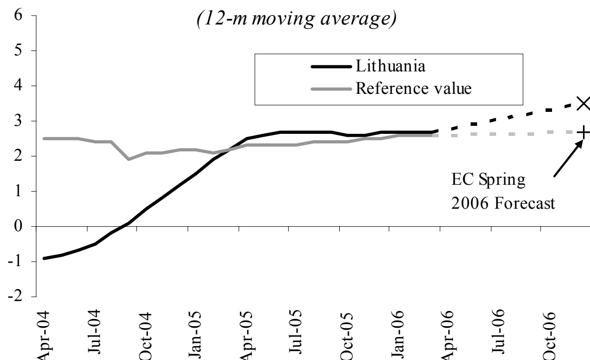
3.1. Recent inflation developments

HICP inflation, which had been low or even negative since 1999, picked up in early 2004 and rose to slightly above 3 percent until early 2005; it decreased temporarily in the period from May to July 2005 when it fell to just below 2 percent. In the following months HICP inflation increased again, partly in response to higher oil prices on the world markets, and reached 3.1 percent in March 2006. As a result, 12-month average inflation gradually increased from a low of around -1 percent in the second half of 2003 and the first half of 2004 to around 2.7 percent by June 2005 and it has been hovering around this level between July 2005 and March 2006.

3.2. Respect of the reference value

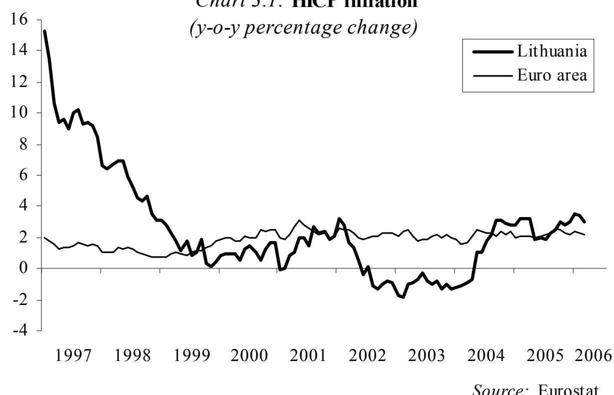
The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since April 2005. The difference between Lithuanian 12-month average inflation and the reference value narrowed from July 2005 onwards to 0.1 percentage point in the first months of 2006. In March 2006 the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 2.7 percent, 0.1 percentage points above the reference value.

Chart 3.2. **Inflation criterion**
(12-m moving average)



Source: Eurostat, Commission services

Chart 3.1. **HICP inflation**
(y-o-y percentage change)



Source: Eurostat

Table 3.1.

Lithuania: Average inflation rate (HICP) and the reference value[1)]
(percentage change)

	December 2002	December 2003	December 2004	December 2005	March 2006
LT	0.3	-1.1	1.2	2.7	2.7
Reference value[2)]	2.9	2.7	2.2	2.5	2.6

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period

2) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points; only EU-15 Member States are used in the period prior to May 2004.

Source: Eurostat, Commission services

3.3. Underlying factors and sustainability of inflation

The profound economic, institutional and regulatory changes that marked the transition process in Lithuania had an important bearing on inflation. After independence Lithuania experienced triple-digit inflation in the first years of transition when the country was still in the ruble zone. With the introduction of the litas in 1993, inflation was curbed and the exchange rate stabilised. Since April 1994, Lithuania has been operating a currency board regime. The litas was initially pegged to the US dollar, but re-pegged to the euro at the prevailing market rate in February 2002.

As a result of successful stabilisation policies Lithuania achieved remarkable progress in disinflation. Stability-oriented macro-economic policies, progress with structural reforms and the transformation towards a market economy inducing more competition helped anchor inflation and inflation expectations. Inflation dropped to single-digit levels in 1997 and decreased further in the next few years. By then transition-related rapid increases in administered prices had subsided and in the following years rapid productivity growth and the steady appreciation of the nominal effective exchange rate vis-à-vis trading partners in response to the appreciating trends in the respective anchor currencies (first the US dollar, then the euro) also helped to bring inflation down. From April 1999 to July 2004 Lithuania experienced a prolonged period of more than 5 years where harmonised inflation rates were below 2 percent. From June 2002 until April 2004, consumer prices even decreased year-on-year.

Positive inflation rates re-emerged subsequently, however, and year-on-year HICP inflation rates increased to around 3 percent in the course of the second half of 2004. After some easing in the summer of 2005, inflation picked up again and reached 3.1 percent in March 2006. The return of positive headline inflation rates reflected a combination of factors including a pick-up in wage costs; substantial increases in unprocessed food prices which were partly linked to price arbitrage as EU accession enabled the convergence of food prices; increases in indirect taxes and in administered prices; and higher energy prices. Inflation excluding administered and energy prices also edged up, from around 1 percent in the summer of 2005 to 2.7 percent on average in the first quarter of 2006, notably for food, transport and some services components, such as prices of restaurant services. While a tight budgetary stance had contributed to low inflation in 2001-2002, the budgetary stance eased in the next two years. Against the backdrop of an estimated positive output gap, the cyclically adjusted deficit widened to close to 2 percent of GDP in 2004 and decreased to 1.2 percent in 2005, while general government consumption growth was strong in the last two years.

Table 3.2.

Lithuania: Components of inflation[1)]
(percentage change)

	2001	2002	2003	2004	2005	2006[2)]
HICP	1.6	0.3	-1.1	1.2	2.7	3.3
Non-energy industrial goods	-2.6	-1.7	-1.5	-0.2	-0.7	0.2
Energy	0.0	1.7	1.1	2.7	7.2	9.7
Unprocessed food	9.0	-2.2	-11.9	2.3	6.4	6.7
Processed food	-0.2	0.8	3.1	2.4	1.4	0.9
Services	4.4	3.2	0.3	-0.3	3.3	4.0

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period

2) Average of January-March 2006

Source: Eurostat and Commission services

Wages and labour costs

The development of wages and unit labour costs in recent years reflected the lagged impact of buoyant economic activity on the labour market. While real GDP growth had been high since 2001, unit labour costs in Lithuania decreased markedly in 2000 and 2001 and rose only moderately in the period 2002-2004. This pattern mirrors the rapid gains in labour productivity in recent years (with the exception of 2002 when weaker productivity growth went hand in hand with moderate wage increases), initially coupled with relatively restrained wage gains. Labour compensation reacted only with a lag to productivity developments. The growth of nominal compensation per employee picked up gradually from 3.8 percent in 2001 to between 8 and 9 percent in the periods 2003-2005 amidst signs of a tightening labour market. Unit labour costs growth picked up in 2005 to 3.8 percent.

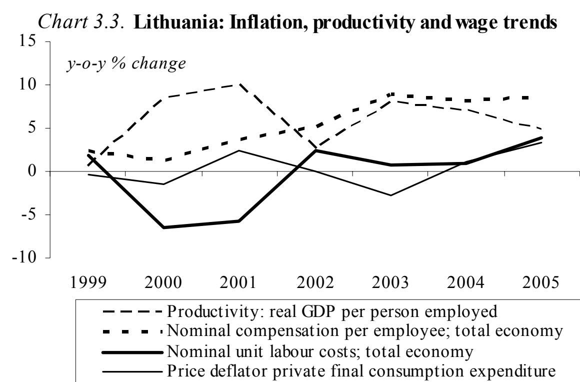


Chart 3.3. **Lithuania: Inflation, productivity and wage trends**

Source: Commission services

From a sectoral perspective, unit labour costs increased more rapidly in services than in manufacturing in recent years. Labour cost pressures on prices in the non-tradable sector strengthened notably from 2004 onwards. Unlike in manufacturing, a relatively high wage growth in the private non-tradable sectors was not matched by productivity increases and led to an increase in relative unit labour costs in services which fuelled services inflation. More generally, hourly labour cost increases accelerated to double digit figures in the course of 2005 in all industries and most strongly in the buoyant construction and real estate sector where there are indications of shortages in some categories of skilled workers partly driven by lower labour supply due to emigration.

Table 3.3.
Lithuania: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005	2006[1)]
Private consumption deflator						
LT	2.4	-0.1	-2.7	1.1	3.3	3.5
EUR-12	2.4	1.9	2.0	2.0	1.9	2.1
Nominal compensation per employee						
LT	3.8	5.1	8.9	8.2	8.7	8.9
EUR-12	2.8	2.7	2.6	2.4	2.1	2.3
Labour productivity						
LT	10.1	2.7	8.0	7.1	4.7	5.5
EUR-12	0.5	0.4	0.6	1.7	0.9	1.3
Nominal unit labour costs						
LT	-5.7	2.4	0.8	1.0	3.8	3.2
EUR-12	2.3	2.3	2.0	0.7	1.2	1.1
Imports of goods deflator						
LT	-3.0	-4.7	-3.4	-0.5	9.0	7.5
EUR-12	0.4	-2.9	-2.2	1.5	4.0	4.1

1) Spring Forecast

Source: Commission services

Market functioning, domestic competition and EU accession

The disinflation process in Lithuania has been supported by a progressive improvement in competition environment on the domestic market as a result of liberalisation. This has been in particular visible in a subdued development of prices for non-energy industrial goods and in a marked slowdown of the price increases in telecommunications in recent years. The opening of retail trade to foreign entrants and increases in the scale of operations of retail outlets have also helped to boost competition and dampen consumer prices. However, inflows of foreign direct investment have been relatively low compared to most other new Member States, limiting the speed of industrial restructuring (see chapter "other factors").

EU accession on 1 May 2004 had important consequences for the opening of markets and for price developments in a number of areas. As a result of the alignment of trade policy to EU standards, a number of products from both EU and non-EU Member States obtained easier access to the Lithuanian market. This facilitated imports of goods from the other EU Member States, and helped strengthen competition on the domestic markets with arguably permanent effects on price formation for imported traded goods.

This notwithstanding, it is likely that the abolishment of the remaining tariffs on exports of food products to other EU Member States had an upward impact on food prices in Lithuania from mid-2004 onwards. It is difficult to identify the precise impact of accession-related factors on food prices, as other influences, such as weather conditions, arguably also played a role. However, it appears that the opening of EU markets and the availability of subsidies on exports to third countries encouraged the convergence of food prices in Lithuania and the EU. In combination with a harmonisation of food safety regulations, the shifting supply conditions on the domestic market are seen to have contributed to a sharp increase in prices for unprocessed food. Inflation in this category peaked at a rate of around 10 percent in early 2005 and initially declined after May 2005, as the base effect of price increases upon EU entry faded. Since then, however, prices for unprocessed food have trended up again, suggesting a more prolonged period of food price adjustments in the wake of EU accession and possibly also reflecting buoyant domestic demand.

In addition, like elsewhere in the EU, prices of traded goods in Lithuania benefited from a benign global environment in particular related to competition from Asia. The most noticeable contribution came from the segment of clothing and footwear, where competition from China led to a sharp drop in prices in 2005. To the extent that this segment has been directly influenced by a relaxation of trade restrictions in 2005, the favourable impact on inflation could be considered temporary. Indeed, price declines for these goods were less marked from the autumn of 2005 onwards.

External influences on domestic prices and changes to indirect taxation

The existence of a currency board in Lithuania contributed to negative import price inflation, thereby exerting a moderating impact on overall consumer prices for a series of years. The restraining impact of import prices on inflation was reinforced by the fact that the peg was changed from the US dollar to the euro in 2002. The decline in import prices in 2001 reflected the appreciation of the US dollar, while the euro appreciation in 2002 and 2003 contributed to the decrease in import prices in these two years. Import prices of goods declined by 3.4 percent in 2003 and 0.5 percent in 2004. Whereas the nominal effective exchange rate of the litas still appreciated by around 1 percent in 2004, the appreciation trend of previous years came to a halt in 2005. As a consequence, the continuing surge in commodity prices, in particular oil, led to a sharp increase in import prices in 2005 by 9 percent. Consumer prices for energy accelerated from around 2.7 percent in 2004 to 7.2 percent last year, leading to an increase in the contribution of the energy component from 0.4 percentage point in 2004 to 0.9 percentage point in 2005. Although the increase in electricity prices in 2005 also played a role, the largest part of the rise in the energy component of the HICP was accounted for by higher prices for motor fuels.

In the first months of 2006, import prices – especially of commodities – continued to increase sharply. Import prices for natural gas rose markedly as of 1 January 2006, by around 40 percent, after a multi-year agreement with Russian gas exporter Gazprom had expired. This led to price hikes in gas used for cooking and direct heating, adding around 0.1 percentage point to inflation in January 2006. The main impact of higher import prices for gas is likely to occur with a delay, however, due to the lagged adjustment of regulated prices for distributed heat.

As regards changes in indirect taxes, several changes were implemented in 2004, at or just before EU accession. Excise taxes for fuels and tobacco were increased and a 5 percent VAT rate on drugs and other medical products was introduced. A higher VAT rate was applied on heating and on the publishing and printing of books, newspapers and magazines with a high share of advertisements. The impact of the VAT increase on heating was offset by the introduction of direct compensation for the heating costs of households and as of 2006 Lithuania obtained an exemption to apply a low VAT rate to heating. In the area of administered prices, the most important upward adjustments in 2004 and 2005 were to prices for electricity, public transport, and medical services. The adjustment of indirect taxes and administered prices contributed an estimated 0.4 and 0.9 percentage points to headline inflation in 2004 and 2005, respectively. For 2006 and 2007, no decisions have been taken yet with respect to changes in indirect taxes, but excises on tobacco products in particular will have to be increased in the coming years to reach the minimum level required in the EU, as derogations expire by 2010.[16]

Medium-term prospects

Inflation performance in the remainder of 2006 will reflect upward pressures stemming from labour cost developments and higher import prices, in particular

[16] Without offsetting measures, the harmonisation of excise taxes on tobacco products is estimated to have a cumulative impact on inflation of some 2 percentage points in the period up to 2010.

for energy products, which will partly be reflected in consumer prices only with a lag. As a result, average inflation in 2006 is expected in the Commission spring 2006 forecast to increase to 3.5 percent, from 2.7 percent in 2005.

Beyond 2006, several upward risks to inflation can be identified. The economy is in an advanced stage of the cycle and the labour market has tightened. Apart from the impact of further increases in indirect taxes, there is a risk that buoyant domestic demand could add to inflationary pressures, supported by strong credit growth. The achievement and maintenance of a low level of inflation in the medium-term will therefore depend on wage growth being in line with productivity developments and on fiscal policy being geared towards containing demand pressures.

4. GOVERNMENT BUDGETARY POSITION

4.1. Recent budgetary developments

Following a deterioration of the general government deficit in 2000, partly due to the impact of the Russian crisis in 1998-1999, fiscal consolidation efforts led to a decline of the deficit from 3.6 percent of GDP in 2000 to 1.2 percent of GDP in 2003. The deficit subsequently increased to 1.5 percent of GDP in 2004, following a more expansionary fiscal stance and the introduction of a funded pension system. Lithuania already presents the government accounts taking into account the Eurostat decision of March 2004 on the classification of second pillar pension systems and has included the pension reform costs in the deficit. In 2005, Eurostat decided on a methodological change for the classification of compensations related to real estate property confiscated in Soviet times and private savings lost due to currency devaluations in the early 1990s. Consequently, the related payments have been imputed to the deficit of the year when the liability was recognised. The payments were marginal in 2000 and 2001 but accounted for 0.1 percent of GDP in 2001, 0.1 percent in 2002, 0.7 percent in 2003, 1.1 percent in 2004 and 0.8 percent in 2005.

The general government deficit decreased to 0.5 percent of GDP in 2005. This compares to an estimated outcome of 1.5 percent of GDP in the December 2005 update of Lithuania's convergence programme and 2.0 percent in the Commission services' autumn 2005 forecasts. The more favourable result stems from a good budgetary performance at all levels of general government, which are estimated to have recorded higher-than-planned revenues while expenditure plans were broadly achieved. This was possible due to higher-than-foreseen economic activity and improvements in tax collection and enforcement. In contrast to previous practice, additional expenditure through supplementary budgets in the second half of the year was avoided. Good times were thus used to step up the budgetary consolidation effort in 2005, in line with the Council opinion on the previous convergence programmes of Lithuania.

Under a no-policy-change assumption, the deficit is expected to remain broadly stable in 2006, although there are some uncertainties related to the absorption of EU funds and the impact of the tax reform. The first steps of the tax reform approved in 2005 will be implemented in 2006. They mainly consist in a *de facto* temporary increase in the corporate income tax by 4 percentage points, applicable as of January 2006, and a reduction of the personal income tax rate from 33 percent of the gross salary to 27 percent from July 2006. While neutral in 2006, the net impact of the tax reform is expected to be negative in subsequent years, but this should be partly offset by high tax revenue growth and a lower increase of current government expenditure. The structural deficit (equal to the cyclically adjusted balance as there are no one-off measures) is expected to remain below 1¾ percent of GDP, which is the minimal benchmark for providing a safety margin against breaching the 3 percent of GDP reference value under normal cyclical conditions, in line with the Stability and Growth Pact.

Cyclical conditions contributed unevenly to fiscal consolidation in the period 2000-2004. A significant budgetary consolidation effort was made in 2001, when a decline in the structural general government deficit was achieved despite unfavourable cyclical conditions as suggested by the wide negative (although rapidly closing) output gap.[17] Since 2003, cyclical conditions became supportive, but the structural deficit deteriorated in 2003 and 2004, partly reflecting a higher primary deficit, to which the pension reform contributed. In 2005, the primary deficit improved, as did the structural deficit. Positive cyclical conditions are expected to continue over 2006, with the output gap remaining positive.

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[17] The calculations of potential growth (and hence the output gap) must be treated cautiously as they may be exposed to considerable uncertainty particularly for countries experiencing a catching-up process.

Table 4.1.
Lithuania: Budgetary developments
(as percentage of GDP unless otherwise indicated)

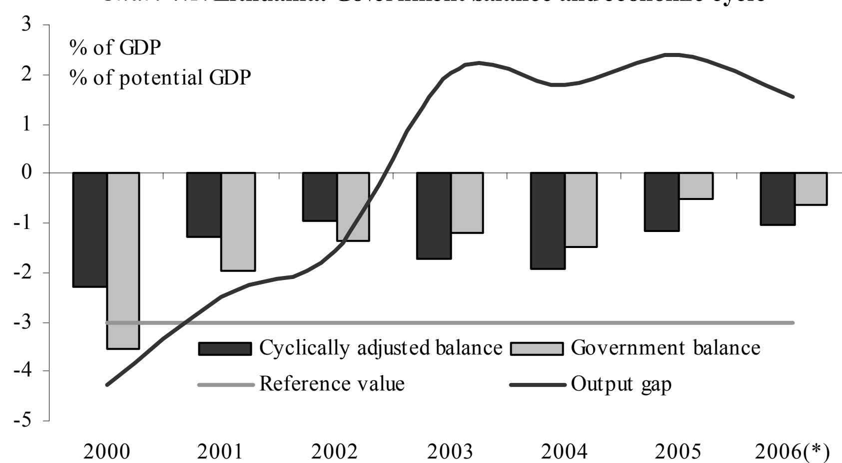
	2000	2001	2002	2003	2004	2005	2006(*)
General government balance[1)]	-3.6	-2.0	-1.4	-1.2	-1.5	-0.5	-0.6
- Total revenue	35.8	33.1	32.9	31.9	31.9	33.1	32.0
- Total expenditure	39.3	35.1	34.3	33.2	33.4	33.7	32.6
of which: interest	1.7	1.5	1.3	1.2	0.9	0.8	0.7
primary expenditure	37.6	33.6	33.0	31.9	32.5	32.8	31.9
GFCF	2.4	2.2	2.9	3.0	3.4	3.5	3.5
Primary balance	-1.8	-0.5	-0.1	0.0	-0.5	0.3	0.1
p.m. Tax burden	30.3	29.0	28.6	28.3	28.7	29.1	28.7
Government debt	23.6	22.9	22.3	21.2	19.5	18.7	18.9
p.m. Real GDP growth	3.9	6.4	6.8	10.5	7.0	7.5	6.5
p.m. HICP inflation	1.1	1.6	0.3	-1.1	1.2	2.7	3.5

(*) Spring Forecast

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

Source: Commission services

Chart 4.1. **Lithuania: Government balance and economic cycle**



(*) Spring Forecast

Source : Commission services

The composition of the nominal budgetary adjustment in the period 2000-2004 has been mostly expenditure driven, as the revenue-to-GDP ratio gradually decreased. The primary expenditure ratio fell until 2003, but started increasing in 2004 on the back of a strong increase in social related expenditure, agricultural subsidies, public sector salaries and investment. Interest payments on public debt as a percentage of GDP gradually dropped from 1.7 percent in 2000 to 0.9 percent in 2004. After declining slightly in 2001, the public investment to GDP ratio increased steadily to 3.5 percent in 2005 and remains well above the EU average (2.5 percent of GDP). Unlike in previous years, the budgetary adjustment in 2005 was revenue-driven, mainly stemming from favourable tax collection, while current expenditure increased significantly. The tax burden fell below 30 percent of GDP in 2001 and remained at around 28-29 percent until 2005.

4.2. Government debt

Lithuania’s government debt ratio declined steadily from 23.6 percent at the end of 2000 to 19.5 percent at the end of 2004 and is well below the 60 percent of GDP reference value. The main factor contributing to the decrease was the impact of financial transactions of the government (stock-flow adjustment). This was mostly influenced by privatisation receipts and positive foreign debt valuation effects related to the nominal appreciation of the litas, which was initially pegged to the dollar until February 2002, and thereafter to the euro. The “snow-ball” effect, which is the combined effect of implicit interest rates and nominal GDP growth, contributed slightly to improve the debt ratio, primarily due to high real GDP growth, as inflation remained low. The primary deficit was the major factor increasing the debt ratio over 2000-2004. In 2005, the debt ratio decreased further to below 19 percent, led by the positive impact of the snow-ball effect. In 2006, the debt ratio is expected to remain broadly stable with the snow-ball effect largely offsetting a negative contribution of the primary balance.

4.3. Medium-term prospects

The sustainability of the budgetary position is examined in the most recent update of Lithuania's convergence programme, submitted in December 2005. The programme's main goal is to reduce the general government deficit in structural terms to or below 1 percent of GDP. This is the country's medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact.

Against the background of robust GDP growth, the update foresees the headline general government deficit to gradually decrease from 1.5 percent of GDP in 2005 to 1 percent in 2008. The time profile of the primary deficit is similar, with a decline from 0.6 percent of GDP in 2005 to 0.2 percent over the same 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 cuts in collective consumption and social transfers in percent of GDP. A significant increase in government investment is planned, from 3.4 percent of GDP in 2004 to 5.2 percent in 2008. The revenue ratio is planned to drop by ½ percent of GDP over the programme period, mostly due to the impact of the pension and tax reforms.

The update of the convergence programme estimates Lithuania’s debt ratio to remain at about 19-20 percent of GDP throughout the remainder of the programme horizon. The debt-increasing contribution of the primary deficit is expected to progressively fade out. The combined effect of interest rates and GDP growth will have a decreasing effect on the debt ratio, while financial transactions are expected to increase the debt.

The Council examined the updated convergence programme on 14 March 2006. Overall, the programme's budgetary strategy was regarded as plausible and risks to the budgetary projections were judged broadly balanced. Nevertheless, the MTO might not be reached during the programme's period. A temporary deviation from the minimum adjustment path towards the MTO required by the pact was granted, justified by the pension reform costs. The allowance of a temporary deviation was conditional on meeting the minimum benchmark in 2006, as is expected in the Spring 2006 Commission forecasts. The general government deficit outcome in 2005 is estimated to have been lower than projected in the programme. A carry-over to 2006 would imply that outcomes could be better than targeted also in 2006.

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. 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, aiming at increasing the replacement rates for pensioners and at the same time gradually raising the retirement age.

Table 4.2.

Lithuania: Convergence programme projections for general government balance and debt (as percentage of GDP)

	2004	2005	2006	2007	2008
Balance[1)]	-1.4	-1.5	-1.4	-1.3	-1.0
Debt	19.5	19.2	19.9	19.8	18.9

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

Source: December 2005 convergence programme and Commission services

The Council invited Lithuania to strengthen the effort in the structural budgetary adjustment, in order to speed up the attainment of the MTO. In response, Lithuania announced its intention to carry over the better-than-projected deficit outcome in 2005 to 2006.

5. EXCHANGE RATE STABILITY

Lithuania entered ERM II on 28 June 2004 and has, by the time of the drafting of this report, so far spent 22 months in ERM II. There has been no deviation from the central rate since the litas started participating in ERM II. The authorities have committed to unilaterally maintain the long-standing currency board in the mechanism.

Before ERM II entry, the Bank of Lithuania had already been operating its currency board as of April 1994 with the litas initially pegged to the US dollar at LTL 4 per USD. The litas peg was changed to the euro in February 2002 at the prevailing market rate of LTL 3.4528 per euro. The ERM II central parity corresponds to this exchange rate, which had been unchanged since repegging to the euro.

During more than a decade, the currency board arrangement has served as a disciplining force for imposing and maintaining prudent macro-economic policies. The currency board has proven its ability to withstand shocks, such as the banking crisis of 1996 and the Russian crisis of 1998, which in combination with a severe recession and a worsening fiscal position put the system under substantial strain. The success of re-pegging to the euro in 2002 was based on continuing sound macro-economic policies and thorough technical preparation. Public confidence in the currency board arrangement continues to be strong.

The development of additional indicators does not reveal any major exchange rate pressures on the litas. In accordance with the Litas Credibility Law, the Bank of Lithuania guarantees that the total amount of litas put into circulation does not exceed gold and foreign currency reserves. In practice, the ratio of official reserve assets to the monetary base has well exceeded 100 percent, underpinning the credibility of the currency board arrangement. On average, this backing was around 125 percent at at the end of 2005. Barring short-term changes in government deposits, the ratio of foreign reserves to GDP has also been relatively stable in recent years, indicating that the trend increase in official reserve assets moves in line with economic activity. Beyond the standard characteristics of a currency board, the Bank of Lithuania also has control of some money market instruments which it can use to influence liquidity.

Chart 5.1. **Exchange rates: LTL/EUR**
(monthly averages)

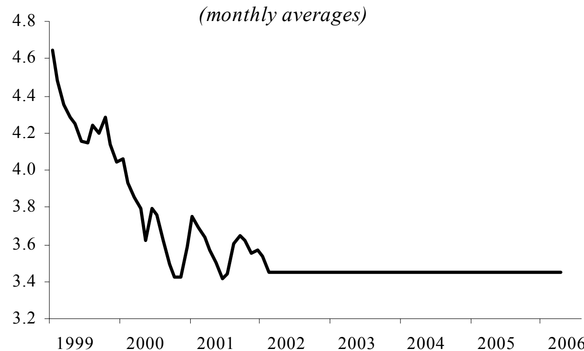
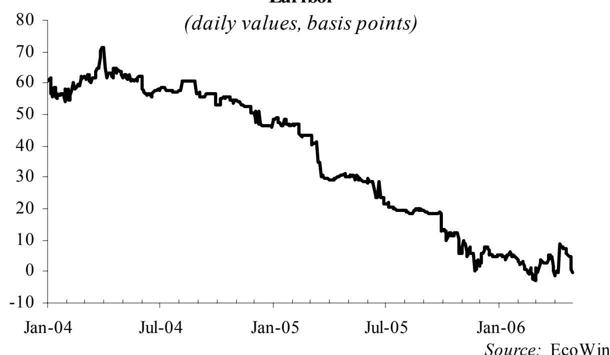


Chart 5.2. **Lithuania : 3-M Vilibor spread to 3-M Euribor**
(daily values, basis points)



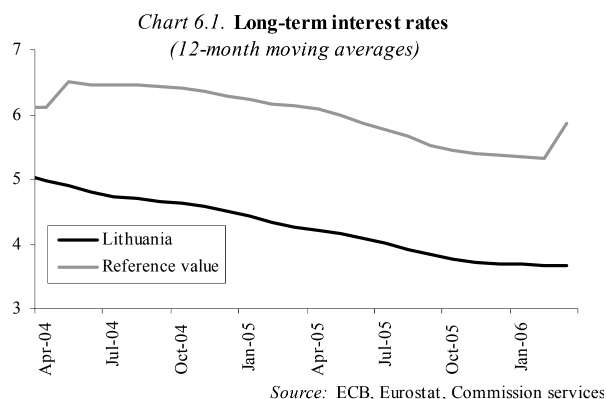
Source: EcoWin

However, the Bank of Lithuania has not been actively using these discretionary facilities to any significant extent. Exchange rate stability in the period May 2004 – April 2006 has been achieved in the presence of a narrowing short-term interest rate differential vis-à-vis the euro area. While in April 2004 the 3-month VILIBOR on average stood around 65 basis points above the EURIBOR, the spread narrowed gradually since then to a mere 3 basis points on average in the period January-March 2006. The close alignment of short-term rates to the euro area illustrates the stability of the litas peg and suggests that no appreciable currency risk is priced in.

6. LONG-TERM INTEREST RATES

At the beginning of 2001, Lithuania was among the new Member States with the highest long-term interest rates of around 9½ percent. Long-term interest rates progressively declined in the following years, indicative of the credibility of Lithuanian macro-economic policies and the perspective of euro area accession. The spread vis-à-vis euro area average interest rates had been declining markedly in the run-up to ERM II entry in June 2004. Subsequently, spreads have fallen further from around 55 basis points in June 2004 to around 3 basis points in March 2006. Over the assessment period, foreign investors have generally shown strong interest in Lithuanian government securities, driving yields downwards as demand has exceeded supply in auctions. Since long-term interest rates for Lithuania reflect primary market rates, the short-term fluctuations in the spread mostly mirrored the volatility of euro area long-term interest rates. The remaining positive differential at auctions is accounted for by the illiquidity of the market for Lithuanian government bonds and by the remaining currency risk premium incurred by foreign investors.

Chart 6.1. **Long-term interest rates**
(12-month moving averages)



Source: ECB, Eurostat, Commission services

The Lithuanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period, largely reflecting a global decline in bond yields. The reference value for the long-term interest rate criterion has been declining at a broadly similar pace. In March 2006 the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points, stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Lithuanian benchmark bond stood at 3.7 percent, below the reference value.

Table 6.1.
Lithuania: Long-term interest rates
(12-month averages)

	December 2003	**December 2004**	**December 2005**	**March 2006**
LT	5.3	4.5	3.7	3.7
Reference value[1)]	6.1	6.3	5.4	5.9

1) Average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points

Source: ECB, Eurostat, Commission services

7. ADDITIONAL FACTORS

7.1. Financial market integration[18]

Lithuania's financial system has substantially integrated into the broader EU financial system. The main channels of integration have been a high degree of foreign ownership of financial intermediaries associated with substantial foreign currency borrowing. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.[19]

The size of the financial system remains small relative to GDP, but financial development is catching-up broadly in line with economic development.[20] Reflecting low central government debt, outstanding debt securities are also low by EU-15 standards at less than 20 percent of GDP, while stock market capitalisation is a little higher at 25 percent of GDP *(Chart 7.1)*. Banks strongly predominate among financial intermediaries, while other financial intermediaries – i.e. insurance companies, investment funds, leasing companies and pension funds – are still at a very early stage of development.

Lithuania's banking system is fully privatised since 2002. Foreign ownership has progressively increased to represent 75 percent of total assets, with notably Swedish banks acquiring the two largest banks. The banking system is now highly concentrated, with a top five banks concentration ratio (CR5) of 80 percent *(Chart 7.2)*.

Reflecting progressive financial deepening, domestic lending to the private sector continued to expand strongly. *(Chart 7.3)*. While credit growth was the highest of all EU10 Member States over the past years, it has to be noted that the expansion takes place from low levels. Debt dynamics are mitigated by the fact that Lithuania has still the lowest loan to GDP ratio among EU10 Member States and that the wide majority are long-term loans (85 percent). The share of foreign currency loans rose to about 70 percent for companies and 60 percent for households. Following the re-pegging of the litas to the euro in 2002, the share of euro denominated loans increased rapidly and is now widely dominating in most sectors *(Chart 7.4)*.

Foreign currencies denominated credits are substantially higher than foreign currency deposits within the private sector. Given the high credibility of its currency-board arrangement, however, Lithuania's exposure to currency risk is mitigated, and short-term debt is broadly covered by official reserves.

The importance of capital markets remains limited in Lithuania. Government debt securities account for over 90 percent of debt securities outstanding, with about one third being denominated in euro. The Vilnius Stock Exchange (VSE) performed strongly following EU entry, but remains relatively illiquid. VSE is part of the Nordic Exchange (OMX), offering access to the Nordic and Baltic securities markets, and the three Baltic exchanges with harmonized market practices and rules.

High concentration and foreign ownership highlight the importance of cross-border cooperation to ensure adequate supervisory structures in safeguarding financial stability as the financial system develops and integrates further with the EU. The securities market is regulated and supervised by the Securities Commission of the Republic of Lithuania while the Bank of Lithuania supervises credit institutions. Both institutions are co-operating to improve the supervision of individual sectors.

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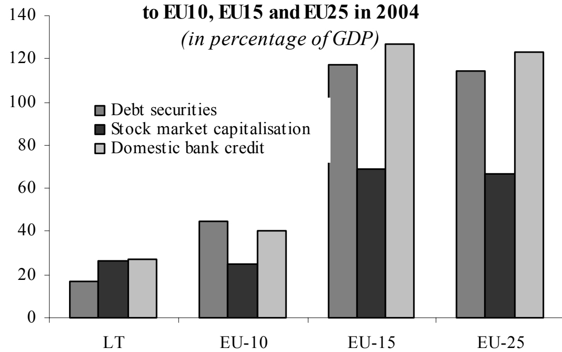
[18] This section draws mainly on information provided by the Central Bank of Lithuania its Quarterly and Monthly Bulletins as well as a number of recent cross-country studies published by the ECB, the OeNB, the RZB Group and independent researchers.

[19] See: Transposition of FSAP Directives - State of play http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/memberstate_en.pdf

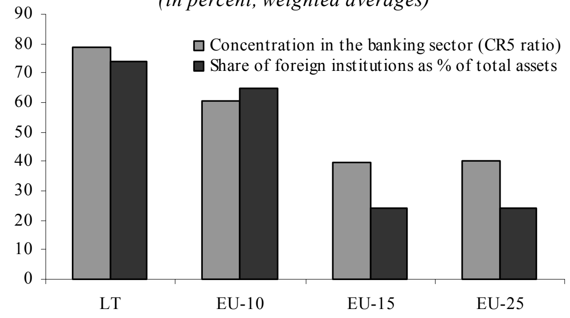
[20] GDP per capital levels (PPP) in Lithuania are among the lowest in EU-10, broadly in line with Poland, Estonia and Latvia.

Chart 7.1. **Structure of financial system relative to EU10, EU15 and EU25 in 2004**
(in percentage of GDP)



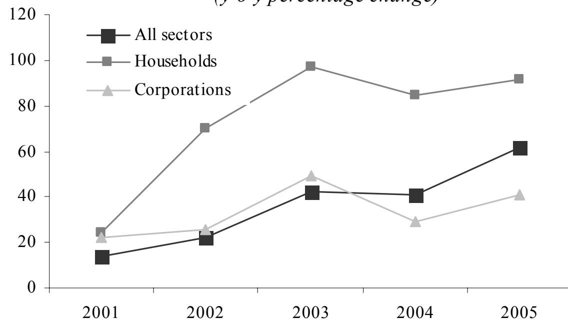
Source : European Banking Federation, Eurostat, ECB, Commission services

Chart 7.2. **Foreign ownership and concentration in the banking sector in 2004**
(in percent, weighted averages)



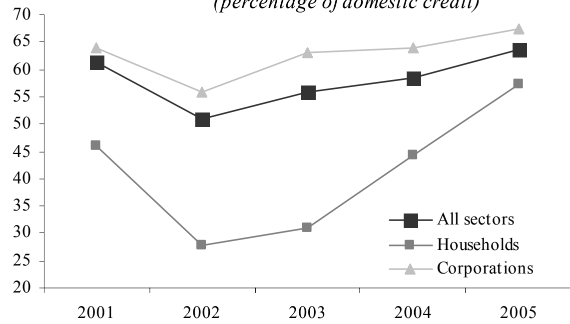
Source : ECB: EU Banking Structures (October 2005)

Chart 7.3. **Lithuania: Domestic credit expansion**
(y-o-y percentage change)



Source : Bank of Lithuania

Chart 7.4. **Lithuania: Share of foreign currency loans**
(percentage of domestic credit)



Source: Bank of Lithuania

7.2. Product market integration

Similarly to the other new Member States, Lithuania experienced an important structural change over the past 15 years, which was further promoted by the process of integration with EU. Trade and foreign direct investment (FDI) data show that Lithuania has become increasingly integrated in the EU economy and the country is already among the most open economies in the EU25. Differences regarding the sectoral composition of production in Lithuania *vis-à-vis* the EU remain, however considerable.

Important efforts have been made with respect to the adoption and application of the Internal Market *acquis* and improvement of the business environment in order to put in place the necessary conditions for a smooth process of integration.

Trade and FDI

The high degree of product market integration is desirable in view of the process of real convergence of the Lithuanian economy towards EU average income levels. Trade and investment links with the EU increase the scale of operations of local firms and enhance domestic competition levels eventually resulting in higher efficiency levels, better allocation of resources and enhanced adaptability to asymmetric shocks.

Lithuania is a small and fairly open market economy in the EU context. The degree of openness, defined as the average of imports and exports of goods and services divided by GDP, has been increasing over time. During the period 2000-2005, the degree of openness (around 60 percent) was already higher than the small EU Member States average (56 percent). The other EU Member States are Lithuania’s main trading partners but trade with third countries remains important. While trade flows with the EU have increased with the general economic catching-up and continuous removal of barriers, between 2000 and 2005 the intra-EU trade to GDP ratio remained lower than the average for the small Member States. Moreover, it is among the lowest in the new Member States; only Poland and Cyprus (which trades mainly in services) have lower ratios.

Lithuania's sectoral export composition shows few similarities with the EU-15.[21] Despite having grown gradually more similar over time, Lithuania’s export sectoral profile (with Latvia’s) differs the most from that of the EU-15. This difference in trade structure reflects the much larger importance of labour-intensive industries in the total manufacturing value added compared to the EU average. The share of low tech industries in Lithuania is also among the highest in the EU.[22]

Product market integration can also be assessed on the basis of FDI performance. Like in most new Member States, FDI inflows, particularly from the EU, have been substantial since the mid-nineties. However, in terms of inward FDI stocks Lithuania was still below the average for the new Member States in 2004. FDI has been particularly important in the industrial restructuring of the Lithuanian economy. It has been an important source of funding for private investment and has contributed to covering current account deficits. The presence of foreign firms has also been an important means for the transfer of technology, organisational and managerial skills and to boost competition pressure in the economy.

[21] See “Patterns of Trade, Delocalisation Choices and Catching-up”, Luca de Benedectis and Lucia Tajoli, 2005

[22] See “Statistics in Focus - Industry, trade and services”, no. 41/2004, Eurostat

Implementation of the Internal Market

The building of an institutional framework conducive to adequate levels of competition in product markets is relatively well developed In Lithuania. Encouraging progress has been made with the implementation of the competition law and in establishing independent competition and regulatory authorities.

Lithuania is among the best performers as regards the transposition of Internal Market directives. In December 2005, only 0.4 percent of the directives are yet to be transposed (down from 1 percent in 2004) *vis-à-vis* 1.6 percent in the EU on average.

With respect to the business environment important progress has also been achieved. Lithuania is the best performer among the new Member States in the World Bank ranking on the ease of doing business. Among the EU Member States, the country ranks sixth; only the Scandinavian countries, Ireland and the UK rank higher.

Table 7.1.

Lithuania: Product market integration

	Lithuania						EU25					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Trade opennes [1] (%)	47.8	52.6	55.7	54.2	55.8	59.8(f)	36.2	36.0	34.8	34.3	35.5	36.7(f)
Extra-EU trade GDP ratio [2] (%)	14.4	15.8	17.2	18.5	17.0	-	10.2	9.9	9.4	9.2	9.6	-
Intra EU-trade GDP ratio [3] (%)	24.1	26.5	27.7	26.2	31.3	-	19.1	18.9	18.4	18.4	19.1	-
Intra-EU trade in services GDP ratio [4] (%)	-	-	-	4.5	4.8	-	-	-	-	4.6	4.7	-
Intra-EU trade balance [5]	-0.2	-0.2	-0.7	-0.9	-1.3	-1.1	84.5	104.2	115.0	97.3	77.9	79.9
Total FDI inflows GDP ratio [6] (%)	3.3	3.7	5.1	1.0	3.4	-		5.8	5.0	3.5	2.1	-
Intra-EU FDI inflows GDP ratio [7] (%)	-	-		0.5	2.5	-	-	4.3	3.7	2.3	1.4	-
FDI intensity [8]	-	-		0.3	1.7	-		3.9	3.7	2.5	1.7	-
Internal Market Directives [9] (%)	-	-	-	-	1.0	0.4	-	-	-	-	1.9	1.6
Price levels[10]	51.6	53.0	54.6	54.9	54.6	-	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7 Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of Intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

Source: Eurostat, Commission services

7.3. Development of the balance of payments

As a consequence of strong domestic demand, in particular for investment, the Lithuanian current account deficit widened from 4.7 percent of GDP in 2003 to 7.7 percent of GDP in 2004. This trend was halted in 2005 as the current account balance in Lithuania recorded a deficit of 7.0 percent of GDP. The reduction in the current account deficit was due to improvements in the services and transfers balances (with the rise in the latter in the last two years mainly due to inflows of EU funds), while the deficit in goods trade widened and reached 11.2 percent of GDP as imports were buoyed by rapid real GDP growth. The balance on current income was negative at 2.4 percent of GDP, a similar figure as in the previous two years, mainly due to a sizeable repatriation of profits by foreign companies (underlining the healthy profitability of past foreign direct investment). The improvement in the current account went hand in hand with capital inflows and Lithuania recorded an increase in reserve assets, following a slight decline in 2004. Inflows of foreign direct investment increased to 2.6 percent of GDP in 2005, while loans from foreign banks to Lithuanian subsidiaries accounted for an appreciable share of inflows in other investment.

Lithuania has had rather large current account deficits for many years, principally in view of substantial deficits in goods trade partly offset by positive balances of services and current transfers. This pattern is consistent with the rapid catch-up path of the economy, where foreign savings are mobilised via external borrowing to increase domestic investment and productivity growth. In an environment of high prospective economic growth, the foreign inflows thus compensate for lower domestic saving rates to finance the expansion path, as domestic agents increase consumption faster than income in anticipation of future increases in permanent income. From this intertemporal perspective, several studies indicate that the current account deficit in Lithuania has been within the range implied by underlying fundamentals.

So far, the financing of the current account deficits appear to have been unproblematic, but the external position reflects substantial financing needs in the medium term. The main challenge for Lithuania will be to ensure that there is no substantial widening of the external deficit and that growth rates can be sustained in the future without negatively impacting on competitiveness. To that end, investment needs to be channelled to sectors that will contribute to productivity growth. However, in recent years foreign direct investment inflows remained relatively modest, compared with some of the neighbouring countries. In order to avoid a too rapid increase in external debt, national savings need to remain at adequate levels. In this regard, a significant contribution to domestic investment is expected to come from EU structural funds, which will help to alleviate the external constraint without affecting external indebtedness.

Table 7.2.

Lithuania: Balance of payments (percentage of GDP)

	2001	2002	2003	2004	2005
Current account	-4.7	-5.1	-6.8	-7.7	-7.0
Of which: Balance of trade in goods	-9.1	-9.4	-9.1	-10.6	-11.2
Balance of trade in services	3.8	3.8	3.3	3.6	4.1
Income balance	-1.5	-1.2	-2.6	-2.7	-2.4
Balance of current transfers	2.1	1.6	1.6	2.0	2.5
Financial and capital accounts	3.4	4.1	5.9	6.9	6.6
Of which: Net FDI	3.6	5.0	0.8	2.3	2.6
Net portfolio inflows	2.1	0.1	1.5	0.9	-1.5
Net other inflows	0.4	1.7	6.4	1.9	6.8
Net capital account	0.0	0.4	0.4	1.3	1.4
Change in reserves (+ is a decrease)	-2.7	-3.1	-2.9	0.5	-2.7
Errors and omissions	1.3	1.1	0.9	0.8	0.3
Gross capital formation	20.4	21.6	22.9	24.2	25.0
Gross saving	15.8	16.8	16.1	16.2	18.1

Source: Eurostat and Commission services