



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.5.2006  
COM(2006) 223 final

**REPORT FROM THE COMMISSION**  
**CONVERGENCE REPORT 2006 ON LITHUANIA**

(prepared in accordance with Article 122(2) of the Treaty at the request of Lithuania)

[SEC(2006) 614]

## **1. PURPOSE OF THE REPORT**

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union.

This report has been prepared at the request of Lithuania, submitted on 16 March 2006. A more detailed assessment of the state of convergence in Lithuania is provided in a technical annex to this report (SEC(2006) 614).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires that the reports include an examination of the compatibility of national legislation, including the statutes of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB. The reports also have to examine the achievement of a high degree of sustainable convergence in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and take account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

## **2. LEGAL COMPATIBILITY**

In its 2004 Convergence Report (COM(2004) 690), 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 with respect to the Bank's objectives.

These incompatibilities have been addressed in three laws that were adopted by the Seimas on 25 April 2006 and shall 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. The first Law governs amendments to the Law on the Bank of Lithuania. The second Law repeals the Law on Currency and the Law on the Credibility of the litas, which also contained several incompatibilities. The third Law introduces amendments to Article 125 of the Constitution of the Republic of Lithuania.

With respect to the Law on the Bank of Lithuania, the incompatibilities raised in the 2004 Convergence Report have been removed. The amendments strengthen "personal" independence and take account of EC Treaty requirements, in particular as regards the respective roles and competences of the ECB, the ESCB and the Council in the area of monetary policy, the conduct of foreign exchange operations and the definition of foreign exchange policy, the holding and managing of foreign reserves and the issuance of banknotes and coins. The need for the ECB's prior

approval for the participation of the Bank of Lithuania in international monetary organisations is fully taken into account, while the possibility for the Parliament to wind up the Bank of Lithuania has been removed. In addition, a reference to the ESCB's secondary objective has been inserted, which takes precedence over the Bank of Lithuania's additional objective of supporting the economic policy carried out by the national authorities.

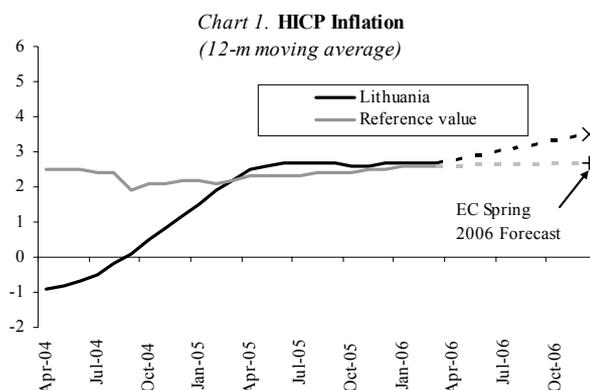
Legislation in Lithuania, in particular the Law on the Bank of Lithuania and Lithuania's Constitution, are compatible with the requirements of the EC Treaty and the ESCB/ECB Statute.

### 3. PRICE STABILITY

#### *Evolution of the reference value*

In the 2004 convergence report Lithuania was found to have fulfilled the criterion on price stability. The average inflation rate in Lithuania during the 12 months to August 2004 was -0.2 percent, below the reference value of 2.4 percent.

The 12-month average inflation, which is used for the convergence assessment, declined in the course of 2002 and was negative in 2003 and most of 2004. From the middle of 2004 onwards it started to increase gradually and has been above the reference value since April 2005. 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, just above the reference value.



*Source: Eurostat, Commission services*

#### *Underlying factors and sustainability*

After independence Lithuania experienced triple-digit inflation in the first years of transition. With the introduction of the litas in 1993, inflation was curbed and the exchange rate stabilised. 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 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 were even decreasing year-on-year, helped by the change of the peg of the litas to the euro in early 2002, which extended the period of

effective nominal appreciation of the litas. Positive inflation rates re-emerged subsequently and year-on-year HICP inflation rates increased to around 3 percent in the second half of 2004. The return of positive 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 the impact of higher energy prices. While a significant part of the pick-up in HICP inflation from the summer of 2005 onwards was accounted for by external factors, such as increases in energy prices, inflation excluding administered and energy prices also edged up, from around 1 percent in the summer of 2005 to 2.7 percent in the first quarter of 2006, notably for food, transport and some services components, such as restaurant services.

Import prices for natural gas rose markedly as of 1 January 2006, by around 40 percent, after a multi-year agreement with a major gas exporter 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 adjustment of regulated prices for distributed heat.

Inflation in the remainder of 2006 is expected to rise gradually reflecting upward pressures stemming from higher labour costs (unit labour costs growth picked up in 2005 to 3.8 percent) and import prices, in particular for energy products, which will partly be reflected in consumer prices only with a lag. Average inflation in 2006 is expected to increase to 3.5 percent, from 2.7 percent in 2005.

In a longer-term perspective, buoyant domestic demand and increases in certain excise duties represent risk factors to inflation. The achievement and maintenance of a low level of inflation in the medium-term will depend on keeping wage growth in line with productivity developments.

The 12-month average inflation in Lithuania has been above the reference value since April 2005 and is likely to stay above it in the months ahead. Lithuania does not fulfil the criterion on price stability.

#### **4. GOVERNMENT BUDGETARY POSITION**

In the 2004 Convergence Report, the Commission stated that Lithuania was not subject to a Council decision on the existence of an excessive deficit and that it fulfilled the criterion on the government budgetary position.

The general government deficit declined from 3.6 percent of GDP in 2000 to 1.2 percent of GDP in 2003. In 2004 the deficit increased slightly to 1.5 percent of GDP, to which also the introduction of a funded pension scheme contributed. The deficit decreased to 0.5 percent of GDP in 2005. Unlike in previous years, the budgetary adjustment in 2005 was revenue-driven. Strong revenue growth reflected buoyant economic activity and improvements in tax collection and enforcement. Expenditure targets were broadly met, as additional expenditures through supplementary budgets in the second half of the year, which had been the case before, were avoided. Cyclical conditions have become supportive of fiscal consolidation since 2003 but

the structural deficit deteriorated in 2003 and 2004 on the back of a significant worsening of the primary deficit. In 2005, the primary deficit improved, as did the structural deficit. Lithuania thus continues recording budgetary deficit outcomes below the 3 percent of GDP threshold. The deficit is expected to remain broadly stable in 2006, although there are uncertainties related to the absorption of EU funds and the impact of the tax reform that will decrease the personal income tax rate while raising the corporate tax.

The ratio of general government debt to GDP declined steadily from 23.6 percent at the end of 2000 to below 19 percent in 2005. The main factor contributing to the decrease was the impact of financial transactions of the government, reflecting mainly privatisation receipts and positive valuation effects on

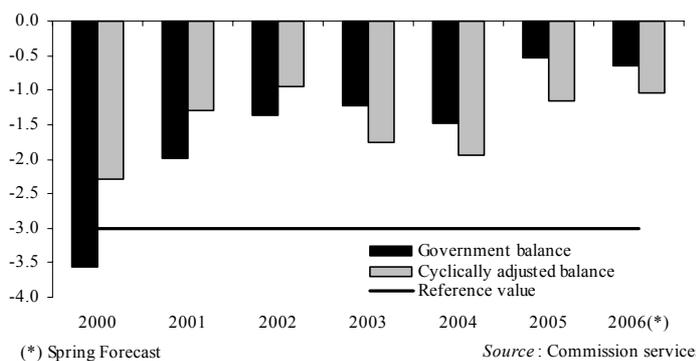
foreign debt related to the nominal appreciation of the litas. The debt ratio has remained well below the 60 percent of GDP threshold, and is expected to remain stable also in the medium term.

According to the December 2005 convergence programme, the headline general government deficit was expected to gradually decrease from 1.5 percent of GDP in 2005 (the actual outcome in 2005 was a lower deficit of 0.5 percentage point of GDP) to 1 percent of GDP in 2008, against the background of robust GDP growth. The foreseen consolidation is expenditure-driven, mostly due to cuts in collective consumption and social transfers in percent of GDP, while a significant increase in government investment is planned. 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 Council examined the updated convergence programme on 14 March 2006. It regarded the programme's budgetary strategy as plausible and saw the risks to the budgetary projections in the programme to be broadly balanced. However, as the medium-term objective of a cyclically adjusted deficit at or below 1 percent of GDP might not be reached during the programme's period, the Council invited Lithuania to strengthen the effort in the structural budgetary adjustment. As regards the sustainability of public finances, Lithuania appears to be at low risk in view of the projected budgetary costs of ageing.

Lithuania is not subject to a Council decision on the existence of an excessive deficit and fulfils the criterion on the government budgetary position.

Chart 2. Lithuania: Government balance  
(in percent of GDP)



## 5. EXCHANGE RATE STABILITY

In the 2004 Convergence Report Lithuania was assessed not to fulfil the exchange rate criterion. By the time of the examination, the country had been participating in ERM II for two months.

The two-year period relevant for the assessment of exchange rate stability extends from May 2004 to April 2006. Lithuania entered ERM II on 28 June 2004, maintaining its longstanding currency board as a unilateral commitment within the mechanism, and has so far spent 22 months in ERM II. The litas-euro exchange rate in the two months prior to ERM II entry was stable with only minor deviations from the central rate. There has been no deviation from the central rate since the litas started participating in ERM II.

Public and market confidence in ERM II participation and the currency board remains strong, and the development of additional indicators does not reveal any major exchange rate pressures on the litas. The ratio of official reserve assets to the monetary base has well exceeded 100 percent and reached 127.5 percent in 2005. Discretionary facilities to influence liquidity have not been used actively to a significant extent.

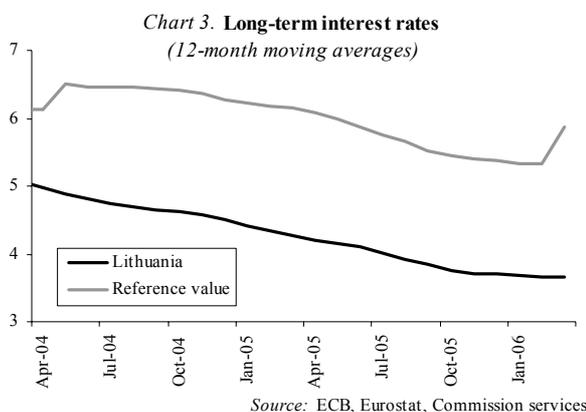
Short-term interest rates have become very closely aligned to the euro area, suggesting that no appreciable currency risk is priced in by financial markets. The spread of the 3-month VILIBOR to the EURIBOR has decreased markedly, from around 65 basis point on average in April 2004 to around 3 basis points on average in the period January-March 2006.

The litas has been at the ERM II central rate for the period of two years covered by this assessment. There has been no devaluation of the central parity of the litas inside ERM II on the initiative of Lithuania. By the time of a possible Council decision in July 2006, the litas will have participated in ERM II for more than 24 months. Lithuania fulfils the exchange rate criterion.

## 6. LONG-TERM INTEREST RATES

In the 2004 Convergence Report Lithuania fulfilled the criterion on the convergence of interest rates. The average long-term interest rate in Lithuania in the year to August 2004 was 4.7 percent, below the reference value of 6.4 percent.

The spread vis-à-vis euro area average long-term interest rates had been declining markedly in the run-up to ERM II entry in June 2004. Subsequently, the spreads have fallen further from around 55 basis points around the time of ERM II entry to around 25 basis points in March 2006, indicative of



– among other factors – the credibility of Lithuanian macro-economic policies. 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 twelve-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period. In March 2006, the latest date for which data are available, 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. Lithuania fulfils the criterion on long-term interest rate convergence.

## **7. ADDITIONAL FACTORS**

Lithuania has made encouraging progress with respect to the integration of financial and product markets in several areas. 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. The size of the financial system remains relatively small compared to GDP, but financial deepening is progressing rapidly in line with economic development. High concentration and foreign ownership highlights the importance of cross-border cooperation to ensure adequate supervisory structure and safeguard financial stability.

Similar to other new EU Member States, Lithuania experienced important changes in the structure of its economy in the past 15 years. Data on trade and foreign direct investment show that Lithuania has become increasingly integrated in the EU economy. The presence of foreign firms has been instrumental in promoting technology transfer, boosting organisational and managerial skills, and fostering competition. Differences in the sectoral composition of production and exports in comparison with the euro area remain considerable, while consumer price levels in Lithuania are still considerably lower than the EU average (54.6 percent in 2004). Important progress has been made with respect to the adoption and application of the Internal Market acquis and improvement of the business environment.

Lithuania has had rather high current account deficits for many years, reflecting substantial deficits in goods trade partly compensated by a positive balance on services and current transfers. The current account deficit in Lithuania widened from 4.7 percent of GDP in 2003 to 7.7 percent of GDP in 2004, mainly on account of strong domestic demand. This trend was halted in 2005 as the current account deficit slightly decreased to 7.0 percent of GDP. The slight 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 pattern of high real GDP growth rates with relatively high current account deficits is consistent with the rapid catch-up path of the economy, whereby foreign savings are mobilised via external financing to finance investment. So far, the financing of the current account deficit has been unproblematic, but the external position reflects substantial financing needs in the medium term. A key 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. Looking forward, a substantial contribution to domestic investment is expected to come from EU funds, which will help external financing without increasing external indebtedness.

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Lithuania has made significant progress towards reaching a high degree of sustainable convergence by meeting the criteria on public finances, exchange rate stability and long-term interest rates. Lithuania does not, as yet, meet the criterion on price stability.

In the light of this assessment the Commission concludes that there should be no change in the status of Lithuania as a Member State with a derogation.