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# Assessment of the 2011 national reform programme and convergence programme for LITHUANIA

*Accompanying the document*

**Recommendation for a**

**COUNCIL RECOMMENDATION**

**on the National Reform Programme 2011 of Lithuania and delivering a Council Opinion on the updated convergence programme of Lithuania, 2011-2014**

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## 1. INTRODUCTION

'The Lithuanian economy was severely hit by the crisis and underwent a sharp adjustment in 2009. Lithuania's commitment to the currency board arrangement was underpinned by sizeable fiscal consolidation and public and private sector wage adjustment. This policy action combined with an improved global environment helped to secure access to international capital markets on improving terms and laid ground for the economy to return to growth in 2010. The government's measures to step up the pace of structural reforms are set out in the National Reform Programme (NRP) and the Convergence Programme (CP) submitted to the Commission on 28 April 2011. These documents also reflect the short term commitments that the Lithuanian government presented on 22 April 2011 under the Euro Plus Pact with the objective to improve Lithuania's competitiveness and contribute to a higher degree of convergence in the euro area.

## 2. ECONOMIC SITUATION AND OUTLOOK

### 2.1. RECENT ECONOMIC DEVELOPMENTS

Lithuania experienced rapid growth following the Russian crisis at the end of the 1990's. Between 1999 ad 2008, economic activity expanded on average by 7% per year, with real GDP per capita in PPS rising from around 40% to 60% of the EU average. This robust growth was underpinned predominantly by improvements in competitiveness at the beginning of the period. However, an externally-financed domestic demand boom became progressively the main driver of growth and pro-cyclical fiscal policy further contributed to the overheating of the economy.

The accumulation of internal and external imbalances eventually culminated in a severe crisis. The rapid expansion of the banking sector and high wage growth in excess of productivity gains, especially in 2006 and 2007, fed the build-up of macroeconomic imbalances, including the accumulation of private sector – especially household – debt, stimulated in turn by buoyant private sector credit growth and booming house prices. Lithuania's current account deficit as a share of GDP soared to double-digit levels underpinned by a large merchandise trade deficit and sizeable capital inflows as investors searched for higher returns in a context of low global risk aversion. Lithuania's net foreign asset position deteriorated steadily amid large increases in both assets and liabilities. At the same time, headline HICP inflation accelerated, peaking at 12.2% in 2008, deteriorating competitiveness. Eventually, the sudden reversal in capital flows engendered by the global financial crisis led to a bursting of the housing and credit bubbles. Real GDP contracted by 17% from peak to trough as a collapse in domestic demand was amplified by a slump in global trade.

The Lithuanian economy is recovering following a determined policy response and the global economic upturn since the second half of 2009. The government's commitment to the currency board arrangement, underpinned by substantial fiscal consolidation together with adjustment in private sector wages and measures aimed at strengthening financial system stability, has played a key role in stabilising the economy. The rebound in the global economy, combined with recouped competitiveness, has led to a surge in exports. The rebuilding of inventories after a sharp drop in stocks in 2009 has also helped to support the recovery. The housing market has shown some tentative signs of improvement: the pace of price declines has decelerated markedly and the number of transactions has doubled from the crisis low. The main stock market index has risen by 145% between March 2009 and May 2011.

Most macroeconomic imbalances have adjusted rapidly but unemployment remains high:

- The sizeable correction in the current account reflects large swings in exports and imports on the back of pronounced fluctuations in domestic and external demand. After a deficit of more than 13% of GDP in 2008, the current account recorded a surplus of 4.3% of GDP in 2009 as imports contracted significantly more than exports during the downturn, while net transfers rose sharply at the same time due to frontloading of EU structural funds payments. The current account surplus declined to 1.8% of GDP in 2010 as lower risk premia underpinned renewed capital inflows and the export-led recovery gradually shifted towards domestic demand. This adjustment in the current account balance eased external financing needs despite net capital outflows, which reflected banks' repayments of liabilities to their parent banks. These repayments were partly compensated by government debt issuance. Gross external debt increased slightly to around 88% of GDP in Q3 2010 despite the deleveraging in the private sector.

- Inflation fell rapidly in the crisis, while recent price increases have been driven by external factors. Headline HICP inflation dropped from double-digit rates at the beginning of 2008 and briefly turned negative in Q1 2010 on the back of the collapse in domestic demand. Core inflation declined more markedly, reflecting weak domestic demand, high unemployment and muted wage pressures. However, higher food and energy prices, combined with lagged effects of hikes in excise duties at the end of 2009, have put inflation on an upward trajectory once again.

- The Lithuanian labour market reacted rapidly to the crisis: wages declined quickly and unemployment rose to record highs. Unemployment peaked at 18.3% in Q2 2010 from a low of 4.2% at the beginning of 2008. Youth unemployment soared to nearly 37% by Q2 2010, spurring a pronounced emigration wave. Average gross earnings fell sharply in both private and public sectors, underpinning significant improvement in Lithuania's competitiveness[1]. While wages have resumed their upward trend since spring 2010 as the economic recovery progressively gathered momentum, they remain below their 2009 level.

- The bursting of the domestic bubble and the global economic crisis is weighing heavily on public finances. In the period following EU accession, government finances were supported by strong economic growth and a tax-revenue-rich environment. This was reflected in the relatively small budget deficits recorded between 2004 and 2007 as well as the fall in the government debt ratio. However, this masks remarkable expenditure growth: over 2004-2008, public sector expenditure grew annually in real terms (deflated by the GDP deflator) by around 10% and in nominal terms by nearly 19% on average. A significant tax shortfall and increases in social expenditure resulted in a general government deficit of 9.5% of GDP in 2009, despite fiscal consolidation measures amounting to around 8% of GDP. In 2010, the general government deficit narrowed to 7.1% following an additional fiscal effort of 3.7% of GDP. Consequently, public debt increased to over 38% of GDP in 2010, up from the pre-crisis low of 15.6% of GDP in 2008.

- Action by the Lithuanian authorities safeguarded the financial system. Financial market tensions, already visible in 2007, intensified abruptly in late 2008 and spring 2009 as the

[1] The real effective exchange rates based on unit labour costs (ULC) in the total economy depreciated by 11.8% between Q3 2008 and Q4 2010 vis-à-vis the IC35, and real effective exchange rates based on unit labour costs in manufacturing depreciated by more than 22% vis-à-vis the IC35.

impact of the collapse in the domestic demand boom was amplified by the global financial crisis. Measures aimed at alleviating liquidity shortages and strengthening the banking system, combined with the commitment to preserve the currency board arrangement, have helped to restore market confidence. By mid-March 2011, the spread between the 6-month VILIBOR[2] and EURIBOR[3] rates, an indicator of the domestic funding pressures, had narrowed markedly to around 22 basis points, reaching levels recorded shortly before the start of financial market tensions in summer 2007. The spread between the 10-year Lithuanian and German government bond yields and the 5-year credit default swap (CDS) spread - indicators of the risk premia - have also fallen substantially to around 200 basis points. Furthermore, non-performing loans[4] rose sharply from 1% in 2007 to above 19% of total loans by the end of 2009 and have since stabilised. However, these developments hide large divergences across sectors. The quality of loans to households remains better than those to non-financial corporations. However, the quality of the former has continued to deteriorate, whilst that of the latter has stabilised.

### 2.2. OUTLOOK

Domestic demand is expected to underpin robust growth in both 2011 and 2012. According to the spring 2011 Commission forecast, real GDP is set to expand by 5.0% in 2011 and 4.7% in 2012 as the economic recovery becomes more broadly based and self sustained. Domestic demand is projected to become the main engine of growth, reflecting an upturn in private investment due to a more favourable business outlook and improved credit flows. Further frontloading of EU funds should support public investment, while private consumption is expected to recover amid a brighter outlook for wages and employment. Inflation is likely to accelerate in 2011, driven by higher energy, commodity and food prices. Increased excise duties on tobacco and fuel (from the beginning of 2011) and the expiration of the reduced VAT rate on heating (planned in September 2011) will add to inflation dynamics. The extent of second-round effects, related to the pass-through of higher production costs to consumer prices, remains uncertain. Core inflation is projected to increase slightly over the forecast horizon, albeit from very low levels, as the negative output gap is progressively closed.

The current account balance is expected to turn negative by 2012 as the trade deficit widens further. Export growth is projected to remain robust against the backdrop of a broadly stable outlook for the global economy. However, imports are set to pick-up more strongly on the back of inventory rebuilding and the projected recovery in private consumption and investment. Continuing inflows of EU funds and expected private sector transfers should partly dampen the impact of the rising trade deficit on the current account balance.

The government has reiterated its full commitment to deficit reduction, and revised downwards its general government deficit targets to 5.3% for 2011 and 2.8% for 2012. Such deficit dynamics would help to stabilise public debt at 38% of GDP by 2012.

The balance of risks related to this baseline macroeconomic scenario seems to be tilted to the upside. Positive risks relate to reduced global risk aversion and an improved business outlook might trigger stronger-than-projected capital inflows. Moreover, the deleveraging process

[2] Vilnius Interbank Offered Rate.

[3] Euro Interbank Offered Rate.

[4] NPL are defined as non-impaired loans overdue more than 60 days plus impaired loans (that is loans for which specific provisions were made). Cross-country comparison must take into account Lithuania's relatively strict definition of NPL.

might prove to be less protracted as both household and corporate debt levels remain relatively low compared to other EU Member States or major economies. As the momentum builds up and is sustained, a positive feedback loop between the real and financial sector might emerge, further strengthening output dynamics. On the other hand, downside risks relate to a slow reduction in structural unemployment, difficulties in progressing with the remaining fiscal consolidation as well as higher-than-expected energy prices.

## 3. MONITORING, PROCEDURAL ISSUES AND GOVERNANCE

The Lithuanian Convergence Programme (CP) and the National Reform Programme (NRP) outline in an integrated and coherent manner the fiscal consolidation efforts on the one hand and reforms underpinning macro-economic stabilisation and key structural reforms on the other hand. They were submitted to the European Commission on 28 April 2011 together with the commitments made by Lithuania under the Euro Plus Pact. The NRP was prepared in consultation with the social partners.

Lithuania's targets specified in the NRP in the field of employment, R&D, education, energy and climate change and poverty reduction for 2014 and 2020 set up the long-term development trajectory for the necessary modernisation of the Lithuanian economy and put imminent reform priorities in a broader context.

**Table 1: Lithuanian Europe 2020 targets**

| Europe 2020 targets | Current situation in Lithuania[5] | Lithuanian Europe 2020 target in the NRP |
|---|---|---|
| R&D investment (% of GDP) | 0.84 (2009) | 1.9% |
| Employment rate (%) | 64.4% (2010) | 72.8% |
| Early school leaving (%) | 8.7% (2009) | 9% |
| Tertiary education attainment (%) | 40.6% (2009) | 40% |
| Reduction of number of people in or at risk of poverty or exclusion | 985,000 | -170,000 |
| Energy efficiency – reduction of energy consumption in MToe[6] | 7.9 Mtoe in 2005[7] | Reduction in energy consumption by 1.14 |
| Reduction in greenhouse gas emissions (from sources not covered by the Emission Trading System) | +8%[8] | +15%[9] |
| Renewable energy (% of total energy use) | 16% | 23% |

## 4. POLICY CHALLENGES, AGENDA AND ASSESSMENT OF POLICY AGENDA

### 4.1. CHALLENGES

[5] Eurostat figures.
[6] As estimated by the Commission. Mtoe = Million tonnes of oil equivalent.
[7] As estimated by the Commission Services.
[8] This quantity corresponds to the 2005-2008 evolution of the emissions not covered by the EU Emissions Trading System. As the scope of the Emissions Trading System evolved between 2005 and 2008, these emissions are estimated on the basis of the main relevant UNFCCC source categories (as opposed to the difference between total emissions and EU ETS verified emissions).
[9] The national emissions limitation target defined in Decision 2009/406/EC (or "Effort Sharing Decision") concerns the emissions not covered by the EU Emissions Trading System. It is expressed as the minimum relative decrease (if negative) or the maximum relative increase (if positive) compared to 2005 levels.

Lithuania is facing a set of interrelated policy challenges due to macro-structural bottlenecks to growth, namely:

- *Reducing the high general government structural deficit and improving the long-term sustainability of public finances.* The high general government deficit poses a considerable challenge as Lithuania seeks to reduce it below the 3% threshold by 2012, in line with the Excessive Deficit Procedure deadline. This target is at risk despite an improving macro-economic outlook since a number of consolidation measures will expire at the end of 2011. In view of the required sizeable adjustment, defining further consolidation measures and securing the necessary co-financing in order to frontload the absorption of EU structural funds and increase productive investment into economy could prove challenging. Improvements in public sector efficiency could create additional room for expenditure adjustments without compromising the quality of public services. Fiscal consolidation would be complemented by further structural reforms to the social security and pension system, and state-owned enterprises. Looking further ahead, ensuring the sustainability of public finances is also a key challenge as the long-term budgetary impact of an ageing population is slightly above the EU average. This is mainly due to the projected increase in pension expenditure.

- *Avoiding recurrence of economic and financial imbalances as the economic growth resumes.* Most macro-economic imbalances that emerged during the boom years were corrected during the ensuing downturn. However, the extent to which this unwinding is cyclical or structural in nature is still unclear. This calls for close monitoring of capital flows, credit flows, asset prices and balance sheets in the coming period if a recurrence of economic and financial imbalances is to be avoided as economic growth resumes.

- *Rebalancing the economy towards a stronger external sector* so as to reduce the reliance on internal demand as an engine for growth and re-equilibrate the trade accounts. This will require further investment in both physical and human capital as well as implementation of policies that ensure access to finance for viable businesses.

- *More competition in energy markets.* In common with the other Baltic States, Lithuania is isolated from EU electricity and gas markets in terms of both physical interconnection and market organisation. However, work is underway to remedy this. Completion of these projects would help to address concerns over security of energy supplies, and support greater competition in electricity generation. The implementation of the Third Package of EU electricity and gas market legislation would complement this.

- *Energy tax rates, including those for the registration and ownership of transport vehicles, which encourage a more efficient energy use,* while also supporting fiscal consolidation in the short-term. Despite progress in recent years, Lithuania’s energy use per unit of output is more than twice the EU average.

- *Avoiding risks of high unemployment becoming structural* requires better matching in the labour market and more efficient reallocation of labour to expanding sectors. Enhancing labour market activation policies and removing disincentives to work could lead to resumed employment growth, while addressing the gaps between current skills and future needs could prevent jobseekers from withdrawing from the labour force and could increase productivity.

- *Improving the business environment* would underpin the necessary rebalancing of the economy: According to the "Ease of doing business" index, Lithuania ranks 23 out of 183 surveyed economies in 2011. However, it scores relatively poorly in three specific areas, namely start-up conditions, delivery of construction permits and protection of investors, warranting improvements to business regulations in these domains. In particular, significant administrative burdens result from inefficient procedures and fragmentation of public authorities in the areas of licensing and business inspections. Moreover, there are indications that progress with reforms in competition policy is relatively slow. In particular, food retail and energy sectors show insufficient levels of competition. There is also evidence of SME's constrained access to finance, while there remains untapped potential in the use of EU financial engineering instruments. Finally, successful reform of state-owned enterprises would also contribute to enhancing competition and the business environment. In 2010 Lithuania began a reform in five major sectors. While the Government's Resolution on Improvement of Efficiency in December 2010 provided a further credible framework for the reform, it lacks a number of key measures which would have ensured the separation of regulatory and ownership functions.

- *Prioritising and further focusing investments in research and innovation* is necessary to increase Lithuania's long term economic competitiveness and secure high-quality jobs. While continuing to support current reforms of the science and technology base, public budget to research and innovation could be further concentrated on a limited number of scientific and technological domains, research infrastructures and research centres where Lithuania has strengths identified by international benchmarking that can attract talents and business activities.

**Box 1: Lithuania's Commitments under the Euro Plus Pact (EPP)**

To meet the objectives of the Euro Plus Pact, Lithuania plans to implement the following actions in 2011:

*a. Foster competitiveness*

1. Reduce the administrative burden and reform of business-inspecting institutions;
2. Restructure of electricity and natural gas sectors in line with the Third EU Energy Package;
3. Enhance transparency of the public procurement system;
4. Implement the "Innovation Voucher" scheme, support incubation activities, foster protection of industrial property rights and promote of clustering process;
5. Achieve further consolidation in the higher-education network;
6. Implement measures to improve the quality of higher-education studies;
7. Unify labour remuneration terms for employees performing work of the same complexity and requiring the same qualification in different entities funded by the State.

*b. Foster employment*

1. Increase labour participation by: 1) providing incentives for employers to employ young people; 2) promoting self-employment of the unemployed through compensation of the expenses related to business certificate acquisition and starting business; paying subsidies in case such a person provides a job for another unemployed person; 3) reforming the planning of vocational training for unemployed (this would require a tripartite agreement based on a voucher scheme, allowing the job seekers to choose the form, time and place of training);

2. Draft a Law on Illegal Work Prohibition and make respective amendments to the Code of Administrative Offenses and the Criminal Code foreseeing sanctions both employers and employees. Oblige employers to inform the Social Insurance fund no later that one day after the commencement of employment;
3. Draft amendments to legal acts governing employment relations to provide conditions for flexible employment agreements and flexible working hour arrangements;
4. Install a system for long-term qualification demand forecasting;
5. Develop a set of entrepreneurship promotion measures.

*c. Contribute further to the sustainability of public finances*

1. Adopt laws facilitating accumulation of funds in the State Treasury reserve for the times of economic difficulties and promote a responsible anti-inflationary budgetary policy;
2. Ensure sustainability and adequacy of pensions and social benefits by: 1) gradually increasing retirement age; 2) reviewing the calculation of State Social insurance schemes 3) In Q2 2012, optimising the accounting funds within the budget of the State Social Insurance Fund (SSIF) and restructuring of the SSIF administration;
3. Optimise the healthcare network and restructure the system of healthcare institutions;
4. Define short-term operational objectives and targets for the State-Owned Enterprises.

## 4.2. ASSESSMENT OF THE POLICY AGENDA

### 4.2.1 Macroeconomic policies

#### 4.2.1.1 Public finances

According to the macro economic scenario underpinning the budgetary projections in the April 2011 Convergence Programme, real GDP growth is expected to sharply accelerate in 2011 before gradually easing over the remaining part of the forecast horizon. This strong economic recovery is driven by domestic demand following an upturn in investment and consumption. In 2012, some deceleration in output dynamics is projected stemming from the rise in trade balance deficit, while from 2013 onwards, it is due to the softening domestic demand growth. The labour market is expected to noticeably improve, with the unemployment rate declining from nearly 18% in 2010 to less than 8.0% by 2014.

The Lithuanian authorities' projections for real GDP growth are broadly consistent with the latest Commission services forecast for 2011 and 2012. The national projections are significantly above the AWG estimates of potential output under "lost decade scenario" for 2013 and 2014 as the large output gap is expected to be closing. As to the composition of growth, the authorities are more upbeat on private consumption and gross fixed capital formation on the back of a stronger rebound in demand for Lithuanian exports. While the average growth rate of around 3.5% of GDP envisaged for the final two programme years appears plausible, the composition of growth is less so, in particular as regards the sharp reversal in the contribution of net exports to growth for this phase of the cycle. The output gaps as recalculated by Commission services' based on the information in the programme, following the commonly agreed methodology point to the faster output gap closure than estimated in the Convergence Programme[10]. This reflects Commission's lower potential output growth estimates driven by a strong negative contribution from the labour component.

[10] The recalculated output gaps in the Commission services forecasts point to the output gap closure by 2012, while the Convergence Programme projects the output gap to close by 2014.

The budgetary outturn in 2010 was better than the government's deficit target of 8.1% of GDP, with the general government deficit reaching 7.1% of GDP. This reflects predominantly higher-than-expected output growth and revenues, while government continued, though to a lesser extent than in 2009, its consolidation efforts on the expenditure side. In particular, the government extended some temporary expenditure-reducing measures, such as cuts in wages salaries for politicians, lawyers and government officials. It also prolonged the reduction of transfers of contributions to the second pillar pension funds. Moreover, maternity benefits were reduced and a part of the sickness leave benefits were to be permanently paid by the employers rather than the Social Security Fund. However, some other expenditure items, including interest payments, healthcare spending, capital expenditure and social benefits increased in 2010.

**Box 2. Main budgetary measures**

| **Revenue** | **Expenditure** |
|---|---|
| **2011** | |
| • Excise tax increases on diesel and tobacco, (0.1% of GDP)<br>• Improvement in tax compliance (impact not specified) | • Meternity/parental benefits' cuts (0.1% of GDP)<br>• Prolongation of pension cuts (0.6% of GDP)<br>• Extension of reduced wages for state politicians, judges, officials and civil servants (0.5% of GDP)<br>• Prolongation of the reduced general sickness leave payments (savings - up to LTL 78 million, or 0.1% of GDP) |
| **2012** | |
| • Improvement in tax compliance (impact not specified) | • Maternity/parental benefits' cuts (0.2% of GDP) |

On the back of an improved macro-economic forecast underlying the 2011 Convergence Programme, the government reduced its deficit targets to 5.3% of GDP in 2011 and 2.8% in 2012. This is in line with the deadline set by the Council to reduce the deficit below the 3% reference value by 2012. To meet these targets, the government relies on strong revenue growth, partly due to better tax compliance, and some increases in non-tax revenue, which mainly relate to a higher inflow of EU structural funds. However, additional tax revenues, expected in the Tax Compliance Strategy are uncertain and are likely to materialise only gradually. In January 2011 excise duties on tobacco and fuel were increased according to EU legislation. Personal income tax for the self-employed was reduced from 15% to 5% as of 2011. The 2011 budget foresees a 4.6% increase in government expenditures compared to the 2010 budget due to higher debt service costs and increased social expenditure. According to the three-year investment programme, general government investment is planned to slightly decrease in 2011, before resuming in 2012.

The Commission Spring 2011 forecast projects a general government deficit of 5.5% for 2011. This compares to the target of 5.8% of GDP specified in the 2010 Convergence Programme. This difference stems predominantly from a better-than-expected starting position at the end of 2010. However, under customary no-policy change scenario, the

Commission services project the general government deficit to decline to 4.8% in 2012 despite stronger growth as a number of temporary consolidation measures expire. Hence, additional measures will need to be adopted to ensure that the 2012 EDP target is met. As such, the average annual fiscal effort over the period of 2010-2012 is substantially below the 2¼ % of GDP recommended by the Council under the EDP procedure on 16 February 2010.

The envisaged correction of the excessive deficit situation in the convergence programme is back loaded as the structural balance is projected to improve by 1.3 p.p. of GDP in 2011 and 1.9 p.p. of GDP in 2012. The fiscal consolidation path provided in the programme relies on a reduction of primary expenditure by over 8% of GDP over the period between 2010 and 2014; however, the reduction of primary expenditure up to 2012 is limited to 1.2% of GDP. The programme update provides only limited information regarding envisaged consolidation measures to support this consolidation path (see Box 2), while these measures are expected to be spelled out in detail in forthcoming budgets. Achievement of the 2012 budgetary target is based on strongly improving cyclical conditions, as evidenced by the recalculated output gap closure by 2012. The structural deficit, as recalculated by the Commission services based on the information in the programme according to the commonly agreed methodology, slightly narrows in 2011, but does not improve in 2012.

The medium-term objective of a structural surplus of 0.5% of GDP, unchanged from the previous programme, is not foreseen to be achieved within the programme period. When assessed against the projected rate of medium term potential output, the 2012 expenditure projections seem not to ensure an appropriate adjustment path towards the MTO.

The general government debt increased substantially during the crisis and reached 38.2% of GDP by the end of 2010. The debt-to-GDP ratio is projected to decline over the programme period, reaching 35.4% of GDP in 2014. This compares to a slightly upward sloping path projected in the spring 2011 Commission forecast. The structure of the general government debt, consisting predominantly of long-term liabilities, does not present immediate risks to government's borrowing ability.

Lithuania is at high risk with regard to the long-term sustainability of public finances. The long-term cost of ageing is above the EU average and the current budgetary position compounds the cost of ageing. Based on the current fiscal position, debt would increase to 69% of GDP by 2020. However, the full implementation of the programme would be enough to put debt on a downward sloping path by 2020. Ensuring sufficient primary surpluses over the medium-term would improve the sustainability of public finances.

The sustainability of the Lithuanian pension system is at risk as age-related expenditure is estimated to increase substantially mainly as a result of unfavourable demographics (by 6.0% of GDP between 2010 and 2060 in absence of reform, with 4.9% of GDP due to increases in pension expenditure). The relatively generous social system is not matched by the current tax structure. In addition, the adequacy of pensions remains insufficient and fiscal disincentives for working at pensionable age[11] contribute to the high at-risk-of-poverty amongst pensioners. The NRP announces a range of reforms including plans to gradually raise the retirement age to 65 by 2026 starting from 2012 (final voting in the Parliament postponed to June 2011), reviewing early retirement schemes (adding financial disincentives for early retirement and awarding late retirement) and measures to improve older worker participation in lifelong learning .

[11] Currently working pensioners lose the right to getting full pension if they receive additional revenues.

Lithuania made progress in 2010, when the Government adopted the Concept of a Comprehensive Social Security and Pension Reform. This is a welcome first step which would benefit from the adoption of the necessary legal changes to launch the actual reform. This would be complemented by a revised active ageing strategy, which expires in 2013, so that measures to ensure longer working careers are in place.

#### 4.2.1.2 Financial sector

In 2009, financial sector assets represented nearly 100% of GDP. The banking and non-banking[12] sectors accounted for four fifths and one fifth of total financial assets respectively. Lithuania's banking sector is relatively concentrated, with the three largest banks controlling more than 60% of the banking system assets.

The banking system was severely hit by the financial crisis, though it successfully absorbed adverse economic shocks thanks to determined policy action by the Lithuanian authorities and support from parent foreign banks. While bank profitability collapsed in 2009 amid a rise in credit losses and shrinking net interest rate income, banks slowly returned to profitability over 2010 as the Lithuanian economy recovered and global financial conditions improved markedly. Recent capital increases should further contribute to enhance stability of the banking system. At the same time, market regulators should remain proactive to ensure proper provisioning and capitalization in all institutions.

Given the high presence of Scandinavian banking groups in the Baltic States, the ministries of finance, central banks and financial supervisory authorities in Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden signed a Memorandum of Understanding (MoU) on financial stability, crisis management and crisis resolution in August 2010. This MoU strengthens the preparedness for dealing with cross-border financial stability issues in the Nordic-Baltic region. The Parties recognised that they have common financial stability concerns stemming from potential systemic inter-linkages between their respective countries, justifying enhanced cooperation in financial crisis prevention, management and resolution.

### 4.2.2 Labour market policies

**Getting the unemployed back to work**

The economic downturn has had a sizeable negative effect on the labour market, adding to its structural weakness through skills mismatches. In the short term, despite the economic recovery, active labour market policies remain essential both to address these skill mismatches and to ensure that unemployment does not become structural[13]. This demands a sufficient level of financing and effective design to ensure the efficiency of Active labour market measures, which currently cover only about 20% of the unemployed.

In 2010 the government devoted EUR 1.6 billion (about 6% of GDP) to job support schemes, partly financed by the EU funds. This included measures to stimulate labour demand (via the reduction in employer's social security contributions for those hiring young employees), public work programmes, incentives for hiring young people without work experience, and

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[12] The non-banking system comprises credit unions, Central Credit Union, leasing companies that are members of the Lithuanian Leasing Association, insurance companies, capital market participants and pension funds. Leasing companies are by far the largest holder of financial assets within the non-banking system.

[13] Long-term unemployment accounted for more than 42% of the total unemployment in Q3 2010, up from the pre-crisis low of 16.9% in Q2 2008.

supporting job creation through new micro-credit measure for business start-ups. Further measures introduced include support for youth employment, reductions in the costs of acquisition of business certificates, compensation for social insurance contributions for the unemployed who wish to self-employed. To facilitate short-term employment, Lithuanian government has recently adopted the Law on Temporary Employment Agencies.

**Balancing security and flexibility**

Lithuania's "Employment Protection Legislation" index is close to the EU average, although the legislation's enforcement is rather weak. A range of indicators from the "Ease of Doing Business" published by the World Bank, point towards rigidities in the area of employing workers. For example less than 2% of employment is under a fixed-term contract. This suggests a benefit from more flexible labour legislation, especially with regard to both hiring and dismissal conditions and from providing opportunities for short-term work.

The 2009 reform of the Labour code helped to remove restrictions on flexible work arrangements and reduced the monetary hurdles to labour shedding such as redundancy, paid leave and severance pay. However, these amendments expired at the end of 2010. In 2010 further changes to the Labour Code were made to provide more opportunities for using fixed-term contracts for newly established vacancies. However, these amendments will also expire in August 2012.

**Making work more attractive**

The wage determination process in Lithuania is rather flexible, with private sector wages usually set at firm level. The tax wedge lies at around the EU average, although there is a high tax wedge on the low paid[14]. Unemployment traps are high for low-wage earners, but benefits are both limited in coverage and of a low level. Reform of the social assistance system to remove disincentives to work would help tackle these traps. Possible solutions include targeted active labour market policy measures for those receiving social assistance, the introduction of in-work benefits, gradual phasing out of social assistance when moving from unemployment to employment and increasing the amount of income that remains untaxed.

**Combating poverty and promoting social inclusion**

Prior to the economic crisis social benefits were significantly revised upwards. This resulted in sizable increases in expenditure on social protection during the crisis as unemployment rose sharply. Despite this, at-risk-of-poverty and material deprivation rates remain well above the EU average suggesting that these increased benefits have not effectively helped redistribute income to the needy. In 2009, close to 30% of the population were at-risk-of-poverty or social exclusion, with the unemployed, single adults (with or without dependent children), families with three or more children, and the retired being particularly vulnerable. The ongoing Social Security System reform should help tackle these inefficiencies, and a focus on labour market inclusion measures would complement this by reducing the general risk of poverty.

**Labour supply and skill mismatches**

In order to achieve the employment target of 72.8% by 2020, the long-term challenges include increasing labour supply by raising the retirement age, ensuring that the labour force has adequate skills, implementing targeted measures for the disadvantaged groups and facilitating return to work after childcare. A well-designed and accessible lifelong learning system would

[14] Lithuania ranks 6th among the EU Member States as regards marginal effective tax rate on low wage earners.

help to contain the negative trends in adult life long learning[15] and encourage occupational mobility. This requires sufficient incentives to upgrade the skills, with one possible means being the introduction of training voucher system for workers, especially targeted at the low skilled and older workers. The new forecasting tools for labour demand will help to better match qualifications required the market. Regarding the availability of affordable childcare, Lithuania recently set the legal basis for the right to childcare from birth, simplified conditions for setting up and running of private childcare services, and introduced a money-follows-child principle of financing in the pre-school care. Further reform making maternity/parental benefits more flexible would complement these measures.

**Assessment of the policy response**

The NRP itself set out measures aimed at increasing the employment rate and reducing social exclusion, focusing on four areas: i) to increase labour participation; ii) to make work more attractive; iii) to get the unemployed back to work; iv) to balance security and flexibility. These include the adoption of the Law on Temporary Employment Agencies, tax measures to promote self employment, a revision of the tax-benefit system to strengthen activation, the introduction of a forecasting system for labour force qualifications, and the continuation of tertiary and secondary education reform. The latter could be complemented with similar reforms in the areas of vocational education and training.

Lithuania’s immediate labour market challenges require sufficient financing of the active labour market policies, removing disincentives to work and reducing employment protection legislation rigidities (in the context of a flexicurity-based approach). In the medium to longer-term Lithuania faces an important labour supply and skill challenge. Measures to increase labour supply by raising the retirement age and removing fiscal disincentives to work for people at or approaching pensionable age, and implementing targeted measures for the disadvantaged groups, would contribute to achieving the 72.8% employment rate.

### 4.3. GROWTH-ENHANCING STRUCTURAL MEASURES

**The Business Environment and Competition**

The government reform programme regarding the improvement of business environment rests on four pillars: Licensing reform (covering the Services Directive); Reform of the Business Inspectorate institutions[16]; reducing administrative burdens in priority sectors; and strengthening the enforcement of competition policy by enhancing the powers of the Competition Council.

There are indications that progress with reforms in the competition area is slow. The food retail sector shows insufficient level of competition, due partly to its structure and inefficiencies in market regulation. Concentration in the food retail chains has been on an upward trend, with the share of the four largest retailers reaching 72% of the total sales in 2008. While offering efficiency gains through economies of scale, this may have reduced the bargaining power along the food supply chain. Moreover, consumer prices showed a limited and lagged decrease despite protracted and marked declines in food producers' prices and agricultural commodity prices over the period mid-2008-2009. In an effort to address this, in 2009 the Lithuanian authorities passed a law on prohibition of unfair operations of retail trade

[15] Participation in lifelong learning in Lithuania is very low (4.5% in Lithuania, 13.8% in the EU in 2009), with rates extremely low for the low-skilled (3.2%) and older workers (1.9% of 45-54 year olds).

[16] The reform of the Business Inspectorate institutions foresees the integration of the institutions into 9 clusters, coordinated and publicized inspection plans and an increase in the share of planned inspections.

undertakings to ensure more balances bargaining power between wholesale and retail. The Competition Council has conducted a cartel investigation in several subsectors and imposed fines in the milk sector in 2009.

In common with the other Baltic States, Lithuania is isolated from EU electricity and gas markets. However, the revised national energy independence strategy, in the context of the Baltic Energy Market Interconnection Plan, foresees substantial development of grid and generation infrastructure (in particular the LitPolLink, NordBalt, Visaginas NPP, LNG terminal projects) hence integrating the three Baltic States with Continental Europe. Lithuania also aims at unbundling the gas sector ownership, creating a regional gas market and diversifying its gas supply. Completion of these projects will help to address concerns over security of energy supplies, and could also support greater competition in electricity generation. Further progress on structural reforms in the energy market could be made through implementation of the Third Package of EU electricity and gas market legislation.

There is ample room to boost competition and to promote a more level playing field in Lithuania's public sector enterprises. Lithuanian State-Owned Enterprises (SOE's) represent over LTL 18 billion of commercial assets (about 18% of GDP), and are prone to inefficiencies and unsatisfactory financial returns well below the European average. One major reason for these inefficiencies is an inadequate governance system whereby a particular ministry acts both as an owner of a specific asset and as a regulator for the sector, thus creating a conflict of interest. In 2010 Lithuania embarked on an ambitious reform of its State-Owned assets in five major sectors (energy, forestry, real estate, transport and others) aiming at reforming corporate governance, increasing transparency and separating ownership and regulatory functions. The first step taken in June 2010 was the approval of Transparency guidelines for SOEs, which provide a basis for government accountability and limit the opportunity for self-serving policies. The Government's Resolution on Improvement of Efficiency of SOEs adopted in December 2010 is a more detailed and credible framework for the reform. Nevertheless, The Resolution does not contain some key measures initially proposed, ensuring separation of regulatory and ownership functions. The publication of the first Quarterly Review and the second Annual Review of the sector (both to be published in 2011) will form the next important step in implementing the strategy. The government intends to analyse the social and commercial functions of SOEs and prepare further governance reforms.

Lithuania has adopted the horizontal law transposing the Services Directive and introduced a number of changes to sector-specific legislation. However, concerns remain on the completeness of the transposition, and Lithuania should ensure the adoption of all the required changes to legislation as a matter of urgency. Lithuania has also set up a single point of contact (www.verslovartai.lt), offering the possibility to complete online some of the most important procedures, but which does not yet cover all aspects foreseen by the Services Directive.

**Climate and Energy**

Despite improvements in recent years, Lithuania has a high level of energy intensity with a level that remains more than twice the average of EU. This is to a considerable extent related to household heating where poorly maintained multi-apartment buildings count for the bulk of the problem. Adopted in 2004, the Lithuanian Housing Strategy set a number of aims to be reached by 2020. Currently the main vehicle for this is the JESSICA Holding Fund established in 2009, containing EUR 227 million (EUR 127 from the ERDF). However, to date, few projects have been approved for funding and very few actual investments have been made. In comparison to 2009, Lithuania plans to reduce final energy consumption by 17% by

2020, hence achieving 1.14 Mtoe of primary energy savings. About two thirds of savings are expected to be generated in the households and transport sectors. Accelerating investment in thermal renovation of buildings as well as improvement of the overall efficiency of district heating would help to reduce household energy consumption. Significant primary energy savings could also be achieved through ensuring efficient recovery of waste heat from industry as well as existing and planned new power generation.

In spite of the influence of the economic crisis, the recent evolution of the greenhouse gas emissions does not appear in line with the 2020 national target defined at the European level (+15% compared to 2005 levels). Additional emissions reduction measures and/or the use of flexibility mechanisms would be needed. Particular attention could be paid to the road transportation sector given its weight in the national emissions and its current trend.

Levels of car ownership have increased rapidly to approach the EU average, while revenues from energy and transport taxes have fallen relative to GDP and to taxes on labour. Increasing energy tax rates, including those for registration and ownership of transport vehicles, would support fiscal consolidation in the short-term, while also incentivising more efficient energy use. In the sectors not covered by the EU emissions trading scheme (mostly transport, agriculture and services), national data show that the current emissions trend is not compatible with the 2020 emissions limitation target agreed under the Climate and Energy package.

**Research and Innovation**

Over recent years Lithuania has conducted a large set of reforms of its science base, including addressing the autonomy and new governance of universities, a reorganisation of the network of public research institutions, an increase in the share of competitive funding and of performance-based institutional funding, and the creation and development of five clusters (called "Valleys") integrating higher-education institutions, research institutions and businesses in identified scientific and technology areas. While these reforms will help to strengthen Lithuania's innovation and research capacity, they are not always accompanied by sustained private investment. While in 2009 public sector expenditure on R&D in Lithuania amounted close to the European average of 0.64%, private sector expenditure on R&D amounted to only 0.2% of GDP (EU average 1.21 %). Hence, increasing the R&D capacity and creating an innovation culture in the private sector would appear to be a key element in future reforms. The success of the reforms also crucially rests on the development of an innovation culture and entrepreneurial skills and ensuring appropriate incentives and training for researchers. To this end, a considerable amount of Structural Funds may need to be directed to R&D after 2013 to avoid a strong decline in funding. The success of these reforms may rely on ensuring a focus on "smart specialisation" to ensure the public R&I budget concentrates on a limited number of scientific and technological domains, research infrastructures and research centres where Lithuania has strengths identified by international benchmarking.

## 5. SUMMARY

The Lithuanian economy is recovering at a rapid pace from a deep recession as strong export dynamics is spurring investment and consumption. However, the general government deficit is projected to remain sizeable despite the better than-expected budgetary outturn in 2010. Additional consolidation measures seem important in order to bring the general government deficit below the EDP target of 3.0% of GDP by 2012 and progress towards the medium-term budgetary objective. The planned adjustment strategy strongly relies on improved tax compliance and stronger revenue growth amid the brighter macro-economic outlook. The government's efforts in fighting the shadow economy are welcome, although experience in other countries suggests that the resulting tax revenue gains are subject to high uncertainty and tend to materialize only gradually. The improved growth outlook may lead to difficulties for the necessary fiscal adjustment.

Structural reforms outlined in the NRP should help to create conditions for more sustainable growth. The main challenges ahead include enabling a shift of the economy towards the tradable sectors, tackling labour market mismatches, ensuring that unemployment does not become structural, and creating a healthy business environment that helps generate competition, something that would be aided the implementation of the Services Directive. Planned and ongoing reforms aim at improving energy interconnections, reducing the administrative burden and supporting innovation and research that concentrates investment on a limited number of scientific and technological domains should all contribute to an improved business environment and competitiveness.

# Annexes

## STATISTICAL ANNEX

### Table I. Macro-economic indicators

| | 1995-1999 | 2000-2004 | 2005-2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|
| **Core indicators** | | | | | | | |
| GDP growth rate | 4,5 | 6,9 | 7,1 | -14,7 | 1,3 | 5,0 | 4,7 |
| Output gap [1] | -5,5 | -0,9 | 7,3 | -8,9 | -7,5 | -2,9 | 0,1 |
| HICP (annual % change) | 10,5 | 0,6 | 5,8 | 4,2 | 1,2 | 3,2 | 2,4 |
| Domestic demand (annual % change) [2] | 7,0 | 7,8 | 8,5 | -24,6 | 1,8 | 5,6 | 5,4 |
| Unemployment rate (% of labour force) [3] | 9,6 | 14,1 | 6,0 | 13,7 | 17,8 | 15,5 | 12,7 |
| Gross fixed capital formation (% of GDP) | 21,8 | 20,5 | 25,4 | 17,1 | 16,1 | 17,6 | 19,3 |
| Gross national saving (% of GDP) | 12,8 | 14,7 | 15,6 | 13,3 | 17,3 | 18,5 | 19,4 |
| **General Government (% of GDP)** | | | | | | | |
| **Net lending (+) or net borrowing (-)** | **-4,5** | **-2,3** | **-1,3** | **-9,5** | **-7,1** | **-5,5** | **-4,8** |
| **Gross debt** | **16,0** | **21,9** | **17,2** | **29,5** | **38,2** | **40,7** | **43,6** |
| **Net financial assets** | **35,5** | **11,7** | **10,5** | **-0,7** | **n.a** | **n.a** | **n.a** |
| Total revenue | 35,6 | 33,1 | 33,5 | 34,5 | 34,2 | 33,5 | 33,5 |
| Total expenditure | 40,1 | 35,4 | 34,8 | 44,0 | 41,2 | 39,0 | 38,3 |
| *of which: Interest* | 0,9 | 1,4 | 0,7 | 1,3 | 1,8 | 2,0 | 2,0 |
| **Corporations (% of GDP)** | | | | | | | |
| **Net lending (+) or net borrowing (-)** | **-6,4** | **-2,9** | **-4,9** | **13,4** | **n.a** | **n.a** | **n.a** |
| **Net financial assets; non-financial corporations** | **-88,9** | **-87,0** | **-97,1** | **-106,9** | **n.a** | **n.a** | **n.a** |
| **Net financial assets; financial corporations** | **-2,4** | **-1,5** | **-1,1** | **2,0** | **n.a** | **n.a** | **n.a** |
| Gross capital formation | 16,3 | 14,0 | 18,6 | 3,5 | n.a | n.a | n.a |
| Gross operating surplus | 23,8 | 31,3 | 33,5 | 31,3 | n.a | n.a | n.a |
| **Households and NPISH (% of GDP)** | | | | | | | |
| **Net lending (+) or net borrowing (-)** | **0,8** | **-0,5** | **-3,6** | **2,8** | **n.a** | **n.a** | **n.a** |
| **Net financial assets** | **37,1** | **41,3** | **35,4** | **39,2** | **n.a** | **n.a** | **n.a** |
| Gross wages and salaries | 31,2 | 31,4 | 34,2 | 34,7 | n.a | n.a | n.a |
| Net property income | 10,1 | 17,3 | 13,0 | 16,5 | n.a | n.a | n.a |
| Current transfers received | 10,7 | 11,5 | 13,0 | 19,6 | n.a | n.a | n.a |
| Gross saving | 1,8 | 2,8 | -0,8 | 5,8 | n.a | n.a | n.a |
| **Rest of the world (% of GDP)** | | | | | | | |
| **Net lending (+) or net borrowing (-)** | **-10,1** | **-5,7** | **-9,8** | **7,0** | **5,3** | **3,9** | **2,9** |
| **Net financial assets** | **19,4** | **36,0** | **52,7** | **67,4** | **n.a** | **n.a** | **n.a** |
| Net exports of goods and services | -10,3 | -6,1 | -10,6 | -1,4 | -0,9 | -1,4 | -1,9 |
| Net primary income from the rest of the world | -1,5 | -1,7 | -2,8 | 1,9 | -1,5 | -1,9 | -2,1 |
| Net capital transactions | -0,1 | 0,3 | 1,6 | 4,4 | 3,9 | 3,7 | 3,6 |
| Tradable sector | 53,2 | 54,8 | 52,6 | 50,4 | 53,1 | n.a | n.a |
| Non tradable sector | 35,3 | 34,5 | 37,4 | 39,7 | 36,6 | n.a | n.a |
| *of which: Building and construction sector* | 6,6 | 5,8 | 8,2 | 5,8 | 5,1 | n.a | n.a |
| Real effective exchange rate (index, 2000=100) | 82,4 | 103,1 | 123,3 | 128,0 | 116,9 | 116,6 | 119,7 |
| Terms of trade goods and services (index, 2000=100) | 90,6 | 101,6 | 108,2 | 105,7 | 107,4 | 107,8 | 107,9 |
| Market performance of exports (index, 2000=100) | 120,3 | 125,3 | 146,4 | 167,2 | 177,6 | 183,8 | 185,1 |

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2000 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

*Source* :

*Commission services' spring 2011 forecast*

## Table II. Macro economic scenario for the budgetary projections

| | 2010 | | 2011 | | 2012 | | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|
| | COM | CP | COM | CP | COM | CP | CP | CP |
| Real GDP (% change) | 1.3 | 1.3 | 5.0 | 5.8 | 4.7 | 4.7 | 3.7 | 3.4 |
| Private consumption (% change) | -4.5 | -4.1 | 3.3 | 3.8 | 3.9 | 5.3 | 4.6 | 3.6 |
| Gross fixed capital formation (% change) | 0.0 | 0.0 | 16.9 | 18.1 | 13.8 | 15.1 | 6.7 | -0.5 |
| Exports of goods and services (% change) | 17.4 | 16.3 | 11.2 | 12.5 | 7.1 | 10.6 | 10.0 | 7.9 |
| Imports of goods and services (% change) | 17.9 | 17.6 | 12.0 | 12.8 | 8.0 | 13.0 | 11.5 | 7.4 |
| *Contributions to real GDP growth:* | | | | | | | | |
| - Final domestic demand | -3.8 | 2.3 | 4.9 | 6.2 | 5.5 | 6.7 | 5.2 | 3.2 |
| - Change in inventories | 5.7 | n.a. | 0.7 | n.a. | 0.0 | n.a. | n.a. | n.a. |
| - Net exports | -0.5 | -1.0 | -0.7 | -0.4 | -0.8 | -2.0 | -1.5 | 0.2 |
| Output gap[1] | -7.5 | -8.2 | -2.9 | -4.3 | 0.1 | -2.0 | -0.8 | 0.4 |
| Employment (% change) | -5.1 | -5.1 | 2.1 | 3.4 | 2.8 | 2.6 | 0.9 | 0.5 |
| Unemployment rate (%) | 17.8 | n.a. | 15.5 | 14.9 | 12.7 | 11.5 | 9.3 | 7.8 |
| Labour productivity (% change) | 6.8 | 6.8 | 2.8 | 2.3 | 1.9 | 2.1 | 2.8 | 2.9 |
| HICP inflation (%) | 1.2 | 1.2 | 3.2 | 3.3 | 2.4 | 3.3 | 3.0 | 3.3 |
| GDP deflator (% change) | 2.1 | 3.1 | 3.3 | 2.9 | 2.9 | 3.2 | 3.4 | 3.5 |
| Comp. of employees (per head, % change) | -1.3 | 0.1 | 3.4 | -0.8 | 5.8 | 6.9 | 5.9 | 9.3 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | 5.3 | 4.5 | 3.9 | 1.4 | 2.9 | 0.5 | 0.0 | 0.7 |

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

*Commission services' spring 2011 forecasts (COM); Convergence programme (CP).*

## Table III. Composition of the budgetary adjustment

| (% of GDP) | 2010 | 2011 | | 2012 | | 2013 | 2014 | Change: 2010-2014 |
|---|---|---|---|---|---|---|---|---|
| | **COM** | **COM** | **CP** | **COM** | **CP** | **CP** | **CP** | **CP** |
| **Revenue** | **34.2** | **33.5** | **33.9** | **33.5** | **37.4** | **33.9** | **32.6** | **-1.6** |
| *of which:* | | | | | | | | |
| - Taxes on production and imports | 11.8 | 11.7 | 11.9 | 11.7 | 12.9 | 12.4 | 12.4 | 0.6 |
| - Current taxes on income, wealth, etc. | 4.7 | 4.8 | 4.7 | 4.9 | 5.3 | 5.5 | 5.5 | 0.8 |
| - Social contributions | 10.8 | 10.6 | 9.9 | 10.6 | 9.9 | 9.8 | 10.0 | -0.8 |
| - Other (residual) | 6.8 | 6.4 | 7.4 | 6.2 | 9.3 | 6.2 | 4.7 | -2.1 |
| **Expenditure** | **41.2** | **39.0** | **39.2** | **38.3** | **40.2** | **35.7** | **33.4** | **-7.8** |
| *of which:* | | | | | | | | |
| - Primary expenditure | 39.4 | 37.0 | 37.2 | 36.3 | 38.2 | 33.7 | 31.4 | -8.0 |
| *of which:* | | | | | | | | |
| Compensation of employees | 11.1 | 10.4 | 10.5 | 10.0 | 9.7 | 10.1 | 10.5 | -0.6 |
| Intermediate consumption | 6.6 | 6.4 | 5.5 | 6.3 | 5.4 | 5.5 | 5.6 | -1.0 |
| Social payments | 15.0 | 13.8 | 13.9 | 13.7 | 13.7 | 12.6 | 11.8 | -3.2 |
| Subsidies | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.4 | 0.4 | -0.1 |
| Gross fixed capital formation | 4.6 | 4.2 | 4.8 | 3.9 | 6.0 | 3.3 | 1.5 | -3.1 |
| Other (residual) | 1.6 | 1.7 | 2.0 | 1.9 | 2.5 | 1.5 | 1.2 | -0.4 |
| - Interest expenditure | 1.8 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 0.2 |
| **General government balance (GGB)** | **-7.1** | **-5.5** | **-5.3** | **-4.8** | **-2.8** | **-1.8** | **-0.8** | **6.3** |
| **Primary balance** | **-5.3** | **-3.5** | **-3.3** | **-2.8** | **-0.8** | **0.2** | **1.2** | **6.5** |
| One-off and other temporary measures | 0.6 | 0.6 | 0.3 | 0.5 | 0.3 | 0.3 | 0.5 | -0.1 |
| **GGB excl. one-offs** | **-7.7** | **-6.1** | **-5.6** | **-5.4** | **-3.1** | **-2.1** | **-1.3** | **6.4** |
| Output gap[2] | -7.5 | -2.9 | -4.3 | 0.1 | -2.0 | -0.8 | 0.4 | 7.9 |
| Cyclically-adjusted balance[2] | -5.1 | -4.7 | -4.1 | -4.8 | -2.3 | -1.6 | -0.9 | 4.2 |
| **Structural balance[3]** | **-5.7** | **-5.3** | **-4.4** | **-5.4** | **-2.6** | **-1.9** | **-1.4** | **4.3** |
| *Change in structural balance* | | *0.4* | *1.3* | *-0.1* | *1.9* | *0.7* | *0.5* | |
| Structural primary balance[3] | -3.9 | -3.3 | -2.4 | -3.4 | -0.6 | 0.1 | 0.6 | 4.5 |
| *Change in structural primary balance* | | *0.6* | *1.5* | *0.0* | *1.9* | *0.7* | *0.5* | |

Notes*:*

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source *:*

*Convergence programme (CP); Commission services' spring 2011 forecasts (COM); Commission services' calculations*

## Table IV. Debt dynamics

| (% of GDP) | average 2005-09 | 2010 | 2011 | | 2012 | | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|
| | | | COM | CP | COM | CP | CP | CP |
| **Gross debt ratio[1]** | **19.7** | **38.2** | **40.7** | **38.1** | **43.6** | **37.9** | **37.1** | **35.4** |
| Change in the ratio | 2.0 | 8.7 | 2.6 | -0.1 | 2.8 | -0.2 | -0.8 | -1.7 |
| *Contributions [2] :* | | | | | | | | |
| **1. Primary balance** | **2.1** | **5.3** | **3.5** | **3.3** | **2.8** | **0.8** | **-0.2** | **-1.2** |
| **2. "Snow-ball" effect** | **-0.3** | **0.8** | **-0.9** | **-1.0** | **-0.8** | **-0.8** | **-0.5** | **-0.4** |
| *Of which:* | | | | | | | | |
| Interest expenditure | 0.8 | 1.8 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| Growth effect | -0.3 | -0.4 | -1.8 | -2.0 | -1.8 | -1.7 | -1.3 | -1.2 |
| Inflation effect | -0.8 | -0.6 | -1.2 | -1.0 | -1.1 | -1.1 | -1.2 | -1.2 |
| **3. Stock-flow adjustment** | **0.3** | **2.6** | **0.0** | **-2.3** | **0.9** | **-0.1** | **0.0** | **-0.1** |
| *Of which:* | | | | | | | | |
| Cash/accruals diff. | 0.4 | 1.4 | | | | | | |
| Acc. financial assets | -0.1 | 1.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| *Privatisation* | -0.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Val. effect & residual | 0.0 | 0.1 | | | | | | |

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

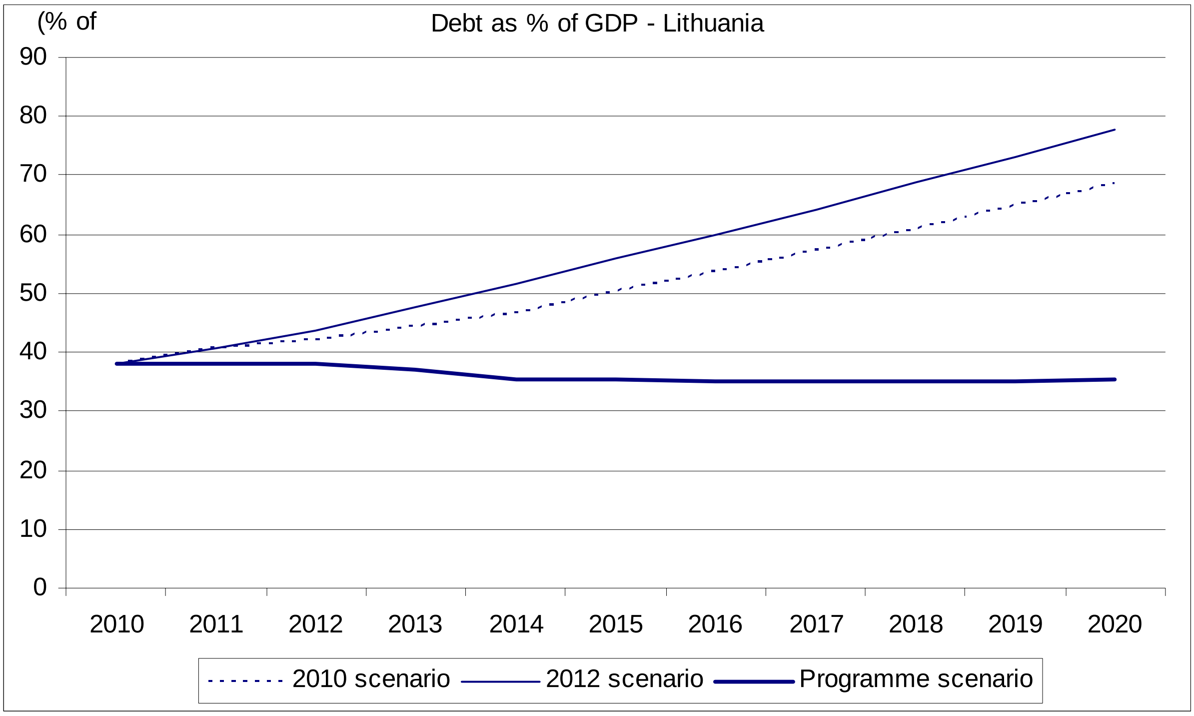
*Source :*
*Convergence programme (CP); Commission services' spring 2011 forecasts (COM); Commission services' calculations*

## Table V. Long-term sustainability indicators

| **Lithuania** | **Baseline scenario (2010)** | | | **Programme scenario** | | |
|---|---|---|---|---|---|---|
| | **S1** | | **S2** | **S1** | | **S2** |
| Value | 6.7 | | 8.2 | 2.3 | | 3.9 |
| *of which:* | | | | | | |
| Initial budgetary position (IBP) | 4.3 | | 4.4 | 0.1 | | 0.2 |
| Debt requirement in 2060 (DR) | -0.2 | | - | -0.3 | | - |
| Long-term change in the primary balance (LTC) | 2.6 | | 3.7 | 2.6 | | 3.7 |
| | 2010 | 2015 | 2020 | 2010 | 2015 | 2020 |
| Debt as % of GDP | 38.2 | 50.1 | 68.5 | 38.2 | 35.2 | 35.4 |

*Note:* The 'baseline' scenario (2010) depicts the sustainability gap under the assumption that the 2010 budgetary position remains unchanged over the medium–term (until the end of the period covered by the programme). The 'programme' scenario depicts the sustainability gap under the assumption that the budgetary plans of the programme are fully implemented.

**Figure. Medium term debt projection**




*Source: Commission services*

## Table VI. Financial market indicators

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| Total assets of the banking sector (% of GDP) | 62.7 | 70.6 | 78.6 | 98.2 | 94.0 |
| Share of assets of the five largest banks (% of total assets) | 82.5 | 80.9 | 81.3 | 80.5 | … |
| Foreign ownership of banking system (% of total assets) | 76.7 | 83.7 | 84.8 | 83.4 | … |
| Financial soundness indicators: | | | | | |
| - non-performing loans (% of total loans) [1] | 1.0 | 1.0 | 4.6 | 19.3 | 19.7 |
| - capital adequacy ratio (%) [2] | 10.8 | 10.9 | 12.9 | 14.2 | 15.6 |
| - profitability - return on equity (%) [3] | 20.3 | 25.9 | 13.5 | -48.4 | -4.7 |
| Private credit growth (annual % change) | 60.3 | 40.8 | 31.5 | 0.2 | -6.8 |
| Residential property prices (y-o-y % change) | | | | | |
| Exposure to countries receiving/repaying official financial assistance (% of GDP)[4] | … | … | … | … | … |
| Private debt (% of GDP) | 49.8 | 59.7 | 62.7 | 69.5 | 62.8 |
| Gross external debt (% of GDP) | | | | | |
| - Public | 12.6 | 11.5 | 9.0 | 19.8 | 28.9 |
| - Private | 21.5 | 25.4 | 26.2 | 25.4 | 23.4 |
| Long term interest rates spread versus Bund (basis points)* | 31.8 | 32.9 | 162.3 | 1078.2 | 282.3 |
| Credit default swap spreads for sovereign securities (5-year)* | … | … | 529.2 | 482.6 | 258.9 |

Notes:

[1] From 2005 to 2007, loans overdue 60 days and more. From 2008 onwards, non-impaired loans overdue more than 60 days plus impaired loans.

[2] The capital adequacy ratio is defined as total capital devided by risk weigthed assets.

[3] Net income to equity ratio. After extraordinary items and taxes. Branches of foreign banks are excluded.

[4] Covered countries are IE, EL, PT, RO, LV and HU.

* Measured in basis points.

*Source* :

*Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission services (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).*

## Table VII. Labour market and social indicators

| Labour market indicators | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| Employment rate (% of population aged 20 - 64) | 70,6 | 71,6 | 72,9 | 72,0 | 67,2 | 64,4 |
| Employment growth (% change from previous year) | 2,5 | 1,8 | 2,8 | -0,7 | -6,8 | -5,1 |
| Employment rate of women (% of female population aged 20 - 64) | 66,6 | 68,3 | 69,5 | 68,8 | 67,5 | 65,1 |
| Employment rate of men (% of male population aged 20 - 64) | 74,9 | 75,2 | 76,5 | 75,5 | 66,9 | 63,6 |
| Employment rate of older workers (% of population aged 55 - 64) | 49,2 | 49,6 | 53,4 | 53,1 | 51,6 | 48,6 |
| Part-time employment (% of total employment) | 7,1 | 9,9 | 8,6 | 6,7 | 8,3 | 8,1 |
| Fixed term employment (% of employees with a fixed term contract) | 5,5 | 4,5 | 3,5 | 2,4 | 2,2 | 2,4 |
| Unemployment rate[1] (% of labour force) | 8,3 | 5,6 | 4,3 | 5,8 | 13,7 | 17,8 |
| Long-term unemployment[2] (% of labour force) | 4,3 | 2,5 | 1,4 | 1,2 | 3,2 | 7,4 |
| Youth unemployment rate (% of youth labour force aged 15-24) | 15,7 | 9,8 | 8,2 | 13,4 | 29,2 | 35,1 |
| Youth NEET[3] rate (% of population aged 15-24) | 8,6 | 8,2 | 7,0 | 8,9 | 12,4 | : |
| Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training) | 8,1 | 8,2 | 7,4 | 7,4 | 8,7 | : |
| Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education) | 37,9 | 39,4 | 38,0 | 39,9 | 40,6 | : |
| Labour productivity per person employed (annual % change ) | 5,2 | 5,9 | 6,9 | 3,6 | -8,5 | 6,8 |
| Hours worked per person employed (annual % change) | 3,4 | -0,8 | 1,1 | 1,6 | -2,3 | 1,0 |
| Labour productivity per hour worked (annual % change; constant prices) | 1,7 | 6,8 | 5,7 | 2,0 | -6,4 | 5,7 |
| Compensation per employee (annual % change; constant prices) | 4,6 | 9,5 | 4,9 | 4,2 | -7,7 | -3,3 |
| Nominal unit labour cost growth (annual % change) | 6,0 | 10,1 | 6,5 | 10,4 | -2,8 | -7,5 |
| Real unit labour cost growth (annual % change) | -0,6 | 3,4 | -1,8 | 0,5 | 0,9 | -9,3 |

Notes:

[1] According to ILO definition, age group 15-74)

[2] Share of persons in the labour force who have been unemployed for at least 12 months.

[3] NEET are persons that are neither in employment nor in any education or training.

*Sources:*

Comission services (EU Labour Force Survey and European National Accounts)

**Table VII. Labour market and social indicators (continued)**

| Expenditure on social protection benefits (% of GDP) | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| Sickness/Health care | 3,76 | 3,85 | 4,13 | 4,29 | 4,62 |
| Invalidity | 1,32 | 1,33 | 1,36 | 1,45 | 1,63 |
| Old age and survivors | 6,11 | 5,93 | 5,75 | 6,57 | 6,98 |
| Family/Children | 1,14 | 1,18 | 1,14 | 1,21 | 1,88 |
| Unemployment | 0,35 | 0,38 | 0,40 | 0,39 | 0,39 |
| Housing and Social exclusion n.e.c. | 0,33 | 0,22 | 0,21 | 0,18 | 0,20 |
| **Total** | 13,0 | 12,9 | 13,0 | 14,1 | 15,7 |
| of which: Means tested benefits | 0,44 | 0,27 | 0,23 | 0,21 | 0,26 |
| **Social inclusion indicators** | **2005** | **2006** | **2007** | **2008** | **2009** |
| Risk-of-poverty or exclusion[1] (% of total population) | 41,0 | 35,9 | 28,7 | 27,6 | 29,5 |
| Risk-of-poverty or exclusion of children (% of people aged 0-17) | 42,5 | 37,2 | 29,9 | 29,4 | 31,0 |
| Risk-of-poverty or exclusion of elderly (% of people aged 65+) | 46,1 | 41,3 | 39,1 | 38,1 | 35,8 |
| At-Risk-of-Poverty rate[2] (% of total population) | 20,5 | 20,0 | 19,1 | 20,0 | 20,6 |
| Value of relative poverty threshold (single HH per year) - in PPS | 2304 | 2772 | 3432 | 4164 | 4380 |
| Severe Material Deprivation[3] (% of total population) | 32,6 | 25,3 | 16,6 | 12,3 | 15,1 |
| Share of people living in low work intensity households[4] (% of people aged 0-59 not student) | 9,5 | 8,3 | 6,4 | 5,1 | 6,9 |
| In-work at-risk-of poverty rate (% of persons employed) | 10,2 | 10,1 | 8,1 | 9,5 | 10,6 |

Notes:

[1] People at-risk-of poverty or social exclusion (AROPE): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

[2] At-risk-of poverty rate: share of people with an equivalised disposable income below 60% of the national equivalised median income.

[3] Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone

[4] People living in households with very low work intensity: Share of people aged 0-59 living in households where the adults work less than 20% of their total work-time potential during the previous 12 months.

*Sources:*

For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

## Table VIII. Product market indicators

| Performance indicators | 2001-2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| Labour productivity[1] total economy (annual growth in %) | **6,9** | **5,9** | **6,9** | **3,6** | **-8,5** | **6,8** |
| Labour productivity[1] in manufacturing (annual growth in %) | **9,8** | **10,2** | **3,1** | **1,7** | **-3,2** | **17,6** |
| Labour productivity[1] in electricity, gas, water (annual growth in %) | **16,2** | **-1,9** | **4,5** | **-5,1** | **14,1** | n.a. |
| Labour productivity[1] in the construction sector (annual growth in %) | **2,4** | **7,3** | **4,8** | **3,3** | **-25,1** | **20,9** |
| Patent intensity in manufacturing[2] (patents of the EPO divided by gross value added of the sector) | **0,4** | **0,3** | **0,2** | n.a. | n.a. | n.a. |
| **Policy indicators** | **2001-2005** | **2006** | **2007** | **2008** | **2009** | **2010** |
| Enforcing contracts[3] (days) | n.a. | **210** | **210** | **210** | **275** | **275** |
| Time to start a business[3] (days) | n.a. | **26** | **26** | **26** | **26** | **22** |
| R&D expenditure (% of GDP) | **0,7** | **0,8** | **0,8** | **0,8** | **0,8** | n.a. |
| Tertiary educational attainment (% of 30-34 years old population) | **27,8** | **39,4** | **38,0** | **39,9** | **40,6** | n.a. |
| Total public expenditure on education (% of GDP) | **5,4** | **4,8** | **4,7** | **4,9** | n.a. | n.a. |
| | **2003** | **2005** | **2006** | **2008** | **2009** | **2010** |
| Product market regulation[4], Overall (Index; 0=not regulated; 6=most regulated) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Product market regulation[4], Retail (Index; 0=not regulated; 6=most regulated) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Product market regulation[4], Network Industries6 (Index; 0=not regulated; 6=most regulated) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |

Notes:

[1]Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.

[2]Patent data refer to applications designated to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.

[3] The methodologies, including the assumptions, of this indicator is presented in detail at the website http://www.doingbusiness.org/methodology.

[4] The methodologies of the Product market regulation indicators are presented in detail at the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html. The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.

6 Aggregate ETCR.

*figure for 2007.

*Source* :

*Commission services, World Bank Doing Business (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).*